

## **FEDERAL RESERVE SYSTEM**

### **12 CFR Part 223**

**[Regulation W; Docket No. R-1103]**

#### **Transactions between Member Banks and their Affiliates**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Final rule.

**SUMMARY:** The Board of Governors of the Federal Reserve System (Board) is adopting a final rule (Regulation W) to implement comprehensively sections 23A and 23B of the Federal Reserve Act and provide several new exemptions consistent with the purposes of the statute. The final rule combines statutory restrictions on transactions between a member bank and its affiliates with numerous Board interpretations and exemptions in an effort to simplify compliance with sections 23A and 23B.

**DATES:** The final rule is effective April 1, 2003.

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#### **SUPPLEMENTARY INFORMATION:**

##### **Introduction**

Sections 23A and 23B of the Federal Reserve Act are important statutory provisions designed to protect against a depository institution suffering losses in transactions with affiliates. They also limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution’s access to the Federal safety net. Sections 23A and 23B apply, by their terms, to banks that are members of the Federal Reserve System (“member banks”). Other Federal law subjects insured nonmember banks and insured thrifts to sections 23A and 23B in the same manner and to the same extent as if they were member banks.

Although sections 23A and 23B each explicitly grant the Board broad authority to issue regulations to administer the section,<sup>1</sup> the Board has never issued a regulation fully implementing either section. Instead, depository institutions seeking guidance on how to comply with the statute have relied on a series of Board interpretations and informal staff guidance. Institutions have increasingly sought guidance from the Board on section 23A issues

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<sup>1</sup> 12 U.S.C. 371c(f), 371c-1(e).

in recent years as a result of the increasing scope of activities conducted by modern financial holding companies and the growing complexities of the U.S. financial markets.

On May 11, 2001, the Board issued a proposed Regulation W to implement comprehensively sections 23A and 23B.<sup>2</sup> The Board decided to issue such a rule for several reasons. First, the new regulatory framework established by the Gramm-Leach-Bliley Act (“GLB Act”)<sup>3</sup> emphasizes the importance of sections 23A and 23B as a means to protect depository institutions from losses in transactions with affiliates. In addition, adoption of a comprehensive rule would simplify the interpretation and application of sections 23A and 23B, ensure that the statute is consistently interpreted and applied, and minimize burden on banking organizations to the extent consistent with the statute’s goals. Finally, issuing a comprehensive proposed rule allowed the public an opportunity to comment on Board and staff interpretations of sections 23A and 23B, many of which were adopted without the benefit of public comment.

Among other things, the GLB Act required the Board to adopt final rules, by May 12, 2001, to address under section 23A credit exposure by a member bank to its affiliates on derivative transactions and intraday credit extensions. The Board issued interim final rules to fulfill this statutory mandate on May 11, 2001 (concurrently with proposed Regulation W). The interim final rules became effective January 1, 2002. The Board also sought public comment as part of the Regulation W rulemaking process on how these types of transactions should be treated under section 23A.

The Board received approximately 120 public comments on the proposed Regulation W and the interim final rules on derivative transactions and intraday extensions of credit. Commenters included 3 Members of Congress, 75 banking organizations, 20 trade associations representing the banking or financial services industry, 5 state banking departments or other governmental agencies, 9 law firms or individuals, and several other organizations. Nearly all the commenters supported the Board’s decision to issue Regulation W and the interim rules but opposed or raised concerns about one or more aspects of the regulations.

The Board has carefully reviewed and analyzed the issues raised by commenters and has decided to issue a final Regulation W that is substantially similar to the proposed rule. The Board has modified the proposed rule in many important respects, however, to reflect the concerns of commenters and further analysis by the Board. The final rule supersedes any Board interpretations or staff opinions of sections 23A and 23B that are inconsistent with the rule. In a separate rulemaking concurrent with the issuance of final Regulation W, the Board is rescinding its existing interpretations of and exemptions from section 23A contained in part 250 of title 12 of the Code of Federal Regulations because all such interpretations and exemptions are included within Regulation W.

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<sup>2</sup> 66 FR 24186, May 11, 2001.

<sup>3</sup> Pub. L. No. 106-102, 113 Stat. 1338 (1999).

The Board expects each depository institution with affiliates that is subject to sections 23A and 23B to implement policies and procedures to ensure compliance with the final rule.

## **Background**

As noted above, sections 23A and 23B by their terms limit the risks to a member bank from transactions with affiliates and limit the ability of a member bank to transfer its Federal subsidy to affiliates. Section 23A achieves these goals in four major ways. First, it limits a member bank's "covered transactions" with any single "affiliate" to no more than 10 percent of the bank's capital stock and surplus, and transactions with all affiliates combined to no more than 20 percent of the bank's capital stock and surplus. "Covered transactions" include purchases of assets from an affiliate, extensions of credit to an affiliate, investments in securities issued by an affiliate, guarantees on behalf of an affiliate, and certain other transactions that expose the member bank to an affiliate's credit or investment risk. A member bank's "affiliates" include, among other companies, any companies that control the bank, any companies under common control with the bank, and certain investment funds that are advised by the bank or an affiliate of the bank.

Second, the statute requires all transactions between a member bank and its affiliates to be on terms and conditions that are consistent with safe and sound banking practices. Third, the statute prohibits a member bank from purchasing low-quality assets from its affiliates. Finally, section 23A requires that a member bank's extensions of credit to affiliates and guarantees on behalf of affiliates be appropriately secured by a statutorily defined amount of collateral.

Section 23B protects a member bank by requiring that certain transactions between the bank and its affiliates occur on market terms; that is, on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies. Section 23B applies this restriction to any covered transaction (as defined in section 23A) with an affiliate as well as certain other transactions, such as (i) any sale of assets by the member bank to an affiliate; (ii) any payment of money or furnishing of services by the member bank to an affiliate; and (iii) any transaction by the member bank with a third party if an affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction.

Section 23A originally was enacted as part of the Banking Act of 1933, and the restrictions of section 23A applied only to member banks. Since 1933, Congress has amended the statute several times, including a comprehensive revision in 1982.<sup>4</sup> Congress also amended the Federal Deposit Insurance Act ("FDI Act") in 1966 to apply section 23A to insured nonmember banks in the same manner and to the same extent as if they were member banks.<sup>5</sup>

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<sup>4</sup> Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 410, 96 Stat. 1515 (1982) (codified at 12 U.S.C. 371c).

<sup>5</sup> Pub. L. No. 89-485, § 12(c), 80 Stat. 242 (1966) (codified at 12 U.S.C. 1828(j)).

In addition, Congress revised the Home Owners' Loan Act ("HOLA") in 1989 to apply section 23A to insured savings associations in the same manner and to the same extent as if they were member banks.<sup>6</sup> Congress enacted section 23B of the Federal Reserve Act as part of the Competitive Equality Banking Act of 1987,<sup>7</sup> and has subsequently expanded its scope to cover the same set of depository institutions as are covered by section 23A. Consequently, sections 23A and 23B now apply to all insured depository institutions and uninsured member banks.

The GLB Act amended the Federal Reserve Act in 1999 so that sections 23A and 23B would apply to transactions between a bank and its "financial subsidiaries." Section 23A, as amended by the GLB Act, defines a financial subsidiary as any subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States. Section 5136A of the Revised Statutes generally defines a financial subsidiary as a subsidiary of an insured depository institution that engages in activities that are not permissible for national banks to engage in directly (unless national banks are authorized by the express terms of a Federal statute to own or control the subsidiary).<sup>8</sup> The GLB Act provides that a financial subsidiary of a bank, unlike most other subsidiaries of a bank, is considered an "affiliate" of the bank for purposes of sections 23A and 23B. The GLB Act also establishes certain special rules under section 23A for financial subsidiaries.

## **Explanation of Final Rule**

### **I. Format of Regulation**

Regulation W provides users with a single, comprehensive reference tool for complying with and analyzing issues arising under sections 23A and 23B.<sup>9</sup> The regulation restates the statutory definitions, restrictions, and exemptions, and also includes Board interpretations of the sections. Commenters agreed that including the statutory provisions in the rule would make understanding and using the rule easier.

The regulation first provides, in subpart A, a comprehensive glossary of the terms used in the regulation and the statute. The regulation then sets forth, in subpart B, the principal restrictions and requirements imposed by section 23A. Next, in subpart C, the regulation

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<sup>6</sup> Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 301, 103 Stat. 342 (1989) (codified at 12 U.S.C. 1468(a)).

<sup>7</sup> Pub. L. No. 100-86, § 102, 101 Stat. 552, 564 (1987) (codified at 12 U.S.C. 371c-1).

<sup>8</sup> See 12 U.S.C. 24a(g).

<sup>9</sup> The regulation implements sections 23A and 23B of the Federal Reserve Act. The regulation does not contain or implement statutory or regulatory restrictions on transactions between member banks and their affiliates that may be applicable under other provisions of law, including those that may apply to member banks subject to prompt corrective action under section 38 of the FDI Act (12 U.S.C. 1831o).

discusses the appropriate valuation and timing principles for covered transactions. Subpart D discusses the appropriate treatment under section 23A for transactions with financial subsidiaries, bank-affiliate derivative transactions, and certain bank-affiliate merger and acquisition transactions. Subpart E sets forth available exemptions from certain of the requirements of section 23A. Subpart F lays out the operative provisions of section 23B. Subpart G discusses the application of sections 23A and 23B and the rule to U.S. branches and agencies of foreign banks. Subpart H contains the Board's miscellaneous interpretations of the statute.

The regulation also includes examples illustrating how several of the rule's provisions would apply in particular circumstances. The examples included in the rule are considered part of the rule and compliance with an example, to the extent applicable, would constitute compliance with the rule. Each example included in the rule illustrates only the scope and application of the particular topic addressed by the example and does not illustrate any other topic or issue that may arise under the rule.

## II. Scope of Regulation

As noted above, although sections 23A and 23B apply by their terms only to member banks, the FDI Act subjects insured nonmember banks to the restrictions of sections 23A and 23B as if they were member banks. In order to clarify how sections 23A and 23B applied to each type of bank, the proposed Regulation W applied by its terms to member banks and insured nonmember banks. The Federal Deposit Insurance Corporation ("FDIC") objected to the scope of the proposed rule and urged the Board to amend the rule so that it would not apply by its terms to insured nonmember banks. The Board has decided to revise the rule to apply by its terms only to member banks. Notwithstanding this restriction of the scope of Regulation W, insured nonmember banks must comply with the rule as if they were member banks.<sup>10</sup>

As noted above, HOLA subjects insured savings associations to sections 23A and 23B as if they were member banks. HOLA also imposes several restrictions on transactions between an insured savings association and certain of its affiliates that are not contained in section 23A<sup>11</sup> and provides the Office of Thrift Supervision ("OTS") with authority to impose additional restrictions on transactions between an insured savings association and its affiliates.<sup>12</sup> In light of the stricter regulatory regime governing transactions between an insured

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<sup>10</sup> Accordingly, an insured nonmember bank also may take advantage of Regulation W's exemptions as if it were a member bank.

<sup>11</sup> HOLA prohibits an insured savings association from (i) making loans or extending credit to any affiliate unless that affiliate is engaged solely in activities that the Board has determined to be permissible under section 4(c) of the Bank Holding Company Act (12 U.S.C. 1843(c)); and (ii) investing in securities issued by any affiliate other than shares issued by a subsidiary. 12 U.S.C. 1468(a)(1).

<sup>12</sup> 12 U.S.C. 1468(a)(4).

savings association and its affiliates and in light of a request by the OTS that Regulation W not specifically cover such institutions, the final rule (like the proposed rule) does not apply by its terms to insured savings associations. The Board notes, however, that because insured savings associations are subject to sections 23A and 23B as if they were member banks, insured savings associations must comply with Regulation W as if they were member banks.<sup>13</sup> Moreover, any parallel regulation adopted by the OTS to govern transactions with affiliates must be at least as strict on insured savings associations as Regulation W is on member banks.

### III. Definitions--Subpart A

Subpart A of Regulation W sets forth definitions of the terms used in sections 23A and 23B and the rule. Terms that are defined in the regulation as they are defined in the statute generally are not discussed below. Material terms that the Board proposes to define or clarify for purposes of the regulation are discussed below.

#### A. Definition of affiliate (§ 223.2)

##### 1. Investment funds advised by the member bank or an affiliate of the member bank (§ 223.2(a)(6))

Section 23A includes as an affiliate any company that is sponsored and advised by the member bank or any of its affiliates.<sup>14</sup> Section 23A also includes as an affiliate any investment company for which the member bank or its affiliate serves as an investment advisor, as defined in the Investment Company Act of 1940 (“1940 Act”).<sup>15</sup> The proposed regulation included these provisions and also included as an affiliate any investment fund -- even if not an investment company for purposes of the 1940 Act -- for which the member bank or an affiliate of the bank serves as an investment advisor, if the bank or an affiliate of the bank owns or controls more than 5 percent of any class of voting securities or similar interests of the fund.<sup>16</sup>

A number of commenters expressed opposition to this proposal. According to these commenters, the proposal would violate the careful statutory framework established by Congress for determining which investment funds are affiliates of banks. In addition, these commenters claimed that there is little potential for conflicts of interest, and no evidence of abuse, in transactions between banks and unregistered funds. One commenter urged the Board

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<sup>13</sup> Accordingly, an insured savings association also may take advantage of Regulation W’s exemptions as if it were a member bank.

<sup>14</sup> 12 U.S.C. 371c(b)(1)(D)(i).

<sup>15</sup> 12 U.S.C. 371c(b)(1)(D)(ii).

<sup>16</sup> As noted above, proposed Regulation W applied by its terms to “banks,” and the final rule applies by its terms only to member banks. Nevertheless, to make comparisons of the proposed and final rules easier for readers, the remainder of this preamble discusses the proposed rule as if it applied only to member banks.

to deem an unregistered investment fund to be an affiliate of a bank only if the bank or an affiliate controls the fund.

The Board has determined to adopt this proposal. Most investment funds that are advised by a member bank (or an affiliate of a member bank) are affiliates of the bank under section 23A because the funds either are investment companies under the 1940 Act or are sponsored by the member bank (or an affiliate of the member bank). In some instances, however, the member bank or its affiliate may advise but not sponsor an investment fund that is not an investment company under the 1940 Act. Although such a fund would not fit within the statutory definition of affiliate, section 23A also authorizes the Board to determine, by regulation or order, that any company is an affiliate of a member bank if the company has “a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship to the detriment of the member bank or its subsidiary.”<sup>17</sup>

The Board believes that the advisory relationship of a member bank or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is an investment company under the 1940 Act.<sup>18</sup> An investment fund typically escapes from the definition of investment company under the 1940 Act because it (i) sells interests only to a limited number of investors or only to sophisticated investors; or (ii) invests primarily in financial instruments that are not securities.<sup>19</sup> The Board does not believe that the private nature or investment strategy of a fund should have a substantial effect on the fund’s affiliate status under section 23A because these factors do not alter the conflicts of interest presented in the advisory relationship between the member bank or its affiliate and the fund.<sup>20</sup>

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<sup>17</sup> 12 U.S.C. 371c(b)(1)(E).

<sup>18</sup> In fact, a member bank may face greater risk from the conflicts of interest arising from its relationships with an investment fund that is not registered as an investment company under the 1940 Act because the 1940 Act restricts transactions between a registered investment company and entities affiliated with the company’s investment advisor. See 15 U.S.C. 80a-17.

<sup>19</sup> The term “investment company” in the 1940 Act does not include a company that is owned by qualified persons or by no more than 100 persons, provided that the company does not engage in a public offering of its securities. See 15 U.S.C. 80a-3(c)(1), (7). The term also generally does not include investment funds that are engaged primarily in investing in financial instruments other than securities. See 15 U.S.C. 80a-3(a)(1).

<sup>20</sup> The Board also believes that investment funds organized outside the United States for which a member bank or affiliate serves as investment advisor are affiliates of the bank for purposes of section 23A. See Letter dated July 24, 1990, from J. Virgil Mattingly, Jr., General Counsel of the Board, to Anne B. McMillen. The term “investment company” in the 1940 Act does include investment funds organized under the laws of a non-U.S. jurisdiction.

2. Financial subsidiaries (§§ 223.2(a)(8) and 223.3(p))

Congress amended section 23A in 1982 to provide that subsidiaries of a member bank are not affiliates of the bank under the statute. Congress adopted this approach on the premise that subsidiaries of a member bank generally are consolidated with the bank and engage only in those activities that the bank itself could engage in directly, and hence that such a subsidiary was more like a department of the bank than a separate company. In order to prevent evasions of section 23A, the 1982 amendments gave the Board explicit authority to treat as an affiliate of a member bank any subsidiary if the relationship between the bank and the subsidiary could affect transactions between the companies to the detriment of the bank.<sup>21</sup>

In 1997, in light of the expanding powers of subsidiaries of banks, the Board relied on this statutory authority to issue for comment a proposal to extend section 23A to transactions between a member bank and a subsidiary of the bank engaged in activities not permissible for the bank to engage in directly. The Board took no final action on this proposal in light of Congressional consideration of financial modernization legislation. In 1999, the GLB Act authorized banks to own “financial subsidiaries” that engage in activities not permissible for the parent bank to conduct directly, such as underwriting and dealing in bank-ineligible securities. The GLB Act also amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank and, thus, subjected transactions between the bank and a financial subsidiary to the limitations of sections 23A and 23B.

Section 23A, as amended by the GLB Act, defines a financial subsidiary as a subsidiary of any bank (state or national) that is engaged in an activity that is not permissible for national banks (other than a subsidiary that Federal law specifically authorizes national banks to control).<sup>22</sup> Proposed Regulation W defined financial subsidiary by repeating the definition of the term in section 23A. The proposed rule also noted that many state banks have authority to engage in activities that would not be permissible for national banks and sought comment on how to apply the section 23A definition of financial subsidiary to state banks. In addition, the proposal requested comment on whether to exempt from the definition of financial subsidiary any subsidiary of a bank that engages solely in agency activities.

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<sup>21</sup> 12 U.S.C. 371c(b)(2)(A).

<sup>22</sup> Specifically, section 23A defines a “financial subsidiary” as “any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.” 12 U.S.C. 371c(e)(1). Section 5136A, in turn, defines a financial subsidiary as any company that is controlled by one or more insured depository institutions, other than (i) a subsidiary that engages solely in activities that national banks are permitted to engage in directly or (ii) a subsidiary that national banks are specifically authorized to control by the express terms of a Federal statute (other than section 5136A), such as an Edge Act corporation or a SBIC. 12 U.S.C. 24a(g)(3). Section 5136A also generally prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities. 12 U.S.C. 24a(a)(2).



a. Subsidiaries of state banks

Commenters offered a wide variety of alternative ways for the Board to apply the statute's definition of financial subsidiary to state banks. One set of commenters (including the Conference of State Bank Supervisors and the American Bankers Association) asked the Board to define a financial subsidiary of a state bank to include only those subsidiaries that are engaged in activities that the parent state bank could not engage in directly. Another set of commenters argued that the Board should define a financial subsidiary of a state bank to include only those subsidiaries subject to section 46 of the FDI Act; that is, those subsidiaries that are engaged in principal activities that may only be conducted by a national bank through a financial subsidiary (currently, only subsidiaries engaged in underwriting and dealing in bank-ineligible securities). Other commenters advocated for a complete exemption for all subsidiaries of a state bank. Over 30 commenters -- the largest number of commenters on any issue raised by the proposed rule -- urged the Board to define financial subsidiary to exclude those subsidiaries of state banks that are engaged in grandfathered securities investment activities under section 24(f) of the FDI Act.<sup>23</sup>

The Board believes that the literal terms of section 23A provide that a subsidiary of a state bank that engages in an activity that is not permissible for national banks to conduct directly is a financial subsidiary of the state bank (unless Federal law specifically authorizes national banks to control such a subsidiary). This conclusion holds regardless of whether the activity (i) is permissible for the state bank to conduct directly; (ii) is an agency or principal activity; (iii) was approved by the FDIC under section 24 of the FDI Act; or (iv) was conducted by the subsidiary before the enactment of the GLB Act.

The final rule defines financial subsidiary in this manner but also contains exemptions for two classes of subsidiaries of state banks. First, the final rule exempts any subsidiary of a state bank that engages in activities that the parent state bank may engage in directly under Federal and state law.<sup>24</sup> In the Board's view, if a state bank has authority under applicable law to conduct an activity directly in the bank, section 23A normally should not apply to transactions between the bank and a subsidiary engaged in the activity. In these circumstances, the bank could conduct the activity directly in the bank and fund the activity free of section 23A. The Board is aware of no material supervisory reason to create a disincentive for the bank to conduct such a bank-permissible activity through a subsidiary if the bank has determined -- for tax, liability, or other reasons -- that the activity is most safely and efficiently

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<sup>23</sup> 12 U.S.C. 1831a(f). Section 24(f) of the FDI Act permits state banks that had lawfully made certain liquid equity investments in 1990-91 to continue to engage in such equity investment activities so long as such equity investments do not exceed an amount equal to the bank's capital.

<sup>24</sup> For purposes of applying this exemption, a state bank may directly engage in an activity under Federal law if Federal law does not prohibit the state bank from directly engaging in the activity. If, on the other hand, Federal law prohibits a state bank from directly engaging in an activity -- such as equity investment (see 12 U.S.C. 1831a(c) and (f)) -- a subsidiary of a state bank that engaged in the activity could not qualify for this exemption.

conducted through a subsidiary. This approach is consistent with the spirit of the GLB Act and with the Board's 1997 rulemaking on subsidiaries of member banks.

Second, the final rule exempts any subsidiary of a state bank that engages in activities that the subsidiary was legally conducting before issuance of final Regulation W. Among other things, this exemption would remove from the definition of financial subsidiary those subsidiaries of state banks that are engaged in the limited, grandfathered securities investment activities authorized under section 24(f) of the FDI Act. The Board does not believe that this exemption would apply to a significant number of other material subsidiaries of state banks. The exemption would be appropriate, however, so as not to impose a hardship on the existing business operations and structures of state banks.<sup>25</sup>

As noted above, some commenters argued that the only section 23A financial subsidiaries of state banks are those subsidiaries that are subject to section 46 of the FDI Act. The Board does not believe that this argument is convincing. Although section 46 of the FDI Act specifically notes that sections 23A and 23B apply to transactions between a state bank and a section 46 subsidiary, section 46 does not change the definition of financial subsidiary contained in section 23A or, by its terms, limit the coverage of section 23A's financial subsidiary provisions to only section 46 subsidiaries.

Several commenters also argued that the Board should exempt any subsidiary of a state bank (other than a section 46 subsidiary) approved by the FDIC under section 24 of the FDI Act. Section 24 of the FDI Act prevents a subsidiary of an insured state bank from engaging in any principal activity that is not permissible for a subsidiary of a national bank unless (i) the FDIC has made a determination that the activity would pose no significant risk to the Federal deposit insurance funds; and (ii) the state bank remains in compliance with the capital guidelines of its appropriate Federal banking agency.<sup>26</sup> As noted above, the final rule contains an exemption for any subsidiary of a state bank that engages in activities permissible for the parent state bank to conduct directly. Accordingly, the principal effect of granting an exemption for section 24 subsidiaries would be to exempt from section 23A transactions between a state bank and its section 24 subsidiaries engaged in activities the parent bank may not conduct directly. Such subsidiaries would include those engaged in equity investment

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<sup>25</sup> Neither of these exemptions would be available for any subsidiary of a state bank that engages in principal activities that the GLB Act requires a national bank to conduct in a financial subsidiary, such as underwriting and dealing in bank-ineligible securities. Section 46 of the FDI Act explicitly provides that such subsidiaries of a state bank are to be treated as section 23A affiliates of the bank. 12 U.S.C. 1831w.

The GLB Act authorizes the Board and the Treasury Department to determine jointly, on or after November 12, 2004, that financial subsidiaries may engage in merchant banking activities. GLB Act § 122. If the Board and Treasury were to make such a determination, the merchant banking subsidiaries of banks would be section 23A financial subsidiaries under the final rule.

<sup>26</sup> 12 U.S.C. 1831a(d).

(which Federal law prohibits insured state banks from engaging in)<sup>27</sup> or real estate investment and development (in those states that do not permit state banks to conduct such activities directly).

Commenters argued that various considerations support granting an exemption for section 24 subsidiaries that conduct activities not permissible for their parent state bank. First, commenters contended that section 24 of the FDI Act and the FDIC's regulations thereunder establish a reasonably comprehensive system for protecting insured state banks that engage, or propose to engage, in principal activities not permissible for national banks. In this regard, the FDIC's section 24 regulations impose restrictions on transactions between a state bank and many types of section 24 subsidiaries (including subsidiaries engaged in real estate investment and development).<sup>28</sup> In addition, the FDIC has approved only a few hundred section 24 subsidiaries since Congress added section 24 to the FDI Act in 1991, and the FDIC has received very few requests under section 24 in the past couple of years. Finally, a large majority of section 24 subsidiaries represent a small part of the capital of their parent state banks, and section 24 subsidiaries have not to date materially affected the safety and soundness of state banks.

The Board believes that there are important reasons, however, not to include in the final rule an exemption for section 24 subsidiaries that engage in activities their parent bank may not conduct directly. First, Congress provided a definition of financial subsidiary in section 23A that, by its terms, covers section 24 subsidiaries.<sup>29</sup> In addition, coverage of section 24 subsidiaries that engage in activities not permissible for their parent bank (and, by definition, activities not permissible for national banks) is consistent with an important purpose of the GLB Act -- constraining the ability of a bank to transfer the subsidy arising from the bank's access to the Federal safety net to affiliates engaged in activities that the bank cannot conduct directly.

Furthermore, the activities conducted by many section 24 subsidiaries, including in particular real estate investment and development, increase the risk profile of their parent bank

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<sup>27</sup> Federal law generally prohibits insured state banks from making equity investments of a type or in an amount that is not permissible for national banks. See 12 U.S.C. 1831a(c) and (f).

<sup>28</sup> See 12 CFR 362.4(b)(5) and (d).

<sup>29</sup> Some commenters argued that section 24 subsidiaries engaged in real estate investment and development or equity investment are not section 23A financial subsidiaries because (i) section 23A defines a financial subsidiary as a subsidiary that "would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes" and (ii) section 5136A prohibits financial subsidiaries of national banks from engaging in real estate investment and development and merchant banking. The Board finds this argument unpersuasive. Although section 5136A prohibits financial subsidiaries of national banks from engaging in real estate investment and development or equity investment, a subsidiary engaged in such activities would meet the terms of the financial subsidiary definition in section 23A and section 5136A.

and historically have caused significant losses to the Federal deposit insurance funds.<sup>30</sup> Although section 24 subsidiaries have not to date imperiled their parent banks, banks have been operating in a favorable economic environment since Congress enacted section 24 of the FDI Act. Moreover, the section 24 restrictions imposed by the FDIC are not as comprehensive as those in section 23A<sup>31</sup> and could be removed or relaxed by the FDIC at any time.<sup>32</sup> Furthermore, although the Board could revoke any exemption granted to section 24 subsidiaries if the exemption were to have adverse safety and soundness consequences, such a future revocation may be difficult to effect because it would come at a time when state banks are least able to comply with the requirements of section 23A. For these reasons, the final rule does not contain an exemption for section 24 subsidiaries of a state bank that engage in activities their parent bank may not conduct directly.

b. Agency subsidiaries of national banks and state banks

Section 23A's definition of financial subsidiary does not exclude subsidiaries of banks that are engaged solely in agency activities.<sup>33</sup> As a result, insurance agency subsidiaries of

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<sup>30</sup> As noted above, Congress expressed specific concern in the GLB Act about real estate investment and development by prohibiting the financial subsidiaries of national banks from engaging in these activities. 12 U.S.C. 24a(a)(2). It is also worth noting that, because the final rule includes an exemption for subsidiaries of a state bank engaged in activities that the parent state bank could engage in directly, the principal beneficiaries of a separate exemption for section 24 subsidiaries would be subsidiaries of a state bank engaged in activities that state or Federal law has determined are too risky to be conducted directly in the bank.

<sup>31</sup> The FDIC's restrictions, among other things, do not (i) include a 10 percent quantitative limit on covered transactions between the bank and any single section 24 subsidiary; (ii) restrict the ability of a bank to finance a third party's purchase of assets from a section 24 subsidiary of the bank; or (iii) treat a purchase of assets from a section 24 subsidiary or the issuance of a guarantee or letter of credit on behalf of a section 24 subsidiary as covered transactions.

<sup>32</sup> In many past cases, the FDIC required state banks to deduct from tier 1 capital the full amount of their equity investments in most section 24 subsidiaries (including real estate investment and development subsidiaries). Consistent with the interagency capital rule on nonfinancial equity investments adopted on January 25, 2002, however, the FDIC now requires that state banks deduct from tier 1 capital between 8 percent and 25 percent of an equity investment in most section 24 subsidiaries. See 12 CFR part 325, Appendix A, § II.B.6.ii. The FDIC retains authority under the nonfinancial equity investment capital rule to apply a higher capital charge on these investments, but the FDIC has not chosen to do so at this time.

<sup>33</sup> Some commenters argued that agency subsidiaries of state banks cannot be financial subsidiaries under section 23A because (i) the only section 23A financial subsidiaries of state banks are subsidiaries that qualify as financial subsidiaries under section 46 of the FDI Act and (ii) agency subsidiaries cannot qualify as financial subsidiaries under section 46. For the reasons discussed above, the Board does not believe that this argument is convincing.

national banks that operate outside a town of 5,000, for example, are financial subsidiaries of their parent banks under the statute.

A large number of commenters urged the Board to exclude subsidiaries engaged in agency activities from the definition of financial subsidiary. The Board has decided to exempt from the definition of financial subsidiary any subsidiary of a national bank or state bank that would be considered a financial subsidiary solely because the subsidiary engages in insurance agency activities that are not permissible for the parent bank. The Federal banking agencies have had significant experience in supervising insurance agency subsidiaries of banks, and such subsidiaries do not pose the kind of threat to bank safety and soundness that section 23A was designed to prevent. In addition, because insurance agency subsidiaries are not capital-intensive, they require little funding from the parent bank and, hence, stand to benefit less from the subsidy implicit in the Federal safety net than would a subsidiary engaged in activities as principal. Under the final rule, therefore, subsidiaries of banks engaged in insurance agency activities or agency activities permissible for the bank to engage in directly are not section 23A financial subsidiaries.

The Board does not believe that it is appropriate at this time to grant an exemption for all subsidiaries engaged exclusively in agency activities because defining what constitutes an agency activity is problematic, and some agency activities involve significant risk. In the unusual circumstance where a subsidiary of a bank conducts a non-insurance agency activity that is not permissible for the bank to conduct directly, the bank may request that the Board grant a specific exemption for the subsidiary.

The Board notes that it retains discretion under section 23A to determine, by regulation or order, that any subsidiary of a member bank (even a subsidiary that qualifies for a regulatory exemption from the definition of financial subsidiary) is an affiliate of the bank if the relationship between the bank and the subsidiary is such that covered transactions between the bank and the subsidiary may be affected by the relationship to the detriment of the bank.<sup>34</sup>

c. Subsidiaries of thrifts

Although section 23A applies by its terms only to member banks, HOLA subjects every thrift to section 23A “in the same manner and to the same extent as if the [thrift] were a member bank.”<sup>35</sup> As noted above, section 23A defines a financial subsidiary as “any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank.” Because all “member banks” under section 23A are also “banks” under section 23A, and because HOLA subjects every thrift to section 23A as if the thrift were a “member bank,” one could

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<sup>34</sup> 12 U.S.C. 371c(b)(1)(E) and (b)(2)(A). As discussed below in part III.A.6. of this preamble, § 223.2(a)(12) of the final rule also authorizes the appropriate Federal banking agency for a depository institution to determine by order that a subsidiary of the institution is an affiliate.

<sup>35</sup> 12 U.S.C. 1468(a).

read the financial subsidiary definition in section 23A as covering any subsidiary of a thrift that would be a financial subsidiary of a national bank.

On the other hand, the OTS argued that thrifts generally are not “banks” under section 23A and, hence, that thrifts do not have financial subsidiaries under section 23A. The OTS also pointed out that, although the GLB Act contains explicit and detailed provisions (unrelated to section 23A) regarding financial subsidiaries of national banks and state banks, the GLB Act does not contain any explicit reference to financial subsidiaries of thrifts. In addition, HOLA already contains numerous provisions that protect thrifts in their transactions with subsidiaries. For example, HOLA requires thrifts to deduct from their capital all investments in, and extensions of credit to, any subsidiary engaged in activities that are not permissible for national banks.<sup>36</sup> HOLA also prohibits a thrift from investing more than 3 percent of its assets in service corporation subsidiaries.<sup>37</sup> The Board further notes that there is little empirical evidence to date that subsidiaries of thrifts have had a material adverse effect on the safety or soundness of their parent thrifts since becoming subject to heightened Federal regulation in 1989.

In light of the statutory ambiguities, the protections contained in HOLA, and a request by the OTS that the final rule not treat subsidiaries of thrifts as financial subsidiaries, the final rule does not address financial subsidiaries of thrifts.

3. Companies held under merchant banking or insurance company investment authority (§ 223.2(a)(9))

The GLB Act amended the Bank Holding Company Act (“BHC Act”) to permit bank holding companies (“BHCs”) and foreign banks that qualify as financial holding companies (“FHCs”) to engage in merchant banking and insurance company investment activities.<sup>38</sup> If a FHC owns or controls more than 25 percent of a class of voting shares of a company under the merchant banking or insurance company investment authority, the company is an affiliate of any member bank controlled by the FHC by operation of the statutory definitions contained in section 23A. The GLB Act also added paragraph (b)(11) to section 23A, which creates a rebuttable presumption that a company is an affiliate of a member bank for purposes of section 23A if the bank is affiliated with a FHC and the FHC owns or controls 15 percent or more of the equity capital of the company pursuant to the FHC’s merchant banking or insurance company investment authority.<sup>39</sup>

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<sup>36</sup> 12 U.S.C. 1464(t)(5); 12 CFR 559.3(j)(2) and part 567.

<sup>37</sup> 12 U.S.C. 1464(c)(4)(B).

<sup>38</sup> GLB Act § 103(a); 12 U.S.C. 1843(k)(4)(H) and (I).

<sup>39</sup> GLB Act § 121(b)(2). As noted above, this rebuttable presumption applies only if the affiliated FHC owns or controls 15 percent or more of the company’s equity capital under the new merchant banking or insurance company investment authorities. The Board notes, however, that under existing Board precedents a BHC may not own any shares of a company in

The regulation includes within the definition of “affiliate” any company subject to this rebuttable presumption. The regulation also provides a definition of equity capital, identifies three situations or “safe harbors” where the statute’s presumption would be deemed to be rebutted, and clarifies the application of the presumption to private equity funds. The Regulation W provisions that implement the statutory presumption are substantially identical to those contained in the Board’s merchant banking rule.<sup>40</sup>

The statute does not provide a definition of equity capital. The regulation defines equity capital roughly in accordance with the GAAP definition of stockholders’ equity. Equity capital includes a company’s preferred stock, common stock, capital surplus, retained earnings, and accumulated other comprehensive income, less treasury stock.<sup>41</sup> The definition of equity capital also makes clear that any other account of the company that constitutes equity should be included in the company’s equity capital. Accordingly, the Board retains its authority on a case-by-case basis to require a holding company to treat a subordinated debt investment in a company as equity capital of the company for purposes of applying the 15 percent presumption.

The regulation also provides three specific regulatory safe harbors from the 15 percent presumption. These safe harbors apply in situations where the holding company owns or controls more than 15 percent of the total equity of the company under the merchant banking or insurance company investment authority (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the company (thereby not meeting the statutory definition of control). The three situations are substantially identical to those listed in the Board’s merchant banking regulation.<sup>42</sup>

The first exemption applies where no director, officer, or employee of the holding company serves as a director (or individual exercising similar functions) of the company. The second exemption applies where an independent third party controls a greater percentage of the equity capital of the company than is controlled by the holding company, and no more than one officer or employee of the holding company serves as a director (or individual exercising similar functions) of the company. The third exemption applies where an independent third party controls more than 50 percent of the voting shares of the company, and officers and

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reliance on section 4(c)(6) or 4(c)(7) of the BHC Act where the holding company owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company.

<sup>40</sup> See 12 CFR 225.176(b).

<sup>41</sup> Although the proposed rule only explicitly included perpetual preferred stock in a company’s equity capital, the final rule includes all forms of preferred stock. The Board believes that any instrument in the form of equity should be treated as equity capital for purposes of Regulation W.

<sup>42</sup> See 12 CFR 225.176(b)(2) and (3).

employees of the holding company do not constitute a majority of the directors (or individuals exercising similar functions) of the company.<sup>43</sup>

These safe harbors do not require Board review or approval. Moreover, the safe harbors are not intended to be a complete list of circumstances in which the 15 percent presumption may be rebutted. The regulation also provides, consistent with the GLB Act, that a holding company may rebut the presumption with respect to a portfolio company by presenting information to the Board that demonstrates, to the Board's satisfaction, that the holding company does not control the portfolio company. The Board notes that a company that qualifies as an affiliate under the 15 percent presumption and under another prong of the regulation's definition of affiliate cannot avoid affiliate status through a rebuttal of the 15 percent presumption (either by qualifying for one of the three regulatory safe harbors or by obtaining an ad hoc rebuttal of the presumption from the Board).

A FHC generally is considered to own or control only those shares or other ownership interests that are owned or controlled by itself or by a subsidiary of the holding company. The rule clarifies that, for purposes of applying the presumption of affiliation described above, a FHC that has an investment in a private equity fund (as defined in the Board's merchant banking rule) will not be considered indirectly to own the equity capital of a company in which the fund has invested unless the FHC controls the private equity fund (as described in the Board's merchant banking rule).

#### 4. Partnerships (§ 223.2(a)(4) and (10))

The proposed rule generally deemed partnerships for which the member bank or an affiliate of the bank serves as a general partner to be an affiliate of the bank. Several commenters expressed concern that this interpretation of section 23A would eliminate bank funding of legitimate commercial and community development transactions. This concern of commenters is unwarranted. Although partnerships for which a member bank serves as a general partner are on the section 223.2(a) list of entities that generally are affiliates, such partnerships typically will be excluded from the definition of affiliate in section 223.2(b) as subsidiaries of their parent bank. The Board traditionally has considered the general partner interest in a limited partnership to be a separate class of voting securities of the partnership. Accordingly, a limited partnership would be considered an operating subsidiary of a member bank (that is, a subsidiary of a member bank that is not a section 23A affiliate of the bank) in the typical circumstances where the member bank owns or controls more than 25 percent of the general partner interests in the partnership and the partnership is not a financial subsidiary of the bank.

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<sup>43</sup> For purposes of these safe harbors, the rule provides that the term "holding company" includes any subsidiary of the holding company, including any subsidiary bank of the holding company. Accordingly, if a director of a subsidiary bank or nonbank subsidiary of a FHC also serves as a director of a portfolio company, the first safe harbor, for example, would be unavailable.



The final rule amends the proposed rule on general partners in one respect to prevent evasion. The proposed rule defined as an affiliate of a member bank any partnership if the member bank or an affiliate of the bank causes any officer or employee of the bank or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the bank, as discussed above). The final rule expands the proposed rule to provide that a partnership also will be considered an affiliate of the member bank if the bank or an affiliate of the bank causes any director of the bank or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the bank).

5. Subsidiaries of affiliates (§ 223.2(a)(11))

In the proposal, the Board invited public comment on whether to add to the definition of affiliate any company controlled by an investment fund that is an affiliate of the member bank. A few commenters objected to this proposal on the grounds that it would have little section 23A benefit and would require banks to implement complex monitoring and aggregation systems.

The Board has decided to accord affiliate status to any company controlled by an investment fund affiliate of a member bank. The conflicts of interest that exist between a member bank and any investment fund that it or its affiliate advises also would appear to exist between the bank and a portfolio company controlled by the fund. A member bank would have an incentive to provide financial assistance to such a portfolio company in order to enhance the returns of the investment fund affiliate of the bank. As a result, covered transactions between the member bank and such a portfolio company may be affected by the control relationship between the investment fund and the portfolio company to the detriment of the bank.

The Board also has determined, more broadly, to deem an affiliate any company controlled by another affiliate of the member bank. This regulatory position is consistent with the long-standing view of Board staff. Although section 23A by its terms defines as affiliates most subsidiaries of an affiliate of the member bank, there are a few exceptions to the rule. In addition to covering subsidiaries of investment fund affiliates, this action will make clear, for example, that subsidiaries of interlocking directorate affiliates (§ 223.2(a)(4)) and sponsored and advised affiliates (§ 223.2(a)(5)) also are treated as affiliates of the member bank. Again, the control relationship between such statutory affiliates and their subsidiaries may affect covered transactions between the member bank and such subsidiaries to the detriment of the bank.

6. Companies designated by the appropriate Federal banking agency (§ 223.2(a)(12))

As noted above, section 23A authorizes the Board to determine that any company that has certain relationships with a member bank or an affiliate of the bank is itself an affiliate of the bank. Unlike the proposed rule, final Regulation W provides that these determinations may be made by the Board or by the appropriate Federal banking agency for the relevant depository institution (under authority delegated by the Board). The Board believes that this delegation of authority should enhance the ability of the Federal banking agencies to protect depository institutions in their transactions with associated companies. A depository institution may petition the Board for review of any such affiliate determination made by the institution's

appropriate Federal banking agency under the general procedures established by the Board for review of actions taken under delegated authority.<sup>44</sup>

7. Certain joint venture companies (§ 223.2(b)(1)(iii))

As noted above, under the terms of section 23A, subsidiaries of a member bank generally are not treated as affiliates of the bank, even if they would otherwise qualify as affiliates.<sup>45</sup> The statute contains two specific exceptions to this general rule: “financial subsidiaries” of a member bank and “bank” subsidiaries of a member bank are treated as affiliates of the parent bank. As also noted above, the statute provides that the Board may determine that other subsidiaries of a member bank should be treated as affiliates in appropriate circumstances.<sup>46</sup>

Pursuant to this authority, the Board proposed that two additional classes of subsidiaries of a member bank should be treated as affiliates: (i) certain joint venture companies; and (ii) employee benefit plans. This section of the preamble discusses joint venture companies; the following section addresses employee benefit plans.

First, the proposed regulation provided that any subsidiary of a member bank in which an affiliate of the bank directly owns or controls 25 percent or more of any class of voting securities would be considered an affiliate of the bank. For example, under the proposed rule, a joint venture company that is 50 percent owned by a BHC directly and 50 percent owned by one of its subsidiary member banks, would be treated as an affiliate of the bank.

One commenter objected to this provision in light of the fact that such joint venture companies and their investors are supervised by the Federal banking agencies. The Board does not believe that supervision of the joint venture company or the affiliated investor is sufficient to protect the member bank. Although such a joint venture company qualifies as a subsidiary of the member bank under section 23A because the bank owns more than 25 percent of the company’s voting stock, an affiliate’s substantial direct interest in the company creates the potential for conflicts of interest that may endanger the bank. The Board notes that, with the

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<sup>44</sup> See 12 CFR 265.3.

<sup>45</sup> See 12 U.S.C. 371c(b)(1)(A) and (b)(2)(A). Section 23A defines a subsidiary of a specified company as a company that is controlled by the specified company. Under the statute, a company controls another company if the first company owns or controls 25 percent or more of a class of voting securities of the other company, controls the election of a majority of the directors of the other company, or exercises a controlling influence over the policies of the other company. 12 U.S.C. 371c(b)(3) and (4).

<sup>46</sup> 12 U.S.C. 371c(b)(2)(A).

limited exception of sister banks, Congress did not exempt entities from the definition of affiliate under section 23A because of their supervisory status.<sup>47</sup>

The Board has determined to modify the joint venture rule in several respects. The proposed rule only treated a subsidiary of a member bank as an affiliate of the bank if one or more affiliates of the bank directly owned or controlled 25 percent or more of any class of voting securities of the joint venture. The final rule, however, treats a subsidiary of a member bank as an affiliate if one or more affiliates of the bank, or one or more controlling shareholders of the bank, directly control the joint venture. The Board intends this expansion of the joint venture exclusion to cover situations where an affiliate exercises direct control over the joint venture through a manner other than ownership of voting securities (for example, through majority interlock or ownership of nonvoting securities). This expansion also covers situations where a controlling natural person shareholder or group of controlling natural person shareholders of the member bank (who, as natural persons, are not themselves section 23A affiliates of the bank) exercise direct control over the joint venture company.

This regulatory treatment of certain bank-affiliate joint ventures as affiliates does not apply to joint ventures between a member bank and any affiliated insured depository institutions. For example, if two affiliated member banks each own 50 percent of the voting common stock of a company, the company would continue to qualify as a subsidiary and not an affiliate of each bank (despite the fact that an affiliate of each bank owned more than 25 percent of a class of voting securities of the company). Such a special rule for joint ventures between a member bank and affiliated insured depository institutions is consistent with the purpose behind the sister-bank and affiliated-bank exemptions contained in section 23A. The Board does not believe that transactions between a member bank and a company that is wholly owned by the member bank and its affiliated insured depository institutions generally pose material risks to the safety and soundness of the shareholding institutions or to the Federal deposit insurance funds. The Board would retain authority to treat such joint ventures as affiliates under section 23A on a case-by-case basis.

#### 8. Employee benefit plans (§ 223.2(b)(1)(iv))

The second proposed regulatory exception to the general rule that subsidiaries of a member bank are not treated as affiliates of the bank relates to employee benefit plans. Board staff traditionally has taken the position that most employee stock option plans, trusts, or similar entities that exist to benefit shareholders, members, officers, directors, or employees of a member bank or its affiliates (“ESOPs”) should be treated as affiliates of the bank for purposes of sections 23A and 23B. In most cases, the ESOP’s share ownership or the interlocking management between the ESOP and its associated member bank or BHC exceeds

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<sup>47</sup> Several other commenters asked that the final rule not exclude joint venture subsidiaries of a bank so long as the bank owns more than 50 percent of the voting securities of the joint venture company. The Board declines to adopt this position because, notwithstanding the bank’s controlling voting interest in the subsidiary, the bank’s less-than-100 percent interest and the affiliate’s substantial direct interest in the company may provide the bank with inappropriate incentives to support the company.

the statutory thresholds for determining that a company is an affiliate. Some institutions have argued, however, that ESOPs should be considered subsidiaries of the member bank and therefore exempt from coverage. The proposed rule provided that the ESOP of a member bank or an affiliate of the bank cannot itself avoid classification as an affiliate of the bank by also qualifying as a subsidiary of the bank.

Although one commenter supported the proposed rule's approach to ESOPs, several commenters objected to the approach. These commenters principally argued that (i) ESOPs are regulated by the Department of Labor and transactions between a bank and an associated ESOP are adequately governed by ERISA; (ii) Congress has expressed support for ESOPs; (iii) regulating bank-ESOP transactions under section 23A would prevent banks from effectively using ESOPs to compensate employees and would put banks at a competitive disadvantage to nonbank firms; and (iv) treating ESOPs as affiliates of their associated bank may prevent some banks from establishing ESOPs because third-party lenders to an ESOP generally require the employer to guarantee the loan and ESOPs often would have no collateral to pledge for the bank guarantee other than unacceptable affiliate-issued securities.

Notwithstanding these considerations, the Board believes that the relationship between a member bank and its or its affiliate's ESOP generally warrants coverage by sections 23A and 23B. In the past, banks have made unsecured loans to their ESOPs or their affiliates' ESOPs or have guaranteed loans to such ESOPs that were made by a third party. These ESOPs, however, generally have no means to repay the loans other than with funds provided by the bank. In addition, the issuance of holding company shares to an ESOP that is funded by a loan from the holding company's subsidiary bank could be used as a vehicle by the bank to provide funds to its parent holding company when the bank is unable to pay dividends or is otherwise restricted in providing funds to its holding company.

#### 9. Securitization vehicles and other special purpose entities ("SPEs")

In the proposal, the Board sought comment on whether additional clarification is necessary in the area of securitizations. The Board specifically requested comment on the question of whether securitization SPEs should in any circumstances be deemed to be affiliates of the member bank involved in the securitization. The Board received a significant amount of comment on this issue. Commenters uniformly recommended that the Board not treat SPEs as affiliates of any bank associated with the securitization. Due to the complexities of this issue and the pending proposal by the Financial Accounting Standards Board ("FASB") on the consolidation of SPEs,<sup>48</sup> the Board is deferring at this time any rulemaking with respect to the relationships between member banks and SPEs.

The Board reminds banking organizations that any company sponsored and advised on a contractual basis by a member bank or an affiliate of the bank is an affiliate of the bank under the express terms of section 23A and the final rule. The legislative history of the statute suggests that such "sponsored and advised" companies would include, at a minimum, any

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<sup>48</sup> FASB Proposed Interpretation, Consolidation of Certain Special-Purpose Entities, an Interpretation of ARB No. 51 (June 28, 2002).

company that receives investment advice and administrative services on a contractual basis from a member bank, whose trustees or managers are selected by the bank, and that has a name similar to that of the bank. The Board expects that member banks, at a minimum, would treat companies meeting or substantially meeting these three indicia of sponsorship and advice as affiliates under section 23A.

B. Other definitions (§ 223.3)

1. Capital stock and surplus (§ 223.3(d))

Under section 23A, the quantitative limits on covered transactions are based on the “capital stock and surplus” of the member bank.<sup>49</sup> The proposed regulation included a definition of capital stock and surplus that the Board previously adopted as an interpretation of section 23A.<sup>50</sup> Under this definition, capital stock and surplus is the sum of the member bank’s tier 1 capital and tier 2 capital and the balance of the bank’s allowance for loan and lease losses not included in its tier 2 capital. This definition employs familiar concepts contained in the Federal banking agencies’ capital adequacy guidelines,<sup>51</sup> and is consistent with the lending limits applicable to national banks<sup>52</sup> and the Board’s Regulation O, which limits lending to a member bank’s insiders.<sup>53</sup>

The final rule, consistent with a discussion in the preamble to the proposed rule, alters the definition of capital stock and surplus in one regard. The National Bank Act requires a national bank, “in determining compliance with applicable capital standards,” to deduct from its capital the aggregate amount of any outstanding equity investments, including retained earnings, of the bank in all its financial subsidiaries.<sup>54</sup> The FDI Act imposes the same capital deduction requirement on insured state banks that establish financial subsidiaries.<sup>55</sup> In determining compliance with the quantitative limits of section 23A, a bank is required by statute to include in its covered transactions any equity investments (excluding retained earnings) of the bank in its financial subsidiaries. It would be unfair to compel a bank to include such investments in its covered transaction amount (the numerator of the fraction in section 23A’s quantitative limits) but to exclude such investments from capital stock and surplus (the denominator of the fraction). Accordingly, the final rule explicitly permits a

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<sup>49</sup> 12 U.S.C. 371c(a)(1).

<sup>50</sup> See 61 FR 19805, May 3, 1996.

<sup>51</sup> See, e.g., 12 CFR part 225, appendix A.

<sup>52</sup> 12 CFR 32.2(b).

<sup>53</sup> 12 CFR 215.2(i).

<sup>54</sup> 12 U.S.C. 24a(c)(1).

<sup>55</sup> 12 U.S.C. 1831w(a)(2).

member bank with a financial subsidiary to add back to its section 23A capital stock and surplus the amount of any investment in a financial subsidiary that counts as a covered transaction and is required to be deducted from the bank's capital for regulatory capital purposes.

2. Control (§ 223.3(g))

Section 23A provides that a company or shareholder shall be deemed to have control over another company if, among other things, such company or shareholder controls in any manner the election of a majority of the “directors or trustees” of the other company.<sup>56</sup> Regulation W expands this prong of the control definition to conform it to the control definition contained in the Board's Regulation Y by adding that control also exists when a company or shareholder controls the election of a majority of the “general partners (or individuals exercising similar functions)” of another company. This expansion of the control definition is intended to ensure that banking organizations understand that a company or shareholder would be deemed to control another company (including a partnership, limited liability company, or other similar organization) under section 23A if the company or shareholder controls the election of a majority of the principal policymakers of such other company.

The regulation also includes two additional presumptions of control that are similar to presumptions contained in Regulation Y. First, a company will be deemed to control securities, assets, or other ownership interests controlled by any subsidiary of the company.<sup>57</sup> Second, a company that controls instruments (including options and warrants) that are convertible or exercisable, at the option of the holder or owner, into securities, will be deemed to control the securities.<sup>58</sup>

One commenter asked the Board to clarify that a company or person may rebut the convertibility presumption of control. The Board agrees with this position and has amended the final rule to provide that, as under Regulation Y, this presumption is rebuttable. Commenters also suggested that the convertibility presumption should apply only to convertible instruments that are immediately convertible, or convertible within a short time frame, into the underlying securities. Consistent with the Board's interpretations of the parallel Regulation Y provision, the Board declines to adopt this approach. Establishment of any kind of regulatory safe harbor for warrants, options, and other convertible instruments that cannot be exercised or converted for some short period of time is likely to facilitate evasion of

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<sup>56</sup> 12 U.S.C. 371c(b)(3)(A)(ii).

<sup>57</sup> See 12 CFR 225.2(e)(2)(i).

<sup>58</sup> See 12 CFR 225.31(d)(1)(i). The proposed rule referred to “securities” (rather than “instruments”) that are convertible into other securities. The final rule refers more generically to convertible “instruments” to clarify that the convertibility presumption applies regardless of whether the right to convert resides in a financial instrument that technically qualifies as a “security” under section 23A or the Federal securities laws.

the presumption. A company or person that wishes to rebut this presumption based on the specific features of a convertible instrument should present their arguments to the Board for a case-by-case decision.

The final rule supplements the control presumptions contained in proposed Regulation W with one additional rebuttable presumption. The final rule provides that a company or shareholder that owns or controls 25 percent or more of the equity capital of another company controls the other company unless the company or shareholder demonstrates otherwise to the Board based on the facts and circumstances of the particular case. This rebuttable presumption is similar to a presumption applied by the Board under the control provisions of the BHC Act.<sup>59</sup> Such a presumption of control is particularly appropriate in the section 23A context because a BHC, for example, may have incentives to divert the resources of a subsidiary bank to any company in which the holding company has a substantial financial interest, regardless of whether the holding company owns any voting securities of the company.

### 3. Covered transaction (§ 223.3(h))

The restrictions of section 23A do not apply to every transaction between a member bank and its affiliates. The section only applies to “covered transactions” between a member bank and its affiliates. The statute defines a covered transaction as (i) an extension of credit to an affiliate; (ii) a purchase of or investment in securities issued by an affiliate; (iii) a purchase of assets from an affiliate; (iv) the acceptance of securities issued by an affiliate as collateral for an extension of credit to any person; and (v) the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate.<sup>60</sup> Among the transactions that generally are not subject to section 23A are dividends paid by a member bank to its holding company, sales of assets by a member bank to an affiliate, an affiliate’s purchase of securities issued by a member bank, and many service contracts between a member bank and an affiliate. This section of the preamble discusses whether certain classes of transactions between a member bank and an affiliate are covered transactions for purposes of section 23A.

#### a. Confirmation of a letter of credit issued by an affiliate (§ 223.3(h)(5))

As noted, section 23A includes as a covered transaction the issuance by a member bank of a letter of credit on behalf of an affiliate. The proposed regulation provided that a member bank’s confirmation of a letter of credit issued by an affiliate is also a covered transaction.

One commenter noted staff’s traditional position that certain confirmations of a documentary letter of credit issued by an affiliate are not covered transactions and asked the Board to clarify that such confirmations would not be treated as covered transactions under

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<sup>59</sup> See, e.g., 12 CFR 225.143 (Board Policy Statement on Nonvoting Equity Investments).

<sup>60</sup> 12 U.S.C. 371c(b)(7).

Regulation W.<sup>61</sup> The Board has decided to reverse the staff position on this issue and to treat all confirmations of a letter of credit issued by an affiliate as a covered transaction. Under the current law applicable to letters of credit, when a bank confirms a letter of credit, it assumes the risk of the underlying transaction to the same extent as if it had issued the letter of credit.<sup>62</sup> Accordingly, the rule treats confirmations of a letter of credit issued by an affiliate in the same fashion as issuances of a letter of credit on behalf of an affiliate.

b. Credit enhancements supporting a securities underwriting

The Board has confirmed previously and hereby reconfirms that section 23A's definition of guarantee would not include a member bank's issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the bank.<sup>63</sup> Such a credit enhancement would not be issued "on behalf of" the affiliate. In addition, although the guarantee does provide some benefit to the affiliate (by facilitating the underwriting), this benefit is indirect. Accordingly, the proceeds of the guarantee would not be transferred to the affiliate for purposes of the attribution rule of section 23A.<sup>64</sup> Of course, section 23B would apply to the transaction and, where an affiliate was issuer as well as underwriter, the transaction would be covered by section 23A because the credit enhancement would be on behalf of the affiliate.

c. Cross-guarantee agreements and cross-affiliate netting arrangements (§ 223.3(h)(5))

Board staff has confirmed previously that a cross-guarantee agreement among a member bank, an affiliate, and a nonaffiliate in which the nonaffiliate may use the bank's assets to satisfy the obligations of a defaulting affiliate is a guarantee for purposes of section 23A.<sup>65</sup> The Board believes that such cross-guarantee arrangements among member banks and their affiliates should be subject to the quantitative limits and collateral requirements of section 23A.

Similarly, the Board understands that some member banks have entered into or are contemplating entering into cross-affiliate netting arrangements ("CANAs"). These include arrangements among a member bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank, where a nonaffiliate is permitted to deduct obligations of an affiliate

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<sup>61</sup> See Letter dated May 5, 1981, from Robert E. Mannion, Deputy General Counsel of the Board, to Andrew T. Moore, Jr.; see also Letter dated July 17, 1980, from Robert E. Mannion, Deputy General Counsel of the Board, to Baldwin B. Tuttle.

<sup>62</sup> See U.C.C. 5-107(2).

<sup>63</sup> See 62 FR 45295, Aug. 27, 1997.

<sup>64</sup> See 12 U.S.C. 371c(a)(2).

<sup>65</sup> See Letter dated Aug. 6, 1993, from J. Virgil Mattingly, Jr., General Counsel of the Board, to Richard Lasner.



of the bank to the nonaffiliate when settling the nonaffiliate's obligations to the bank. These arrangements also would include agreements where a member bank is required or permitted to add the obligations of an affiliate of the bank to a nonaffiliate when determining the bank's obligations to the nonaffiliate.

These types of CANAs expose a member bank to the credit risk of its affiliates because the bank may become liable for the obligations of its affiliates. Because the exposure of a member bank to an affiliate in such an arrangement resembles closely the exposure of a member bank when it issues a guarantee on behalf of an affiliate, the final rule explicitly includes such arrangements in the definition of covered transaction. Accordingly, the quantitative limits of section 23A would prohibit a member bank from entering into such a CANA to the extent that the netting arrangement does not cap the potential exposure of the bank to the participating affiliate(s).

Several commenters urged the Board to withhold judgment on CANAs until standardized documentation is developed by the industry. These commenters advised that CANAs are of many types and, therefore, that the Board should not adopt a fixed rule for all CANAs. One commenter encouraged the Board to clarify in particular that CANAs that do not make the bank liable for the obligations of its affiliates or otherwise cause any detriment to the bank are not covered transactions. By only addressing the CANAs described above, the rule only treats CANAs as covered transactions in situations where the member bank may become liable for the obligations of its affiliates. The Board intends to monitor industry developments in this area and will revisit this aspect of Regulation W or issue further interpretive guidance on CANAs as warranted.

d. Keepwell agreements

Banking organizations have asked for guidance on the question of whether a "keepwell" agreement should be considered a guarantee for purposes of section 23A. In a keepwell agreement between a member bank and an affiliate, the bank typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the member bank in entering into such a keepwell agreement is similar to the credit risk incurred by a member bank in connection with issuing a guarantee on behalf of an affiliate. As a consequence, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

4. Extension of credit (§ 223.3(o))

Although section 23A includes a "loan or extension of credit" to an affiliate as a covered transaction, the statute does not define these terms. The regulation defines "extension of credit" to an affiliate to mean the making or renewal of a loan to an affiliate, the granting of a line of credit to an affiliate, or the extending of credit to an affiliate in any manner whatsoever, including on an intraday basis. The regulation also provides a nonexhaustive list of transactions that the Board deems to be extensions of credit to an affiliate, including an advance to an affiliate by means of an overdraft, cash item, or otherwise; a lease that is the

functional equivalent of an extension of credit to an affiliate;<sup>66</sup> an acquisition of a note or other obligation of an affiliate, including commercial paper or other debt securities issued by an affiliate; and any increase in the amount of, extension of the maturity of, or adjustment in the interest rate term or other material term of an extension of credit to an affiliate.<sup>67</sup> The final rule also includes a sale of Federal funds to an affiliate on the list of examples. This position reflects the long-standing view of the Board about the nature of Federal funds transactions.<sup>68</sup>

In addition to these examples, the final rule specifies that other similar transactions that result in an affiliate owing money to a member bank are extensions of credit by the member bank to the affiliate. This aspect of the definition of extension of credit is consistent with the definition of the same term in Regulation O and would cover, among other things, situations where an affiliate fails to pay on a timely basis for services rendered to the affiliate by the member bank.

As noted, the regulation provides that a member bank's purchase of a debt security issued by an affiliate is an extension of credit by the bank to the affiliate for purposes of section 23A.<sup>69</sup> Several commenters objected to this interpretation of the statute and argued that a purchase of an affiliate's debt securities is a "purchase of or investment in securities issued by an affiliate" for purposes of section 23A, and that such a purchase cannot also then be an "extension of credit" for purposes of section 23A. Other commenters criticized this position on the grounds that (i) it often would not be feasible (due to negative pledge covenants) for the bank to obtain collateral for the security after the terms of the security are fixed at inception; and (ii) requiring collateral for purchases of debt securities but not for purchases of equity securities is perverse.

The Board does not find any of these objections persuasive. Although the Board is aware that section 23A's definition of covered transaction separately includes a member bank's purchase of securities issued by an affiliate and a member bank's loan to an affiliate, the fact that a holder of debt securities expects repayment of principal upon maturity makes debt securities closely resemble loans for purposes of section 23A and the statute's objective of protecting the member bank. There is nothing in the text or legislative history of section 23A

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<sup>66</sup> The Board would consider a full-payout, net lease permissible for a national bank under 12 U.S.C. 24(Seventh) and 12 CFR part 23 to be the functional equivalent of an extension of credit.

<sup>67</sup> A floating-rate loan does not become a new covered transaction whenever there is a change in the relevant index (for example, LIBOR or the member bank's prime rate) from which the loan's interest rate is calculated. If the member bank and the borrower, however, amend the loan agreement to change the interest rate term from "LIBOR plus 100 basis points" to "LIBOR plus 150 basis points," the parties have engaged in a new covered transaction.

<sup>68</sup> See 12 CFR 250.160.

<sup>69</sup> This position is consistent with the Board's long-standing view. See 37 Federal Reserve Bulletin 960 (1951).

that indicates that a particular transaction may be slotted only into one category of covered transaction.

Although the Board recognizes the incongruities of requiring collateral for debt investments by a member bank in an affiliate but not equity investments by a member bank in an affiliate, this is an unalterable aspect of the statutory framework. The prevalence of these incongruities, moreover, is constrained by the limited ability of member banks to make equity investments. Importantly, the Board's action on this matter removes an incongruity more likely to occur -- treating differently under section 23A two transaction forms (loans and debt securities) that are substantially equivalent from a credit risk perspective.

For all these reasons, therefore, Regulation W provides that a member bank that buys debt securities issued by an affiliate has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with section 23A's collateral requirements. As discussed below, the final rule provides an exemption from the collateral requirements in situations where a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary market transaction.<sup>70</sup>

#### 5. Low-quality asset (§ 223.3(v))

Two provisions of section 23A restrict a member bank's ability to engage in transactions with affiliates that involve low-quality assets. First, the statute prohibits a member bank from purchasing a low-quality asset from an affiliate unless the bank performs an independent credit evaluation and commits to purchase the asset before the affiliate acquires the asset.<sup>71</sup> Second, the statute prohibits a member bank from counting a low-quality asset toward section 23A's collateral requirements for credit transactions with an affiliate.<sup>72</sup>

Section 23A defines a low-quality asset to include (i) an asset classified as "substandard," "doubtful," or "loss," or treated as "other loans especially mentioned," in the most recent report of examination or inspection by a Federal or State supervisory agency (a "classified asset"); (ii) an asset in nonaccrual status; (iii) an asset on which payments are more than thirty days past due; or (iv) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.<sup>73</sup> The Board notes that any asset meeting one of the above four criteria, including securities and real property, is a low-quality asset.<sup>74</sup>

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<sup>70</sup> See part IV.B.5. of this preamble.

<sup>71</sup> 12 U.S.C. 371c(a)(3).

<sup>72</sup> 12 U.S.C. 371c(c)(3).

<sup>73</sup> 12 U.S.C. 371c(b)(10).

<sup>74</sup> The Federal banking agencies generally consider non-investment grade securities to be classified assets. See, e.g., "Uniform Agreement on the Classification of Assets and Appraisal

The regulation broadens the definition of low-quality asset in three ways. First, the regulation provides that an asset identified by examiners as an “other transfer risk problem” (“OTRP”) is a low-quality asset.<sup>75</sup> Such assets represent credits to countries that are not complying with their external debt-service obligations, but are taking positive steps to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund program. Although OTRP assets are not considered classified assets, examiners are instructed to consider these assets in their assessment of a bank’s asset quality and capital adequacy.<sup>76</sup>

Second, the regulation reflects the increasing use by financial institutions of their own internal asset classification systems. A 1998 Board study of the 50 largest U.S. banks demonstrated that all use internal loan classifications, and a substantial proportion of such institutions have relatively advanced internal rating systems.<sup>77</sup> There is considerable variance in how large banks rate performing assets; however, banks are required to use the same categories employed by the Federal banking agencies for rating classified assets.

Because examinations may be twelve months apart -- eighteen months for smaller banks -- these internal classification systems may cause a bank to regrade an asset long before its next examination. Accordingly, the rule includes within the definition of low-quality asset not only assets classified during the last examination but also assets classified or treated as special mention under the institution’s internal classification system (or assets that received an internal rating that is substantially equivalent to classified or special mention in such an internal system).

Several commenters objected to this aspect of the proposed rule. They argued that the statute provides a highly articulated definition of low-quality asset that should not be supplemented by the Board. They also cautioned that the rule would penalize banks with careful internal classification systems and would create perverse incentives for banks to avoid internally classifying bad assets. The Board acknowledges these concerns but believes that the rule is consistent with the text and intent of section 23A and that the supervisory benefits of the rule would outweigh any adverse effects. The purchase by a depository institution from an affiliate of assets that have been internally classified raises potentially significant safety and soundness concerns.

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of Securities Held by Banks” (May 7, 1979); Federal Reserve Commercial Bank Examination Manual § 2020.1. Assets identified by examiners through the Shared National Credit and International Country Exposure Review Committee processes also should be considered classified assets for purposes of section 23A.

<sup>75</sup> No commenter objected to this provision of the proposed rule.

<sup>76</sup> See Federal Reserve Commercial Bank Examination Manual § 7040.1.

<sup>77</sup> William F. Treacy & Mark S. Carey, Credit Risk Rating at Large U.S. Banks, 84 Federal Reserve Bulletin 897 (1998).

The Board shares the concern of commenters that this provision of the rule may induce companies to avoid or defer reclassification of an asset in order to allow its sale to an affiliated depository institution, but believes that such evasions can be addressed through the examination process. The Board expects companies with internal rating systems to use the systems consistently over time and over similar classes of assets and will view as an evasion of section 23A any company's deferral or alteration of an asset's rating to facilitate sale of the asset to an affiliated institution.

Finally, the proposed rule defined low-quality asset to include foreclosed property designated "other real estate owned" ("OREO"), until it is reviewed by an examiner and receives a favorable classification. One commenter criticized this interpretation and represented that OREO is often good collateral collected from a bad borrower. This commenter further advised that a bank should be allowed to purchase OREO from an affiliate if the bank uses the OREO as premises.

The final rule contains an expanded version of the proposed rule's OREO provision. The final rule defines as a low-quality asset any asset (not just real estate) that is acquired in satisfaction of a debt previously contracted (not just through foreclosure) if the asset has not yet been reviewed in an examination or inspection. In the Board's experience, property acquired from a borrower in default is often of such poor quality that its ownership poses the same risk to the bank as a classified loan. In response to the concerns expressed by the commenter, the Board notes that, under the rule, if a particular asset is good collateral taken from a bad borrower, the asset should cease to be a low-quality asset upon examination.

#### 6. Member bank (§ 223.3(w))

As discussed above, although proposed Regulation W applied by its terms to all "banks," the final rule applies by its terms to all "member banks." Consistent with section 1 of the Federal Reserve Act, the final rule defines "member bank" to mean "any national bank, State bank, banking association, or trust company that is a member of the Federal Reserve System."

The definition of member bank in the regulation also states that most subsidiaries of a member bank are to be treated as part of the member bank itself for purposes of sections 23A and 23B. The only subsidiaries of a member bank that are excluded from this treatment are financial subsidiaries, insured depository institution subsidiaries, certain joint venture subsidiaries, and ESOPs -- companies that are deemed affiliates of the member bank under the regulation. This treatment of subsidiaries reflects the fact that the statute typically does not distinguish between a member bank and its subsidiaries, and all the significant restrictions of the statute apply to actions taken by a member bank "and its subsidiaries." Defining the term "member bank" as described above and using the term "member bank" wherever the statute says "member bank and its subsidiaries" makes the regulation shorter and easier to understand. The definition also should help to remind member banks that certain subsidiaries should not be treated as part of the member bank for purposes of the statute.

7. Obligations of, or fully guaranteed as to principal and interest by, the United States or its agencies (§ 223.3(z))

Section 23A accords special treatment to extensions of credit secured by “obligations of the United States or its agencies” or “obligations fully guaranteed by the United States or its agencies as to principal and interest” (collectively, “U.S. government obligations”). First, the statute imposes the lowest collateral requirement, 100 percent of the loan amount, on extensions of credit secured by U.S. government obligations.<sup>78</sup> Second, the statute provides an exemption for extensions of credit fully secured by U.S. government obligations.<sup>79</sup>

The proposed rule did not provide guidance as to what financial instruments qualify as U.S. government obligations. Several commenters asked the Board to clarify that U.S. government obligations for section 23A purposes would include, at a minimum, all the obligations identified in the Board’s Regulation A as eligible to serve as collateral for advances by Federal Reserve Banks to member banks under section 13(8) of the Federal Reserve Act.<sup>80</sup> The final rule provides this clarification, which is consistent with staff’s long-standing position under section 23A. The final rule also indicates that U.S. government obligations do not include mortgage loans insured by the Federal Housing Administration or the Veterans Administration because the backing of the U.S. government for these loans is not a full and unconditional guarantee of the principal and interest of the underlying mortgage loans. This exclusion also is consistent with staff’s traditional interpretation of section 23A.

8. Purchase of assets (§ 223.3(dd))

The proposed rule defined a purchase of an asset as the acquisition of an asset in exchange for cash or any other consideration, including an assumption of liabilities. The preamble to the proposed rule indicated the Board’s view that merging an affiliate with and into a member bank generally would constitute a purchase of assets by the bank from the affiliate. Consistent with the preamble to the proposed rule, the final rule also provides that the merger of an affiliate into a member bank is a purchase of assets by the bank from the affiliate if the bank assumes any liabilities of an affiliate or pays any other form of consideration in the transaction.

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<sup>78</sup> 12 U.S.C. 371c(c)(1)(A)(i) and (ii).

<sup>79</sup> 12 U.S.C. 371c(d)(4)(A) and (B).

<sup>80</sup> See 12 CFR 201.108(b). Section 13(8) of the Federal Reserve Act authorizes Federal Reserve Banks to make advances to member banks secured by, among other things, U.S. government obligations eligible for purchase by a Federal Reserve Bank under section 14(b) of the Federal Reserve Act. 12 U.S.C. 347. The description of U.S. government obligations in section 14(b) of the Federal Reserve Act is virtually identical to the description of U.S. government obligations in section 23A. See 12 U.S.C. 355.

9. Securities (§ 223.3(ff))

Section 23A defines “securities” to mean “stocks, bonds, debentures, notes, or other similar obligations.”<sup>81</sup> Because of the ambiguous nature of this definition, the Board generally has looked to the Federal securities laws for guidance in determining which financial instruments should be considered securities for purposes of section 23A. In light of the similarities between commercial paper and debentures and notes and the countervailing fact that the Securities Exchange Act of 1934 excludes some forms of commercial paper from its definition of security,<sup>82</sup> the regulation clarifies that commercial paper is a security for purposes of section 23A.<sup>83</sup>

One commenter on the proposed rule asked the Board to indicate whether annuities are securities for purposes of section 23A. The Board would consider annuities that are securities for purposes of the Federal securities laws to be securities for purposes of Regulation W.

10. Voting securities (§ 223.3(jj))

Section 23A uses both the terms “voting shares” and “voting securities.” To remove ambiguity and enhance regulatory consistency, Regulation W replaces all statutory uses of the term “voting shares” with the term “voting securities” and defines “voting securities” to have the same meaning as “voting securities” in Regulation Y.<sup>84</sup>

IV. General Provisions of Section 23A--Subpart B

Subpart B of the regulation sets forth the principal restrictions of section 23A, including the quantitative limits, the safety and soundness requirement, the collateral requirement, and the prohibition on the purchase of low-quality assets. This subpart also includes section 23A’s attribution rule, which provides that any transaction with a nonaffiliate will be considered 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. In addition, subpart B incorporates previous Board and staff interpretations of these provisions, and a few new interpretations of these provisions. These interpretations of the statute are discussed below.

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<sup>81</sup> 12 U.S.C. 371c(b)(9).

<sup>82</sup> See 15 U.S.C. 78c(a)(10).

<sup>83</sup> As noted above in part III.B.4. of this preamble, the Board considers a member bank’s investment in commercial paper issued by an affiliate to be both an investment in securities issued by an affiliate and an extension of credit to an affiliate.

<sup>84</sup> See 12 CFR 225.2(q).

A. Quantitative limits (§§ 223.11 and 223.12)

Section 23A(a)(1) provides that a member bank may engage in a covered transaction with an affiliate only if, upon consummation of the proposed transaction, the aggregate amount of the bank's covered transactions (i) with any single affiliate would not exceed 10 percent of the bank's capital stock and surplus and (ii) with all affiliates would not exceed 20 percent of the bank's capital stock and surplus.<sup>85</sup> Sections 223.11 and 223.12 of the regulation set forth these quantitative limits. The quantitative limits of Regulation W (consistent with section 23A) only prohibit a member bank from engaging in a new covered transaction if the bank would be in excess of the 10 or 20 percent threshold after consummation of the new transaction. The regulation (consistent with section 23A) generally does not require a member bank to unwind existing covered transactions if the bank exceeds the 10 or 20 percent limit because its capital declined or a preexisting covered transaction increased in value.

Section 23A(a)(1)(A) states that a member bank "may engage in a covered transaction with an affiliate only if . . . in the case of any affiliate," the aggregate amount of covered transactions of the bank would not exceed 10 percent of the capital stock and surplus of the bank. The proposed rule interpreted this limitation to prevent a member bank from engaging in a new covered transaction with an affiliate if the aggregate amount of covered transactions between the bank and any affiliate (not only the particular affiliate with which the bank proposes to engage in the new covered transaction) would be in excess of 10 percent of the bank's capital stock and surplus after consummation of the new transaction. Several commenters argued that this reading of the 10 percent limit is inconsistent with the statutory language of section 23A and existing bank practices. These commenters urged the Board to interpret the 10 percent limit to prohibit a bank from engaging in a covered transaction with an affiliate only when the aggregate amount of covered transactions between the bank and that affiliate would exceed 10 percent of the bank's capital.

The Board believes that both the interpretation of the 10 percent limit set forth in the proposed rule and the interpretation advocated by commenters are consistent with the statutory language. In light of the numerous other existing safeguards in sections 23A and 23B, including in particular the 20 percent quantitative limit and the collateral requirements, and the other supervisory tools available to the Federal banking agencies, the Board has determined to adopt the interpretation advocated by commenters in the final Regulation W. Notwithstanding this more liberal interpretation of the 10 percent limit, the Board strongly encourages member banks with covered transactions in excess of the 10 percent threshold with any affiliate to reduce those transactions before expanding the scope or extent of the bank's relationships with other affiliates.

Another commenter asked the Board to clarify in section 223.11 that transactions between a bank and a financial subsidiary of the bank are not subject to the 10 percent limit of section 23A. Although proposed Regulation W made this point in the section of the rule relating to financial subsidiaries, the Board agrees that clarity would be enhanced if the final rule also made this point in the section of the rule that sets forth the 10 percent limit. Accordingly,

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<sup>85</sup> 12 U.S.C. 371c(a)(1).



section 223.11 of the final rule states that transactions between a member bank and its financial subsidiary are not subject to the 10 percent limit.

B. Collateral requirements (§ 223.14)

Section 223.14 of the regulation sets forth the collateral requirements established by section 23A(c) for loans and extensions of credit to an affiliate, and guarantees, acceptances, and letters of credit issued on behalf of an affiliate (collectively, “credit transactions”). As a general matter, section 23A requires any credit transaction by a member bank with an affiliate to be secured with a statutorily prescribed amount of collateral. The required collateral varies from 100 percent of the value of the credit extended (when the collateral is a deposit account or U.S. government obligations) to 130 percent of the credit extended (when the collateral is stock, leases, or certain other “real or personal property”).<sup>86</sup>

1. Deposit account collateral (§ 223.14(b)(1)(i)(D))

Under section 23A, a member bank may satisfy the collateral requirements of the statute by securing a credit transaction with an affiliate with a “segregated, earmarked deposit account” maintained with the bank in an amount equal to 100 percent of the credit extended.<sup>87</sup> The proposed regulation clarified that, to satisfy the statute’s “segregated, earmarked” requirement, the account must exist for the sole purpose of securing the credit extended and be so identified.

Numerous commenters asked the Board to remove this regulatory gloss and explicitly state that banks may satisfy the collateral requirements of section 23A by (i) using a single deposit account to collateralize one or more covered transactions with one or more affiliates or (ii) entering into a cross-collateralization agreement with one or more affiliates under which all of such affiliates’ deposit accounts are pledged as collateral for all of such affiliates’ credit transactions with the bank. According to these commenters, such collateral arrangements are a common, safe, and efficient means of satisfying the letter and spirit of the collateral requirements of section 23A.

The Board has analyzed the claims of these commenters and has decided not to require a member bank accepting deposit account collateral to establish a separate segregated, earmarked deposit account to secure each covered transaction with an affiliate. The Board recognizes that such a strict reading of the “segregated, earmarked” requirement is not required by the statute and would impose a substantial compliance burden on member banks that engage in a significant number of covered transactions with affiliates. Moreover, in some circumstances, using an omnibus deposit account for multiple affiliates and multiple covered transactions may have prudential advantages for the member bank as compared to using separate deposit accounts for each outstanding covered transaction.

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<sup>86</sup> 12 U.S.C. 371c(c)(1).

<sup>87</sup> 12 U.S.C. 371c(c)(1)(A)(iv).

Although the final rule does not include the proposed regulatory gloss, the Board expects that member banks that secure covered transactions with omnibus deposit accounts will take steps to ensure that such accounts fully secure the relevant covered transactions. Such steps might include substantial overcollateralization or the use of subaccounts or other recordkeeping devices to match deposits with covered transactions. In addition, as required by the final rule, to obtain full credit for any deposit accounts taken as section 23A collateral, member banks must ensure that they have a perfected, first priority security interest in the accounts.

Several commenters asked the Board to replace the “segregated, earmarked” requirement for deposit accounts with a requirement that banks have a perfected, first priority security interest in the accounts. These commenters explained that, although the “segregated, earmarked” requirement made sense before the adoption of revised Article 9 of the Uniform Commercial Code, the revised Article 9 has rendered segregation and earmarking of a deposit account legally irrelevant to ensuring that a bank has a perfected, first priority security interest in the account. Despite the revisions to Article 9, the final rule maintains the “segregated, earmarked” requirement because it is required by the plain language of section 23A and because segregating and earmarking deposit account collateral is a prudent practice even under revised Article 9.

## 2. Ineligible collateral (§ 223.14(c))

The purpose of section 23A’s collateral requirements is to ensure that member banks that engage in credit transactions with affiliates have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended. The statute recognizes that certain types of assets are not appropriate to serve as collateral for credit transactions with an affiliate. In particular, the statute provides that low-quality assets and securities issued by an affiliate are not eligible collateral for such covered transactions.<sup>88</sup>

The proposed rule provided that intangible assets (as defined by generally accepted accounting principles (“GAAP”)), including servicing assets, are not acceptable collateral to secure credit transactions with an affiliate. Several commenters supported the proposed rule’s categorical exclusion of intangible assets. A larger number of commenters argued, however, that banks should be permitted to use certain intangible assets as section 23A collateral, in particular assets, such as servicing assets and purchased credit card relationships, that count as capital under the Board’s capital adequacy guidelines.

The final rule retains the categorical exclusion of intangible assets.<sup>89</sup> In the Board’s view, intangible assets are particularly hard to value, and a member bank may have significant

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<sup>88</sup> 12 U.S.C. 371c(c)(3) and (4).

<sup>89</sup> The final rule, however, does not define intangible assets by reference to GAAP. Upon further review, the Board has determined that the GAAP definition of intangible asset may be underinclusive for section 23A purposes. If a member bank has doubts as to whether a particular asset is an intangible asset, the bank should consult with Board staff.

difficulty in collecting and selling such assets in a reasonable period of time. The Board believes that these reasons justify the exclusion of intangible assets from the types of collateral eligible to satisfy the requirements of section 23A. The Board notes that the identifiable intangible assets that are not deducted from capital under the capital adequacy guidelines (namely, servicing assets and purchased credit card relationships) are limited quantitatively in the extent to which they count as capital.<sup>90</sup> The Board is willing to consider requests, on a case-by-case basis, to permit particular types of intangible assets to serve as section 23A collateral, and has amended the proposed rule to allow for such ad hoc exceptions to the categorical exclusion.

In addition, the proposed rule provided that guarantees and letters of credit are not eligible collateral for section 23A purposes. Several commenters argued that the rule should permit banks to satisfy the collateral requirements of section 23A with letters of credit. These commenters stated that letters of credit are less likely to fluctuate in value than many other types of eligible section 23A collateral, represent senior claims on banks, are not subject to an automatic stay in bankruptcy, involve lower administrative costs than most other types of collateral, convey an immediate right to cash rather than a possibly illiquid piece of collateral, and are recognized under the net capital rule of the Securities and Exchange Commission (“SEC”). Other commenters argued that banks should be allowed to use guarantees to comply with section 23A’s collateral requirements. These commenters noted that the Board’s capital adequacy guidelines recognize the value of guarantees as a credit risk mitigation device.

The final rule continues to provide that guarantees and letters of credit are not acceptable section 23A collateral.<sup>91</sup> Letters of credit and guarantees are not balance sheet assets under GAAP and, accordingly, would not constitute “real or personal property” under section 23A. Moreover, section 23A(c) requires that credit transactions with an affiliate be “secured” by collateral. A credit transaction between a member bank and an affiliate supported only by a guarantee or letter of credit from a third party would not appear to meet the statutory requirement that the credit transaction be secured by collateral. Of course, the Board could grant an exemption that would permit guarantees or letters of credit to count as collateral or to serve as a replacement for collateral. The Board has decided not to do so at this time because guarantees and letters of credit often are subject to material adverse change clauses and other covenants that allow the issuer of the guarantee or letter of credit to deny coverage. Moreover, in the Board’s view, there is a particularly significant risk, highlighted by recent events, that a member bank may have difficulty collecting on a guarantee or letter of credit provided by a nonaffiliate on behalf of an affiliate of the bank.

As noted above, section 23A prohibits a member bank from accepting securities issued by an affiliate as collateral for an extension of credit to an affiliate. The proposed rule clarified

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<sup>90</sup> See 12 CFR part 225, appendix A, § II.B.1.d-e.

<sup>91</sup> The final rule also provides that instruments “similar” to guarantees and letters of credit are ineligible collateral. For example, in the Board’s view, a member bank cannot satisfy section 23A’s collateral requirements by purchasing credit protection in the form of a credit default swap referencing the affiliate’s obligation.

that securities issued by the member bank itself also are not eligible collateral to secure a credit transaction with an affiliate. Most commenters supported the exclusion of bank-issued equity securities but urged the Board to permit banks to take their own debt securities as section 23A collateral. These commenters pointed out that bank deposits (another form of bank liability) count as a preferred form of collateral under section 23A and that selling or retiring bank-issued debt securities would provide real benefit to the bank upon foreclosure.

The Board has determined to modify the proposed rule to address these comments. Under the final rule, equity securities issued by the lending member bank, and debt securities issued by the lending member bank that count as regulatory capital of the bank, are not eligible collateral under section 23A. If a member bank were forced to foreclose on a credit transaction with an affiliate secured by such securities, the bank may be unwilling to liquidate the collateral promptly to recover on the credit transaction because the sale might depress the price of the bank's outstanding securities or result in a change in control of the bank. In addition, to the extent that a member bank is unable or unwilling to sell such securities acquired through foreclosure, the transaction would likely result in a reduction in the bank's capital, thereby offsetting any potential benefit provided by the collateral.

### 3. Perfection and priority (§ 223.14(d))

To ensure that a member bank has good access to the assets serving as collateral for its credit transactions with affiliates, the final regulation provides (as did the proposed rule) that a member bank's security interest in any collateral required by section 23A must be perfected in accordance with applicable law. This requirement is consistent with court decisions on the issue<sup>92</sup> and ensures that the member bank has the legal right to realize on the collateral in case of default, including a default resulting from the affiliate's insolvency or liquidation. Commenters supported this provision.

For similar reasons, the final rule requires (as did the proposed rule) that a member bank either obtain a first priority security interest in the required collateral or deduct from the amount of collateral obtained by the bank the lesser of (i) the amount of any security interests in the collateral that are senior to that obtained by the bank or (ii) the amount of any credits secured by the collateral that are senior to that of the bank. For example, if a member bank lends \$100 to an affiliate and takes as collateral a second lien on a parcel of real estate worth \$200, the arrangement would only satisfy the collateral requirements of section 23A if the affiliate owed the holder of the first lien \$70 or less (a credit transaction secured by real estate must be secured at 130 percent of the amount of the transaction). Commenters also supported this provision. At the request of a commenter, the final rule includes an example of how to compute the section 23A collateral value of a junior lien.

### 4. Unused portion of an extension of credit (§ 223.14(f)(2))

Section 23A requires that the "amount" of an extension of credit be secured by the statutorily prescribed levels of collateral. Board staff traditionally has advised that a member

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<sup>92</sup> See Fitzpatrick v. FDIC, 765 F.2d 569 (6th Cir. 1985).

bank that provides a line of credit to an affiliate must secure the full amount of the line of credit throughout the life of the credit. That is, staff has not viewed section 23A as permitting a member bank to satisfy the collateral requirements of the statute by securing only the portion of a credit line that has been drawn down by the affiliate. In an acknowledgment that this treatment may be too strict for some lines of credit, the proposed rule provided that the collateral requirements of section 23A would not apply to the unused portion of an extension of credit to an affiliate so long as the member bank does not have any legal obligation to advance additional funds under the credit facility until the affiliate has posted the amount of collateral required by the statute with respect to the entire used portion of the extension of credit.<sup>93</sup> In such credit arrangements, securing the unused portion of the credit line is unnecessary from a safety and soundness perspective because the affiliate cannot require the member bank to advance additional funds without posting the additional collateral required by section 23A.

Numerous commenters endorsed this provision of the proposed rule, and the final rule maintains the provision.<sup>94</sup> The Board notes that, if a member bank voluntarily advances additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire used amount (despite its lack of legal obligation to make such an advance), the Board would view this action as a violation of the collateral requirements of the statute.

#### 5. Purchasing affiliate debt securities in the secondary market (§ 223.14(f)(3))

As described above, the rule treats a member bank's investment in the debt securities of an affiliate as an extension of credit by the bank to the affiliate that is subject to section 23A's collateral requirements. In the preamble to the proposed rule, the Board sought comment on whether the rule should permit member banks in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. In particular, the Board invited comment on whether it should require section 23A collateralization in circumstances where a member bank purchases an affiliate's debt securities (i) from a third party in a bona fide secondary market transaction or (ii) pursuant to a registered public offering document or a private placement memorandum in an offering in which the affiliate receives significant participation from third parties. A large number of commenters expressed support for the first of the proposed exemptions; only a few commenters advocated for (and one commenter criticized) the second proposed exemption.

The Board has decided to adopt the first of the two exemptions described above. When a member bank buys an affiliate's debt securities in a bona fide secondary market transaction, the risk that the purchase is designed to shore up an ailing affiliate is reduced. Moreover, any

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<sup>93</sup> This proposed treatment would not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate, which must be fully collateralized at inception.

<sup>94</sup> The final rule uses the terms "used" and "unused" in place of the proposed rule's "drawn" and "undrawn" to conform to more standard regulatory usage. See, e.g., Schedule RC-L to the bank Call Report.

purchase of affiliate debt securities that qualifies for this exemption would remain subject to the quantitative limits of section 23A and the market terms requirement of section 23B. In analyzing a member bank's good faith under this exemption, the Board would expect examiners to look at the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase, the existence of any relevant agreements or relationships between the bank and the third party seller of the affiliate's debt securities, any history of bank financing of the affiliate, and any other relevant information.

C. Prohibition on the purchase of low-quality assets (§ 223.15)

Section 223.15 of the regulation restates the statute's general prohibition on the purchase by a member bank of low-quality assets from an affiliate.<sup>95</sup> Several commenters on the proposed rule argued that the Board should exempt a bank's purchase of low-quality assets from an insured sister bank. These commenters stated that the cross-guarantee provisions in section 5(e) of the FDI Act eradicate any concern about low-quality asset transactions between sister banks.<sup>96</sup>

The Board has consulted with the other Federal banking agencies on this matter and has determined not to grant the requested exemption for several reasons. First, when Congress added the sister-bank exemption to section 23A in 1982, it specifically and affirmatively left sister banks subject to the prohibition on the purchase of low-quality assets.<sup>97</sup> When Congress added the cross-guarantee provisions to the FDI Act in 1989, it did not amend the sister-bank exemption in section 23A to permit a member bank to buy low-quality assets from a sister bank. In light of such evidence of Congressional intent, the Board should not exempt a member bank's purchase of low-quality assets from a sister bank in the absence of compelling evidence that the exemption would be in the public interest.

The Board does not believe that such compelling evidence exists. Importantly, the FDI Act's cross-guarantee provisions would only assist the FDIC to recoup losses in the event of the failure of a sister bank, and would not ensure that sister banks continue to operate in a safe and sound manner as going concerns. Moreover, the FDI Act's cross-guarantee provisions would not apply to all sets of section 23A sister banks. For example, the cross-guarantee provisions would not apply to section 23A sister banks if the sister banks were not subsidiaries of a BHC or a thrift holding company.<sup>98</sup> Finally, the cross-guarantee provisions would not prevent sister banks from using the requested exemption to transfer low-quality assets back and forth among themselves to escape examination.

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<sup>95</sup> 12 U.S.C. 371c(a)(3). Section 23A does not prohibit an affiliate from donating a low-quality asset to a member bank, so long as the bank provides no consideration for the asset.

<sup>96</sup> See 12 U.S.C. 1815(e).

<sup>97</sup> See 12 U.S.C. 371c(d)(1).

<sup>98</sup> See 12 U.S.C. 1813(w), 1815(e)(1) and (9), and 1841(c)(2).

The proposed rule provided an exception, based on a long-standing staff interpretation, to the general prohibition on purchasing low-quality assets from an affiliate.<sup>99</sup> The exception allowed a member bank that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying loan had become a low-quality asset, so long as certain criteria were met. The proposed rule provided this exception because these renewals or additional credit extensions may enable both the affiliate and the participating member bank to avoid or minimize potential losses. It would be inconsistent with the purposes of section 23A to bar a member bank from using sound banking judgment to take the necessary steps (consistent with the criteria established in the rule) to protect itself from harm in such a situation.

Under the proposed rule, the exception was available only if the underlying loan was not a low-quality asset at the time the member bank purchased its participation and the proposed transaction would not increase the member bank's proportional share of the credit facility. The member bank also had to obtain the prior approval of its board of directors for the transaction and provide its appropriate Federal banking agency with 20 days' prior notice of the transaction.

Commenters expressed support for preserving this exemption in Regulation W but asked the Board to soften three of the conditions to the exemption. Several commenters argued for the removal of the "no increase in the bank's share" requirement on the ground that lead banks involved in a credit restructuring often are required to repurchase participations previously sold to smaller banks, thereby increasing their proportionate share of the problem credit. Another commenter recommended that banks be allowed to increase their share of a problem credit by 5-10 percent.

Commenters also criticized the board of directors' approval requirement on the grounds that it is time consuming and that renewals of problem credits are not sufficiently important to require board-level attention in most cases. Commenters offered several alternatives, including approval by an executive committee of the bank's board of directors, approval by senior bank management, approval under the bank's normal approval process for restructuring problem credits, and approval by bank management under policies adopted by the bank's board of directors.

Moreover, commenters expressed significant opposition to the 20 days' prior notice requirement. They asked the Board to remove the requirement or replace it with an after-the-fact notice requirement. According to these commenters, speed is often of the essence in workout situations, and there is no evidence that this exemption has been abused by banks in the nearly twenty years that it has been available.

Under proposed Regulation W, this restructuring exemption only applied when a member bank renewed a participation in a loan originated by an affiliated depository institution. Some commenters expressed a view that the exemption should be expanded to

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<sup>99</sup> See Letter dated Aug. 10, 1984, from Michael Bradfield, General Counsel of the Board, to Margie Goris.

permit a bank to renew a participation in a loan originated by any affiliate (not just an affiliated depository institution). According to these commenters, such an expansion of the exemption would enhance a bank's ability to protect itself from troubled borrowers by restructuring loans.

In response to these comments, the Board has decided to revise the rule in several respects. First, the final rule contains a 20 days' post-consummation notice requirement in replacement of the proposed rule's 20 days' prior notice requirement. Second, the final rule permits a member bank to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the bank's appropriate Federal banking agency). Third, the final rule expands the scope of the exemption to include renewals of participations in loans originated by any affiliate of the member bank (not just affiliated depository institutions). Fourth, the final rule softens the board of directors' prior approval requirement as follows. For renewals of loans originated by a nondepository affiliate of the member bank, the renewals must be approved, consistent with current practice, by the entire board of directors of the bank. For renewals of loans originated by depository institution affiliates of the member bank, however, the rule provides several different ways to comply with the requirement. The member bank may obtain the prior approval of the entire board of directors, of an executive committee of the board of directors, or of selected senior management officials (so long as, in the case of approvals by management officials, the board of directors of the member bank establishes policies and procedures for such renewals, any approvals by bank management are consistent with such policies and procedures, and the board of directors periodically reviews the policies and procedures and any approvals by management). The Board believes that the conditions to the exemption contained in the final rule should be sufficient to ensure that any exempted problem loan restructurings do not pose a safety and soundness risk to the member bank.

#### D. Attribution rule (§ 223.16)

Section 23A provides that any transaction between a member bank and any person is 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.<sup>100</sup> For example, a member bank's loan to a customer for the purpose of purchasing securities from the inventory of a broker-dealer affiliate of the bank would be a covered transaction under section 23A. This "attribution rule" was included in section 23A to prevent a member bank from evading the restrictions in the section by using intermediaries and to limit the exposure that a member bank has to customers of affiliates of the bank. The proposed regulation restated this provision and provided several exemptions from the attribution rule.

##### 1. In general

Commenters offered a few general suggestions on the scope of section 23A's attribution rule. Several commenters recommended that the Board include a "bona fide, ordinary course transactions" exemption to the attribution rule, similar to the exemption that

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<sup>100</sup> 12 U.S.C. 371c(a)(2).



the Board adopted in Regulation O.<sup>101</sup> In addition, a number of commenters contended that the attribution rule should not apply to transactions where the bank does not know, or have reason to know, that the proceeds are transferred to or used for the benefit of an affiliate. Some of these commenters argued that the purpose of the attribution rule is to prevent sham transactions, not to prevent an affiliate from receiving unintended or accidental benefits from bank action. A few commenters even asked the Board to remove all the particular exemptions from the attribution rule included in Regulation W because, in the view of these commenters, the exemptions create the negative implication that all other transactions with third parties in which money flows to an affiliate are covered.

The Board has decided not to include any such general exemptions from the scope of the attribution rule in final Regulation W. The Board considers an exemption for transactions where the member bank does not know, or have reason to know, that the proceeds will flow to an affiliate as too broad in light of the important place of section 23A in the bank regulatory framework. The Board is not willing to make the applicability of the attribution rule contingent in all cases on subjective factors such as a member bank's knowledge of the purpose of a transaction or on such ambiguous, though objective, factors such as a member bank's reason to know of the purpose of a transaction.

The Board also does not believe that a Regulation O-like exemption, for transactions by a member bank with a third party the proceeds of which are used by the third party in a bona fide transaction to acquire goods or services from an affiliate of the member bank, would be appropriate in the context of section 23A. Regulation O's exemption meshes well into that rule's underlying statutory scheme because sections 22(g) and 22(h) of the Federal Reserve Act do not generally cover asset purchases from an insider; section 23A, on the other hand, generally does restrict asset purchases from an affiliate. Moreover, Regulation O's exemption reflects an underlying policy concern not to discourage qualified business owners from serving as management officials of banks. This sort of concern is not present in the section 23A context.

2. Agency and riskless principal transactions (§ 223.16(b) and (c)(1-2))

Concurrently with proposed Regulation W, the Board issued a final interpretation that exempted from section 23A a loan from a member bank to a nonaffiliate who uses the loan proceeds to purchase securities from a broker-dealer affiliate of the bank acting exclusively as a riskless principal.<sup>102</sup> Proposed Regulation W also included this exemption and sought additional public comment on its terms. Numerous commenters recommended extending the riskless principal exemption to include assets other than securities and selling affiliates other than broker-dealers. These commenters did not provide specific information to the Board about other asset classes that are routinely purchased and sold on a riskless principal basis. In light of this absence of evidence, the Board declines at this time to expand the riskless principal exemption to include other assets or other affiliates.

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<sup>101</sup> See 12 CFR 215.3(f).

<sup>102</sup> 66 FR 24226, May 11, 2001.

Unlike the final interpretation and proposed Regulation W, final Regulation W contains a definition of “acting exclusively as a riskless principal.” The definition generally tracks language in Regulation Y and provides that, for purposes of Regulation W, a company acts exclusively as a riskless principal if the company, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security in a secondary market transaction for its own account to offset a contemporaneous sale to (or purchase from) the customer.<sup>103</sup>

Several commenters stated that Regulation W should clarify that a loan from a bank to a nonaffiliate who uses the loan proceeds to purchase assets through an affiliate of the bank acting solely as an agent is not subject to the attribution rule. Concurrently with the issuance of proposed Regulation W, the Board issued a final interpretation of section 23A confirming, with some conditions, this view.<sup>104</sup> The Board has decided to include this interpretation within the text of Regulation W to advance the goal of making the regulation a single, comprehensive source for the Board’s views on sections 23A and 23B.

The final rule clarifies one of the conditions to both the agency and riskless principal exemptions. Under the final interpretations adopted in May 2001, neither of these exemptions was available to a member bank if the asset purchased by the nonaffiliate was sold “out of the inventory of” any affiliate of the bank. The Board is concerned that users of the regulation may read the “out of the inventory” language so narrowly as to allow a member bank to use these exemptions in situations where the asset purchased by the nonaffiliate was sold as principal by an affiliate of the bank that did not have an inventory of the sold asset. Whether the selling affiliate has accumulated an inventory of the asset sold to the nonaffiliate is not important from section 23A’s perspective; what matters is whether the asset purchased by the nonaffiliate was sold as principal by an affiliate of the member bank. The final rule replaces the “out of the inventory” standard with an “as principal” standard to remove this ambiguity. Accordingly, under the final rule, these two exemptions are not available if the asset purchased by the nonaffiliate was sold as principal (other than as riskless principal) by an affiliate of the member bank.

### 3. Preexisting lines of credit (§ 223.16(c)(3))

Concurrently with proposed Regulation W, the Board issued a final interpretation that exempted from section 23A an extension of credit by a member bank to a nonaffiliate who uses the credit to purchase securities underwritten by or otherwise sold as principal by a broker-dealer affiliate of the bank, if the extension of credit is made pursuant to a preexisting line of credit not entered into in contemplation of transactions with an affiliate of the bank.<sup>105</sup> Proposed Regulation W also included this exemption and sought additional public comment on its terms. Commenters requested that the Board expand the exemption to cover purchases of any asset from any affiliate. In the view of these commenters, an extension of credit pursuant

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<sup>103</sup> See 12 CFR 225.28(b)(7)(ii).

<sup>104</sup> 66 FR 24226, May 11, 2001.

<sup>105</sup> 66 FR 24226, May 11, 2001.

to a general purpose, preexisting line of credit should be exempt from the attribution rule regardless of the type of asset being purchased by the customer. Final Regulation W's version of this exemption is substantially identical to the one contained in the May 2001 final interpretation (and proposed Regulation W). The Board may expand the exemption in the future, however, after it acquires additional supervisory experience with its use.

4. General purpose credit cards (§ 223.16(c)(4))

a. Proposed rule and public comments

Section 23A's attribution rule, by its terms, covers an extension of credit by a member bank to an individual who uses the proceeds to purchase a product or service from an affiliate of the bank. Proposed Regulation W exempted from the attribution rule an extension of credit by a member bank to a nonaffiliate pursuant to a general purpose credit card in such a situation. The proposed rule defined a general purpose credit card as a credit card issued by a member bank that is widely accepted by merchants that are not affiliates of the bank (such as a Visa card or Mastercard) if less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank.<sup>106</sup> Under the proposed rule, extensions of credit to unaffiliated borrowers pursuant to special purpose credit cards (that is, credit cards that may only be used or are substantially used to buy goods from an affiliate of the member bank) remained subject to the attribution rule.<sup>107</sup>

The Board proposed this exemption because the funding benefit received by the member bank's affiliate from the use of general purpose credit cards by unaffiliated borrowers is likely to be minimal, and a member bank's decision to issue a general purpose credit card (and make loans pursuant to such a credit card) to an unaffiliated borrower likely would be based on independent credit standards unrelated to any possible affiliate transaction.

Commenters strongly supported inclusion of an exemption for extensions of credit to nonaffiliates pursuant to a general purpose credit card, but a large number of commenters criticized the rule's definition of general purpose credit card.<sup>108</sup> These commenters contended that the 25 percent limit in the definition of general purpose credit card would

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<sup>106</sup> The proposed rule also required that a general purpose credit card be eligible for use to purchase products or services from nonaffiliates of the card-issuing bank. The Board has deleted this requirement from the final rule because of its redundancy on the "widely accepted" condition.

<sup>107</sup> As noted above, most special purpose credit card banks comply with section 23A by selling their receivables or establishing a segregated, earmarked deposit account to collateralize their receivables at the end of each day.

<sup>108</sup> Many commenters urged the Board to expand the exemption for general purpose credit cards to cover other forms of general revolving consumer debt, including home equity lines of credit, overdraft lines on checking accounts, and margin loans.

impose substantial monitoring and recordkeeping burden on banks. Some of these commenters also alleged that the limit is not needed for safety and soundness given that the card must be widely accepted by merchants and given the virtual impossibility of a bank using credit card transactions to assist a troubled affiliate. These commenters argued that the possibility that customers may use a widely accepted credit card to buy goods from a nonaffiliate should ensure that credit is granted on market terms, and pointed out that credit card transactions expose the bank to the credit risk of thousands or millions of individual unaffiliated credit card customers and do not directly expose the bank to the credit risk of any affiliate.

Several commenters made suggestions about how the Board should modify, or clarify the application of, the quantitative limit in the definition of general purpose credit card. A couple of commenters believed that the rule should raise the 25 percent limit to 50 percent. In addition, several commenters asked the Board to provide banks with a cure period if they exceed the limit and requested that the Board provide guidance as to whether banks must do continuous or only periodic compliance checks with the limit.

b. Final rule

The Board continues to believe that the definition of general purpose credit card should include the 25 percent limit. If more than 25 percent of the purchases effected through a credit card are purchases of products and services from affiliates of the card-issuing bank, the bank has significant incentives to relax its credit underwriting standards to facilitate the sale of goods and services by its affiliates. The Board believes that a limit should be placed on the ability of a bank to use the Federal safety net to subsidize the financing of the sales activities of affiliates of the bank.

The final rule contains several adjustments to ease the burden of complying with the general purpose credit card exemption. First, the final rule provides several different methods for a member bank to demonstrate that its credit card meets the 25 percent test. For a member bank that has no commercial affiliates (other than those permitted for a FHC under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if the bank has no reason to believe that it would fail the test.<sup>109</sup> Such a member bank would not be obligated to establish systems to verify strict, ongoing compliance with the 25 percent test. For a member bank that has commercial affiliates (beyond those permitted for a FHC under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if (i) the bank establishes systems to verify compliance with the 25 percent test on an ongoing basis

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<sup>109</sup> A member bank could use this method of complying with the 25 percent test even if, for example, the bank's FHC controls, under section 4(a)(2), 4(c)(2), or 4(k)(4)(H) of the BHC Act, several companies engaged in nonfinancial activities.

and periodically validates its compliance with the test; or (ii) the bank presents information to the Board demonstrating that its card would comply with the 25 percent test.<sup>110</sup>

The final rule adopts a stricter compliance standard for member banks with commercial affiliates because banks with commercial affiliates typically are the banks whose credit cards are used substantially to purchase goods or services from affiliates. The Board believes that the stricter standard for member banks with commercial affiliates will help constrain the mixing of banking and commerce by limiting the ability of such banks to use the Federal safety net to subsidize the commercial activities of their affiliates.

Second, the final rule provides member banks that fall out of compliance with the 25 percent test a three-month grace period to return to compliance before extensions of credit under the card become covered transactions. Third, the final rule gives member banks that are required to validate their ongoing compliance with the 25 percent test a fixed method, time frames, and examples for computing compliance.

The Board does not expect that member banks whose cards fail to meet the terms of the general purpose credit card exemption would be compelled to discontinue the cards. Most banks that issue special purpose credit cards historically have complied with section 23A by selling their credit card receivables to an affiliate at the end of each day.<sup>111</sup> Under such arrangements, which also would be permissible under final Regulation W, the bank does not provide continuous financing for its commercial affiliates; rather, it obtains funding from outside sources on a daily basis for its affiliate-related credits. Member banks that issue VISA cards and Mastercards that fail to satisfy the 25 percent test would be able to use the same mechanisms to comply with section 23A as do banks that currently issue special purpose credit cards.

#### V. Valuation and Timing Principles under Section 23A--Subpart C

Subpart C of the regulation sets forth the rules that member banks must use to calculate the value of covered transactions for purposes of determining compliance with the quantitative limits and collateral requirements of section 23A. This subpart also sets forth several rules that member banks must employ to determine when a transaction becomes or ceases to be a covered transaction.

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<sup>110</sup> One way that a member bank could demonstrate that its card would comply with the 25 percent test would be to show that the total sales of the bank's affiliates are less than 25 percent of the total purchases by cardholders.

<sup>111</sup> As discussed below, the Board has not historically treated intraday credit extensions as covered transactions under section 23A. Section 223.42(l) of the final Regulation W provides a fairly comprehensive exemption for intraday extensions of credit.

A. Credit transactions with an affiliate (§ 223.21)

1. Valuation (§ 223.21(a))

The proposed regulation provided generally that a credit transaction between a member bank and an affiliate initially must be valued at the amount of funds provided by the member bank to, or on behalf of, the affiliate plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate. The final rule supplements the proposed rule by providing that the section 23A value of a credit transaction between a member bank and an affiliate is the greater of (i) the principal amount of the credit transaction; (ii) the amount owed by the affiliate to the member bank under the credit transaction; or (iii) the result produced by application of the formula set forth in the proposed rule.

The first prong of the final rule's valuation formula for credit transactions ("the principal amount of the credit transaction") likely would determine the valuation of a transaction in which a member bank purchased a zero-coupon note issued by an affiliate. The Board believes that a member bank should value such an extension of credit at the principal, or face, amount of the note (that is, the amount that the affiliate ultimately must pay to the bank) rather than the amount of funds initially advanced by the bank. For example, assume a member bank purchased from an affiliate for \$50 a 10-year zero-coupon note issued by the affiliate with a face amount of \$100. The proposed rule's valuation formula permitted the member bank to value this transaction at \$50 -- the amount provided to the affiliate by the bank in the transaction. The final rule requires the member bank to value this transaction at \$100.

The second prong of the final rule's valuation formula for credit transactions ("the amount owed by the affiliate") likely would determine the valuation of a transaction in which an affiliate fails to pay a member bank when due a fee for services rendered by the bank to the affiliate. This prong of the valuation formula is not intended to include within section 23A's quantitative limits, however, items such as accrued interest not yet due on a member bank's loan to an affiliate or credit exposure of a member bank to an affiliate on a derivative transaction that is not the functional equivalent of a credit transaction (unless and until the affiliate defaults in making a required payment to the bank on a settlement date).

Member banks will be able to determine the section 23A value for most credit transactions under the third prong of the rule's valuation formula. Under this prong, for example, a \$100 term loan is a \$100 covered transaction, a \$300 revolving credit facility is a \$300 covered transaction (regardless of how much of the facility the affiliate has drawn down), and a guarantee backstopping a \$500 debt issuance of the affiliate is a \$500 covered transaction.<sup>112</sup> Several commenters contended that the unused portion of a line of credit should not count toward the quantitative limits of section 23A, especially not if the bank is only conditionally obligated to advance additional funds. In the Board's view, the entire amount (both the used and unused portions) of a line of credit or other loan commitment counts toward a member bank's quantitative limits under section 23A regardless of whether the line of credit contains a "material adverse change" clause or any other provision that is intended to relieve

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<sup>112</sup> These examples are included in the text of the final rule.

the bank of its funding obligation under certain conditions. This position is consistent with the treatment of commitments under the Board's capital adequacy guidelines and is particularly appropriate in the section 23A context because of the risk that a member bank may not use every contractual escape hatch available to avoid funding a troubled affiliate.<sup>113</sup>

Under section 23A and the regulation, a member bank has made an extension of credit to an affiliate if the bank purchases from a third party a loan previously made to an affiliate of the bank. The rule provides a different valuation formula for these indirect credit transactions. For these credit transactions, the member bank must value the transaction at the price paid by the bank for the loan plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the credit agreement.

For example, if a member bank pays a third party \$90 for a \$100 term loan that the third party previously made to an affiliate of the bank (because, for example, the loan was at a fixed rate and has declined in value due to a rise in the general level of interest rates), the covered transaction amount is \$90 rather than \$100.<sup>114</sup> The lower covered transaction amount reflects the fact that the member bank's maximum loss on the transaction is \$90 rather than the original principal amount of the loan. For another example, if a member bank pays a third party \$70 for a \$100 line of credit to an affiliate of which \$70 had been drawn down by the affiliate, the covered transaction amount would be \$100 (the \$70 purchase price paid by the bank for the credit plus the remaining \$30 that the bank could be required to lend under the credit line).

Although a member bank's purchase of, or investment in, a debt security issued by an affiliate is considered an extension of credit to an affiliate under the regulation, these transactions are not valued like other extensions of credit. The valuation rules for purchases of, and investments in, the debt securities of an affiliate are set forth in section 223.23 of the rule, which is discussed below in part IV.C. of this preamble.

## 2. Timing (§ 223.21(b)(1))

The proposed regulation also made clear that a member bank has entered into a credit transaction with an affiliate at the time during the day that the bank becomes legally obligated to make the extension of credit to, or issue the guarantee, acceptance, or letter of credit on behalf of, the affiliate. This timing rule represented a departure from the industry practice of complying with section 23A only with respect to overnight positions. This timing rule also clarified that a covered transaction occurs at the moment that the member bank executes a legally valid, binding, and enforceable credit agreement or guarantee, and does not occur only when a member bank funds a credit facility or makes payment on a guarantee.

Many commenters objected that forcing banks to keep track of extensions of credit to an affiliate on an intraday basis would present serious compliance burdens for banks. These

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<sup>113</sup> See 12 CFR part 225, appendix A, § III.D.2.

<sup>114</sup> The final rule includes this example of the valuation of indirect credit transactions.

commenters believed that banks would have little trouble ensuring that credit transactions satisfy the collateral requirements of section 23A or the market terms requirement of section 23B at the intraday time of the transactions. According to these commenters, however, banks currently record loans and measure loan exposures at the end of each business day, and requiring intraday loan amount tracking would impose a significant cost on banks.

The Board has decided to retain proposed Regulation W's general timing rule for credit transactions. The burden of the timing rule should be significantly mitigated, however, by the exemption for intraday extensions of credit in section 223.42(l) of the regulation.<sup>115</sup> The Board further notes that the burden of the timing rule should be lessened by the fact that Regulation W, consistent with section 23A, only requires a member bank to compute compliance with its quantitative limits when the bank is about to engage in a new covered transaction. Accordingly, Regulation W does not require a member bank to compute compliance with the rule's quantitative limits on a continuous basis.

3. Credit transactions with nonaffiliates that become affiliates (§ 223.21(b)(2))

Banks sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the bank. The proposed regulation provided that credit transactions with a nonaffiliate become covered transactions at the time that the nonaffiliate becomes an affiliate of the member bank. Specifically, the proposed rule required that a member bank (i) ensure that any such credit transaction satisfies the collateral requirements of section 23A promptly after the nonaffiliate becomes an affiliate; and (ii) include the amount of any such transaction in the aggregate amount of the bank's covered transactions for purposes of determining whether any future covered transactions would comply with the quantitative limits of section 23A. The proposal did not require a member bank to reduce the amount of its covered transactions with any affiliate at the time the nonaffiliate becomes an affiliate.<sup>116</sup>

Many commenters criticized this approach. They contended that loans to a nonaffiliate that later becomes an affiliate should be eternally exempt from the quantitative limits and collateral requirements of section 23A because the loans were made on arm's-length terms at inception and the terms of the loans would not change when the nonaffiliate becomes an affiliate. Several of these commenters argued that the proposed rule's approach to these loans is highly burdensome, especially for banking organizations that have a significant equity

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<sup>115</sup> As discussed in more detail below in part VII.L. of this preamble, however, the intraday credit exemption generally applies only to extensions of credit that a member bank expects to be repaid, sold, or terminated by the end of its U.S. business day. Hence, the final rule generally requires a member bank to ensure its intraday compliance with section 23A when making a loan to an affiliate during the day that the bank expects to remain outstanding and on its books overnight.

<sup>116</sup> The proposed rule also set forth a stricter set of compliance rules, which are discussed below, for situations in which a member bank entered into a credit transaction with a nonaffiliate "in contemplation of" the nonaffiliate becoming an affiliate.



investment business (where new companies are constantly becoming, and ceasing to be, 15 percent-owned portfolio company affiliates). According to these commenters, banks currently treat these loans as grandfathered, and the proposed rule's approach would put banks and their merchant banking affiliates at a serious disadvantage to nonregulated lenders and their venture firm affiliates. Other commenters contended that the "prompt" collateral requirement would be burdensome because it may be difficult to obtain collateral if the new affiliate is less than wholly owned or has other debt outstanding with negative pledge covenants.

The Board continues to subscribe to the general approach of the proposed rule in these situations. Although commenters may be correct in asserting that transactions with a nonaffiliate would be on market terms and would stay on market terms after the nonaffiliate becomes an affiliate, section 23A requires more than that covered transactions with affiliates be on market terms. Section 23A supplements the market terms requirement of section 23B with, among other things, quantitative limits and collateral requirements. If the Board did not treat credit transactions with a nonaffiliate as covered transactions at the time that the nonaffiliate becomes an affiliate, a member bank could incur uncollateralized exposure to affiliates well beyond the 20 percent aggregate quantitative limit in section 23A.<sup>117</sup>

The Board agrees, however, that relief from the collateral requirements of section 23A would be appropriate in certain circumstances. Accordingly, the final rule exempts credit transactions from the collateral requirement in situations where the member bank entered into the transaction with the nonaffiliate at least one year before the nonaffiliate became an affiliate of the bank. In such circumstances, it is unlikely that the member bank engaged in the transaction with the nonaffiliate in anticipation of the nonaffiliate becoming an affiliate of the bank. The Board advises member banks, however, that such transactions must comply with the market terms requirement of section 23B.

As noted above, in cases where the member bank entered into the credit transaction with the nonaffiliate "in contemplation of" the nonaffiliate becoming an affiliate of the bank, the proposed rule imposed a more strict set of requirements. In these cases, the proposed rule required the member bank, at or before the time the nonaffiliate becomes an affiliate, (i) to ensure compliance with the collateral requirements of section 23A and (ii) to reduce the aggregate amount of its covered transactions with affiliates if necessary so as not to exceed the quantitative limits of section 23A.

Although commenters did not object to the proposed rule's stricter approach to "in contemplation" transactions, some commenters argued that the "in contemplation" standard in the rule is too vague. Several of these commenters believed the "in contemplation" standard should be replaced with a more objective standard that focuses on whether the nonaffiliate has

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<sup>117</sup> Although the lending limits applicable to national and State member banks would apply to these credit transactions at inception, these lending limits permit loans to a single corporate group in amounts up to 50 percent of the bank's capital stock and surplus. 12 CFR 32.5(d). The lending limits also would cease to apply to these credit transactions after the nonaffiliate becomes an affiliate. 12 CFR 32.1(c)(1).

entered into a binding agreement under the terms of which the nonaffiliate would become an affiliate or whether there has been a publicly announced transaction in which the nonaffiliate would become an affiliate. Other commenters contended that the Board should clarify that a transaction will be deemed “in contemplation of” a nonaffiliate becoming an affiliate only if the bank personnel involved in approving the transaction were aware of negotiations concerning the nonaffiliate’s future affiliation with the bank. According to these commenters, any other formulation would require a banking organization to disseminate broadly throughout the firm prospective merger information (in contravention of good securities law compliance policies).

The Board does not believe that the above-described circumstances constitute a complete set of the situations in which a member bank might make a loan to a nonaffiliate “in contemplation of” the nonaffiliate becoming an affiliate of the bank. To provide some clarity to banking organizations, however, the final rule specifies that a transaction between a member bank and a nonaffiliate is presumed to be “in contemplation of” the nonaffiliate becoming an affiliate if the bank enters into the transaction with the nonaffiliate after the execution of, or commencement of negotiations designed to result in, an agreement under the terms of which the nonaffiliate would become an affiliate.

The exemption from the collateral requirements discussed above does not apply to “in contemplation” transactions. If a member bank engages in a credit transaction with a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank, the bank must ensure that the transaction complies with the collateral requirements of the rule at the time the nonaffiliate becomes an affiliate (regardless of whether a year elapsed between the inception of the credit transaction and the nonaffiliate becoming an affiliate).

B. Asset purchases from an affiliate (§ 223.22)

Regulation W provides that a purchase of assets by a member bank from an affiliate initially must be valued at the total amount of consideration given by the bank in exchange for the asset. This consideration can take any form, and the regulation makes clear that it would include an assumption of liabilities by the member bank. The regulation also indicates that an asset purchase remains a covered transaction for a member bank for as long as the bank holds the asset, and that the value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with GAAP and are reflected on the bank’s financial statements.

The final rule, like the proposed rule, also clarifies that certain asset purchases by a member bank from an affiliate are not valued in accordance with the general asset purchase valuation formula. First, if the member bank buys from one affiliate a loan to a second affiliate, the bank must value the transaction as a credit transaction with the second affiliate under section 223.21 of the final rule.<sup>118</sup> Second, if the member bank buys from one affiliate a security issued by a second affiliate, the bank must value the transaction as an investment in

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<sup>118</sup> The valuation rule for credit transactions is discussed above in part V.A. of this preamble.

securities issued by the second affiliate under section 223.23 of the final rule.<sup>119</sup> Third, if the member bank engages in a constructive asset purchase described in section 223.31 of the final rule, the bank must value the transaction under that section.<sup>120</sup>

The final rule (unlike the proposed rule) also sets forth a special valuation rule for a member bank's purchase of a line of credit or loan commitment from an affiliate. A member bank initially must value such asset purchases at the purchase price paid by the bank for the asset plus any additional amounts that the bank is obligated to provide under the credit facility.<sup>121</sup> The Board has crafted this special valuation rule to ensure that there are limits on the amount of risk a company can shift to an affiliated bank. Without the rule, a company would be able to transfer substantial amounts of unfunded obligations to an affiliated bank in a manner that barely affected the bank's quantitative limits under section 23A.

Under the regulation, in contrast with credit transactions, an asset purchase from a nonaffiliate that later becomes an affiliate generally does not become a covered transaction for the purchasing member bank. If a member bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank, however, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the member bank must ensure that the aggregate amount of the bank's covered transactions (including any such asset purchase from the nonaffiliate) would not exceed the quantitative limits of section 23A at the time the nonaffiliate becomes an affiliate.

The regulation provides several examples designed to assist member banks in valuing purchases of assets from an affiliate.

Several commenters requested confirmation that if a bank receives an encumbered asset from an affiliate, it is not forever a covered transaction in the amount of the encumbrance. The Board has modified an example in the regulation to clarify that a member bank's receipt of an encumbered asset from an affiliate ceases to be a covered transaction when, for example, the bank sells the asset.

#### C. Purchases of and investments in securities issued by an affiliate (§ 223.23)

Section 23A includes as a covered transaction a member bank's purchase of, or investment in, securities issued by an affiliate. Proposed Regulation W required a member bank to value a purchase of, or investment in, securities issued by an affiliate (other than a

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<sup>119</sup> The purchase by a member bank of a security issued by an affiliate is discussed below in part V.C. of this preamble.

<sup>120</sup> These transactions are discussed below in part VI.A. of this preamble.

<sup>121</sup> A member bank would not be required to include unfunded, but committed, amounts in the value of the covered transaction if (i) the credit facility being transferred from the affiliate to the bank is unconditionally cancelable (without cause) at any time by the bank; and (ii) the bank makes a separate credit decision before each drawing under the facility.

financial subsidiary of the bank)<sup>122</sup> at the greater of the bank's purchase price or carrying value of the securities.<sup>123</sup> Under the rule, a member bank that paid no consideration in exchange for affiliate securities would nevertheless have to value the covered transaction at no less than the bank's carrying value of the securities.<sup>124</sup> In addition, under the rule, if the member bank's carrying value of the affiliate securities increased or decreased after the bank's initial investment (due to profits or losses at the affiliate), the amount of the bank's covered transaction would increase or decrease to reflect the bank's changing financial exposure to the affiliate, but could not decline below the amount paid by the bank for the securities.

A number of commenters objected to this valuation formula and offered alternatives. Several commenters argued that investments in an affiliate's securities should be valued at the lower of purchase price or carrying value. Under this formula, a contribution of affiliate securities to a bank would be valued at zero, and the bank would be permitted without limit to reduce the covered transaction amount for a purchase of affiliate securities as the value of the securities declined. These commenters justified their formula's treatment of bank investments in a declining affiliate by pointing out that a bank's capital would be reduced to reflect the decline in value of the affiliate's securities and by noting that their approach more accurately reflects the bank's actual remaining financial exposure to the affiliate.

Under the commenters' proposed formula, a bank's section 23A value for an investment in affiliate securities also would not increase as the value of the securities increased. These commenters argued that an increase in the value of an investment does not create additional risk of loss for the investor and that there is no justification for restricting section 23A lending as an affiliate increases in financial strength. One of these commenters contended that the proposed regulation's valuation rule is inconsistent in increasing the section 23A value of an investment as the affiliate prospers but not decreasing the section 23A value of the investment as the affiliate declines.

Other commenters argued that investments in an affiliate's securities always should be valued at the purchase price or, at a minimum, that a contribution of affiliate securities initially should be valued at zero.

The Board has determined to adopt the valuation rule contained in the proposed regulation. The Board continues to believe that several important considerations support the general carrying value approach of this valuation rule. First, the approach is consistent with GAAP, which would require a bank to reflect its investment in securities issued by an affiliate at carrying value throughout the life of the investment, even if the bank paid no consideration

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<sup>122</sup> The valuation rule for investments in securities issued by a financial subsidiary is discussed below in part VI.B.2. of this preamble.

<sup>123</sup> Staff traditionally advised member banks to value a purchase of securities issued by an affiliate at the purchase price paid by the bank for the securities.

<sup>124</sup> Carrying value refers to the amount at which the securities are carried on the GAAP financial statements of the member bank.

for the securities. Second, the approach is supported by the terms of the statute, which defines both a “purchase of” and an “investment in” securities issued by an affiliate as a covered transaction. The statute’s “investment in” language indicates that Congress was concerned with a member bank’s continuing exposure to an affiliate through an ongoing investment in the affiliate’s securities.

Third, amendments to section 23A made by the GLB Act support the approach. The GLB Act defines a financial subsidiary of a bank as an affiliate of the bank, but specifically provides that the section 23A value of a bank’s investment in securities issued by a financial subsidiary does not include retained earnings of the subsidiary. The negative implication from this provision is that the section 23A value of a bank’s investment in other affiliates includes the affiliates’ retained earnings, which would be reflected in the bank’s carrying value of the investment under the rule.

Finally, the carrying value approach is consistent with the purposes of section 23A -- limiting the financial exposure of banks to their affiliates and promoting safety and soundness. The valuation rule requires a member bank to revalue upwards the amount of an investment in affiliate securities only when the bank’s exposure to the affiliate increases (as reflected on the bank’s financial statements) and the bank’s capital increases to reflect the higher value of the investment. In these circumstances, the valuation rule merely reflects the member bank’s greater financial exposure to the affiliate and enhances safety and soundness by reducing the bank’s ability to engage in additional transactions with an affiliate as the bank’s exposure to that affiliate increases.

As noted above, this valuation rule also provides that the covered transaction amount of a member bank’s investment in affiliate securities can be no less than the purchase price paid by the bank for the securities, even if the carrying value of the securities declines below the purchase price. Although this aspect of the valuation rule is not consistent with GAAP, using the member bank’s purchase price for the securities as a floor for valuing the covered transaction is appropriate for several reasons. First, it ensures that the amount of the covered transaction never falls below the amount of funds actually transferred by the member bank to the affiliate in connection with the investment. In addition, the purchase price floor limits the ability of a member bank to provide additional funding to an affiliate as the affiliate approaches insolvency. If the regulation were to value investments in securities issued by an affiliate strictly at carrying value, then the member bank could lend more funds to the affiliate as the affiliate’s financial condition worsened. As the affiliate declined, the member bank’s carrying value of the affiliate’s securities would decline, the section 23A value of the bank’s investment likely would decline, and, consequently, the bank would be able to provide additional funding to the affiliate under section 23A. This type of increasing support for an affiliate in distress is precisely what section 23A was intended to restrict.

The regulation provides several examples designed to assist member banks in valuing purchases of and investments in securities issued by an affiliate.

D. Posting securities issued by an affiliate as collateral (§ 223.24)

1. General valuation rule (§ 223.24(a) and (b))

Section 23A defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company.<sup>125</sup> This type of covered transaction has two classes: one in which the only collateral for the loan is affiliate securities; and another in which the loan is secured by a combination of affiliate securities and other collateral. Section 23A does not explain how these different types of covered transactions should be valued for purposes of determining compliance with the quantitative limits of the statute.

As a general rule, Regulation W values covered transactions of the first class, where the credit extension is secured exclusively by affiliate securities, at the full amount of the extension of credit. This approach reflects the difficulty of measuring the actual value of typically untraded and illiquid affiliate securities, and conservatively assumes that the value of the securities is equal to the full value of the loan that the securities collateralize. This position also reflects the traditional advice given by Board staff on this issue. Regulation W contains an exception to the general rule where the affiliate securities held as collateral have a ready market. In that case, the transaction may be valued at the fair market value of the affiliate securities. The exception grants relief from staff's traditional position in those circumstances where the value of the affiliate securities is independently verifiable by reference to transactions occurring in a liquid market.<sup>126</sup>

Regulation W values covered transactions of the second class, where the credit extension is secured by affiliate securities and other collateral, at the lesser of (i) the total value of the extension of credit minus the fair market value of the other collateral or (ii) the fair market value of the affiliate securities (if the securities have a ready market). Until 1999, staff advised member banks to value this class of covered transactions at the total amount of the

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<sup>125</sup> 12 U.S.C. 371c(b)(7)(D). This covered transaction only arises when the member bank's loan is to a nonaffiliate. Under section 23A, the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. See 12 U.S.C. 371c(c)(4). Moreover, if the proceeds of a loan that is secured by an affiliate's securities are transferred to an affiliate by the unaffiliated borrower (for example, to purchase assets or securities from the inventory of an affiliate), the loan should be treated as a loan to the affiliate. The loan must then be secured with collateral in an amount and of a type that meets the requirements of section 23A for loans by a member bank to an affiliate.

<sup>126</sup> In either case, the transaction must comply with section 23B; that is, the member bank must obtain the same amount of affiliate securities as collateral on the credit extension that the bank would obtain if the collateral were not affiliate securities.

extension of credit. In January 1999, the staff modified its position on mixed collateral loans to permit member banks to value these transactions in a manner similar to the rule.<sup>127</sup>

The Board believes that where a loan is secured by securities of an affiliate and other collateral, it is reasonable to reflect the fair market value of the other collateral in determining whether, and to what extent, the loan should count toward the member bank's section 23A quantitative limits. Under the rule's method of calculation for mixed-collateral loans, if a loan is fully secured by nonaffiliate collateral with a fair market value that equals or exceeds the loan amount, then the loan would not be included in the member bank's quantitative limits for purposes of section 23A.<sup>128</sup> If the loan is not fully secured by other collateral, then the maximum amount that the member bank must count against its quantitative limits is the difference between the full amount of the loan and the fair market value of the nonaffiliate collateral.

The approach taken in Regulation W, however, is different from that of the 1999 interpretation in two respects. First, although the 1999 interpretation allowed member banks to use the fair market value of the affiliate securities as an upper limit on the value of the transaction regardless of the liquidity of the affiliate securities, the regulation only allows member banks to use the value of the affiliate securities as an upper limit if the affiliate securities have a ready market. The Board is concerned that a member bank could understate the market value of affiliate securities that do not have a ready market in order to shrink the size of the covered transaction. Second, the regulation's ready market requirement replaces an implicit condition of the 1999 interpretation that only a small amount of the total collateral could be affiliate securities. The valuation rule in Regulation W applies regardless of the amount of affiliate collateral.<sup>129</sup>

Commenters did not criticize the proposed rule's general valuation formulas for these covered transactions, and the general formulas contained in the final rule are substantially identical to those in the proposal. Commenters did, however, suggest several new exemptions for this type of covered transaction: (i) transactions in which the affiliate securities serving as

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<sup>127</sup> See Letter dated January 21, 1999, from J. Virgil Mattingly, Jr., General Counsel of the Board, to Bruce Moland. This letter set forth an opinion of Board staff that, for purposes of applying the quantitative limits in section 23A, such mixed-collateral loans should be valued at the lesser of (i) the total amount of the loan less the fair market value of nonaffiliate collateral (if any) or (ii) the fair market value of the affiliate's securities that are used as collateral.

<sup>128</sup> The Board notes, however, that section 23A requires a loan by a member bank that is secured with any amount of an affiliate's securities to be consistent with safe and sound banking practices. 12 U.S.C. 371c(a)(4).

<sup>129</sup> One commenter asked for clarification that a member bank may use the higher of the two valuation options for these transactions if, for example, the bank does not have the procedures and systems in place to verify the fair market value of affiliate securities. The Board has adjusted the language of the rule to clarify that a member bank may choose to use the higher valuation option.

collateral meet the (d)(6) exemption and (ii) transactions in which the affiliate securities serving as collateral represent less than 50 percent of the total collateral. The final rule does not include either of these suggested exemptions. In the Board's view, a loan by a member bank that is secured by affiliate securities could be used to provide indirect financing to an affiliate and exposes the bank (albeit secondarily) to the credit risk of an affiliate regardless of whether the affiliate securities are traded in a liquid market or constitute a minority of the total collateral for the loan.

2. Exemption for shares issued by an affiliated mutual fund (§ 223.24(c))

In connection with the proposed rule, the Board specifically sought comment on whether to exempt from section 23A loans to third parties secured by affiliate-issued mutual fund shares. A large number of commenters advocated granting this exemption and offered the following principal arguments in support of their position: (i) the bank is not funding an affiliate in these transactions; (ii) although section 23A includes as a covered transaction a loan to a third party collateralized by affiliate securities, the purpose of including this covered transaction was to prevent evasion, and evasion is implausible when the collateral taken by the bank is affiliate-issued mutual funds; (iii) tracking these loans can be very burdensome as many of the loans are small and the value of the mutual fund collateral changes daily; (iv) the assets of an affiliated mutual fund generally are shares of nonaffiliates, which could otherwise serve as collateral for the loan without creating a covered transaction under section 23A; and (v) mutual funds are highly regulated, their shares are highly liquid and can only be purchased at their daily net asset value, and mutual funds are required by law to have boards of directors that are largely independent of the bank and its affiliates.

In the proposal, the Board asked for comment on five potential conditions to the availability of this exemption: (i) the borrower does not use the proceeds of the loan to purchase shares of the affiliated mutual fund; (ii) the borrower is not an executive officer of the member bank or its affiliates; (iii) the price of the mutual fund shares is quoted routinely in a widely disseminated news source; (iv) the shares of the mutual fund are widely held by the public; and (v) the member bank and its affiliates do not own in the aggregate more than 5 percent of the shares of the mutual fund. A few commenters recommended that the Board drop all five of these conditions. Other commenters specifically endorsed or specifically objected to particular conditions.

One commenter supported the use of proceeds condition, but other commenters objected to the condition because the use of loan proceeds is hard to monitor and control. Several commenters expressed opposition to the executive officer condition. Many of them noted that Regulation O already comprehensively regulates bank lending to executive officers. A number of other commenters expressed a willingness to support the condition if it were modified to cover only executive officers that are subject to Regulation O restrictions.

A few commenters supported the pricing mechanism condition. One commenter opposed the condition on the grounds that major newspapers only report on large mutual funds, and even small mutual funds are liquid (and must redeem shares upon request at all times) and have prices quoted on internet sites and in other news sources. Several commenters asked the Board to widen this condition to explicitly permit mutual fund price quotes to be obtained from



Morningstar, Lipper, Bloomberg, fund supermarket websites, or any other unaffiliated, real-time, electronic pricing system.

Some commenters expressly supported the widely held condition. Several other commenters criticized the condition. These commenters noted that the daily redemption requirement to which mutual funds are subject should satisfy any liquidity concerns that the Board may have. They advised that concentrated ownership of a fund would not adversely impact the fund's liquidity or the reliability of pricing information.

One commenter supported the 5 percent ownership limit condition. Many commenters opposed the condition, largely because of its purported redundancy on the widely held condition. Some of these commenters asked the Board to replace the 5 percent condition with a "no control" condition.

The Board has decided to include in the final rule an exemption for extensions of credit by a member bank that are secured by shares of an affiliated mutual fund. To qualify for the exemption, the transaction must meet several conditions. First, to ensure that the affiliate collateral is liquid and trades at a fair price, the affiliated mutual fund must be an open-end investment company that is registered with the SEC under the 1940 Act. Second, to ensure that the member bank can easily establish and monitor the value of the affiliate collateral, the affiliated mutual fund's shares serving as collateral for the extension of credit must have a publicly available market price. Third, to reduce the member bank's incentives to use these extensions of credit as a mechanism to support the affiliated mutual fund, the member bank and its affiliates must not own more than 5 percent of the fund's shares (excluding certain shares held in a fiduciary capacity). Finally, the proceeds of the extension of credit must not be used to purchase the affiliated mutual fund's shares serving as collateral or otherwise used to benefit an affiliate. In such circumstances, the member bank's extension of credit would be covered by section 23A's attribution rule.

Instead of creating a separate exemption for these transactions in subpart E of the rule, the Board has decided to effect this exemption by adjusting the valuation rule for extensions of credit secured by affiliate-issued securities. Inserting the exemption into the valuation rule for this type of covered transaction will enable users of the regulation to determine more easily the non-exempt covered transaction amount for loans secured in part by affiliate-issued securities and in part by other collateral. The final rule effects the exemption by providing that an affiliated mutual fund's shares that meet the above-mentioned criteria do not count as affiliate-issued securities for purposes of the valuation rule for extensions of credit secured by affiliate-issued securities.

## VI. Other Requirements under Section 23A--Subpart D

Subpart D of the rule provides guidance to banking organizations on three issues under section 23A: (i) merger and acquisition transactions between a member bank and an affiliate; (ii) financial subsidiaries of a member bank; and (iii) derivative transactions between a member bank and an affiliate.

A. Merger and acquisition transactions between a member bank and an affiliate  
(§ 223.31)

1. The general rule (§ 223.31(a-c))

As noted above, section 23A includes a member bank's purchase of assets from an affiliate and a member bank's purchase of, or investment in, securities issued by an affiliate within the definition of covered transaction. In the past, the Board has been required to apply these provisions to transactions where a member bank directly or indirectly acquires an affiliate. There are three principal methods by which a member bank acquires an affiliate. The first method is where a member bank directly purchases or otherwise acquires the affiliate's assets and assumes the affiliate's liabilities. In this case, the transaction is treated as a purchase of assets, and the covered transaction amount is equal to the amount of any separate consideration paid by the member bank for the affiliate's assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.

The second method is where a member bank acquires an affiliate by merger. Because a merger with an affiliate generally results in the member bank acquiring all the assets of the affiliate and assuming all the liabilities of the affiliate, this transaction is effectively equivalent to the purchase and assumption transaction described in the previous paragraph. Accordingly, the merger transaction also is treated as a purchase of assets, and the covered transaction amount is again equal to the amount of any separate consideration paid by the member bank for the affiliate's assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.<sup>130</sup>

The third method involves the contribution or sale of a controlling block of an affiliate's shares to a member bank. The Board previously has treated these transactions as a purchase of assets covered by section 23A if the member bank paid consideration for the shares or the affiliate whose shares were contributed to the member bank had liabilities to any affiliate of the bank.<sup>131</sup>

The proposed rule did not alter the treatment of the first two types of transaction described above. The proposed rule did set forth, however, a new treatment for the third type of transaction. The proposed rule provided that the acquisition by a member bank of securities

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<sup>130</sup> As noted above, section 223.3(dd) of the final rule makes explicit the Board's view that these merger transactions generally involve the purchase of assets by a member bank from an affiliate.

<sup>131</sup> See, e.g., Letter dated June 11, 1999, from Robert deV. Frierson, Associate Secretary of the Board, to Mr. Robert L. Anderson. The Board adopted this view of these internal reorganizations principally because the transactions often were motivated by funding problems at the transferred affiliate or the member bank's parent holding company and by a desire to use the bank's resources to alleviate those funding needs. Soon after consummating such reorganizations, bank funds typically were used to pay down liabilities that the transferred company had to the parent holding company of the member bank.

issued by a company that was an affiliate of the bank before the acquisition is treated as a purchase of assets from an affiliate if (i) as a result of the transaction, the company becomes an operating subsidiary of the bank; and (ii) the company has liabilities, or the bank gives cash or any other consideration in exchange for the securities. The proposed rule also provided that these transactions must be valued initially at the sum of (i) the total amount of consideration given by the member bank in exchange for the securities; and (ii) the total liabilities of the company whose securities have been acquired by the member bank. In effect, the proposed rule required member banks to treat such share donations and purchases in the same manner as if the member bank had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company (plus any separate consideration paid by the bank for the shares).

A number of commenters objected to this approach. Many of them complained that the approach would prevent banks from efficiently reorganizing their operations and, therefore, would put BHCs at a competitive disadvantage to other less regulated companies. These commenters also contended that the approach ignores the reality of the corporate limited liability shield.

Some of these commenters simply asserted that the rule should not treat a donation of shares as a covered transaction because the bank is obtaining an asset (shares) at no cost. Other commenters offered a variety of alternative formulas for valuing these transactions. The principal alternatives offered were to value these covered transactions at (i) the purchase price paid by the bank for the shares plus any liabilities of the transferred company minus the value of the assets of the transferred company (as verified by an independent third party); (ii) the purchase price paid by the bank for the shares; (iii) the GAAP net worth of the transferred company; or (iv) the purchase price paid by the bank for the shares plus any liabilities owed by the transferred company to affiliates of the bank (staff's traditional approach).

For the following reasons, the Board is adopting a valuation rule for these transactions that is substantially identical to the formula set forth in the proposed rule.<sup>132</sup> Regulation W's treatment of these transactions is consistent with the approach that section 23A takes on subsidiaries of member banks and with economic and marketplace realities. Section 23A treats

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<sup>132</sup> The final rule differs from the proposed rule in one small respect. The final rule explicitly addresses situations in which the assets of the transferred company include securities issued by an affiliate, extensions of credit to an affiliate, or other covered transactions. In these situations, the final rule clarifies that a member bank initially must value these transactions at the greater of (i) the purchase price paid by the bank for the shares of the transferred company plus the total liabilities of the transferred company; or (ii) the total value of all covered transactions acquired by the bank as a result of the transaction. For example, assume the transferred company has \$100 of assets (\$25 of which are loans to an affiliate) and \$40 of liabilities. Upon donation of the company's shares to the member bank, the bank would have a \$40 covered transaction. If \$45 of the transferred company's assets are loans to an affiliate, however, the member bank would have a \$45 covered transaction upon donation of the company's shares to the bank.

member banks and their operating subsidiaries as a single unit. Transactions between a member bank and its operating subsidiaries are not treated as covered transactions between a member bank and an affiliate under section 23A; rather, they are treated as transactions entirely inside the member bank. Similarly, a transaction between a member bank's operating subsidiary and an affiliate of the member bank is treated as a covered transaction between the member bank itself and an affiliate under section 23A. Ignoring the separate corporate form of operating subsidiaries of member banks and treating the assets and liabilities of operating subsidiaries of member banks as assets and liabilities of the member bank itself is, therefore, consistent with the structure of section 23A. Accordingly, under section 23A, these share transfers in which an affiliate of a member bank becomes an operating subsidiary of the bank are properly viewed as a purchase of an affiliate's assets and an assumption of an affiliate's liabilities by the bank.<sup>133</sup>

Regulation W's treatment of affiliate share transfers is also consistent with the Board's supervisory experience. The Board has found that banks often operate their consolidated organizations -- because of capital requirements, financial reporting requirements, and reputational risk concerns -- as if the assets and liabilities of subsidiaries were assets and liabilities of the bank itself. Banks often attempt to shore up their subsidiaries in times of financial stress, despite the limited liability inhering in the corporate form. Accordingly, the rule treats the assets and liabilities of an operating subsidiary of a member bank as assets and liabilities of the bank itself for purposes of section 23A.<sup>134</sup>

The rule only imposes asset purchase treatment on affiliate share transfers where the company whose shares are being transferred to the member bank was an affiliate of the bank before the transfer. If the transferred company were not an affiliate before the transfer, it would not be appropriate to treat the share transfer as a purchase of assets from an affiliate. Similarly, the rule only requires asset purchase treatment for affiliate share transfers where the transferred company becomes a subsidiary and not an affiliate of the member bank through the transfer. If the transferred company were not a subsidiary of the member bank after the transfer (because, for example, the bank acquired less than 25 percent of a class of voting securities of the company) or if the company were an affiliate of the member bank after the transfer (because, for example, the bank's holding company continued to own 25 percent or more of a class of voting securities of the company or because the company became a financial

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<sup>133</sup> One commenter contended that the rule's approach to these reorganization transactions unfairly counts 100 percent of the liabilities of the transferred company even if only 25 percent of the shares of the company are transferred. As noted above, this outcome is consistent with the structure of section 23A, which treats 25-percent-owned operating subsidiaries as part of the member bank itself.

<sup>134</sup> Because a member bank usually can merge a subsidiary into itself, transferring all the shares of an affiliate to a member bank often is functionally equivalent to a transaction in which the bank directly acquires the assets and assumes the liabilities of the affiliate. As noted above, in a direct acquisition of assets and assumption of liabilities, the covered transaction amount would be equal to the total amount of liabilities assumed by the member bank.

subsidiary of the bank after the transfer), the Board does not believe it would be appropriate to treat the liabilities of the company as the liabilities of the bank for purposes of section 23A. In those circumstances, section 23A would not treat the member bank and the transferred company as a single unit.

One commenter speculated that this approach to affiliate share transfers would create an eternal covered transaction. Under the rule, affiliate share transfers are deemed to be an asset purchase by the member bank from an affiliate and would diminish over time in the same manner as any other asset purchase. That is, the amount of the covered transaction would decline over time as the assets of the transferred company were sold or amortized. The amount of the covered transaction would not decline over time, however, as the member bank paid off the liabilities of the transferred company. A valuation example in the final rule will help to explain how the covered transaction amount of these affiliate share transfers winds down over time.

Another commenter asked the Board to clarify that a BHC could reduce the covered transaction amount for an affiliate share transfer by making a cash contribution to the transferee bank in the amount of the liabilities of the transferred company. The Board agrees that an affiliate share transfer would not be a covered transaction if, in addition to receiving the affiliate shares, the transferee member bank received a cash contribution equal to the amount of the liabilities of the transferred company. In this situation, the member bank should not be deemed to have “purchased” the assets of the transferred company.

The Board notes that a member bank that proposes to purchase assets from an affiliate as part of an internal corporate reorganization of a banking organization (including in a transaction that is treated as a purchase of assets under section 223.31 of the rule) may qualify for a regulatory or case-by-case exemption from section 23A. Section 223.41(d) of the final rule sets forth a general regulatory exemption for these covered transactions, and part VII.C. of this preamble discusses both the general regulatory exemption and the Board’s practice of granting case-by-case exemptions for these covered transactions. In addition, section 223.31(d) of the final rule, which is discussed in the following section of the preamble, provides an exemption for certain step transactions that are treated as asset purchases under section 223.31(a) of the rule.

## 2. Step transaction exemption (§ 223.31(d-e))

The proposed regulation also contained a regulatory exemption for certain merger and acquisition transactions that result in the transfer of an affiliate to a member bank. Section 223.31(d) of the proposed rule provided an exemption from the requirements of section 23A (other than the safety and soundness requirement) for transactions in which, for example, a BHC acquires the stock of an unaffiliated company and, immediately after consummation of the acquisition, transfers the shares of the acquired company to the holding company’s subsidiary member bank. Although these transactions technically would be treated as an asset purchase by a member bank from an affiliate -- and the member bank would be required to value the covered transaction at the total amount of the liabilities of the acquired company (plus any separate consideration paid by the bank for the company) -- the Board believed that it would be inappropriate to require a member bank to count these transactions

toward its section 23A quantitative limits. If the member bank had acquired the target company directly, there would have been no covered transaction, and the mere fact that the bank's holding company owned the target company for a moment in time does not change the fundamental nature of the transaction.

Consequently, the proposed regulation exempted these "step" transactions under certain conditions. First, the member bank had to acquire the target company immediately after the company became an affiliate (by being acquired by the bank's holding company, for example). Second, the member bank had to acquire the entire ownership position in the target company that its holding company acquired. Finally, the entire transaction had to comply with the market terms requirement of section 23B.

Many commenters objected to the immediate transfer requirement, mostly on the basis that a BHC may want to hold the target company at the holding company level for some time for tax, business line integration, or regulatory approval reasons. Some commenters advised that the immediate transfer requirement could be replaced with a requirement that the target company be acquired by the BHC "in contemplation of" being put under the bank. Other commenters recommended that the immediate transfer requirement be replaced with a 3-month, 6-month, or 1-year requirement.

As noted in the preamble to the proposed rule, to the extent that the member bank acquires the target company some time after the company becomes an affiliate, the transaction looks less like a single transaction in which the bank acquires the target company and more like two separate transactions, the latter of which involves the bank acquiring assets from an affiliate. Nevertheless, in order to provide banking organizations with a reasonable amount of time to address legal, tax, and business issues relating to an acquisition, the Board has decided to permit member banks to avail themselves of the step transaction exemption if they acquire the target company within three months after the target company becomes an affiliate (so long as the appropriate Federal banking agency for the bank has approved the longer time period). To protect the transferee member bank from a decline in the financial condition or asset quality of the target company during the time that the acquired company is an affiliate of the bank, the final rule adds two conditions to the applicability of the step transaction exemption. First, a member bank must notify its appropriate Federal banking agency and the Board, at or before the time that the target company becomes an affiliate of the bank, of its intent ultimately to acquire the target company. Second, there must be no material change in the business or financial condition of the target company during the time between when the company becomes an affiliate of the member bank and the bank's receipt of the company.

Several commenters also objected to the "bank must acquire all of the target company" requirement. These commenters alleged that there are legitimate business, regulatory, and tax reasons to distribute a target company's assets and subsidiaries to various bank and nonbank subsidiaries of the holding company. Some of these commenters advocated replacing the 100 percent requirement with a 25-50 percent requirement. The Board has decided to keep the 100 percent requirement in order to prevent a holding company from keeping the good subsidiaries of the target company and transferring the bad subsidiaries of the target company to the holding company's subsidiary member bank.

Of course, if a banking organization fails to meet the terms of the step transaction exemption, the organization may be able to satisfy the conditions of Regulation W's internal corporate reorganization exemption or may be able to obtain a case-by-case exemption from the Board.

B. Financial subsidiaries (§ 223.32)

As noted above, the GLB Act amended section 23A to treat a financial subsidiary of a bank as an affiliate of the bank and to establish several special rules that apply to transactions with financial subsidiaries. The regulation combines all of the special rules that apply to transactions with financial subsidiaries in a single section.

1. Applicability of the 10 percent quantitative limit to transactions with a financial subsidiary (§ 223.32(a))

First, consistent with the GLB Act, the regulation provides that the 10 percent quantitative limit in section 23A does not apply with respect to covered transactions between a member bank and any individual financial subsidiary of the bank. Accordingly, a member bank's aggregate amount of covered transactions with any individual financial subsidiary of the bank may exceed 10 percent of the bank's capital stock and surplus.<sup>135</sup> A member bank's covered transactions with its financial subsidiaries, however, are subject to the 20 percent quantitative limit in section 23A. Thus, a member bank may not engage in a covered transaction with any affiliate (including a financial subsidiary) if the bank's aggregate amount of covered transactions with all affiliates (including financial subsidiaries) would exceed 20 percent of the bank's capital stock and surplus.

The Board notes that the exemption from the 10 percent limit for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in the financial subsidiary of an affiliated depository institution. Although the financial subsidiary of an affiliated depository institution is an affiliate of the member bank for purposes of sections 23A and 23B, the GLB Act states that only "covered transactions between a bank and any individual financial subsidiary of the bank" are not subject to the 10 percent limit in section 23A.<sup>136</sup> Accordingly, a member bank may not engage in a covered transaction with the financial subsidiary of an affiliated depository institution if the aggregate amount of the member bank's covered transactions with that financial subsidiary would exceed 10 percent of the bank's capital stock and surplus.

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<sup>135</sup> As noted above, in response to the request of a commenter, section 223.11 of the final rule also indicates that covered transactions between a member bank and its financial subsidiary are exempt from the 10 percent limit.

<sup>136</sup> 12 U.S.C. 371c(e)(3)(A) (emphasis added).

2. Valuation of investments in securities issued by a financial subsidiary (§ 223.32(b))

Because financial subsidiaries of a member bank are considered affiliates of the bank for purposes of section 23A, a member bank's purchases of and investments in the securities of its financial subsidiary are covered transactions under the statute. The GLB Act further provides that a member bank's investment in its own financial subsidiary, for purposes of section 23A, shall not include the retained earnings of the financial subsidiary.<sup>137</sup> In light of this statutory provision, the regulation contains a special valuation rule for investments by a member bank in the securities of its own financial subsidiary.<sup>138</sup> Such investments must be valued at the greater of (i) the price paid by the member bank for the securities; or (ii) the carrying value of the securities on the financial statements of the member bank (determined in accordance with GAAP but without reflecting the bank's pro rata share of any earnings retained or losses incurred by the financial subsidiary after the bank's acquisition of the securities).<sup>139</sup>

This valuation rule differs from the general valuation rule for investments in securities issued by an affiliate only in that the financial subsidiary rule requires, consistent with the GLB Act, that the carrying value of the investment be computed without consideration of the retained earnings or losses of the financial subsidiary since the time of the member bank's investment. As a result of this rule, the covered transaction amount for a member bank's investment in securities issued by its financial subsidiary generally would not increase after it was made except in the event that the member bank made an additional capital contribution to the subsidiary or purchased additional securities of the subsidiary.

The regulation provides several examples designed to assist member banks in valuing investments in securities issued by a financial subsidiary.

One commenter criticized this valuation rule and asserted that a donation of shares of a financial subsidiary to a bank should never have a section 23A value. For the reasons discussed above in part V.C. of this preamble, the Board does not believe that such an approach to valuation would be consistent with the purposes and structure of section 23A.

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<sup>137</sup> GLB Act § 121(b)(1) (codified at 12 U.S.C. 371c(e)(3)(B)).

<sup>138</sup> Consistent with the GLB Act, the special valuation formula in Regulation W for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in a financial subsidiary of an affiliated depository institution. Such investments must be valued using the general valuation formula set forth in section 223.23 of the final rule for investments in securities issued by an affiliate and, further, may trigger the anti-evasion rule contained in section 223.32(c)(1) of the rule.

<sup>139</sup> The regulation also makes clear that if a financial subsidiary is consolidated with its parent member bank under GAAP, the carrying value of the bank's investment in the financial subsidiary shall be determined based on parent-only financial statements of the bank.



3. Anti-evasion rules (§ 223.32(c))

Section 23A generally applies only to transactions between a member bank and an affiliate of the bank and transactions between a member bank and a third party where some benefit of the transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. The GLB Act establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a member bank and another affiliate of the bank.<sup>140</sup> First, the GLB Act provides that any purchase of, or investment in, securities issued by a member bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem an extension of credit made by a member bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasions of the Federal Reserve Act or the GLB Act. The regulation incorporates both of these provisions.

In the proposed regulation, the Board exercised its authority under the second anti-evasion rule by stating that an extension of credit to a financial subsidiary of a member bank by an affiliate of the bank would be treated as an extension of credit by the bank itself to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. An example of the kind of credit extension covered by this provision would be a subordinated loan to a financial subsidiary that is a securities broker-dealer where the loan is treated as capital of the subsidiary under the SEC's net capital rules. Although several commenters opposed this provision of the proposed rule, and argued that it would impede a BHC's ability to serve as a source of strength for a subsidiary bank, the Board has decided to retain this provision in the final rule. The Board believes that treating such an extension of credit as a covered transaction is appropriate because the extension of credit by the affiliate has a similar effect on the subsidiary's regulatory capital as an equity investment by the affiliate, which is treated as a covered transaction by the terms of the GLB Act (as described above). The Board notes that the final rule generally does not prevent a BHC or other affiliate of a member bank from providing financial support to a financial subsidiary of the bank in the form of a senior or secured loan.

One commenter asked the Board to determine that loans from an affiliate to a financial subsidiary of a member bank that count as regulatory capital of the financial subsidiary are treated as investments in the equity securities of an affiliate rather than loans to an affiliate, or to otherwise exempt such transactions from the collateral requirements of section 23A. According to this commenter, such a determination would be consistent with the reason for extending the GLB Act's anti-evasion principle to cover these loans -- that the loans are equivalent to equity investments. The Board disagrees with this comment and believes that such loans by an affiliate to a member bank's financial subsidiary should be treated, consistent with the GLB Act's anti-evasion provisions, as if they were made by the member bank itself. If the member bank itself had made a subordinated loan counting as regulatory capital to its

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<sup>140</sup> GLB Act § 121(b)(1) (codified at 12 U.S.C. 371c(e)(4)).

financial subsidiary, the loan would be subject to the quantitative limits and collateral requirements of section 23A as an extension of credit. Accordingly, under the final rule, such a loan by an affiliate of the member bank to the financial subsidiary also would be subject to the quantitative limits and collateral requirements of section 23A as an extension of credit.

In addition, the proposed regulation provided an exception to the anti-evasion rules for transactions between a member bank's financial subsidiary and another affiliate if the other affiliate were itself a depository institution subject to section 23A. The exception would have avoided treating certain transactions as covered transactions both for the parent member bank of the financial subsidiary and for the other affiliated depository institution. After further analysis, the Board has decided to remove this proposed exception to the anti-evasion rule because the exception also would have allowed the financial subsidiary of a member bank to obtain funding from the entire banking organization in amounts that exceeded 20 percent of the parent bank's capital and surplus. Congress designed the anti-evasion rules to prevent a bank from funding its financial subsidiaries by paying dividends to its parent and having its parent, directly or indirectly, reinvest the funds into the financial subsidiary of the bank. The potential for such "round-tripping" exists whether or not the parent routes such funding flows to a subsidiary bank's financial subsidiary through a sister depository institution of the bank.

The Board may find certain other extensions of credit by an affiliate to a financial subsidiary to be covered transactions under section 23A on a case-by-case basis.

### C. Derivative Transactions (§ 223.33)

#### 1. Background

Derivative transactions between a bank and its affiliates generally arise either from the risk management needs of the bank or the affiliate. Transactions arising from the bank's needs typically arise when a bank enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract or is unable to hedge the risk directly because the bank is not authorized to hold the hedging asset. In order to manage the market risk, the bank may have an affiliate acquire the hedging asset. The bank would then do a "bridging" derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between a bank and its affiliate are affiliate-driven. A bank's affiliate may enter into an interest-rate or foreign-exchange derivative with the bank in order to accomplish the asset-liability management goals of the affiliate. For example, a BHC may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The BHC may then enter into a fixed-to-floating interest-rate swap with its subsidiary bank to reduce the holding company's interest-rate risk.

Banks and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. Banks and their affiliates often choose to use each other as their derivative counterparties, however, in order to maximize the profits of and manage risks within the consolidated financial group.

## 2. Actions already taken by the Board

As noted above, the GLB Act required the Board to adopt, by May 12, 2001, a final rule to address as covered transactions under section 23A the credit exposure arising from derivative transactions between member banks and their affiliates (“bank-affiliate derivatives”).<sup>141</sup> Determining the appropriate treatment for bank-affiliate derivatives under section 23A is a complex and important endeavor. In light of the complexities of the subject matter and in light of the statutory deadline in the GLB Act, the Board took the following two steps on May 11, 2001, to address under section 23A the credit exposure arising from bank-affiliate derivatives.

First, the Board published an interim final rule (concurrently with proposed Regulation W) that subjected bank-affiliate derivatives to the market terms requirement of section 23B. Accordingly, the interim rule required each member bank to (i) have in place credit limits on its derivatives exposure to affiliates that are at least as strict as the credit limits the bank imposes on unaffiliated companies that are engaged in similar businesses and are substantially equivalent in size and credit quality; (ii) monitor derivatives exposure to affiliates in a manner that is at least as rigorous as it uses to monitor derivatives exposure to comparable unaffiliated companies; and (iii) price, and require collateral in, derivative transactions with affiliates in a way that is at least as favorable to the bank as the way the bank prices, or requires collateral in, derivatives with comparable unaffiliated companies.

The interim rule also required, under section 23A, that a member bank establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from the bank’s derivative transactions with affiliates. The policies and procedures, at a minimum, had to provide for monitoring and controlling the credit exposure arising from the member bank’s derivative transactions with affiliates and ensuring that the bank’s derivative transactions with affiliates complied with section 23B. The interim final rule had a delayed effective date of January 1, 2002.

The second step that the Board took to address credit exposure on bank-affiliate derivatives under section 23A was to ask for public comment in the preamble to proposed Regulation W on a set of questions regarding the appropriate treatment of these transactions under section 23A, including whether to subject the transactions to the quantitative limits and collateral requirements of the statute. The preamble made clear that the Board would not take additional steps to address bank-affiliate derivatives without seeking further public comment on a concrete proposal.

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<sup>141</sup> At the time of enactment of the GLB Act, the Board had not ruled on whether derivatives between a member bank and an affiliate were covered transactions under section 23A or subject to the market terms requirement of section 23B. Although industry practice generally treated bank-affiliate derivatives as subject to section 23B, industry practice did not treat bank-affiliate derivatives as subject to section 23A.

### 3. Public comments

About 16 commenters wrote in support of the interim rule approach to bank-affiliate derivatives. One commenter argued, however, that the interim rule was ineffective and insufficiently detailed to satisfy the GLB Act requirement that the Board issue a final rule addressing bank-affiliate derivatives as covered transactions. Another commenter objected to the interim rule on a different ground, arguing that, as long as a BHC manages derivatives credit risk effectively, each subsidiary bank of the BHC should not be required to have separate policies and procedures on bank-affiliate derivatives.

Commenters uniformly argued against subjecting bank-affiliate derivatives to the quantitative limits and collateral requirements of section 23A. The principal arguments advanced by commenters were that (i) derivatives do not fit within any of the five categories of covered transaction in section 23A; (ii) section 23B and the well-developed risk management practices in the institutional derivatives market are sufficient protection to banks; (iii) derivatives generally are not entered into for funding purposes; and (iv) covering derivatives under section 23A would be burdensome and may reduce the ability of a banking organization to centralize its risk management in the unit(s) best able to bear the risk.

### 4. Current actions

The Board is not prepared at this time to subject credit exposure arising from bank-affiliate derivatives to all the requirements of section 23A. The Board continues to collect information regarding the derivatives practices of banks and believes that more time is needed to determine whether the general approach of the interim rule on bank-affiliate derivatives will suffice to prevent banks from incurring problematic levels of credit exposure to affiliates in these transactions.

Federal Reserve examiners recently conducted a limited survey of a number of large banking organizations to ascertain their compliance with the Board's interim rule on bank-affiliate derivatives.<sup>142</sup> The survey suggested that reliance on bank-designed policies and procedures, section 23B, and active examiner supervision to regulate bank-affiliate derivatives is appropriate and should be continued. The Board expects member banks to comply strictly with section 23B in their derivative transactions with affiliates. In this regard, the Board reminds member banks that section 23B requires a member bank to treat an affiliate no better than a similarly situated nonaffiliate. Section 23B generally does not allow a member bank to use with an affiliate the terms and conditions it uses with its most creditworthy unaffiliated customer (unless the bank can demonstrate that the affiliate is of comparable creditworthiness as the bank's most creditworthy unaffiliated customer). Instead, section 23B requires that an affiliate be treated comparably (with respect to terms, conditions, and credit limits) to the majority of third-party customers engaged in the same business, and having comparable credit quality and size, as the affiliate. Because a bank generally has the strongest credit rating

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<sup>142</sup> Federal Reserve examiners also surveyed these same banking organizations to assess their compliance with the Board's interim rule on intraday credit. The results of this survey are discussed below in part VII.L. of this preamble.

within a holding company, the Board generally would not expect an affiliate to obtain better terms and conditions from a member bank than the member bank receives from its major unaffiliated counterparties. In addition, the Board notes that market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a relatively small exposure threshold.

The Board also is taking two additional regulatory steps at this time to address bank-affiliate derivatives.

a. Covering derivatives that are the functional equivalent of a guarantee

First, the Board is incorporating into Regulation W the Board's previously expressed view that credit derivatives between a member bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or decline in value of, an obligation of an affiliate of the bank are covered transactions under section 23A. In the preamble to proposed Regulation W, the Board stated that such derivative transactions are guarantees by a member bank on behalf of an affiliate (and, hence, covered transactions) under section 23A.

A number of commenters discussed the appropriate treatment of these derivatives under section 23A. A few commenters supported treating these derivatives as a guarantee on behalf of an affiliate under section 23A. Several other commenters argued that the Board should not treat these derivatives as section 23A guarantees if the bank has hedged its exposure to the affiliate with a third party. Some commenters also expressed the view that the rule should not treat these derivatives as section 23A guarantees if the affiliate's obligations represent a small portion of the reference assets for the credit derivative.

The final Regulation W provides that these credit derivatives are covered transactions under section 23A and gives several examples.<sup>143</sup> Consistent with the Board's traditional views on hedging under section 23A, the rule does not allow a member bank to reduce its covered transaction amount for these derivatives to reflect hedging positions established by the bank with third parties. In addition, the Board does not agree with commenters that an exception to the rule should be created for a credit derivative in which affiliate obligations represent a small portion of the reference assets underlying the credit derivative. The Board intends to interpret this provision of the rule, however, so as to treat such a credit derivative as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the member bank.

b. Including the interim rule in Regulation W

Second, in order to consolidate all the Board's views on sections 23A and 23B into one place, the Board is incorporating the provisions of the separate interim final rule on bank-affiliate derivatives into Regulation W. Under Regulation W, therefore, each member bank that engages in bank-affiliate derivatives must (i) have policies and procedures to monitor and

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<sup>143</sup> In most instances, the covered transaction amount for such a credit derivative would be the notional principal amount of the derivative.

control the bank's credit exposure to affiliates in derivative transactions (including by imposing appropriate credit limits, mark-to-market requirements, and collateral requirements); and (ii) ensure that its derivative transactions with affiliates comply with section 23B.

#### 5. Future actions

The Board expects to issue, in the near future, a proposed rule that would invite public comment on how to treat as covered transactions under section 23A certain derivatives that are the functional equivalent of a loan by a member bank to an affiliate or the functional equivalent of an asset purchase by a member bank from an affiliate. Although the Board has not yet adopted a rule that explicitly addresses these types of derivatives under section 23A, the Board will treat as a covered transaction, as appropriate on a case-by-case basis, any derivative between a member bank and an affiliate that is entered into for the purpose of evading the requirements of section 23A.

### VII. Exemptions--Subpart E

Section 23A exempts several types of transactions from the statute's quantitative and collateral requirements and other types of transactions from the statute's quantitative, collateral, and low-quality asset requirements.<sup>144</sup> The regulation sets forth the statutory exemptions, clarifies certain of these exemptions, and exempts a number of additional types of transactions. The clarifications and additional exemptions are discussed below.

The Board reserves the right to revoke or modify any additional exemption granted by the Board in Regulation W if the Board finds that the exemption is resulting in unsafe or unsound banking practices. The Board also reserves the right to terminate the eligibility of a particular member bank to use any such exemption if the bank's use of the exemption is resulting in unsafe or unsound banking practices.

#### A. Sister-bank exemption (§ 223.41(a) and (b))

Section 23A(d)(1) exempts any transaction between a member bank and a "bank" if the member bank controls 80 percent or more of the voting securities of the bank, the bank controls 80 percent or more of the voting securities of the member bank, or a company controls 80 percent or more of the voting securities of both the member bank and the bank.<sup>145</sup> Section 23A states that the term "bank" includes "any State bank, national bank, banking association, and trust company," and other Federal law provides that an insured savings association should be treated as a "bank" for purposes of the sister-bank exemption.<sup>146</sup>

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<sup>144</sup> 12 U.S.C. 371c(d).

<sup>145</sup> The sister-bank exemption in section 23A does not allow a member bank to avoid any restrictions on sister-bank transactions that may apply to the bank under the prompt corrective action framework set forth in section 38 of the FDI Act (12 U.S.C. 1831o) and regulations adopted thereunder by the bank's appropriate Federal banking agency.

<sup>146</sup> 12 U.S.C. 371c(b)(5), 1468(a)(2).

Section 23A also provides the Board with authority to issue definitions consistent with the section as may be necessary to carry out the purposes of the section and to prevent evasions thereof.<sup>147</sup> In addition, the statute provides that covered transactions between sister banks must be consistent with safe and sound banking practices.<sup>148</sup>

The proposed rule clarified that the sister-bank exemption generally applies only to transactions between insured depository institutions. Although one commenter wrote in support of this restriction of the sister-bank exemption, many other commenters objected to this action. The protestants argued that restricting the sister-bank exemption to insured depository institutions is inconsistent with the statutory language and the primary purpose behind the exemption, which focused not on the insured status of the sister depository institutions but on the regulated status of the institutions. In addition, several of these commenters expressed the view that the Board does not have rulemaking authority to restrict the sister-bank exemption to insured depository institutions.

The final rule continues to restrict the availability of the sister-bank exemption to insured depository institutions.<sup>149</sup> In the view of the Board, this restriction is consistent with the legislative intent behind the exemption, which was to permit the flow of funds from one insured depository institution to another insured depository institution. In this regard, the Board notes that, under the cross-guarantee provisions of the FDI Act, an insured depository institution is generally liable for any loss incurred by the FDIC in connection with the default of a commonly controlled insured depository institution.<sup>150</sup> Moreover, without such an interpretation of the sister-bank exemption, a member bank would be able to engage in unlimited covered transactions with certain uninsured depository affiliates. Permitting a member bank to provide an unlimited amount of funding to an uninsured depository affiliate would facilitate an unsafe and unsound banking practice and would contravene one of the principal purposes of the statute -- protecting the deposit insurance funds from loss.<sup>151</sup>

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<sup>147</sup> 12 U.S.C. 371c(f)(1).

<sup>148</sup> 12 U.S.C. 371c(a)(4).

<sup>149</sup> For reasons of verbal economy, the final rule uses the term “depository institution” rather than “insured depository institution” to signify the set of institutions eligible for the sister-bank exemption (and for certain other purposes). The final rule defines “depository institution,” however, to mean an “insured depository institution” as defined in the FDI Act.

<sup>150</sup> See 12 U.S.C. 1815(e).

<sup>151</sup> As noted above, a member bank and its operating subsidiaries are considered a single unit for purposes of section 23A. Accordingly, under the statute and the regulation, transactions between a member bank (or its operating subsidiary) and the operating subsidiary of a sister insured depository institution generally qualify for the sister-bank exemption. A few commenters suggested that the proposed rule was ambiguous on this point. The Board has amended the final rule’s definition of “depository institution” to eliminate any such ambiguity.

A number of commenters contended that, if the final rule restricts the availability of the sister-bank exemption to insured depository institutions, the rule also should confirm that an uninsured depository institution subsidiary of a member bank would be considered an operating subsidiary (and not an affiliate) of the bank. According to these commenters, there is no compelling reason under section 23A to treat an uninsured depository institution subsidiary of a member bank any differently than other uninsured subsidiaries (for example, mortgage lending or investment advisory subsidiaries) of the bank. The Board agrees with this position and has revised the rule's definition of affiliate generally to exclude uninsured depository institution subsidiaries of a member bank. Accordingly, under the final rule, covered transactions between a member bank and a parent uninsured depository institution or a commonly controlled uninsured depository institution generally would be subject to section 23A whereas covered transactions between a member bank and a subsidiary uninsured depository institution would not be subject to section 23A.

B. Purchases of loans on a nonrecourse basis (§ 223.41(c))

Under section 23A(d)(6), a member bank may purchase loans on a nonrecourse basis from an affiliated "bank" exempt from section 23A, even if the transaction does not qualify for the sister-bank exemption.<sup>152</sup> The rule clarifies that the scope of this exemption parallels that of the sister-bank exemption by stating that this exemption applies only to a member bank's purchase of a loan from an affiliated insured depository institution.

Section 23A(d)(6) also exempts the purchase from an affiliate of assets that have a readily identifiable market quotation. This exemption is set forth separately in the regulation for purposes of clarity and is discussed in detail below in part VII.F. of this preamble.

C. Internal corporate reorganizations (§ 223.41(d))

The Board has granted numerous section 23A exemptions, on a case-by-case basis, for asset purchases by a bank from an affiliate that are part of a one-time internal corporate reorganization of a banking organization.<sup>153</sup> The Board typically has approved such exemptions only if certain conditions are met, including (i) the bank's parent holding company provides certain assurances concerning the quality of the transferred assets; (ii) the disinterested directors of the bank approve the transaction in advance; (iii) the transfer does not include any low-quality assets; and (iv) the bank's appropriate Federal banking agency and the FDIC inform the Board that they have no objection to the transaction.

Several commenters requested that the Board include such an exemption in the final rule, and the Board has done so. Under this exemption, a member bank would be permitted to purchase assets (other than low-quality assets) from an affiliate (including in connection

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<sup>152</sup> 12 U.S.C. 371c(d)(6).

<sup>153</sup> See, e.g., Travelers Group Inc. and Citicorp, 84 Federal Reserve Bulletin 985, 1013-14 (1998) and Letter dated November 14, 1996, from William W. Wiles, Secretary of the Board, to John Byam.



with an affiliate share transfer that section 223.31 of the rule treats as a purchase of assets) exempt from the quantitative limits of section 23A if the following conditions are met.

First, the asset purchase must be part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate. Stated another way, the asset purchase must not be part of a series of periodic, ordinary course asset transfers from an affiliate to a member bank. Second, the member bank's holding company must provide the Board with contemporaneous notice of the transaction and must commit to the Board to make the bank whole, for a period of two years, for any transferred assets that become low-quality assets.<sup>154</sup> Third, a majority of the member bank's directors must review and approve the transaction before consummation. Fourth, the section 23A value of the covered transaction must be less than 10 percent of the member bank's capital stock and surplus (or up to 25 percent of the bank's capital stock and surplus with the prior approval of the bank's appropriate Federal banking agency). Fifth, the member bank's holding company and all its subsidiary depository institutions must be well capitalized and well managed and must remain well capitalized upon consummation of the transaction.

Although these criteria are stricter than what the Board traditionally has applied in connection with its case-by-case exemptions for asset purchases, the heightened strictness is appropriate in exchange for the flexibility that the regulatory exemption grants member banks. Although the regulatory exemption would limit the Board's opportunity to block certain internal reorganizations of a banking company based on an ad hoc analysis of the condition of the bank or the nature or quality of the assets being transferred to the bank, the Board believes that the well-capitalized and well-managed requirements, the two-year buyback commitment, and the quantitative limit in the rule should prevent banking companies from abusing their banking units in reorganization transactions.

D. Correspondent banking (§ 223.42(a))

Section 23A exempts from its quantitative limits and collateral requirements any deposit by a member bank in an affiliated bank or affiliated foreign bank that is made in the ordinary course of correspondent business, subject to any restrictions that the Board may impose.<sup>155</sup> The final rule (like the proposed rule) further provides that such deposits must represent ongoing, working balances maintained by the member bank in the ordinary course of conducting the correspondent business. Although one commenter argued that the Board should eliminate this regulatory "ongoing, working balances" requirement, in the Board's view, an occasional deposit in an affiliated institution would not be in the ordinary course of correspondent business. Failure to impose this restriction on the correspondent banking

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<sup>154</sup> The notice also must describe the primary business activities of the affiliate whose shares or assets are being transferred to the member bank and must indicate the anticipated date of the reorganization.

<sup>155</sup> 12 U.S.C. 371c(d)(2).

exemption could enable member banks to abuse the exemption to provide one-off funding to an affiliated bank or foreign bank.<sup>156</sup>

Although not required by section 23A or HOLA, the final rule also provides that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

E. Secured credit transactions (§ 223.42(c))

Section 23A exempts any credit transaction by a member bank with an affiliate that is “fully secured” by U.S. government obligations or by a “segregated, earmarked” deposit account.<sup>157</sup> The rule clarifies that a deposit account meets the “segregated, earmarked” requirement only if the account exists for the sole purpose of securing credit transactions between the member bank and its affiliates and is so identified. This requirement would parallel the provision in section 223.14(b)(1)(i)(D) of the rule relating to which deposits count toward the collateral requirements of section 23A.

A few commenters requested confirmation that a credit transaction partially secured by U.S. government obligations or deposit accounts would be exempt under this section to the extent of such collateral. As noted above, under section 23A, if U.S. government obligations or deposit accounts are sufficient to fully secure a credit transaction, then the transaction is completely exempt. Under the statute, however, if the U.S. government obligations or deposit accounts represent less than full security for the credit transaction, then the amount of U.S. government obligations or deposits counts toward the collateral requirements of section 23A, but no part of the transaction is exempt from the statute’s quantitative limits.

In response to the request of commenters, the Board has decided to grant an additional exemption consistent with the spirit of the (d)(4) exemption in section 23A. Under this expanded form of the (d)(4) exemption, a credit transaction with an affiliate will be exempt “to the extent that the transaction is and remains secured” by appropriate (d)(4) collateral. This exemption is consistent with the Board’s treatment of similar transactions under Regulation O and the OCC’s interpretations of the national bank lending limits.<sup>158</sup>

Accordingly, under the final rule, if a member bank makes a \$100 non-amortizing term loan to an affiliate that is secured by \$50 of U.S. Treasury securities and \$75 of real estate, the value of the covered transaction will be \$50. If the market value of the U.S. Treasury

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<sup>156</sup> Unlike the sister-bank exemption, the exemption for correspondent banking deposits would apply to deposits placed by a member bank in an uninsured depository institution or foreign bank. Because the statutory exemption by its terms covers deposits made in a foreign bank, Congress must not have intended to restrict this exemption to deposits made in an insured depository institution.

<sup>157</sup> 12 U.S.C. 371c(d)(4).

<sup>158</sup> See 58 FR 26507-26508, May 4, 1993; 12 CFR 32.3(i).

securities falls to \$45 during the life of the loan, the value of the covered transaction would increase to \$55. The Board expects member banks that use this expanded (d)(4) exemption to review the market value of their U.S. government obligations collateral regularly to ensure compliance with the exemption.

F. Purchases of assets with readily identifiable market quotes (§ 223.42(e))

Section 23A(d)(6) exempts the purchase of assets by a member bank from an affiliate if the assets have a “readily identifiable and publicly available market quotation” and are purchased at their current market quotation.<sup>159</sup> The Board generally has limited the availability of this exemption (the “(d)(6) exemption”) to purchases of assets with market prices that are recorded in widely disseminated publications that are readily available to the general public, such as newspapers with a national circulation. Because as a general matter only exchange-traded assets are recorded in such publications, the test has ensured that the qualifying assets are traded actively enough to have a true “market quotation” and that examiners can verify that the assets are purchased at their current market quotation. Regulation W codifies this Board interpretation of the (d)(6) exemption and clarifies that the exemption applies to a member bank’s purchase from an affiliate of an asset that has a readily identifiable and publicly available market quotation if the asset is purchased at or below the asset’s current market quotation.<sup>160</sup>

A number of commenters requested that the Board clarify that certain assets would be eligible for purchase by a member bank under the statutory (d)(6) exemption. These assets included (i) assets whose prices are quoted on an internet web site that is generally available to the public (with or without a subscription fee) and that provides actual prices of securities traded on at least a daily basis; (ii) securities issued by an affiliate or at least affiliate-issued securities that are fully guaranteed by the U.S. government or its agencies; and (iii) OTC securities, loans, and derivative contracts.

With respect to the first asset class, commenters have failed to demonstrate that an asset whose price is quoted on an internet web site but is not otherwise recorded in a widely disseminated publication is traded in a sufficiently liquid market to ensure that a member bank’s purchase of that asset from its affiliate would be at a fair market price.

With respect to the second asset class, the Board has decided to remove the provision of the proposed rule that rendered the (d)(6) exemption unavailable for purchases of affiliate-issued securities. As discussed in more detail in part X of this preamble (and subpart H of the

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<sup>159</sup> 12 U.S.C. 371c(d)(6).

<sup>160</sup> The proposed rule provided that all U.S. government obligations were eligible (d)(6) assets. The final rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation’s price is quoted routinely in a widely disseminated publication that is readily available to the general public. The Board has tightened the rule in this regard because, although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at publicly available market quotations.

final rule), however, if a member bank purchases from one affiliate securities issued by another affiliate, the bank has engaged in two types of covered transaction. Under the final rule, although the (d)(6) exemption may exempt the one-time asset purchase from the first affiliate, it would not exempt the ongoing investment in securities issued by the second affiliate.

With respect to the third asset class, the Board confirms that the (d)(6) exemption may apply to a purchase of assets that are not traded on an exchange. In particular, purchases of gold and silver, and purchases of OTC securities, loans, and derivative contracts whose prices are recorded in widely disseminated publications, may qualify for the (d)(6) exemption.

G. Purchases of securities with a ready market from a securities affiliate (§ 223.42(f))

Concurrently with the issuance of proposed Regulation W, the Board adopted a final rule that provided an additional exemption from section 23A for certain purchases of securities by a member bank from an affiliate (the “Final (d)(6) Rule”).<sup>161</sup> The Final (d)(6) Rule expanded the statutory (d)(6) exemption to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic screens so long as, among other things, the selling affiliate is a broker-dealer registered with the SEC; the securities are traded in a ready market and eligible for purchase by State member banks; the securities are not purchased within 30 days of an underwriting (if an affiliate of the bank is an underwriter of the securities); and the securities are not issued by an affiliate. Proposed Regulation W also contained this exemption, and the Board sought further comment on the scope and conditions of the exemption. Commenters expressed general support for the new exemption but criticized many of the particular conditions to the exemption.

1. Broker-dealer requirement

Some commenters believed that the new (d)(6) exemption should not contain a U.S. registered broker-dealer requirement. Several other commenters urged the Board, in light of the increasing globalization of fixed-income markets and the rigorous supervisory frameworks for securities firms in many foreign jurisdictions, to allow banks to purchase securities from a registered foreign broker-dealer under the new (d)(6) exemption.

The Board has decided to retain the U.S. registered broker-dealer requirement. 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. The Board believes that these factors will help ensure that member 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

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<sup>161</sup> 66 FR 24220, May 11, 2001.

to different levels of supervision and regulation and because of the increased difficulties associated with monitoring compliance by foreign entities. The final rule explicitly provides, however, that a member bank may request that the Board exempt securities purchases from a particular 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 any event, the Board expects to evaluate the continued need for this requirement as banks and the Board gain experience with this expanded exemption.

2. Securities eligible for purchase by a state member bank

A number of commenters asked the Board to eliminate the requirement in the new (d)(6) exemption that the securities be eligible for purchase by a State member bank. These commenters noted that certain depository institutions (notably State nonmember banks) and certain overseas (for example, Edge corporation) and domestic subsidiaries of banks have broader investment powers, including equity investment powers, than State member banks. Moreover, according to these commenters, this requirement would impose a high recordkeeping and compliance burden on State nonmember banks that are not subject to the State member bank investment rules but are already subject to a host of State and Federal investment regulations.

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 the new (d)(6) exemption. Although this requirement may impose some additional burden on certain State nonmember banks, the Board believes that it is important to provide a level section 23A playing field and to prevent the new (d)(6) exemption from being used to move volatile assets from an affiliate's balance sheet to that of the bank.

In addition, one commenter requested clarification that this requirement would not prevent a bank from using the new (d)(6) exemption to purchase securities permissible for a State member bank to purchase and hold as a hedge (even if not otherwise permissible under a State member bank's general investment powers). For example, the OCC recently determined that a national bank, subject to certain conditions and OCC review and approval, may acquire equity securities solely for the purpose of hedging the bank's exposure arising from customer-driven equity derivative transactions lawfully entered into by the bank.<sup>162</sup> The Federal Reserve also recently determined that it would not prohibit a State member bank from acquiring equity securities to hedge the bank's customer-driven equity derivative transactions, subject to the same conditions and restrictions applicable to national banks.<sup>163</sup> In light of the hedging purpose of these securities purchases, and the remaining conditions to the availability of the new (d)(6) exemption, the Board agrees that a member bank may purchase equity securities from an affiliate under the new (d)(6) exemption if the purchase is made to hedge the bank's permissible customer-driven equity derivative transaction (and the purchase meets all the other requirements of the exemption).

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<sup>162</sup> See OCC Interpretive Ltr. No. 892 (Sept. 13, 2000).

<sup>163</sup> See Board press release dated Feb. 21, 2002.

3. No purchases within 30 days of the underwriting

The Final (d)(6) Rule generally prohibited a member bank from using the new (d)(6) exemption to purchase securities within 30 days of their underwriting if an affiliate of the bank is an underwriter of the securities. One commenter argued that the new (d)(6) exemption should allow banks to purchase debt securities within 30 days of the underwriting because the market price of debt securities is easily verifiable during this time period. A few commenters argued that the new (d)(6) exemption should allow banks to purchase securities within 30 days of the underwriting if the purchase is pre-approved by the bank's board of directors and does not amount to more than 50 percent of the total offering.

The Board has maintained the underwriting period restriction in the final Regulation W because of the uncertain and volatile 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. Commenters did not provide any evidence as to the reliability of pricing data on debt securities during an underwriting period, and the Board is not convinced that capping at 50 percent of the total offering the amount of securities a member bank may purchase would materially ameliorate the conflicts of interest inherent in the underwriting process.

One commenter requested clarification, in light of the fact that an argument can be made that mutual funds are continuously underwritten, as to whether the new (d)(6) exemption could apply to the purchase of mutual fund shares distributed by an affiliate of the purchasing member bank. The price uncertainty and conflicts of interest concerns that motivated the underwriting period restriction in the new (d)(6) exemption do not apply in the context of mutual fund distribution. The 1940 Act and SEC rules thereunder require mutual funds to sell shares at a public net asset value computed each day,<sup>164</sup> and distributors of mutual funds do not bear the same sorts of market risks that underwriters of corporate debt and equity securities typically bear. In view of the special nature of mutual funds, the Board does not believe that the underwriting period restriction in the new (d)(6) exemption should be read to prevent a member bank from purchasing shares of a mutual fund distributed by an affiliate of the bank.<sup>165</sup>

4. No securities issued by an affiliate

Commenters generally supported limiting the availability of the new (d)(6) exemption to purchases of securities that are not issued by an affiliate. Several commenters argued, however, that the new (d)(6) exemption should allow banks to purchase affiliate-issued asset-backed securities because of the liquidity of the market for asset-backed securities. One

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<sup>164</sup> 15 U.S.C. 80a-22(c); 17 CFR 270.22c-1.

<sup>165</sup> The Board notes that neither the old nor the new (d)(6) exemption exempts a member bank's purchase of mutual fund securities that are not only underwritten by an affiliate of the bank but also are issued by a mutual fund affiliate of the bank. See part X of this preamble and § 223.71 of the final rule.

commenter contended, on the other hand, that the new (d)(6) exemption is not the right vehicle for allowing banks to buy affiliate-issued asset-backed securities because most of these securities do not have a listed market price.

A number of commenters argued that the new (d)(6) exemption should allow banks to purchase affiliate-issued mutual fund shares, especially if the mutual fund is an affiliate simply because the bank or an affiliate is the advisor to the fund. These commenters noted that mutual funds have public prices, the SEC regulates mutual funds and mutual fund pricing, and expanding the ability of banks to purchase mutual funds would enhance the ability of banks to diversify their investment portfolios.

Similar to the final rule's approach to the statutory (d)(6) exemption, the Board has decided to remove from the new (d)(6) exemption the requirement that the asset purchased not be a security issued by an affiliate. The Board notes, however, that if a member bank purchases from one affiliate securities issued by another affiliate, although the new (d)(6) exemption may exempt the asset purchase from the first affiliate, it would not exempt the investment in securities issued by the second affiliate.

#### 5. Price verification methods

The new (d)(6) exemption, as set forth in the Final (d)(6) Rule, applied only in situations where the member bank is able to obtain price quotes on the purchased securities from an unaffiliated electronic, real-time pricing service. Many commenters expressed a view that the new (d)(6) exemption should allow banks to purchase securities based on price quotes from two independent dealers. These commenters made the following principal arguments: (i) independent dealers have no incentive to quote an artificial price; (ii) the Board has determined that two dealer bids are an acceptable pricing mechanism for exempt purchases of municipal securities; (iii) the SEC allows mutual funds to purchase securities from an affiliate at the lowest offer price from a disinterested third party after a reasonable inquiry by the mutual fund; (iv) NASD rules require the use of dealer quotes to price certain securities where multiple quotes from an interdealer quotation system are not available; (v) dealer quotes are routinely used by securities traders because some seasoned corporate and mortgage-backed securities are traded infrequently; and (vi) dealer quotes are used to establish the value of securities for close-out and netting purposes in ISDA derivatives master agreements.

Notwithstanding these comments, the Board reaffirms its previous conclusion that it would not be appropriate to use independent dealer quotations to establish a market price for a security under the new (d)(6) exemption. The Board 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 a member bank to purchase unlimited amounts of the security from an affiliate. In the absence of recent, actual, publicly reported transactions, the risks of price manipulations and sham or reciprocal quotation arrangements are too high.

## 6. Record retention

One commenter suggested that the final rule expressly include the 2-year record retention requirement set forth in the preamble to the Final (d)(6) Rule. The Board has supplemented Regulation W to include this recordkeeping requirement.

### H. Purchasing municipal securities (§ 223.42(g))

Regulation W exempts a member bank's purchase of municipal securities from an affiliate if the purchase meets a streamlined version of the requirements applicable to the new (d)(6) exemption.<sup>166</sup> First, as in the new (d)(6) exemption, the member bank must purchase the municipal securities from a broker-dealer affiliate that is registered with the SEC. Second, also as in the new (d)(6) exemption, the municipal securities must be eligible for purchase by a State member bank, and the member bank must report the transaction as a securities purchase in its Call Report. Third, the municipal securities must either be rated by a nationally recognized statistical rating organization or must be part of an issue of securities that does not exceed \$25 million in size. Finally, the price for the securities purchased must be (i) quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks; (ii) verified by reference to two or more actual independent dealer quotes on the securities to be purchased or securities that are comparable to the securities to be purchased; or (iii) in the case of securities purchased during the underwriting period, verified by reference to the price indicated in the syndicate manager's written summary of the underwriting.<sup>167</sup> Under any of the three pricing options, the member bank must purchase the municipal securities at or below the quoted or verified price.

The Board believes that the streamlined set of requirements for purchases of municipal securities is appropriate because municipal obligations generally have comparatively low default risks. In addition, these relaxed requirements are consistent with the expressed desire of Congress to support local communities' use of municipal securities to help meet their financing needs.

### I. Purchases of assets by newly formed banks (§ 223.42(i))

The rule exempts a purchase of assets by a newly chartered member bank from an affiliate if the appropriate Federal banking agency for the bank has approved the purchase.

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<sup>166</sup> The regulation defines municipal securities by reference to section 3(a)(29) of the Securities Exchange Act, which defines municipal securities as direct obligations of, or obligations guaranteed as to principal or interest by, a State or agency, instrumentality, or political subdivision thereof, and certain tax-exempt industrial development bonds. See 17 U.S.C. 78c(a)(29).

<sup>167</sup> Under the Municipal Securities Rulemaking Board's Rule G-11, the syndicate manager for a municipal bond underwriting is required to send a written summary to all members of the syndicate. The summary discloses the aggregate par values and prices of bonds sold from the syndicate account.



This exemption would allow companies to charter a new bank and transfer assets to the bank free of the quantitative limits and low-quality asset prohibition of section 23A. Currently, if a company (usually a BHC) establishes a new subsidiary bank, the newly chartered institution cannot acquire a critical mass of assets from its parent company because of the quantitative limits of section 23A. Commenters generally agreed that applying the restrictions of section 23A to a newly formed bank is unnecessary because the chartering authority for the new bank (and, in the case of a new bank formed under a BHC, the Board) reviews the transaction to ensure that the asset transfer does not result in any safety or soundness problems.

J. Transactions approved under the Bank Merger Act (§ 223.42(j))

Before issuing proposed Regulation W, the Board had provided a regulatory exemption from section 23A for any transaction between affiliated insured depository institutions if the transaction had been approved by the responsible Federal banking agency under the Bank Merger Act.<sup>168</sup> The Board had provided this regulatory exemption because the Bank Merger Act required the primary Federal supervisor of the resulting insured depository institution to review these transactions using safety and soundness and public interest standards similar to those that the Board would apply in reviewing a section 23A exemption request. Proposed Regulation W included this exemption.

Several commenters argued that the Board should expand the Bank Merger Act exemption to include mergers between a national bank and a nonbank subsidiary or affiliate of the bank, which are reviewed by the OCC under the National Bank Consolidation and Merger Act (“NBCM Act”).<sup>169</sup> The Board notes that a member bank should not need a special exemption from section 23A to merge with a nonbank subsidiary (other than a financial subsidiary and certain other nonbank subsidiaries) because such transactions generally will be deemed to be within the bank for purposes of section 23A.

The Board has determined not to grant a regulatory exemption for merger transactions between a national bank and its nonbank affiliate for a number of reasons. First, the legislative history of section 23A and Board experience indicate that merger transactions between banks and their nonbank affiliates have a greater potential for risk of loss to the bank than would similar transactions between sister banks and thus are appropriately subject to greater regulatory scrutiny. In addition, such transactions between banks and their nonbank affiliates have a greater potential for risk of loss to the Federal deposit insurance funds because the cross-guarantee provisions of the FDI Act apply only between affiliated insured depository institutions.<sup>170</sup> Finally, although the NBCM Act provides for OCC review of such transactions, the statute does not establish criteria that a national bank must satisfy to obtain OCC approval,

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<sup>168</sup> See 57 FR 41643, Sept. 11, 1992.

<sup>169</sup> Section 1206(a) of the American Homeownership and Economic Opportunity Act of 2000 amended the NBCM Act to provide that a national bank may merge with one or more of its nonbank subsidiaries or affiliates with the approval of the OCC. See 12 U.S.C. 215a-3.

<sup>170</sup> See 12 U.S.C. 1815(e).

and the OCC has not yet issued implementing regulations for the statute. The Board may consider including in Regulation W an exemption for NBCM Act transactions after reviewing any future implementing regulations adopted by the OCC. The Board notes that any member bank merging or consolidating with a nonbank affiliate may be able to take advantage of the regulatory exemption for internal reorganization transactions contained in section 223.41(d) of the final rule.

A few other commenters urged the Board to expand the Bank Merger Act exemption to include Bank Merger Act transactions with any affiliate (not just an insured depository institution affiliate) and any other transactions with affiliates that are subject to approval by the bank's primary Federal supervisor. For the reasons discussed in the previous paragraph, the Board is not willing to grant a regulatory exemption to any transaction between a member bank and an affiliate that is subject to approval by the bank's primary Federal supervisor.

In light of the comments, however, the final rule does include a partial expansion of the traditional Bank Merger Act exemption. As noted above, the traditional Bank Merger Act exemption only applied to transactions between a member bank and an insured depository institution affiliate. Although the Board does not believe that expanding the Bank Merger Act exemption to include transactions with any affiliate would be consistent with the purposes of section 23A, the final rule makes the Bank Merger Act exemption available for merger and other related transactions between a member bank and a U.S. branch or agency of an affiliated foreign bank. The Bank Merger Act approval process, combined with the ongoing regulation and supervision of U.S. branches and agencies of foreign banks by the Federal banking agencies, should help ensure that such transactions do not pose significant risks to the member bank.

K. Purchases of extensions of credit (§ 223.42(k))

In 1974, the Board issued a formal interpretation of section 23A (codified at 12 CFR 250.250) that exempted a member bank's purchase of a loan from an affiliate if (i) the bank made an independent evaluation of the creditworthiness of the borrower before the affiliate made the loan and (ii) the bank committed to purchase the loan before the affiliate made the loan (the "250.250 exemption").<sup>171</sup> Although the 1974 interpretation did not impose a strict dollar limit on the amount of an affiliate's loans that a member bank could purchase under the exemption, the interpretation cautioned that the purpose of the exemption was to allow a member bank to take advantage of an investment opportunity and not to alleviate the working capital needs of an affiliate.

By 1995, some BHCs were using the 250.250 exemption extensively to fund their nonbank lending affiliates. In these cases, banks were providing all or nearly all of such affiliates' funding. In response, staff indicated in an interpretive letter that the 250.250 exemption was not available if the dollar amount of the bank's purchases from the affiliate

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<sup>171</sup> See 39 FR 28975, Aug. 13, 1974.

represented more than 50 percent of the total dollar amount of loans made by the affiliate.<sup>172</sup> Staff reasoned that, in these circumstances, the asset purchases looked less like the bank taking advantage of an investment opportunity brought to it by the affiliate and more like the bank providing the principal ongoing funding mechanism for the affiliate. Staff intended that this restriction would require the affiliate to have alternative funding sources and would reduce the pressure on the bank to purchase the affiliate's extensions of credit.

Proposed Regulation W included the 250.250 exemption. The proposed rule also included staff's 50 percent test as a condition to the availability of the exemption and solicited comment on whether to supplement the bright-line 50 percent test with a requirement that the member bank not use the exemption to provide "substantial, ongoing funding" to the affiliate.

1. The traditional 50 percent test

Several commenters explicitly supported the Board's retention of a 50 percent limit on the amount of loans a bank may purchase from an affiliate under the 250.250 exemption. Other commenters requested that the Board remove the 50 percent test because, in the view of these commenters, it is unnecessary and burdensome and most of these bank-affiliate arrangements are designed to benefit the bank. A few commenters asked the Board to modify the 50 percent test. One of these commenters stated that, if the rule retains the 50 percent limit, the limit should be revised to be 50 percent of the total assets of the affiliate (not just the credit portfolio of the affiliate). Another commenter asked that the 50 percent per affiliate limit be revised to be 50 percent of the loan portfolio of all lending affiliates in the aggregate (to reduce the burden of monitoring each affiliate's compliance with the 50 percent test).

The Board has decided to retain the 50 percent test. The Board continues to believe that if a member bank purchases more than half of the extensions of credit originated by an affiliate, the purchases represent the principal ongoing funding mechanism for the affiliate. The member bank's status as the predominant source of financing for the affiliate calls into question the availability of alternative funding sources for the affiliate, places significant pressure on the bank to continue to support the affiliate through asset purchases, and reduces the bank's ability to make independent credit decisions with respect to the asset purchases. The final rule does not expand the denominator of the 50 percent test to include all the assets of the affiliate or all the credit portfolios of all the lending affiliates of the member bank. In the Board's view, the member bank's underwriting integrity may be compromised if any single affiliate becomes dependent on the bank for financing, even if that single affiliate is a diversified company that becomes dependent on the bank for financing of only one portion of its business.

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<sup>172</sup> Letter dated April 24, 1995, from J. Virgil Mattingly, Jr., General Counsel of the Board, to William F. Kroener, III, Federal Deposit Insurance Corporation; see also Letter dated January 21, 1987, from Michael Bradfield, General Counsel of the Board, to Jeffrey C. Gerrish.

## 2. The “substantial, ongoing funding” test

One commenter supported the rule’s inclusion of the “substantial, ongoing funding” test. A large number of commenters (including most of the banking industry trade associations) urged the Board to remove the “substantial, ongoing funding” test. These commenters contended that the test is too vague and subjective, may disrupt many existing operations, would prevent banks and their affiliates from accomplishing rational business planning, and is unnecessary in light of the lack of evidence that the existing 50 percent test has failed to check abuse.

A “substantial, ongoing funding” test would provide examiners with the flexibility to stop arrangements in which a bank provides a significant amount of funding to an affiliated lending company but does not provide a majority of the affiliate’s working capital. On the other hand, such a subjective standard would create legal uncertainty for banks that purchase a substantial amount of assets from their lending affiliates. In addition, use of a “substantial, ongoing funding” standard could result in inconsistent application of the 250.250 exemption by the different Federal banking agencies and by different examiners within an agency.

The final rule does not include such a supplemental standard in the 250.250 exemption. The final rule, however, does allow the appropriate Federal banking agency for a member bank to reduce the 50 percent threshold prospectively, on a case-by-case basis, in those situations where the agency believes that the bank’s asset purchases from an affiliate under the exemption may cause harm to the bank. Although this agency discretion to tighten the 50 percent threshold may result in some inconsistency in application of the exemption, the supervisory benefits of the flexibility should outweigh its potential adverse effects.

## 3. Test based on size of bank

The proposed rule also sought comment on whether to limit the amount of assets that a member bank may purchase from an affiliate pursuant to the 250.250 exemption to some percentage of the bank’s total assets. Many commenters objected to placing a limit on the percentage of a bank’s assets that represent assets purchased from an affiliate under the 250.250 exemption. These commenters argued that case-by-case review is a better approach to addressing situations where a large portion of a bank’s assets are loans purchased from an affiliate. These commenters believed that the remaining conditions of the exemption should suffice to prevent abuse of the bank. One commenter, on the other hand, recommended that the rule include a 50 percent limit based on the assets of the bank.

In light of the comments and the fact that the Board did not suggest a specific limit based on the bank’s size in proposed Regulation W, the Board has determined to issue a further proposed rule (concurrently with final Regulation W) that would seek public comment on whether to deny the 250.250 exemption to any member bank if assets purchased by the bank from an affiliate under the 250.250 exemption represent more than 100 percent of the bank’s capital stock and surplus. A more detailed explanation of the Board’s reasons for issuing the further proposed rule is set forth in the preamble to the proposed rule.

#### 4. Independent credit review by the bank

To qualify for the 250.250 exemption, a member bank must independently review the creditworthiness of each obligor before committing to purchase each loan.<sup>173</sup> Several commenters requested that the Board interpret the “independent evaluation” requirement so as not to require an actual evaluation of each credit by the bank if the affiliate uses the same credit underwriting system as the bank. According to these commenters, such an interpretation would recognize appropriately that banks and affiliates often use the same underwriting standards and would encourage banks and affiliates to share effective underwriting practices with each other and to work toward harmonization of underwriting practices within a single organization. These commenters indicated that, as currently interpreted, the 250.250 exemption interferes with efficient, centralized, formula-based credit underwriting processes. In addition, several commenters contended that the Board should interpret the “independent evaluation” requirement so as not to require an actual evaluation of each credit by the bank if the affiliate uses the underwriting standards of Fannie Mae, Freddie Mac, or Ginnie Mae.

The Board does not believe that a member bank can satisfy the “independent evaluation” requirement of the 250.250 exemption by simply having its lending affiliates use the bank’s underwriting standards or the underwriting standards of Fannie Mae or any other government agency or government-sponsored enterprise. Under established Federal Reserve guidance, a State member bank is required to have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the credit and other risks inherent in a proposed transaction.<sup>174</sup> This function is not delegable to any third party, including affiliates of the member bank or government-sponsored enterprises. Accordingly, to qualify for this exemption, the member bank, independently and using its own credit policies and procedures, must itself review and approve each extension of credit before giving a purchase commitment to its affiliate.

#### 5. Miscellaneous

One commenter asked the Board to clarify whether the 250.250 exemption could be used in connection with a bank’s purchase of loans from an affiliate if the affiliate retained recourse on the loans. Consistent with the fact pattern underlying the original 250.250 exemption and staff’s traditional interpretation of the exemption, the final rule specifies that the exemption does not apply in situations where the affiliate retains recourse on the loans purchased by the member bank. In such a circumstance, the member bank has ongoing credit exposure to the affiliate. If the Board were not to adopt this position, a member bank arguably could incur unlimited credit exposure to an affiliate through exempt loan purchases under the 250.250 exemption.

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<sup>173</sup> Consistent with the Board’s 1974 interpretation, the member bank also must not make a legally enforceable blanket advance commitment to purchase a stipulated amount of loans from the affiliate.

<sup>174</sup> See, e.g., Federal Reserve SR Letter No. 97-21 (SUP) (July 11, 1997).

The final rule also specifies, consistent with the fact pattern underlying the original 250.250 exemption and staff's traditional interpretation of the exemption, that the 250.250 exemption only applies in situations where the member bank purchases loans from an affiliate that were originated by the affiliate. The exemption cannot be used by a member bank to purchase loans from an affiliate that the affiliate purchased from another lender. The exemption is designed to facilitate a member bank using its affiliate as an origination agent, not to permit a member bank to take off an affiliate's books loans that the affiliate purchased from a third party. Among other concerns, a contrary determination would increase the likelihood that a member bank could acquire low-quality assets from an affiliate through the exemption.

L. Intraday Extensions of Credit (§ 223.42(l))

As noted above, the GLB Act required the Board to adopt, by May 12, 2001, a final rule to address as covered transactions under section 23A the credit exposure arising from intraday extensions of credit by member banks to their affiliates.<sup>175</sup> The Board took a two-step approach, similar to the Board's approach to bank-affiliate derivatives, to fulfill this statutory mandate. First, the Board published an interim final rule on May 11, 2001, that (i) required, under section 23A, that a member bank establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from the bank's intraday extensions of credit to affiliates; and (ii) clarified that intraday extensions of credit by a member bank to an affiliate are subject to the market terms requirement of section 23B. The policies and procedures, at a minimum, had to provide for monitoring and controlling the member bank's intraday credit exposure to affiliates and ensuring that the bank's intraday credit extensions to affiliates comply with section 23B. The interim final rule had a delayed effective date of January 1, 2002.

Second, the Board requested comment on a more detailed and more restrictive proposed rule on intraday credit extensions by member banks to affiliates in Regulation W. Proposed Regulation W treated all such intraday credit extensions as covered transactions but exempted those intraday credits that arose in connection with the performance by a member bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions on behalf of an affiliate. The more limited Regulation W exemption for intraday credit was available only if the member bank (i) had no reason to believe that the affiliate would have difficulty repaying the extension of credit; (ii) established limits on the net amount of intraday credit that the bank may extend to affiliates; and (iii) maintained policies and procedures for monitoring each affiliate's compliance with the limits. Under the Regulation W proposal, intraday extensions of credit by a member bank to an affiliate that did not meet these

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<sup>175</sup> The text of section 23A does not indicate that an extension of credit must extend overnight to qualify as a covered transaction. Nevertheless, at the time of enactment of the GLB Act, the Board had not ruled on whether intraday credit extensions by a member bank to an affiliate were covered transactions under section 23A or subject to the market terms requirement of section 23B. Industry practice did not treat intraday credit extensions as subject to section 23A or 23B.

conditions were subject to the quantitative, collateral, and other requirements of section 23A. Importantly, under the proposed rule, an intentional intraday loan by a member bank to an affiliate outside of the clearing context (for example, a loan to allow an affiliate to meet a debt obligation coming due during the day) became fully subject to section 23A at the time during the day that the bank made the loan.

Most commenters on the intraday credit issue expressed support for either the interim rule or proposed Regulation W approach to intraday credit, although the interim rule approach garnered more support. A few commenters rejected both approaches, however, and urged the Board to treat intraday credit as not subject to section 23A.

Commenters generally advocated an exemption for intraday credit by banks to affiliates because, in the view of commenters, (i) banks do not use intraday credit to fund affiliates; (ii) intraday credit becomes covered by section 23A at the end of the day and, therefore, banks have incentives to monitor intraday overdrafts by affiliates; (iii) banks do not have the systems to monitor intraday credit transactions with all accounts of all affiliates in real time; and (iv) banks have not suffered losses on intraday credit extensions to affiliates. According to these commenters, the minimal benefits of the Regulation W approach would not outweigh the substantial costs.

Many commenters urged the Board to grant an exemption for intraday credit arising from special purpose credit card transactions if the Board were to decide to treat intraday credit extensions as covered transactions under section 23A. These commenters explained that special purpose credit card banks make thousands of credit extensions each day that are deemed to be credit extensions to affiliates under section 23A's attribution rule. These banks currently comply with section 23A by either selling their credit card receivables at the end of each day or fully securing them at the end of each day with segregated, earmarked deposit accounts. According to commenters, the Regulation W approach to intraday credit would significantly disrupt the existing practices of special purpose credit card banks and would create substantial inefficiencies for these banks (requiring thousands of sales of receivables each day instead of one sale at the end of each day). These commenters emphasized that third-party customers, not the affiliated merchants, are liable for repayment to the bank on these transactions, and that the intraday risk to the bank on these transactions is similar to the risk on payment or settlement transactions.

In the Board's view, existing business practices indicate that the potential risk reduction benefits afforded by full application of the requirements of section 23A to intraday credit exposures to affiliates would not justify the costs to banking organizations of implementing these requirements at this time. Intraday overdrafts and other forms of intraday credit generally are not used as a means of funding or otherwise providing financial support for an affiliate. Rather, these credit extensions typically facilitate the settlement of transactions between an affiliate and its customers when there are mismatches between the timing of funds sent and received during the business day. Although some risk exists that such intraday credit extensions could turn into overnight funding of an affiliate, this risk is sufficiently remote that application of the strict collateral and other requirements of section 23A would not be warranted for the intraday credit exposure. Moreover, mandating that banks collateralize intraday exposures would require banks not only to measure exposures across multiple

accounts, offices, and systems on a global basis but also to adjust collateral holdings in real time throughout the day. The Board is concerned that few banks currently have these capabilities and that they would be very costly to implement. Furthermore, there is no evidence that banks, including special purpose credit card banks, have suffered losses from intraday extensions of credit to affiliates.

Federal Reserve examiners have reviewed the policies and procedures that a number of large banks adopted to comply with the Board's interim final rule on intraday credit to affiliates. This review confirmed that requiring banks to adopt policies and procedures for managing the credit exposure arising from intraday credit extensions to affiliates and subjecting such transactions to section 23B is the most workable solution for addressing intraday credit exposure of banks to affiliates. For the most part, the surveyed banks treated intraday credit to affiliates in the same manner as they treated intraday credit to third parties.

In light of these considerations, the Board is adopting an approach to intraday credit that is a combination of the approaches contained in the interim rule and proposed Regulation W. Final Regulation W provides that intraday credit extensions by a member bank to an affiliate are section 23A covered transactions but exempts all such intraday credit extensions from the quantitative and collateral requirements of section 23A if the member bank (i) maintains policies and procedures for the management of intraday credit exposure and (ii) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms.

The approach of the final rule should impose substantially less burden on banking organizations than the proposed Regulation W approach. Most significantly, whereas the proposed rule exempted only intraday credit extensions relating to clearing and settlement, the final rule exempts all types of intraday credit. In light of the limited scope for, and limited history of, abuse of intraday credit to affiliates and the significant burden of verifying and documenting the use of each intraday credit extension to an affiliate, the Board does not believe that the regulatory benefits of this aspect of the proposed rule would have outweighed its regulatory burden. Unlike the proposed rule, the global exemptive approach of the final rule also should avoid interrupting the existing, unproblematic intraday business practices of banks that issue special purpose credit cards. In addition, the approach of the final rule imposes more discipline on banks than the interim rule approach in that the final rule requires a member bank to make intraday assessments of the credit quality of each affiliated borrower and restricts a member bank's intraday credit extensions to an affiliate if the bank has any doubt as to the affiliate's ability to repay the credit in accordance with its terms.

The proposed rule did not include a definition of an intraday extension of credit. The final rule, however, defines an intraday extension of credit as an extension of credit by a member bank to an affiliate that the member bank expects to be repaid, sold, or terminated, or to qualify for a complete exemption under the rule, by the end of its business day in the United States. An intraday extension of credit would include, for example, a loan by a member bank to an affiliate that (i) by its terms must be repaid before the end of the bank's U.S. business day; (ii) the bank expects to sell at the end of the bank's U.S. business day; or (iii) the bank intends to fully secure with a segregated, earmarked deposit account at the end of the bank's U.S. business day. On the other hand, if a member bank makes a 30-day loan to an affiliate at



2 p.m. on a particular day and does not expect to sell the loan or to qualify the loan for an exemption under the rule by the end of its U.S. business day, the intraday credit exemption would not exempt the loan from 2 p.m. until the end of the bank's U.S. business day. Rather, the member bank must ensure that the loan complies with the requirements of Regulation W as of 2 p.m. on that day (unless the loan qualifies for another exemption in the rule at such time).

M. Riskless principal transactions (§ 223.42(m))

The final rule contains an additional exemption that was not part of the proposed rule. Section 223.42(m) of the final rule exempts the purchase by a member bank of a security from a securities affiliate of the bank if (i) the bank or the securities affiliate is acting exclusively as a riskless principal in the transaction; and (ii) the security purchased is not issued or underwritten, or sold as principal (other than as riskless principal), by any affiliate of the bank.<sup>176</sup> These riskless principal securities transactions between a member bank and an affiliate are covered transactions under section 23A because the member bank, acting as a principal, has purchased an asset from an affiliate, acting as a principal. The Board does not believe that there is any regulatory benefit to subjecting these transactions to section 23A, however, because riskless principal securities transactions closely resemble securities brokerage transactions.

The riskless principal in a riskless principal securities transaction buys and sells the same security contemporaneously. Accordingly, if a member bank acts as a riskless principal in purchasing a security from a securities affiliate, the asset risk passes promptly from the affiliate through the bank on to the bank's customer. If the securities affiliate acts as a riskless principal in selling a security to the member bank, the asset risk passes promptly from a third party through the affiliate to the bank. In neither case would the securities affiliate be able to transfer pre-existing asset risk from its books to the books of the member bank. Although the final rule exempts these riskless principal transactions from section 23A, such transactions would remain subject to section 23B.

N. Additional exemption requests

Approximately 16 commenters asked the Board to establish formal filing and processing guidelines for section 23A exemption requests. These commenters offered a wide variety of suggested time frames for Board action on such requests, but most of them asked that the Board commit to acting within 30 to 60 days of receiving a request. In light of the policy importance and factual intricacy of most section 23A exemption requests, the Board has decided not to adopt regulatory deadlines for processing section 23A exemption requests. The Board has indicated in the final rule, however, that exemption requests should describe in detail the transaction or relationship for which the member bank seeks exemption, explain why the Board should exempt the transaction or relationship, and explain how the exemption would be in the public interest and consistent with the purposes of section 23A.

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<sup>176</sup> This exemption parallels the exemption from the attribution rule provided in section 223.16(c)(1) of the final rule.

As noted above, although sections 23A and 23B apply by their terms only to member banks, other Federal law subjects insured nonmember banks and insured thrifts to the sections as if they were member banks. Accordingly, insured nonmember banks and insured thrifts must apply to the Board (rather than their appropriate Federal banking agency) for any additional exemptions from section 23A or 23B.

#### VIII. General Provisions of Section 23B--Subpart F

Subpart F of the regulation sets forth the principal restrictions of section 23B. These include (i) a requirement that most transactions between a member bank and its affiliates be on terms and circumstances that are substantially the same as those prevailing at the time for comparable transactions with nonaffiliates; (ii) a restriction on a member bank's purchase as fiduciary of assets from an affiliate; (iii) a restriction on a member bank's purchase, during the existence of an underwriting syndicate, of any security if a principal underwriter of the security is an affiliate; and (iv) a prohibition on publishing an advertisement or entering into an agreement stating that a member bank will be responsible for the obligations of its affiliates. For the most part, subpart F restates the operative provisions of section 23B, and these provisions are not discussed below. The remainder of this section of the preamble highlights four areas in which Regulation W provides additional guidance on section 23B.

##### A. Transactions exempt from section 23B (§ 223.52(a)(1))

The market terms requirement of section 23B applies to, among other transactions, any "covered transaction" between a member bank and an affiliate.<sup>177</sup> Section 23B(d)(3) makes clear that the term "covered transaction" in section 23B has the same meaning as the term "covered transaction" in section 23A, but does not include any transaction that is exempt under section 23A(d) -- for example, transactions between sister banks, transactions fully secured by a deposit account or U.S. government obligations, and purchases of assets from an affiliate at a readily identifiable and publicly available market quotation.<sup>178</sup> Consistent with the statute, the regulation exempts from section 23B any transaction that is exempt under section 23A(d).

Regulation W also excludes from section 23B any covered transaction that is exempt from section 23A under section 223.42(i) or (j) of the regulation (that is, asset purchases by a newly formed member bank and transactions approved under the Bank Merger Act). The Board is excluding from section 23B this additional set of transactions because, in each case, the appropriate Federal banking agency for the member bank involved in the transaction should ensure that the terms of the transaction are not unfavorable to the bank.

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<sup>177</sup> 12 U.S.C. 371c-1(a)(2)(A).

<sup>178</sup> 12 U.S.C. 371c-1(d)(3).

B. Purchases of securities for which an affiliate is the principal underwriter  
(§ 223.53(b))

The GLB Act amended section 23B in one respect. Since its passage in 1987, section 23B(b)(1)(B) has prohibited a member bank, whether acting as principal or fiduciary, from purchasing securities during the existence of an underwriting or selling syndicate if a principal underwriter of the securities is an affiliate of the bank.<sup>179</sup> Before the GLB Act, a member bank could escape this prohibition only if a majority of the outside directors of the bank approved the bank's securities purchase before the securities were initially offered to the public.<sup>180</sup> The GLB Act amended section 23B, however, to permit a member bank to purchase securities during an underwriting conducted by an affiliate if the following two conditions are met. First, a majority of the directors of the member bank (with no distinction drawn between inside and outside directors) must approve the securities purchase before the securities are initially offered to the public. Second, such approval must be based on a determination that the purchase would be a sound investment for the member bank regardless of the fact that an affiliate of the bank is a principal underwriter of the securities.<sup>181</sup> The regulation incorporates this new standard and clarifies that if a member bank proposes to make such a securities purchase in a fiduciary capacity, then the directors of the bank must base their approval on a determination that the purchase is a sound investment for the person on whose behalf the bank is acting as fiduciary.

Obviously, a member bank may satisfy this director approval requirement by obtaining specific prior director approval of each securities acquisition otherwise prohibited by section 23B(b)(1)(B). The regulation clarifies, however, that a member bank also satisfies this director approval requirement if a majority of the directors of the bank approves appropriate standards for the bank's acquisition of securities otherwise prohibited by section 23B(b)(1)(B) and each such acquisition meets the standards adopted by the directors. In addition, a majority of the member bank's directors must periodically review such acquisitions to ensure that they meet the standards and must periodically review the standards to ensure they meet the "sound investment" criterion of section 23B(b)(2). The appropriate period of time between reviews would vary depending on the scope and nature of the member bank's program, but such reviews should be conducted by the directors at least annually. Before the passage of the GLB Act, Board staff informally allowed member banks, based on the legislative history of section 23B, to meet the director approval requirement in this fashion, and there is no indication that Congress in the GLB Act intended to alter the procedures that a member bank could use to obtain the requisite director approval.<sup>182</sup>

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<sup>179</sup> 12 U.S.C. 371c-1(b)(1)(B).

<sup>180</sup> Many smaller banking organizations had difficulty meeting this standard because most or all of their banks' directors were officers or employees of the banks or affiliates of the banks.

<sup>181</sup> GLB Act § 738 (codified at 12 U.S.C. 371c-1(b)(2)).

<sup>182</sup> The Conference Report accompanying the Competitive Equality Banking Act of 1987 stated that the prior approval requirement of section 23B(b) could be met "by the establishment

For these reasons, the regulation codifies staff's preexisting approach to the director approval requirement.<sup>183</sup>

C. The definition of affiliate under section 23B (§ 223.2(c))

Section 23B states that the term "affiliate" under section 23B has the meaning given to such term in section 23A except that the term "affiliate" under section 23B does not include a "bank," as defined in section 23A.<sup>184</sup> Other Federal law provides that an insured savings association should be treated as a "bank" for purposes of section 23B.<sup>185</sup> As in the case of the sister-bank exemption, proposed Regulation W clarified that the only companies that qualify for the "bank" exception to section 23B's definition of affiliate are insured depository institutions.

One commenter objected to this aspect of the proposed rule. Without such an interpretation, however, a member bank would be able to engage in transactions with certain uninsured depository affiliates on terms and conditions that were highly unfavorable to the bank. Entering into these kinds of transactions would not be consistent with bank safety and soundness and would contravene one of the goals of section 23B -- protecting the Federal deposit insurance funds. Accordingly, the final rule continues to restrict the "bank" exception from section 23B's definition of affiliate to insured depository institutions.

D. The advertising restriction (§ 223.54)

Section 23B(c), the "advertising restriction," prohibits a member bank from publishing any advertisement or entering into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates.<sup>186</sup> Read literally, this provision appears to prohibit a member bank from issuing a guarantee, acceptance, or letter of credit on behalf of an affiliate. Because section 23A includes as a permissible (though limited) covered transaction the issuance by a member bank of a guarantee, acceptance, or letter of credit on

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in advance of specific standards by the outside directors for such acquisitions. If the outside directors establish such standards, they must regularly review acquisitions to assure that the standards have been followed, and they must periodically review the standards to assure that they continue to be appropriate in light of market and other conditions." See H.R. Conf. Rep. No. 100-261, at 133 (1987).

<sup>183</sup> The rule also provides, consistent with existing Board interpretations, that a U.S. branch, agency, or commercial lending company of a foreign bank may comply with this requirement by obtaining the required approvals and reviews from either a majority of the directors or a majority of the senior executive officers of the foreign bank.

<sup>184</sup> 12 U.S.C. 371c-1(d)(1).

<sup>185</sup> 12 U.S.C. 1468(a)(2)(B).

<sup>186</sup> 12 U.S.C. 371c-1(c).

behalf of its affiliates, Board staff traditionally has read the advertising restriction of section 23B in light of section 23A. That is, Board staff has not read section 23B(c) to prohibit a member bank from issuing a guarantee, acceptance, or letter of credit on behalf of an affiliate to the extent permitted under section 23A. The regulation contains this clarification.<sup>187</sup> In response to comments from several banking organizations, the final rule also clarifies that section 23B(c) does not prohibit a member bank from making reference to such a guarantee, acceptance, or letter of credit in a prospectus or other disclosure document, for example, if otherwise required by law.

#### IX. Application of Sections 23A and 23B to U.S. Branches and Agencies of Foreign Banks-- Subpart G

Subpart G discusses the application of sections 23A and 23B to U.S. branches and agencies of foreign banks. As noted above, sections 23A and 23B apply by their terms only to member banks of the Federal Reserve System, and other Federal banking laws have made insured nonmember banks and insured savings associations subject to the sections. Federal banking law generally does not subject the U.S. branches and agencies of foreign banks to sections 23A and 23B.

Section 114(b)(4) of the GLB Act explicitly authorizes the Board, however, to impose restrictions or requirements on relationships or transactions between a branch, agency, or commercial lending company of a foreign bank in the United States and any affiliate in the United States of such foreign bank. The Board may impose such prudential limits if it finds that the limits are appropriate to prevent an evasion of certain Federal banking laws, avoid a significant risk to the safety and soundness of depository institutions or any Federal deposit insurance fund, or avoid other adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

In order to ensure competitive equity, the Board has for years imposed certain of the requirements of sections 23A and 23B on transactions between a U.S. branch or agency of a foreign bank and its U.S. affiliates engaged in underwriting and dealing in bank-ineligible securities (“section 20 affiliates”).<sup>188</sup> The Board also recently applied sections 23A and 23B to

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<sup>187</sup> The Board also believes that if a member bank and its affiliate enter into a joint undertaking with a third party, the contract among the parties should make clear that the bank is only responsible for its own obligations under the contract.

<sup>188</sup> The Board’s Operating Standards for section 20 affiliates require (i) any intraday extensions of credit by a U.S. branch or agency of a foreign bank to its section 20 affiliates to comply with the market terms requirement of section 23B; (ii) any extensions of credit by a U.S. branch or agency of a foreign bank to its section 20 affiliates and any purchase by such branch or agency of securities for which a section 20 affiliate is the principal underwriter to comply with sections 23A and 23B; and (iii) a U.S. branch or agency of a foreign bank to refrain from advertising or suggesting that it is responsible for the obligations of a section 20 affiliate, consistent with section 23B(c). See 12 CFR 225.200; 62 FR 45295, Aug. 27, 1997. Prior to the adoption of the Operating Standards, all U.S. branches and agencies of a foreign bank (like all member banks) were prohibited from extending credit to, or purchasing assets

transactions between a U.S. branch or agency of a foreign bank and affiliates conducting merchant banking activities under the GLB Act and portfolio companies held under that authority.<sup>189</sup>

With one material exception, the regulation applies sections 23A and 23B to a U.S. branch or agency of a foreign bank as if the branch or agency were a member bank. The material exception is that the only companies that are deemed affiliates of such branch or agency of a foreign bank are affiliates of the foreign bank that are directly engaged in the United States in the following GLB Act financial activities: (i) insurance underwriting pursuant to section 4(k)(4)(B) of the BHC Act; (ii) securities underwriting and dealing pursuant to section 4(k)(4)(E) of the BHC Act; (iii) merchant banking activities pursuant to section 4(k)(4)(H) of the BHC Act;<sup>190</sup> or (iv) insurance company investment activities pursuant to section 4(k)(4)(I) of the BHC Act.<sup>191</sup>

The regulation also treats as a section 23A affiliate of a U.S. branch or agency any subsidiary of an affiliate of the foreign bank directly engaged in the four activities set forth above (regardless of whether the subsidiary itself engages in any of the four activities).<sup>192</sup> In addition, the rule treats as a section 23A affiliate of a U.S. branch or agency any portfolio company controlled by the foreign bank under the GLB Act's merchant banking or insurance company investment authorities (and any subsidiary of such a portfolio company). The regulation does not treat as a section 23A affiliate of a U.S. branch or agency any other type of affiliate of the foreign bank (for example, foreign affiliates or U.S. affiliates engaged in

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from, a section 20 affiliate. Consequently, the Board's 1997 decision partially to apply sections 23A and 23B to such branches and agencies represented a liberalization of the regulatory framework.

<sup>189</sup> See 12 CFR 225.176(b)(6); 66 FR 8466, Jan. 21, 2001.

<sup>190</sup> Regulation W, consistent with the merchant banking rule, imposes sections 23A and 23B on a covered transaction between a U.S. branch or agency of a foreign bank and its U.S. merchant banking affiliate only to the extent the proceeds of the covered transaction are used for the purpose of funding the affiliate's merchant banking activities.

<sup>191</sup> See 12 U.S.C. 1843(k)(4)(B), (E), (H), and (I).

<sup>192</sup> The regulation covers subsidiaries of affiliates directly engaged in the specified activities in order to prevent evasion. If these subsidiaries were not covered, the U.S. branch or agency of a foreign bank arguably could fund the foreign bank's U.S. insurance underwriter outside the scope of sections 23A and 23B by, for example, lending money to a subsidiary of the underwriter and having the subsidiary dividend or on-lend the loan proceeds to the underwriter.

nonbanking activities under section 4(c)(8) of the BHC Act), and does not treat a foreign bank's non-U.S. offices as member banks subject to section 23A.<sup>193</sup>

Applying the restrictions of sections 23A and 23B to transactions between the U.S. branches and agencies of foreign banks and the specified U.S. affiliates will help to ensure maintenance of a competitive playing field between U.S. banks and foreign banks operating in the United States. The issue of competitive equity arises most strongly in connection with those activities that a U.S. bank cannot engage in directly or through an operating subsidiary. A U.S. bank may affiliate itself with a company engaged in the financial activities specified above only if the company is a holding company affiliate of the bank or, in some cases, a financial subsidiary of the bank. In either case, covered transactions between the U.S. bank and the company would be subject to sections 23A and 23B. Without Regulation W's extension of the scope of these statutory provisions, a foreign bank's U.S. branch or agency could fund and engage in transactions with these types of affiliates more freely than could a U.S. bank. To the extent that a foreign bank's U.S. branches and agencies are able to fund these types of U.S. affiliates outside of the restrictions of sections 23A and 23B, the affiliates are able to compete for business in the United States with a potential advantage not available to the analogous affiliates of U.S. banks.

The Board does not believe that it is appropriate or necessary at this time to impose the requirements of sections 23A and 23B on transactions between a foreign bank's U.S. branch or agency and its U.S. affiliates that are engaged only in activities that were permissible for BHCs before the passage of the GLB Act (other than section 20 affiliates). The Board recognizes the hardship this might impose on foreign banks conducting such activities in the United States under previous law. Moreover, most of these activities may be conducted by a U.S. bank directly (or in an operating subsidiary) and, hence, may be funded by a U.S. bank in a manner that is not subject to sections 23A and 23B.<sup>194</sup>

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<sup>193</sup> The text and structure of the final rule on U.S. branches and agencies of foreign banks are somewhat different from that of the proposed rule. The proposed rule provided that section 23A applied to transactions between a U.S. branch or agency of a foreign bank, on the one hand, and certain U.S. affiliates of the foreign bank, on the other hand. The Board has revised the proposed rule to ensure that foreign banks treat certain indirect affiliate transactions as covered transactions under Regulation W. For example, an argument could be made that when a U.S. branch of a foreign bank accepts securities issued by a U.S. insurance company affiliate of the foreign bank as collateral for a loan to a nonaffiliate, there has been no transaction between the branch and the insurance affiliate. These transactions are, however, covered transactions under section 23A. The text and structure of the final rule make clear that such indirect affiliate transactions by a U.S. branch or agency of a foreign bank are subject to the rule.

<sup>194</sup> One U.S. bank commenter contended that Regulation W should be expanded to apply sections 23A and 23B to transactions between a foreign bank's U.S. branch or agency and a U.S. affiliate of the foreign bank engaged in any activities permissible under section 4(c)(8) of the BHC Act but not permissible for U.S. banks or their operating subsidiaries (for example,

The potential scope, nature, and risks of transactions and relationships between U.S. branches and agencies of foreign banks and their affiliates engaged in the United States in insurance underwriting, full-scope securities underwriting and dealing, merchant banking, and insurance company investment are unclear at this time. At least until the Board acquires more information and supervisory experience regarding these transactions and relationships, applying sections 23A and 23B will help ensure competitive equity between foreign banks and U.S. banking organizations in the funding of certain of their U.S. nonbank operations. The Board will regularly review this section of Regulation W, consistent with the requirements of section 114(b)(3) of the GLB Act, to determine whether there is a continuing need for its restrictions and will modify or eliminate any restrictions that are no longer required to mitigate potential or actual adverse effects.

The regulation also provides that the Board may add to the list of affiliates of a foreign bank that are subject to the restrictions of sections 23A and 23B. The Board intends generally to use this reserved authority to ensure competitive equity between foreign banks and U.S. banks with respect to affiliates engaged in the United States in new activities that the Board may authorize for FHCs.

The Board also has considered the issue of how to calculate the capital stock and surplus of a foreign bank's U.S. branch or agency for purposes of section 23A. In light of the fact that foreign banks do not separately capitalize their U.S. branches or agencies, the regulation defines the capital stock and surplus of such branches and agencies by reference to the capital of the foreign bank as calculated under its home country capital standards. This definition is consistent with the approach adopted by the Board in its merchant banking rule,<sup>195</sup> and represents a relaxation from the Board's current position with respect to foreign banks that operate section 20 affiliates in the United States.<sup>196</sup>

A number of commenters strongly objected to the foreign bank provisions of the proposed rule, including the Canadian Department of Finance, the Institute of International Bankers, the Canadian Bankers Association, and the Swiss Bankers Association. Several of

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real estate leasing). The Board has determined not to add such activities to the rule's foreign bank activity list at this time because of the hardship this would impose on foreign banks and because the Board has substantial supervisory experience with such activities and has not observed any adverse competitive effects in the relevant markets. The Board does not intend to add such activities to the list in the future unless adverse competitive effects develop in the relevant markets that could be remedied by an expansion of the scope of sections 23A and 23B to the U.S. operations of foreign banks.

<sup>195</sup> See 66 FR 8466, 8482, Jan. 31, 2001.

<sup>196</sup> The Board's position on section 20 affiliates requires U.S. branches and agencies of foreign banks whose home country supervisor has not adopted capital standards consistent with the Basle Accord to calculate their section 23A capital stock and surplus by reference to the capital of the foreign bank parent as calculated under standards applicable to U.S. banking organizations. See 62 FR 45304, Aug. 27, 1997.



these commenters challenged the Board's authority under section 114 of the GLB Act to apply section 23A to the U.S. branches and agencies of foreign banks. According to these commenters, the Board's action fails to meet the first requirement of section 114 (consistency with Federal banking law) because Federal banking law does not generally subject U.S. branches and agencies of foreign banks to section 23A. In commenters' view, the Board's action also fails to meet the second prong of section 114 (intention to prevent adverse effects) because the Board has not presented specific evidence of actual abuse and is admittedly acting to fight possible future abuse.

The Board believes that its partial application of sections 23A and 23B to the U.S. branches and agencies of foreign banks is consistent with Federal banking law. The Board is aware of, and commenters cited, no Federal banking laws that contradict or otherwise conflict with the provisions of subpart G of Regulation W. Moreover, the Board disagrees with the implication of commenters' views of section 114, which would render section 114 useless by preventing the Board from imposing safeguards under the section unless such safeguards were already present in Federal banking law. Commenters also have failed to present evidence to support their claim that the Board may only use section 114 to combat adverse effects for which the Board has made specific findings. Nothing in the text or legislative history of the GLB Act supports this position. The Board does not believe that section 114 requires the Board to wait, observe, and document damage to U.S. financial institutions or markets before it may take action under the section to impose prudential safeguards.

Some commenters argued that the competitive equity justification for the Board's partial application of sections 23A and 23B to the U.S. branches and agencies of foreign banks does not fit within the "unfair competition" rationale in section 114 of the GLB Act. According to these commenters, the Board previously acknowledged that the "unfair competition" prong of section 4(j) of the BHC Act did not authorize the Board to consider disparities based on the structure of the banking industry.<sup>197</sup> Again, the Board is not aware of, and commenters have not presented, evidence that the phrase "unfair competition" in section 114(b)(4)(B) of the GLB Act cannot or should not be read to include competitive advantages based on regulatory environment. Importantly, the Board is not bound by its former interpretations of the BHC Act when interpreting provisions of the GLB Act. The Board notes that its former interpretation of section 4(j) of the BHC Act explicitly depended on the specific legislative history of section 4(j) and other sections of the BHC Act. The legislative history of the GLB Act does not similarly constrain the Board's interpretation of section 114. Indeed, the Congressional intent behind the GLB Act strongly supports the Board's position on this matter. The GLB Act authorized an expanded set of permissible activities for banking organizations, but required such activities to be conducted in section 23A affiliates of a bank (not directly in the bank) in order to reduce risks to the bank and to constrain the spread of the government subsidy enjoyed by banks. This Congressional concern to limit the transference of the bank subsidy into markets for other financial services is the

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<sup>197</sup> See BankAmerica Corporation, 69 Federal Reserve Bulletin 105, 111 (1983).

same competitive concern that has motivated the Board to apply sections 23A and 23B to some portion of the U.S. operations of foreign banks.<sup>198</sup>

Several commenters on the foreign bank provisions of the proposed rule advanced the proposition that foreign banks do not enjoy a subsidy in the United States and do not have a competitive advantage over U.S. banking organizations. In fact, according to these commenters, U.S. banking firms have a competitive “home field” advantage in the United States.<sup>199</sup> The Board’s partial application of sections 23A and 23B to the U.S. branches and agencies of foreign banks does not depend for its justification on whether foreign banks operating in the United States generally have a competitive advantage over U.S. banking firms. Rather, as noted above, the Board has chosen to extend the scope of sections 23A and 23B to address a specific potential competitive imbalance: the funding advantages enjoyed by the specified types of affiliates of foreign banks as compared to the same types of affiliates of U.S. banks. Foreign banks are able to raise low-cost deposits abroad and to use this low-cost funding to finance, including through their U.S. branches and agencies, the activities of the specified U.S. affiliates without having to comply with sections 23A and 23B. U.S. banks are limited by sections 23A and 23B in the extent to which they are able to finance the operations of the specified affiliates.

Commenters also pointed out alleged inconsistencies in the Board’s treatment of the U.S. branches and agencies of foreign banks under subpart G. First, several commenters stated that it is inconsistent and unfair to subject the U.S. branches and agencies of foreign banks to section 23A but then to deny them the benefits of the sister-bank exemption. Regulation W does not, as a general matter, apply section 23A to transactions between a U.S. branch or agency and a sister U.S. branch, agency, or depository institution. The rule only applies section 23A to transactions between the U.S. branch or agency and a U.S. affiliate of the foreign bank engaged in the United States in insurance underwriting, securities underwriting and dealing, merchant banking, or insurance company investment. Because these activities generally are not permissible activities for a U.S. branch, agency, or subsidiary depository

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<sup>198</sup> The Board also notes that the “adverse effects” clause in section 114 of the GLB Act is broader than the “adverse effects” clause in section 4(j) of the BHC Act. Significantly, section 114, unlike section 4(j), explicitly authorizes the Board to consider risks to the safety and soundness of U.S. depository institutions. In the Board’s view, the safety and soundness of U.S. depository institutions could be put at risk if certain of their affiliates are forced to compete with the affiliates of foreign banks at a significant regulatory disadvantage.

<sup>199</sup> In support of their position, many of these commenters referred to a study conducted by the Federal Reserve System that concluded that section 20 affiliates of U.S. BHCs have outperformed section 20 affiliates of foreign banks. In light of the fact that the Board has imposed many of the restrictions of sections 23A and 23B on transactions between the U.S. branches and agencies of foreign banks and their section 20 affiliates, this study does not provide much evidence as to whether foreign bank-owned securities underwriters and dealers would enjoy a competitive advantage over U.S. BHC-owned securities underwriters and dealers in the absence of an extension of sections 23A and 23B to cover foreign banks.

institution of a foreign bank, subpart G of the rule generally does not apply section 23A to transactions between the U.S. branch or agency of a foreign bank and any sister banks of the branch or agency.

Second, commenters claimed that it is inconsistent to permit a U.S. bank to fund its non-U.S. subsidiaries through a non-U.S. branch without complying with section 23A, but to force a non-U.S. bank to fund its U.S. subsidiaries through a U.S. branch in compliance with section 23A. As explained above, the Board is adopting subpart G of Regulation W in order to mitigate potential competitive inequities in certain nonbanking markets in the United States. Non-U.S. financial regulators are free to address any similar inequities that exist in their nonbanking markets due to disparate regulatory treatment. The Board notes that section 23A generally would apply to transactions between a U.S. bank and a foreign affiliate of the U.S. bank engaged in the four specified activities (other than an Edge subsidiary of the U.S. bank engaged in securities underwriting and dealing or certain limited investment activities).

#### X. Miscellaneous Interpretations--Subpart H

The Board has decided to include a subpart H in final Regulation W to house Board interpretations of sections 23A and 23B that do not fit neatly elsewhere in the regulation. Although subpart H of the final rule contains only a single section, the Board intends to place future Board miscellaneous interpretations of the statute into this subpart.

Section 223.71 of the final rule explains how sections 23A and 23B apply to transactions in which a member bank purchases from one affiliate an asset relating to another affiliate. In some situations in which a member bank purchases an asset from an affiliate, the asset purchase qualifies for an exemption under Regulation W, but the member bank's resulting ownership of the purchased asset also represents another covered transaction (which may or may not qualify for an exemption under the rule). In these situations, the transaction engaged in by the member bank would qualify as two different types of covered transaction. Although an asset purchase exemption may suffice to exempt the member bank's asset purchase from the first affiliate, the asset purchase exemption does not exempt the bank's resulting covered transaction with the second affiliate.

For example, assume a member bank purchases from one affiliate securities issued by another affiliate in a purchase that qualifies for the (d)(6) exemption in section 23A. The member bank's asset purchase from the first affiliate would be exempt under § 223.42(e) of the rule; but the bank also would have acquired an investment in securities issued by the second affiliate, which would be a covered transaction between the bank and the second affiliate that does not qualify for the (d)(6) exemption. The (d)(6) exemption, by its terms, only exempts asset purchases by a member bank from an affiliate; hence, the (d)(6) exemption cannot exempt a member bank's investment in securities issued by an affiliate (even if the securities would qualify for the (d)(6) exemption).

Section 223.71 sets forth this general interpretation and includes several examples to flesh out the interpretation (including the example given in the previous paragraph).<sup>200</sup>

#### XI. Effective Date; Transition Rule

Many commenters urged the Board to provide either a transition period for banks to come into compliance with Regulation W or a grandfather for existing transactions that do not comply with the rule. According to these commenters, banks need such relief because of the many ways in which the rule is inconsistent with existing bank practices or existing staff interpretations of section 23A. Although most commenters did not propose a specific time period, one commenter advocated a transition period of 2 to 3 years.

The Board recognizes that Regulation W tightens a number of traditional Board and staff interpretations of sections 23A and 23B. The Board also believes that the changes effected by the final rule are of substantial regulatory importance, and that the burden on member banks of full and prompt compliance with the final rule will be minimal in most cases. Accordingly, the Board has decided to delay the effective date of the rule only for the minimum period of time required by law and to provide member banks with only a limited transition period and grandfather authority for preexisting transactions.

The Board has decided to make Regulation W effective as of April 1, 2003. Accordingly, transactions entered into on or after April 1, 2003, will be immediately subject to the rule. Transactions entered into after [date of FR notice], but before April 1, 2003, will become subject to the rule on April 1, 2003.

The Board also has determined to adopt a limited transition rule for transactions that consummate on or before the date of publication of final Regulation W in the Federal Register. As a general matter, any transaction engaged in by a member bank on or before [date of FR notice] that would become subject to section 23A or 23B solely as a result of this rule, or whose treatment under section 23A or 23B would change solely as a result of this rule, will not become subject to this rule until July 1, 2003. The Board may, in its discretion, extend this deadline in circumstances where a member bank has demonstrated to the Board's satisfaction that compliance with the deadline would impose regulatory burden on the member bank that outweighs the regulatory benefit of early compliance.

For purposes of the transition rule, a transaction is subject to section 23A or 23B solely as a result of Regulation W if the transaction is subject to section 23A or 23B under the rule but was not subject to section 23A or 23B under the terms of the sections or any written interpretations of the sections by the Board or its staff that predated [date of FR notice]. In addition, a transaction's treatment under section 23A or 23B changes solely as a result of Regulation W if the treatment of the transaction under the rule differs from the treatment of the transaction under the terms of sections 23A and 23B or any written interpretations of the sections by the Board or its staff that predated [date of FR notice].

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<sup>200</sup> In light of the inclusion of section 223.71 in the final rule, the Board has removed certain conditions to the (d)(6)-related exemptions in section 223.42(e) and (f) of the rule.

The transition rule has several exceptions. First, any transaction that qualifies for the transition rule but is renewed, extended, or materially altered on or after April 1, 2003, will be immediately subject to the rule at the time of such renewal, extension, or material alteration. In addition, any transaction that qualifies for the transition rule but is a purchase of assets by a member bank from an affiliate that consummated on or before [date of FR notice] will not be subject to this rule.

The following examples are designed to assist member banks in understanding the transition rule. The first example involves an extension of credit that predates [date of FR notice]. Suppose that on February 18, 2002, a member bank makes a loan to an unregistered investment fund advised (but not sponsored) by the bank. The member bank does not control the fund, but the bank's holding company owns 10 percent of the total equity of the fund. The fund is not an affiliate of the member bank under sections 23A and 23B and written interpretations of such sections by the Board and its staff at the time the loan is made. The fund would become an affiliate of the member bank under Regulation W, and the loan would become a covered transaction, as of July 1, 2003.<sup>201</sup> If the member bank renews the loan on May 14, 2003, however, the loan would become a covered transaction as of May 14, 2003.

The second example involves an asset purchase that predates [date of FR notice]. Suppose that on August 9, 2002, a member bank purchases assets from an uninsured depository institution affiliate in a transaction that qualifies for the sister-bank exemption in section 23A(d)(4). Although Regulation W renders the sister-bank exemption unavailable for transactions with uninsured depository institution affiliates as of April 1, 2003, the asset purchase would permanently qualify for the sister-bank exemption.

The Board also has determined to allow member banks to apply certain provisions of Regulation W that relieve regulatory burden before the rule's effective date.<sup>202</sup> In particular, notwithstanding the effective date and transition rule provisions discussed above, a member bank may choose to apply any of the following provisions of the rule beginning on [date of FR notice]: (i) section 223.16(c)(4); (ii) section 223.24(a), (b), or (c); (iii) section 223.31(d); (iv) section 223.41(d); or (v) section 223.42(c), (f), (g), (i), (j), or (k).

### **Regulatory Flexibility Act**

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 604(a)), the Board must publish a final regulatory flexibility analysis with this rulemaking. Sections 23A and 23B of the Federal Reserve Act limit transactions between a depository institution and its affiliates and authorize the Board to issue regulations as necessary to administer and carry out

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<sup>201</sup> The Board would expect member banks to treat such a transaction, as of July 1, 2003, in accordance with the timing rules set forth in section 223.21(b)(2) of Regulation W for a credit transaction with a nonaffiliate that becomes an affiliate.

<sup>202</sup> Permitting member banks to comply with provisions of the final rule that relieve burden prior to the rule's effective date is consistent with applicable Federal law. See 5 U.S.C 553 and 12 U.S.C. 4802.

the purposes of the sections.<sup>203</sup> Sections 23A and 23B are two of the most important statutory protections against a depository institution suffering losses from its transactions with affiliates and, correspondingly, are two of the most effective means of limiting the ability of a depository institution to transfer to its affiliates the subsidy arising from its access to the Federal safety net. Although sections 23A and 23B each grant the Board authority to issue regulations, the Board has never issued a regulation fully implementing either section. Instead, depository institutions seeking guidance on how to comply with sections 23A and 23B have relied on a series of Board interpretations and informal staff opinions. Banking organizations have increasingly sought guidance from the Board on section 23A issues in recent years as a result of the increasing scope of activities conducted by modern FHCs and the growing complexities of the U.S. financial markets.

As noted above, the Board believes that adoption of a comprehensive regulation implementing sections 23A and 23B is appropriate for several reasons. First, the new regulatory framework established by the GLB Act emphasizes the importance of sections 23A and 23B as a means to protect depository institutions from losses in transactions with affiliates. Moreover, adoption of a comprehensive regulation will simplify the interpretation and application of sections 23A and 23B, ensure that the statute is consistently interpreted and applied, and minimize burden to the extent consistent with the statute's goals.

The Board received approximately 120 public comments in response to the Board's proposed section 23A rulemakings. As discussed above, nearly all commenters supported the Board's decision to issue Regulation W, but raised specific concerns on certain aspects of the regulation. The preamble provides a detailed discussion of the public comments. The Board considered the alternatives proposed by the comments, and the preamble describes the numerous changes that the Board made to the proposed rule as a result of the comments.

Regulation W provides users with a single, comprehensive reference tool for complying with and analyzing issues arising under sections 23A and 23B. Accordingly, the regulation incorporates Board and staff interpretations and also restates the statutory definitions, restrictions, and exemptions in order to make understanding and using the regulation easier.

The regulation first sets forth, in subpart A, a comprehensive glossary of the terms used in the regulation. Subpart B then describes the principal restrictions and requirements imposed by section 23A. Next, in subpart C, the regulation discusses the appropriate valuation and timing principles for covered transactions. Subpart D discusses the appropriate treatment under section 23A for transactions with financial subsidiaries, derivative transactions with affiliates, and certain merger and acquisition transactions with affiliates. Subpart E sets forth available exemptions from certain of the requirements of section 23A. Subpart F lays out the operative provisions of section 23B. Subpart G discusses the application of the rule to U.S. branches and agencies of foreign banks. Subpart H contains an additional interpretation of the statute. Regulation W also includes examples illustrating how several of the rule's provisions apply in particular circumstances.

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<sup>203</sup> 12 U.S.C. 371c(f) and 371c-1(e).

Regulation W applies, by its terms, to all member banks regardless of their size. The regulation affects all insured depository institutions, however, because other Federal law subjects insured nonmember banks and insured thrifts to sections 23A and 23B as if they were member banks. The rule also applies indirectly to the “affiliates” of insured depository institutions. A depository institution’s affiliates include, among other companies, any company that controls the institution, any company under common control with the institution, and certain investment funds that are advised by the institution or an affiliate of the institution. The number of small entities affected by Regulation W is estimated to be a little over 6,500, including 3,292 depository institutions. For purposes of this regulatory flexibility analysis, the Board defines small entity as any depository institution or other company with less than \$150 million in total assets. The Board does not collect data on all affiliates of depository institutions at this time. Accordingly, the exact number of small entities affected by the rule would require additional surveys or reports, which would increase the burden on the public and are not necessary for implementation of the rule.

The vast majority of depository institutions that are currently in compliance with sections 23A and 23B will also be in compliance with the rule. The rule does not impose any new compliance requirements and mainly codifies existing practice and grants new exemptions. The rule includes several exemptions that will be available to a depository institution only if it notifies its primary Federal supervisor. This notification, however, allows the institution to engage in a transaction that is otherwise prohibited by law and replaces the current requirement of a more time-consuming case-by-case exemption request to the Board. The primary Federal supervisor of an institution also may require additional documentation to ensure compliance with the regulation. Moreover, the Board has delegated authority to the primary Federal supervisors of depository institutions to make certain determinations as to the permissibility of certain transactions.

The rule does not result in significant additional burden to the institutions that must comply with its terms. The provisions of Regulation W, in fact, may be less burdensome than existing law because of the increased number of exemptions. One alternative to adopting this rule is to maintain the current collection of formal and informal Board and staff interpretations. Most public commenters believed, however, that the adoption of Regulation W would reduce burden by placing sections 23A and 23B and the Board’s interpretations thereof in a single, comprehensive, public document.

### **Paperwork Reduction Act**

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the rule under the authority delegated to the Board by the Office of Management and Budget. The Federal Reserve may not conduct or sponsor, and an organization is not required to respond to, an information collection unless the Federal Reserve displays a currently valid OMB control number. The Federal Reserve will assign an OMB control number.

The collection of information requirements in this final rulemaking are found in 12 CFR 223.15(b)(4), 223.31(d)(4), 223.41(d)(2), and 223.43(b). This information is required to evidence compliance with sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c

and 371c-1). The respondents are all insured depository institutions and uninsured member banks.

The notice requirement cited in 12 CFR 223.15(b)(4) is a condition to an exemption for renewals of loan participations involving problem loans. The participating depository institution must provide its appropriate Federal banking agency with written notice of the renewal or extension of additional credit not later than 20 days after consummation. There will be no reporting form associated with this information collection. The Board estimates that approximately 10 depository institutions will file this notice annually and that it will take approximately 2 hours to prepare the notice.

The notice requirement cited in 12 CFR 223.31(d)(4) is a condition to an exemption for a depository institution's acquisition of an affiliate that becomes an operating subsidiary of the institution after the acquisition. The institution must provide its appropriate Federal banking agency and the Board with written notice of its intention to acquire the company at or before the time that the company becomes an affiliate of the institution. There will be no reporting form associated with this information collection. The Board estimates that approximately 10 depository institutions will file this notice annually and that it will take approximately 6 hours to prepare the notice.

The notice requirement cited in 12 CFR 223.41(d)(2) is a condition to an exemption for internal corporate reorganization transactions. The depository institution must provide its appropriate Federal banking agency and the Board with written notice of the transaction before consummation. The notice must describe the primary business activities of the affiliate and indicate the proposed date of the reorganization. There will be no reporting form associated with this information collection. The Board estimates that approximately 20 depository institutions will file this notice annually and that it will take approximately 6 hours to prepare a notice.

The notice requirement cited in 12 CFR 223.43(b) provides procedures for requesting additional exemptions from the requirements of section 23A. The depository institution must submit a written request to the General Counsel of the Board. The request must describe in detail the transaction or relationship for which the institution seeks exemption; explain why the Board should exempt the transaction or relationship; and explain how the exemption would be in the public interest and consistent with the purposes of section 23A. There will be no reporting form associated with this information collection. The Board estimates that approximately 5 depository institutions will file these requests annually and that it will take approximately 10 hours to prepare a request.

The total estimated annual burden for the depository institutions that must comply with the above-mentioned requirements is 250 hours. Based on a rate of \$50 per hour, the total annual cost to the public for these collections of information is estimated to be \$12,500.

In addition, there are existing reports (such as the Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates (FR Y-8; OMB No. 7100-0126)) that will be modified to reflect the adoption of this rule. The Board expects to



publish a separate notice describing the changes to these reports. The burden associated with these collections of information will be addressed at that time.

Comments are invited on (i) whether the proposed notifications are necessary for the proper performance of the Board's functions, including whether the information contained in the notifications would have practical utility; (ii) the accuracy of the Board's estimate of the burden of the proposed information collections, including the cost of compliance; (iii) ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) ways to minimize the burden of information collections on respondents, including through the use of automated collection techniques or other forms of information technology.

Comments regarding any aspect of these information collections, including suggestions for reducing the burden, must be submitted on or before [INSERT DATE 60 DAYS FROM PUBLICATION IN THE FEDERAL REGISTER], and may be sent to: Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-[to be assigned]), Washington, D.C. 20503.

### **Solicitation of Comments Regarding Use of "Plain Language"**

Section 722 of the GLB Act requires the Board to use "plain language" in all proposed and final rules published after January 1, 2000. The Board invited comments about how to make the proposed rule easier to understand and, in doing so, posed the following questions:

- (1) Has the Board organized the material in an effective manner? If not, how could the material be better organized?
- (2) Are the terms of the rule clearly stated? If not, how could the terms be more clearly stated?
- (3) Does the rule contain technical language or jargon that is unclear? If so, which language requires clarification?
- (4) Would a different format (with respect to grouping and order of sections and use of headings) make the rule easier to understand? If so, what changes to the format would make the rule easier to understand?
- (5) Would increasing the number of sections (and making each section shorter) clarify the rule? If so, which portions of the rule should be changed in this respect?
- (6) What additional changes would make the rule easier to understand?

The Board also provided examples in the proposed rule to illustrate how several of the rule's provisions would apply in particular circumstances, and solicited comment on what kinds of additional examples should be added to the rule.

Commenters generally expressed support for the format of the regulation and believed that the rule conveyed the Board's interpretations of section 23A in plain language. Several

commenters did recommend, however, that the Board move the definitional sections of the rule to the front. In response to these comments, the Board has placed the rule's definitions in the first subpart of the rule.

Several commenters also recommended clarification of several examples contained in the proposed rule and inclusion of additional examples, particularly in the valuation subpart of the rule. The final rule modifies several of the proposed rule's examples to enhance their illustrative power and includes a number of new examples to increase the ability of users of the regulation to understand the valuation formulas of the rule.

### **List of Subjects in 12 CFR part 223**

Banks, Banking; Federal Reserve System.

For the reasons set out in the preamble, title 12 of the Code of Federal Regulations is amended by adding a new part 223 to read as follows:

### **PART 223—TRANSACTIONS BETWEEN MEMBER BANKS AND THEIR AFFILIATES (REGULATION W)**

#### **Subpart A—Introduction and Definitions**

223.1 Authority, purpose, and scope.

223.2 What is an “affiliate” for purposes of sections 23A and 23B and this regulation?

223.3 What are the meanings of the other terms used in sections 23A and 23B and this regulation?

#### **Subpart B—General Provisions of Section 23A**

223.11 What is the maximum amount of covered transactions that a member bank may enter into with any single affiliate?

223.12 What is the maximum amount of covered transactions that a member bank may enter into with all affiliates?

223.13 What safety and soundness requirement applies to covered transactions?

223.14 What are the collateral requirements for a credit transaction with an affiliate?

223.15 May a member bank purchase a low-quality asset from an affiliate?

223.16 What transactions by a member bank with any person are treated as transactions with an affiliate?

#### **Subpart C—Valuation and Timing Principles under Section 23A**

223.21 What valuation and timing principles apply to credit transactions?

223.22 What valuation and timing principles apply to asset purchases?

223.23 What valuation and timing principles apply to purchases of and investments in securities issued by an affiliate?

223.24 What valuation principles apply to extensions of credit secured by affiliate securities?

**Subpart D—Other Requirements under Section 23A**

223.31 How does section 23A apply to a member bank's acquisition of an affiliate that becomes an operating subsidiary of the member bank after the acquisition?

223.32 What rules apply to financial subsidiaries of a member bank?

223.33 What rules apply to derivative transactions?

**Subpart E—Exemptions from the Provisions of Section 23A**

223.41 What covered transactions are exempt from the quantitative limits and collateral requirements?

223.42 What covered transactions are exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition?

223.43 What are the standards under which the Board may grant additional exemptions from the requirements of section 23A?

**Subpart F—General Provisions of Section 23B**

223.51 What is the market terms requirement of section 23B?

223.52 What transactions with affiliates or others must comply with section 23B's market terms requirement?

223.53 What asset purchases are prohibited by section 23B?

223.54 What advertisements and statements are prohibited by section 23B?

223.55 What are the standards under which the Board may grant exemptions from the requirements of section 23B?

**Subpart G—Application of Sections 23A and 23B to U.S. Branches and Agencies of Foreign Banks**

223.61 How do sections 23A and 23B apply to U.S. branches and agencies of foreign banks?

## **Subpart H—Miscellaneous Interpretations**

223.71 How do sections 23A and 23B apply to transactions in which a member bank purchases from one affiliate an asset relating to another affiliate?

Authority: 12 U.S.C. 371c(b)(1)(E), (b)(2)(A), and (f), 371c-1(e), 1828(j), and 1468(a).

## **Subpart A—Introduction and Definitions**

### **§ 223.1 Authority, purpose, and scope.**

(a) Authority. The Board of Governors of the Federal Reserve System (Board) has issued this part (Regulation W) under the authority of sections 23A(f) and 23B(e) of the Federal Reserve Act (12 U.S.C. 371c(f), 371c-1(e)).

(b) Purpose. Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c-1) establish certain quantitative limits and other prudential requirements for loans, purchases of assets, and certain other transactions between a member bank and its affiliates. This regulation implements sections 23A and 23B by defining terms used in the statute, explaining the statute's requirements, and exempting certain transactions.

(c) Scope. Sections 23A and 23B and this regulation apply by their terms to “member banks” – that is, any national bank, State bank, trust company, or other institution that is a member of the Federal Reserve System. In addition, the Federal Deposit Insurance Act (12 U.S.C. 1828(j)) applies sections 23A and 23B to insured State nonmember banks in the same manner and to the same extent as if they were member banks. The Home Owners' Loan Act (12 U.S.C. 1468(a)) also applies sections 23A and 23B to insured savings associations in the same manner and to the same extent as if they were member banks (and imposes two additional restrictions).

### **§ 223.2 What is an “affiliate” for purposes of sections 23A and 23B and this regulation?**

(a) For purposes of this part and except as provided in paragraphs (b) and (c) of this section, “affiliate” with respect to a member bank means:

(1) Parent companies. Any company that controls the member bank;

(2) Companies under common control by a parent company. Any company, including any subsidiary of the member bank, that is controlled by a company that controls the member bank;

(3) Companies under other common control. Any company, including any subsidiary of the member bank, that is controlled, directly or indirectly, by trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank;

(4) Companies with interlocking directorates. Any company in which a majority of its directors, trustees, or general partners (or individuals exercising similar functions) constitute a

majority of the persons holding any such office with the member bank or any company that controls the member bank;

(5) Sponsored and advised companies. Any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or an affiliate of the member bank;

(6) Investment companies.

(i) Any investment company for which the member bank or any affiliate of the member bank serves as an investment adviser, as defined in section 2(a)(20) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(20)); and

(ii) Any other investment fund for which the member bank or any affiliate of the member bank serves as an investment advisor, if the member bank and its affiliates own or control in the aggregate more than 5 percent of any class of voting securities or of the equity capital of the fund;

(7) Depository institution subsidiaries. A depository institution that is a subsidiary of the member bank;

(8) Financial subsidiaries. A financial subsidiary of the member bank;

(9) Companies held under merchant banking or insurance company investment authority.

(i) In general. Any company in which a holding company of the member bank owns or controls, directly or indirectly, or acting through one or more other persons, 15 percent or more of the equity capital pursuant to section 4(k)(4)(H) or (I) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H) or (I)).

(ii) General exemption. A company will not be an affiliate under paragraph (a)(9)(i) of this section if the holding company presents information to the Board that demonstrates, to the Board's satisfaction, that the holding company does not control the company.

(iii) Specific exemptions. A company also will not be an affiliate under paragraph (a)(9)(i) of this section if:

(A) No director, officer, or employee of the holding company serves as a director, trustee, or general partner (or individual exercising similar functions) of the company;

(B) A person that is not affiliated or associated with the holding company owns or controls a greater percentage of the equity capital of the company than is owned or controlled by the holding company, and no more than one officer or employee of the holding company serves as a director or trustee (or individual exercising similar functions) of the company; or

(C) A person that is not affiliated or associated with the holding company owns or controls more than 50 percent of the voting shares of the company, and officers and employees

of the holding company do not constitute a majority of the directors or trustees (or individuals exercising similar functions) of the company.

(iv) Application of rule to private equity funds. A holding company will not be deemed to own or control the equity capital of a company for purposes of paragraph (a)(9)(i) of this section solely by virtue of an investment made by the holding company in a private equity fund (as defined in the merchant banking subpart of the Board's Regulation Y (12 CFR 225.173(a))) that owns or controls the equity capital of the company unless the holding company controls the private equity fund under 12 CFR 225.173(d)(4).

(v) Definition. For purposes of this paragraph (a)(9), "holding company" with respect to a member bank means a company that controls the member bank, or a company that is controlled by shareholders that control the member bank, and all subsidiaries of the company (including any depository institution that is a subsidiary of the company).

(10) Partnerships associated with the member bank or an affiliate. Any partnership for which the member bank or any affiliate of the member bank serves as a general partner or for which the member bank or any affiliate of the member bank causes any director, officer, or employee of the member bank or affiliate to serve as a general partner;

(11) Subsidiaries of affiliates. Any subsidiary of a company described in paragraphs (a)(1) through (10) of this section; and

(12) Other companies. Any company that the Board determines by regulation or order, or that the appropriate Federal banking agency for the member bank determines by order, to have a relationship with the member bank, or any affiliate of the member bank, such that covered transactions by the member bank with that company may be affected by the relationship to the detriment of the member bank.

(b) "Affiliate" with respect to a member bank does not include:

(1) Subsidiaries. Any company that is a subsidiary of the member bank, unless the company is:

(i) A depository institution;

(ii) A financial subsidiary;

(iii) Directly controlled by:

(A) One or more affiliates (other than depository institution affiliates) of the member bank; or

(B) A shareholder that controls the member bank or a group of shareholders that together control the member bank;

(iv) An employee stock option plan, trust, or similar organization that exists for the benefit of the shareholders, partners, members, or employees of the member bank or any of its affiliates; or

(v) Any other company determined to be an affiliate under paragraph (a)(12) of this section;

(2) Bank premises. Any company engaged solely in holding the premises of the member bank;

(3) Safe deposit. Any company engaged solely in conducting a safe deposit business;

(4) Government securities. Any company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and

(5) Companies held DPC. Any company where control results from the exercise of rights arising out of a bona fide debt previously contracted. This exclusion from the definition of “affiliate” applies only for the period of time specifically authorized under applicable State or Federal law or regulation or, in the absence of such law or regulation, for a period of two years from the date of the exercise of such rights. The Board may authorize, upon application and for good cause shown, extensions of time for not more than one year at a time, but such extensions in the aggregate will not exceed three years.

(c) For purposes of subpart F (implementing section 23B), “affiliate” with respect to a member bank also does not include any depository institution.

### **§ 223.3 What are the meanings of the other terms used in sections 23A and 23B and this regulation?**

For purposes of this part:

(a) “Aggregate amount of covered transactions” means the amount of the covered transaction about to be engaged in added to the current amount of all outstanding covered transactions.

(b) “Appropriate Federal banking agency” with respect to a member bank or other depository institution has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(c) “Bank holding company” has the same meaning as in 12 CFR 225.2.

(d) “Capital stock and surplus” means the sum of:

(1) A member bank’s tier 1 and tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency, based on the member bank’s most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3);

(2) The balance of a member bank's allowance for loan and lease losses not included in its tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency, based on the member bank's most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3); and

(3) The amount of any investment by a member bank in a financial subsidiary that counts as a covered transaction and is required to be deducted from the member bank's capital for regulatory capital purposes.

(e) "Carrying value" with respect to a security means (unless otherwise provided) the value of the security on the financial statements of the member bank, determined in accordance with GAAP.

(f) "Company" means a corporation, partnership, limited liability company, business trust, association, or similar organization and, unless specifically excluded, includes a member bank and a depository institution.

(g) Control. (1) In general. "Control" by a company or shareholder over another company means that:

(i) The company or shareholder, directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;

(ii) The company or shareholder controls in any manner the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of the other company; or

(iii) The Board determines, after notice and opportunity for hearing, that the company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.

(2) Ownership or control of shares as fiduciary. Notwithstanding any other provision of this regulation, no company will be deemed to control another company by virtue of its ownership or control of shares in a fiduciary capacity, except as provided in paragraph (a)(3) of § 223.2 or if the company owning or controlling the shares is a business trust.

(3) Ownership or control of securities by subsidiary. A company controls securities, assets, or other ownership interests owned or controlled, directly or indirectly, by any subsidiary (including a subsidiary depository institution) of the company.

(4) Ownership or control of convertible instruments. A company or shareholder that owns or controls instruments (including options or warrants) that are convertible or exercisable, at the option of the holder or owner, into securities, controls the securities, unless the company or shareholder presents information to the Board that demonstrates, to the Board's satisfaction, that the company or shareholder should not be deemed to control the securities.



(5) Ownership or control of nonvoting securities. A company or shareholder that owns or controls 25 percent or more of the equity capital of another company controls the other company, unless the company or shareholder presents information to the Board that demonstrates, to the Board's satisfaction, that the company or shareholder does not control the other company.

(h) "Covered transaction" with respect to an affiliate means:

(1) An extension of credit to the affiliate;

(2) A purchase of, or an investment in, a security issued by the affiliate;

(3) A purchase of an asset from the affiliate, including an asset subject to recourse or an agreement to repurchase, except such purchases of real and personal property as may be specifically exempted by the Board by order or regulation;

(4) The acceptance of a security issued by the affiliate as collateral for an extension of credit to any person or company; and

(5) The issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the affiliate, a confirmation of a letter of credit issued by the affiliate, and a cross-affiliate netting arrangement.

(i) "Credit transaction" with an affiliate means:

(1) An extension of credit to the affiliate;

(2) An issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the affiliate and a confirmation of a letter of credit issued by the affiliate; and

(3) A cross-affiliate netting arrangement.

(j) "Cross-affiliate netting arrangement" means an arrangement among a member bank, one or more affiliates of the member bank, and one or more nonaffiliates of the member bank in which:

(1) A nonaffiliate is permitted to deduct any obligations of an affiliate of the member bank to the nonaffiliate when settling the nonaffiliate's obligations to the member bank; or

(2) The member bank is permitted or required to add any obligations of its affiliate to a nonaffiliate when determining the member bank's obligations to the nonaffiliate.

(k) "Depository institution" means, unless otherwise noted, an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), but does not include any branch of a foreign bank. For purposes of this definition, an operating subsidiary of a depository institution is treated as part of the depository institution.

(l) “Derivative transaction” means any derivative contract listed in sections III.E.1.a. through d. of Appendix A to 12 CFR part 225 and any similar derivative contract, including a credit derivative contract.

(m) “Eligible affiliated mutual fund securities” has the meaning specified in paragraph (c)(2) of § 223.24.

(n) “Equity capital” means:

(1) With respect to a corporation, preferred stock, common stock, capital surplus, retained earnings, and accumulated other comprehensive income, less treasury stock, plus any other account that constitutes equity of the corporation; and

(2) With respect to a partnership, limited liability company, or other company, equity accounts similar to those described in paragraph (n)(1) of this section.

(o) “Extension of credit” to an affiliate means the making or renewal of a loan, the granting of a line of credit, or the extending of credit in any manner whatsoever, including on an intraday basis, to an affiliate. An extension of credit to an affiliate includes, without limitation:

(1) An advance to an affiliate by means of an overdraft, cash item, or otherwise;

(2) A sale of Federal funds to an affiliate;

(3) A lease that is the functional equivalent of an extension of credit to an affiliate;

(4) An acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate;

(5) Any increase in the amount of, extension of the maturity of, or adjustment to the interest rate term or other material term of, an extension of credit to an affiliate; and

(6) Any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent).

(p) “Financial subsidiary”

(1) In general. Except as provided in paragraph (p)(2) of this section, the term “financial subsidiary” means any subsidiary of a member bank that:

(i) Engages, directly or indirectly, in any activity that national banks are not permitted to engage in directly or that is conducted under terms and conditions that differ from those that govern the conduct of such activity by national banks; and

(ii) Is not a subsidiary that a national bank is specifically authorized to own or control by the express terms of a Federal statute (other than 12 U.S.C. 24a), and not by implication or interpretation.

(2) Exceptions. “Financial subsidiary” does not include:

(i) A subsidiary of a member bank that is considered a financial subsidiary under paragraph (p)(1) of this section solely because the subsidiary engages in the sale of insurance as agent or broker in a manner that is not permitted for national banks; and

(ii) A subsidiary of a State bank (other than a subsidiary described in section 46(a) of the Federal Deposit Insurance Act (12 U.S.C. 1831w(a))) that is considered a financial subsidiary under paragraph (p)(1) of this section solely because the subsidiary engages in one or more of the following activities:

(A) An activity that the State bank may engage in directly under applicable Federal and State law and that is conducted under the same terms and conditions that govern the conduct of the activity by the State bank; and

(B) An activity that the subsidiary was authorized by applicable Federal and State law to engage in prior to [date of publication in Federal Register], and that was lawfully engaged in by the subsidiary on that date.

(3) Subsidiaries of financial subsidiaries. If a company is a financial subsidiary under paragraphs (p)(1) and (p)(2) of this section, any subsidiary of such a company is also a financial subsidiary.

(q) “Foreign bank” and an “agency,” “branch,” or “commercial lending company” of a foreign bank have the same meanings as in section 1(b) of the International Banking Act of 1978 (12 U.S.C. 3101).

(r) “GAAP” means U.S. generally accepted accounting principles.

(s) “General purpose credit card” has the meaning specified in paragraph (c)(4)(ii) of § 223.16.

(t) In contemplation. A transaction between a member bank and a nonaffiliate is presumed to be “in contemplation” of the nonaffiliate becoming an affiliate of the member bank if the member bank enters into the transaction with the nonaffiliate after the execution of, or commencement of negotiations designed to result in, an agreement under the terms of which the nonaffiliate would become an affiliate.

(u) “Intraday extension of credit” has the meaning specified in paragraph (1)(2) of § 223.42.

(v) “Low-quality asset” means:

(1) An asset (including a security) classified as “substandard,” “doubtful,” or “loss,” or treated as “special mention” or “other transfer risk problems,” either in the most recent report of examination or inspection of an affiliate prepared by either a Federal or State supervisory agency or in any internal classification system used by the member bank or the affiliate

(including an asset that receives a rating that is substantially equivalent to “classified” or “special mention” in the internal system of the member bank or affiliate);

(2) An asset in a nonaccrual status;

(3) An asset on which principal or interest payments are more than thirty days past due;

(4) An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor; and

(5) An asset acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted, if the asset has not yet been reviewed in an examination or inspection.

(w) “Member bank” means any national bank, State bank, banking association, or trust company that is a member of the Federal Reserve System. For purposes of this definition, an operating subsidiary of a member bank is treated as part of the member bank.

(x) “Municipal securities” has the same meaning as in section 3(a)(29) of the Securities Exchange Act of 1934 (17 U.S.C. 78c(a)(29)).

(y) “Nonaffiliate” with respect to a member bank means any person that is not an affiliate of the member bank.

(z) “Obligations of, or fully guaranteed as to principal and interest by, the United States or its agencies” includes those obligations listed in 12 CFR 201.108(b) and any additional obligations as determined by the Board. The term does not include Federal Housing Administration or Veterans Administration loans.

(aa) “Operating subsidiary” with respect to a member bank or other depository institution means any subsidiary of the member bank or depository institution other than a subsidiary described in paragraphs (b)(1)(i) through (v) of § 223.2.

(bb) “Person” means an individual, company, trust, joint venture, pool, syndicate, sole proprietorship, unincorporated organization, or any other form of entity.

(cc) “Principal underwriter” has the meaning specified in paragraph (c)(1) of § 223.53.

(dd) “Purchase of an asset” by a member bank from an affiliate means the acquisition by a member bank of an asset from an affiliate in exchange for cash or any other consideration, including an assumption of liabilities. The merger of an affiliate into a member bank is a purchase of assets by the member bank from an affiliate if the member bank assumes any liabilities of the affiliate or pays any other form of consideration in the transaction.

(ee) Riskless principal. A company is “acting exclusively as a riskless principal” if, after receiving an order to buy (or sell) a security from a customer, the company purchases (or sells) the security in the secondary market for its own account to offset a contemporaneous sale to (or purchase from) the customer.

(ff) “Securities” means stocks, bonds, debentures, notes, or similar obligations (including commercial paper).

(gg) “Securities affiliate” with respect to a member bank means:

(1) An affiliate of the member bank that is registered with the Securities and Exchange Commission as a broker or dealer; or

(2) Any other securities broker or dealer affiliate of a member bank that is approved by the Board.

(hh) “State bank” has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(ii) “Subsidiary” with respect to a specified company means a company that is controlled by the specified company.

(jj) “Voting securities” has the same meaning as in 12 CFR 225.2.

(kk) “Well capitalized” has the same meaning as in 12 CFR 225.2 and, in the case of any holding company that is not a bank holding company, “well capitalized” means that the holding company has and maintains at least the capital levels required for a bank holding company to be well capitalized under 12 CFR 225.2.

(ll) “Well managed” has the same meaning as in 12 CFR 225.2.

## **Subpart B—General Provisions of Section 23A**

### **§ 223.11 What is the maximum amount of covered transactions that a member bank may enter into with any single affiliate?**

A member bank may not engage in a covered transaction with an affiliate (other than a financial subsidiary of the member bank) if the aggregate amount of the member bank’s covered transactions with such affiliate would exceed 10 percent of the capital stock and surplus of the member bank.

### **§ 223.12 What is the maximum amount of covered transactions that a member bank may enter into with all affiliates?**

A member bank may not engage in a covered transaction with any affiliate if the aggregate amount of the member bank’s covered transactions with all affiliates would exceed 20 percent of the capital stock and surplus of the member bank.

### **§ 223.13 What safety and soundness requirement applies to covered transactions?**

A member bank may not engage in any covered transaction, including any transaction exempt under this regulation, unless the transaction is on terms and conditions that are consistent with safe and sound banking practices.

**§ 223.14 What are the collateral requirements for a credit transaction with an affiliate?**

(a) Collateral required for extensions of credit and certain other covered transactions. A member bank must ensure that each of its credit transactions with an affiliate is secured by the amount of collateral required by paragraph (b) of this section at the time of the transaction.

(b) Amount of collateral required. (1) The rule. A credit transaction described in paragraph (a) of this section must be secured by collateral having a market value equal to at least:

(i) 100 percent of the amount of the transaction, if the collateral is:

(A) Obligations of the United States or its agencies;

(B) Obligations fully guaranteed by the United States or its agencies as to principal and interest;

(C) Notes, drafts, bills of exchange, or bankers' acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or

(D) A segregated, earmarked deposit account with the member bank that is for the sole purpose of securing credit transactions between the member bank and its affiliates and is identified as such;

(ii) 110 percent of the amount of the transaction, if the collateral is obligations of any State or political subdivision of any State;

(iii) 120 percent of the amount of the transaction, if the collateral is other debt instruments, including loans and other receivables; or

(iv) 130 percent of the amount of the transaction, if the collateral is stock, leases, or other real or personal property.

(2) Example. A member bank makes a \$1,000 loan to an affiliate. The affiliate posts as collateral for the loan \$500 in U.S. Treasury securities, \$480 in corporate debt securities, and \$130 in real estate. The loan satisfies the collateral requirements of this section because \$500 of the loan is 100 percent secured by obligations of the United States, \$400 of the loan is 120 percent secured by debt instruments, and \$100 of the loan is 130 percent secured by real estate.

(c) Ineligible collateral. The following items are not eligible collateral for purposes of this section:

(1) Low-quality assets;

(2) Securities issued by any affiliate;

(3) Equity securities issued by the member bank, and debt securities issued by the member bank that represent regulatory capital of the member bank;

(4) Intangible assets (including servicing assets), unless specifically approved by the Board; and

(5) Guarantees, letters of credit, and other similar instruments.

(d) Perfection and priority requirements for collateral. (1) Perfection. A member bank must maintain a security interest in collateral required by this section that is perfected and enforceable under applicable law, including in the event of default resulting from bankruptcy, insolvency, liquidation, or similar circumstances.

(2) Priority. A member bank either must obtain a first priority security interest in collateral required by this section or must deduct from the value of collateral obtained by the member bank the lesser of:

(i) The amount of any security interest in the collateral that is senior to that of the member bank; or

(ii) The amount of any credit secured by the collateral that is senior to that of the member bank.

(3) Example. A member bank makes a \$2,000 loan to an affiliate. The affiliate grants the member bank a second priority security interest in a piece of real estate valued at \$3,000. Another institution that previously lent \$1,000 to the affiliate has a first priority security interest in the entire parcel of real estate. This transaction is not in compliance with the collateral requirements of this section. Due to the existence of the prior third-party lien on the real estate, the effective value of the real estate collateral for the member bank for purposes of this section is only \$2,000 -- \$600 less than the amount of real estate collateral required by this section for the transaction ( $\$2,000 \times 130 \text{ percent} = \$2,600$ ).

(e) Replacement requirement for retired or amortized collateral. A member bank must ensure that any required collateral that subsequently is retired or amortized is replaced with additional eligible collateral as needed to keep the percentage of the collateral value relative to the amount of the outstanding credit transaction equal to the minimum percentage required at the inception of the transaction.

(f) Inapplicability of the collateral requirements to certain transactions. The collateral requirements of this section do not apply to the following transactions.

(1) Acceptances. An acceptance that already is fully secured either by attached documents or by other property that is involved in the transaction and has an ascertainable market value.

(2) The unused portion of certain extensions of credit. The unused portion of an extension of credit to an affiliate as long as the member bank does not have any legal obligation to advance additional funds under the extension of credit until the affiliate provides

the amount of collateral required by paragraph (b) of this section with respect to the entire used portion (including the amount of the requested advance) of the extension of credit.

(3) Purchases of affiliate debt securities in the secondary market. The purchase of a debt security issued by an affiliate as long as the member bank purchases the debt security from a nonaffiliate in a bona fide secondary market transaction.

**§ 223.15 May a member bank purchase a low-quality asset from an affiliate?**

(a) In general. A member bank may not purchase a low-quality asset from an affiliate unless, pursuant to an independent credit evaluation, the member bank had committed itself to purchase the asset before the time the asset was acquired by the affiliate.

(b) Exemption for renewals of loan participations involving problem loans. The prohibition contained in paragraph (a) of this section does not apply to the renewal of, or extension of additional credit with respect to, a member bank's participation in a loan to a nonaffiliate that was originated by an affiliate if:

(1) The loan was not a low-quality asset at the time the member bank purchased its participation;

(2) The renewal or extension of additional credit is approved, as necessary to protect the participating member bank's investment by enhancing the ultimate collection of the original indebtedness, by the board of directors of the participating member bank or, if the originating affiliate is a depository institution, by:

(i) An executive committee of the board of directors of the participating member bank;  
or

(ii) One or more senior management officials of the participating member bank, if:

(A) The board of directors of the member bank approves standards for the member bank's renewals or extensions of additional credit described in this paragraph (b), based on the determination set forth in paragraph (b)(2) of this section;

(B) Each renewal or extension of additional credit described in this paragraph (b) meets the standards; and

(C) The board of directors of the member bank periodically reviews renewals and extensions of additional credit described in this paragraph (b) to ensure that they meet the standards and periodically reviews the standards to ensure that they continue to meet the criterion set forth in paragraph (b)(2) of this section;

(3) The participating member bank's share of the renewal or extension of additional credit does not exceed its proportional share of the original transaction by more than 5 percent, unless the member bank obtains the prior written approval of its appropriate Federal banking agency; and



(4) The participating member bank provides its appropriate Federal banking agency with written notice of the renewal or extension of additional credit not later than 20 days after consummation.

**§ 223.16 What transactions by a member bank with any person are treated as transactions with an affiliate?**

(a) In general. A member bank must treat any of its transactions with any person as a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate.

(b) Certain agency transactions. (1) Except to the extent described in paragraph (b)(2) of this section, an extension of credit by a member bank to a nonaffiliate is not treated as an extension of credit to an affiliate under paragraph (a) of this section if:

(i) The proceeds of the extension of credit are used to purchase an asset through an affiliate of the member bank, and the affiliate is acting exclusively as an agent or broker in the transaction; and

(ii) The asset purchased by the nonaffiliate is not issued, underwritten, or sold as principal by any affiliate of the member bank.

(2) The interpretation set forth in paragraph (b)(1) of this section does not apply to the extent of any agency fee, brokerage commission, or other compensation received by an affiliate from the proceeds of the extension of credit. The receipt of such compensation may qualify, however, for the exemption contained in paragraph (c)(2) of this section.

(c) Exemptions. Notwithstanding paragraph (a) of this section, the following transactions are not subject to the quantitative limits of §§ 223.11 and 223.12 or the collateral requirements of § 223.14. The transactions are, however, subject to the safety and soundness requirement of § 223.13 and the market terms requirement and other provisions of subpart F (implementing section 23B).

(1) Certain riskless principal transactions. An extension of credit by a member bank to a nonaffiliate, if:

(i) The proceeds of the extension of credit are used to purchase a security through a securities affiliate of the member bank, and the securities affiliate is acting exclusively as a riskless principal in the transaction;

(ii) The security purchased by the nonaffiliate is not issued, underwritten, or sold as principal (other than as riskless principal) by any affiliate of the member bank; and

(iii) Any riskless principal mark-up or other compensation received by the securities affiliate from the proceeds of the extension of credit meets the market terms standard set forth in paragraph (c)(2) of this section.

(2) Brokerage commissions, agency fees, and riskless principal mark-ups. An affiliate's retention of a portion of the proceeds of an extension of credit described in paragraph (b) or (c)(1) of this section as a brokerage commission, agency fee, or riskless principal mark-up, if that commission, fee, or mark-up is substantially the same as, or lower than, those prevailing at the same time for comparable transactions with or involving other nonaffiliates, in accordance with the market terms requirement of § 223.51.

(3) Preexisting lines of credit. An extension of credit by a member bank to a nonaffiliate, if:

(i) The proceeds of the extension of credit are used to purchase a security from or through a securities affiliate of the member bank; and

(ii) The 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 member bank.

(4) General purpose credit card transactions.

(i) In general. An extension of credit by a member bank to a nonaffiliate, if:

(A) The proceeds of the extension of credit are used by the nonaffiliate to purchase a product or service from an affiliate of the member bank; and

(B) The extension of credit is made pursuant to, and consistent with any conditions imposed in, a general purpose credit card issued by the member bank to the nonaffiliate.

(ii) Definition. "General purpose credit card" means a credit card issued by a member bank that is widely accepted by merchants that are not affiliates of the member bank for the purchase of products or services, if:

(A) Less than 25 percent of the total value of products and services purchased with the card by all cardholders are purchases of products and services from one or more affiliates of the member bank;

(B) All affiliates of the member bank would be permissible for a financial holding company (as defined in 12 U.S.C. 1841) under section 4 of the Bank Holding Company Act (12 U.S.C. 1843), and the member bank has no reason to believe that 25 percent or more of the total value of products and services purchased with the card by all cardholders are or would be purchases of products and services from one or more affiliates of the member bank; or

(C) The member bank presents information to the Board that demonstrates, to the Board's satisfaction, that less than 25 percent of the total value of products and services purchased with the card by all cardholders are and would be purchases of products and services from one or more affiliates of the member bank.

(iii) Calculating compliance. To determine whether a credit card qualifies as a general purpose credit card under the standard set forth in paragraph (c)(4)(ii)(A) of this section, a

member bank must compute compliance on a monthly basis, based on cardholder purchases that were financed by the credit card during the preceding 12 calendar months. If a credit card has qualified as a general purpose credit card for 3 consecutive months but then ceases to qualify in the following month, the member bank may continue to treat the credit card as a general purpose credit card for such month and three additional months (or such longer period as may be permitted by the Board).

(iv) Example of calculating compliance with the 25 percent test. A member bank seeks to qualify a credit card as a general purpose credit card under paragraph (c)(4)(ii)(A) of this section. The member bank assesses its compliance under paragraph (c)(4)(iii) of this section on the 15<sup>th</sup> day of every month (for the preceding 12 calendar months). The credit card qualifies as a general purpose credit card for at least three consecutive months. On June 15, 2005, however, the member bank determines that, for the 12-calendar-month period from June 1, 2004, through May 31, 2005, 27 percent of the total value of products and services purchased with the card by all cardholders were purchases of products and services from an affiliate of the member bank. Unless the credit card returns to compliance with the 25 percent limit by the 12-calendar-month period ending August 31, 2005, the card will cease to qualify as a general purpose credit card as of September 1, 2005. Any outstanding extensions of credit under the credit card that were used to purchase products or services from an affiliate of the member bank would become covered transactions at such time.

### **Subpart C—Valuation and Timing Principles under Section 23A**

#### **§ 223.21 What valuation and timing principles apply to credit transactions?**

(a) Valuation. (1) Initial valuation. Except as provided in paragraph (a)(2) or (3) of this section, a credit transaction with an affiliate initially must be valued at the greater of:

- (i) The principal amount of the transaction;
- (ii) The amount owed by the affiliate to the member bank under the transaction; or
- (iii) The sum of:

(A) The amount provided to, or on behalf of, the affiliate in the transaction; and

(B) Any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

(2) Initial valuation of certain acquisitions of a credit transaction. If a member bank acquires from a nonaffiliate a credit transaction with an affiliate, the covered transaction initially must be valued at the sum of:

(i) The total amount of consideration given (including liabilities assumed) by the member bank in exchange for the credit transaction; and

(ii) Any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

(3) Debt securities. The valuation principles of paragraphs (a)(1) and (2) of this section do not apply to a member bank's purchase of or investment in a debt security issued by an affiliate, which is governed by § 223.23.

(4) Examples. The following are examples of how to value a member bank's credit transactions with an affiliate.

(i) Term loan. A member bank makes a loan to an affiliate that has a principal amount of \$100. The affiliate pays \$2 in up-front fees to the member bank, and the affiliate receives net loan proceeds of \$98. The member bank must initially value the covered transaction at \$100.

(ii) Revolving credit. A member bank establishes a \$300 revolving credit facility for an affiliate. The affiliate has drawn down \$100 under the facility. The member bank must value the covered transaction at \$300 throughout the life of the facility.

(iii) Guarantee. A member bank has issued a guarantee to a nonaffiliate on behalf of an affiliate under which the member bank would be obligated to pay the nonaffiliate \$500 if the affiliate defaults on an issuance of debt securities. The member bank must value the guarantee at \$500 throughout the life of the guarantee.

(iv) Acquisition of a loan to an affiliate. A member bank purchases from a nonaffiliate a fixed-rate loan to an affiliate. The loan has an outstanding principal amount of \$100 but, due to movements in the general level of interest rates since the time of the loan's origination, the member bank is able to purchase the loan for \$90. The member bank initially must value the credit transaction at \$90 (and must ensure that the credit transaction complies with the collateral requirements of § 223.14 at the time of its acquisition of the loan).

(b) Timing. (1) In general. A member bank engages in a credit transaction with an affiliate at the time during the day that:

(i) The member bank becomes legally obligated to make an extension of credit to, issue a guarantee, acceptance, or letter of credit on behalf of, or confirm a letter of credit issued by, an affiliate;

(ii) The member bank enters into a cross-affiliate netting arrangement; or

(iii) The member bank acquires an extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate.

(2) Credit transactions by a member bank with a nonaffiliate that becomes an affiliate of the member bank.

(i) In general. A credit transaction with a nonaffiliate becomes a covered transaction at the time that the nonaffiliate becomes an affiliate of the member bank. The member bank must treat the amount of any such credit transaction as part of the aggregate amount of the member bank's covered transactions for purposes of determining compliance with the quantitative limits of §§ 223.11 and 223.12 in connection with any future covered transactions. Except as

described in paragraph (b)(2)(ii) of this section, the member bank is not required to reduce the amount of its covered transactions with any affiliate because the nonaffiliate has become an affiliate. If the nonaffiliate becomes an affiliate less than one year after the member bank enters into the credit transaction with the nonaffiliate, the member bank also must ensure that the credit transaction complies with the collateral requirements of § 223.14 promptly after the nonaffiliate becomes an affiliate.

(ii) Credit transactions by a member bank with a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the member bank. Notwithstanding the provisions of paragraph (b)(2)(i) of this section, if a member bank engages in a credit transaction with a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the member bank, the member bank must ensure that:

(A) The aggregate amount of the member bank's covered transactions (including any such credit transaction with the nonaffiliate) would not exceed the quantitative limits of § 223.11 or 223.12 at the time the nonaffiliate becomes an affiliate; and

(B) The credit transaction complies with the collateral requirements of § 223.14 at the time the nonaffiliate becomes an affiliate.

(iii) Example. A member bank with capital stock and surplus of \$1,000 and no outstanding covered transactions makes a \$120 unsecured loan to a nonaffiliate. The member bank does not make the loan in contemplation of the nonaffiliate becoming an affiliate. Nine months later, the member bank's holding company purchases all the stock of the nonaffiliate, thereby making the nonaffiliate an affiliate of the member bank. The member bank is not in violation of the quantitative limits of § 223.11 or 223.12 at the time of the stock acquisition. The member bank is, however, prohibited from engaging in any additional covered transactions with the new affiliate at least until such time as the value of the loan transaction falls below 10 percent of the member bank's capital stock and surplus. In addition, the member bank must bring the loan into compliance with the collateral requirements of § 223.14 promptly after the stock acquisition.

## **§ 223.22 What valuation and timing principles apply to asset purchases?**

(a) Valuation. (1) In general. Except as provided in paragraph (a)(2) of this section, a purchase of an asset by a member bank from an affiliate must be valued initially at the total amount of consideration given (including liabilities assumed) by the member bank in exchange for the asset. The value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with GAAP.

(2) Exceptions. (i) Purchase of an extension of credit to an affiliate. A purchase from an affiliate of an extension of credit to an affiliate must be valued in accordance with § 223.21, unless the note or obligation evidencing the extension of credit is a security issued by an affiliate (in which case the transaction must be valued in accordance with § 223.23).

(ii) Purchase of a security issued by an affiliate. A purchase from an affiliate of a security issued by an affiliate must be valued in accordance with § 223.23.

(iii) Transfer of a subsidiary. A transfer to a member bank of securities issued by an affiliate that is treated as a purchase of assets from an affiliate under § 223.31 must be valued in accordance with paragraph (b) of § 223.31.

(iv) Purchase of a line of credit. A purchase from an affiliate of a line of credit, revolving credit facility, or other similar credit arrangement for a nonaffiliate must be valued initially at the total amount of consideration given by the member bank in exchange for the asset plus any additional amount that the member bank could be required to provide to the borrower under the terms of the credit arrangement.

(b) Timing. (1) In general. A purchase of an asset from an affiliate remains a covered transaction for a member bank for as long as the member bank holds the asset.

(2) Asset purchases by a member bank from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the member bank. If a member bank purchases an asset from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the member bank, the asset purchase becomes a covered transaction at the time that the nonaffiliate becomes an affiliate of the member bank. In addition, the member bank must ensure that the aggregate amount of the member bank's covered transactions (including any such transaction with the nonaffiliate) would not exceed the quantitative limits of § 223.11 or 223.12 at the time the nonaffiliate becomes an affiliate.

(c) Examples. The following are examples of how to value a member bank's purchase of an asset from an affiliate.

(1) Cash purchase of assets. A member bank purchases a pool of loans from an affiliate for \$10 million. The member bank initially must value the covered transaction at \$10 million. Going forward, if the borrowers repay \$6 million of the principal amount of the loans, the member bank may value the covered transaction at \$4 million.

(2) Purchase of assets through an assumption of liabilities. An affiliate of a member bank contributes real property with a fair market value of \$200,000 to the member bank. The member bank pays the affiliate no cash for the property, but assumes a \$50,000 mortgage on the property. The member bank has engaged in a covered transaction with the affiliate and initially must value the transaction at \$50,000. Going forward, if the member bank retains the real property but pays off the mortgage, the member bank must continue to value the covered transaction at \$50,000. If the member bank, however, sells the real property, the transaction ceases to be a covered transaction at the time of the sale (regardless of the status of the mortgage).

### **§ 223.23 What valuation and timing principles apply to purchases of and investments in securities issued by an affiliate?**

(a) Valuation. (1) In general. Except as provided in paragraph (b) of § 223.32 with respect to financial subsidiaries, a member bank's purchase of or investment in a security issued by an affiliate must be valued at the greater of:

(i) The total amount of consideration given (including liabilities assumed) by the member bank in exchange for the security, reduced to reflect amortization of the security to the extent consistent with GAAP; or

(ii) The carrying value of the security.

(2) Examples. The following are examples of how to value a member bank's purchase of or investment in securities issued by an affiliate (other than a financial subsidiary of the member bank).

(i) Purchase of the debt securities of an affiliate. The parent holding company of a member bank owns 100 percent of the shares of a mortgage company. The member bank purchases debt securities issued by the mortgage company for \$600. The initial carrying value of the securities is \$600. The member bank initially must value the investment at \$600.

(ii) Purchase of the shares of an affiliate. The parent holding company of a member bank owns 51 percent of the shares of a mortgage company. The member bank purchases an additional 30 percent of the shares of the mortgage company from a third party for \$100. The initial carrying value of the shares is \$100. The member bank initially must value the investment at \$100. Going forward, if the member bank's carrying value of the shares declines to \$40, the member bank must continue to value the investment at \$100.

(iii) Contribution of the shares of an affiliate. The parent holding company of a member bank owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the member bank. The member bank gives no consideration in exchange for the shares. If the initial carrying value of the shares is \$300, then the member bank initially must value the investment at \$300. Going forward, if the member bank's carrying value of the shares increases to \$500, the member bank must value the investment at \$500.

(b) Timing. (1) In general. A purchase of or investment in a security issued by an affiliate remains a covered transaction for a member bank for as long as the member bank holds the security.

(2) A member bank's purchase of or investment in a security issued by a nonaffiliate that becomes an affiliate of the member bank. A member bank's purchase of or investment in a security issued by a nonaffiliate that becomes an affiliate of the member bank must be treated according to the same transition rules that apply to credit transactions described in paragraph (b)(2) of § 223.21.

#### **§ 223.24 What valuation principles apply to extensions of credit secured by affiliate securities?**

(a) Valuation of extensions of credit secured exclusively by affiliate securities. An extension of credit by a member bank to a nonaffiliate secured exclusively by securities issued by an affiliate of the member bank must be valued at the lesser of:

(1) The total value of the extension of credit; or

(2) The fair market value of the securities issued by an affiliate that are pledged as collateral, if the member bank verifies that such securities meet the market quotation standard contained in paragraph (e) of § 223.42 or the standards set forth in paragraphs (f)(1) and (5) of § 223.42.

(b) Valuation of extensions of credit secured by affiliate securities and other collateral. An extension of credit by a member bank to a nonaffiliate secured in part by securities issued by an affiliate of the member bank and in part by nonaffiliate collateral must be valued at the lesser of:

(1) The total value of the extension of credit less the fair market value of the nonaffiliate collateral; or

(2) The fair market value of the securities issued by an affiliate that are pledged as collateral, if the member bank verifies that such securities meet the market quotation standard contained in paragraph (e) of § 223.42 or the standards set forth in paragraphs (f)(1) and (5) of § 223.42.

(c) Exclusion of eligible affiliated mutual fund securities. (1) The exclusion. Eligible affiliated mutual fund securities are not considered to be securities issued by an affiliate, and are instead considered to be nonaffiliate collateral, for purposes of paragraphs (a) and (b) of this section, unless the member bank knows or has reason to know that the proceeds of the extension of credit will be used to purchase the eligible affiliated mutual fund securities collateral or will otherwise be used for the benefit of or transferred to an affiliate of the member bank.

(2) Definition. “Eligible affiliated mutual fund securities” with respect to a member bank are securities issued by an affiliate of the member bank that is an open-end investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), if:

(i) The securities issued by the investment company:

(A) Meet the market quotation standard contained in paragraph (e) of § 223.42;

(B) Meet the standards set forth in paragraphs (f)(1) and (5) of § 223.42; or

(C) Have closing prices that are made public through a mutual fund “supermarket” website maintained by an unaffiliated securities broker-dealer or mutual fund distributor; and

(ii) The member bank and its affiliates do not own or control in the aggregate more than 5 percent of any class of voting securities or of the equity capital of the investment company (excluding securities held by the member bank or an affiliate in good faith in a fiduciary capacity, unless the member bank or affiliate holds the securities for the benefit of the member bank or affiliate, or the shareholders, employees, or subsidiaries of the member bank or affiliate).



(3) Example. A member bank proposes to lend \$100 to a nonaffiliate secured exclusively by eligible affiliated mutual fund securities. The member bank knows that the nonaffiliate intends to use all the loan proceeds to purchase the eligible affiliated mutual fund securities that would serve as collateral for the loan. Under the attribution rule in § 223.16, the member bank must treat the loan to the nonaffiliate as a loan to an affiliate, and, because securities issued by an affiliate are ineligible collateral under § 223.14, the loan would not be in compliance with § 223.14.

#### **Subpart D—Other Requirements under Section 23A**

#### **§ 223.31 How does section 23A apply to a member bank's acquisition of an affiliate that becomes an operating subsidiary of the member bank after the acquisition?**

(a) Certain acquisitions by a member bank of securities issued by an affiliate are treated as a purchase of assets from an affiliate. A member bank's acquisition of a security issued by a company that was an affiliate of the member bank before the acquisition is treated as a purchase of assets from an affiliate, if:

(1) As a result of the transaction, the company becomes an operating subsidiary of the member bank; and

(2) The company has liabilities, or the member bank gives cash or any other consideration in exchange for the security.

(b) Valuation. (1) Initial valuation. A transaction described in paragraph (a) of this section must be valued initially at the greater of:

(i) The sum of:

(A) The total amount of consideration given by the member bank in exchange for the security; and

(B) The total liabilities of the company whose security has been acquired by the member bank, as of the time of the acquisition; or

(ii) The total value of all covered transactions (as computed under this part) acquired by the member bank as a result of the security acquisition.

(2) Ongoing valuation. The value of a transaction described in paragraph (a) of this section may be reduced after the initial transfer to reflect:

(i) Amortization or depreciation of the assets of the transferred company, to the extent that such reductions are consistent with GAAP; and

(ii) Sales of the assets of the transferred company.

(c) Valuation example. The parent holding company of a member bank contributes between 25 and 100 percent of the voting shares of a mortgage company to the member bank.

The parent holding company retains no shares of the mortgage company. The member bank gives no consideration in exchange for the transferred shares. The mortgage company has total assets of \$300,000 and total liabilities of \$100,000. The mortgage company's assets do not include any loans to an affiliate of the member bank or any other asset that would represent a separate covered transaction for the member bank upon consummation of the share transfer. As a result of the transaction, the mortgage company becomes an operating subsidiary of the member bank. The transaction is treated as a purchase of the assets of the mortgage company by the member bank from an affiliate under paragraph (a) of this section. The member bank initially must value the transaction at \$100,000, the total amount of the liabilities of the mortgage company. Going forward, if the member bank pays off the liabilities, the member bank must continue to value the covered transaction at \$100,000. If the member bank, however, sells \$15,000 of the transferred assets of the mortgage company or if \$15,000 of the transferred assets amortize, the member bank may value the covered transaction at \$85,000.

(d) Exemption for step transactions. A transaction described in paragraph (a) of this section is exempt from the requirements of this regulation (other than the safety and soundness requirement of § 223.13 and the market terms requirement of § 223.51) if:

(1) The member bank acquires the securities issued by the transferred company within one business day (or such longer period, up to three months, as may be permitted by the member bank's appropriate Federal banking agency) after the company becomes an affiliate of the member bank;

(2) The member bank acquires all the securities of the transferred company that were transferred in connection with the transaction that made the company an affiliate of the member bank;

(3) The business and financial condition (including the asset quality and liabilities) of the transferred company does not materially change from the time the company becomes an affiliate of the member bank and the time the member bank acquires the securities issued by the company; and

(4) At or before the time that the transferred company becomes an affiliate of the member bank, the member bank notifies its appropriate Federal banking agency and the Board of the member bank's intent to acquire the company.

(e) Example of step transaction. A bank holding company acquires 100 percent of the shares of an unaffiliated leasing company. At that time, the subsidiary member bank of the holding company notifies its appropriate Federal banking agency and the Board of its intent to acquire the leasing company from its holding company. On the day after consummation of the acquisition, the holding company transfers all of the shares of the leasing company to the member bank. No material change in the business or financial condition of the leasing company occurs between the time of the holding company's acquisition and the member bank's acquisition. The leasing company has liabilities. The leasing company becomes an operating subsidiary of the member bank at the time of the transfer. This transfer by the holding company to the member bank, although deemed an asset purchase by the member bank

from an affiliate under paragraph (a) of this section, would qualify for the exemption in paragraph (d) of this section.

**§ 223.32 What rules apply to financial subsidiaries of a member bank?**

(a) Exemption from the 10 percent limit for covered transactions between a member bank and a single financial subsidiary. The 10 percent quantitative limit contained in § 223.11 does not apply with respect to covered transactions between a member bank and a financial subsidiary of the member bank. The 20 percent quantitative limit contained in § 223.12 does apply to such transactions.

(b) Valuation of purchases of or investments in the securities of a financial subsidiary.  
(1) General rule. A member bank's purchase of or investment in a security issued by a financial subsidiary of the member bank must be valued at the greater of:

(i) The total amount of consideration given (including liabilities assumed) by the member bank in exchange for the security, reduced to reflect amortization of the security to the extent consistent with GAAP; and

(ii) The carrying value of the security (adjusted so as not to reflect the member bank's pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the member bank's acquisition of the security).

(2) Carrying value of an investment in a consolidated financial subsidiary. If a financial subsidiary is consolidated with its parent member bank under GAAP, the carrying value of the member bank's investment in securities issued by the financial subsidiary shall be equal to the carrying value of the securities on parent-only financial statements of the member bank, determined in accordance with GAAP (adjusted so as not to reflect the member bank's pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the member bank's acquisition of the securities).

(3) Examples of the valuation of purchases of and investments in the securities of a financial subsidiary. The following are examples of how a member bank must value its purchase of or investment in securities issued by a financial subsidiary of the member bank. Each example involves a securities underwriter that becomes a financial subsidiary of the member bank after the transactions described below.

(i) Initial valuation. (A) Direct acquisition by a member bank. A member bank pays \$500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the member bank's parent-only GAAP financial statements is \$500. The member bank initially must value the investment at \$500.

(B) Contribution of a financial subsidiary to a member bank. The parent holding company of a member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at \$500, and immediately contributes the shares to the member bank. The member bank gives no consideration in exchange for the shares. The member bank initially must value the investment at the carrying value of the shares on the member bank's parent-

only GAAP financial statements. Under GAAP, the member bank's initial carrying value of the shares would be \$500.

(ii) Carrying value not adjusted for earnings and losses of the financial subsidiary. A member bank and its parent holding company engage in the transaction described in paragraph (b)(3)(i)(B) of this section, and the member bank initially values the investment at \$500. In the following year, the securities underwriter earns \$25 in profit, which is added to its retained earnings. The member bank's carrying value of the shares of the underwriter is not adjusted for purposes of this part, and the member bank must continue to value the investment at \$500. If, however, the member bank contributes \$100 of additional capital to the securities underwriter, the member bank must value the aggregate investment at \$600.

(c) Treatment of an affiliate's investments in, and extensions of credit to, a financial subsidiary of a member bank. (1) Investments. Any purchase of, or investment in, the securities of a financial subsidiary of a member bank by an affiliate of the member bank is treated as a purchase of or investment in such securities by the member bank.

(2) Extensions of credit that are treated as regulatory capital of the financial subsidiary. Any extension of credit to a financial subsidiary of a member bank by an affiliate of the member bank is treated as an extension of credit by the member bank to the financial subsidiary if the extension of credit is treated as capital of the financial subsidiary under any Federal or State law, regulation, or interpretation applicable to the subsidiary.

(3) Other extensions of credit. Any other extension of credit to a financial subsidiary of a member bank by an affiliate of the member bank will be treated as an extension of credit by the member bank to the financial subsidiary, if the Board determines, by regulation or order, that such treatment is necessary or appropriate to prevent evasions of the Federal Reserve Act or the Gramm-Leach-Bliley Act.

### **§ 223.33 What rules apply to derivative transactions?**

(a) Market terms requirement. Derivative transactions between a member bank and its affiliates (other than depository institutions) are subject to the market terms requirement of § 223.51.

(b) Policies and procedures. A member bank must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its derivative transactions with affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for:

(1) Monitoring and controlling the credit exposure arising at any one time from the member bank's derivative transactions with each affiliate and all affiliates in the aggregate (through, among other things, imposing appropriate credit limits, mark-to-market requirements, and collateral requirements); and

(2) Ensuring that the member bank's derivative transactions with affiliates comply with the market terms requirement of § 223.51.

(c) Credit derivatives. A credit derivative between a member bank and a nonaffiliate in which the member bank provides credit protection to the nonaffiliate with respect to an obligation of an affiliate of the member bank is a guarantee by a member bank on behalf of an affiliate for purposes of this regulation. Such derivatives would include:

(1) An agreement under which the member bank, in exchange for a fee, agrees to compensate the nonaffiliate for any default of the underlying obligation of the affiliate; and

(2) An agreement under which the member bank, in exchange for payments based on the total return of the underlying obligation of the affiliate, agrees to pay the nonaffiliate a spread over funding costs plus any depreciation in the value of the underlying obligation of the affiliate.

### **Subpart E—Exemptions from the Provisions of Section 23A**

#### **§ 223.41 What covered transactions are exempt from the quantitative limits and collateral requirements?**

The following transactions are not subject to the quantitative limits of §§ 223.11 and 223.12 or the collateral requirements of § 223.14. The transactions are, however, subject to the safety and soundness requirement of § 223.13 and the prohibition on the purchase of a low-quality asset of § 223.15.

(a) Parent institution/subsidiary institution transactions. Transactions with a depository institution if the member bank controls 80 percent or more of the voting securities of the depository institution or the depository institution controls 80 percent or more of the voting securities of the member bank.

(b) Transactions between a member bank and a depository institution owned by the same holding company. Transactions with a depository institution if the same company controls 80 percent or more of the voting securities of the member bank and the depository institution.

(c) Certain loan purchases from an affiliated depository institution. Purchasing a loan on a nonrecourse basis from an affiliated depository institution.

(d) Internal corporate reorganization transactions. Purchasing assets from an affiliate (including in connection with a transfer of securities issued by an affiliate to a member bank described in paragraph (a) of § 223.31), if:

(1) The asset purchase is part of an internal corporate reorganization of a holding company and involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate;

(2) The member bank provides its appropriate Federal banking agency and the Board with written notice of the transaction before consummation, including a description of the primary business activities of the affiliate and an indication of the proposed date of the asset purchase;

(3) The member bank's top-tier holding company commits to its appropriate Federal banking agency and the Board before consummation either:

(i) To make quarterly cash contributions to the member bank, for a two-year period following the member bank's purchase, equal to the book value plus any write-downs taken by the member bank, of any transferred assets that have become low-quality assets during the quarter; or

(ii) To repurchase, on a quarterly basis for a two-year period following the member bank's purchase, at a price equal to the book value plus any write-downs taken by the member bank, any transferred assets that have become low-quality assets during the quarter;

(4) The member bank's top-tier holding company complies with the commitment made under paragraph (d)(3) of this section;

(5) A majority of the member bank's directors reviews and approves the transaction before consummation;

(6) The value of the covered transaction (as computed under this part), when aggregated with the value of any other covered transactions (as computed under this part) engaged in by the member bank under this exemption during the preceding 12 calendar months, represents less than 10 percent of the member bank's capital stock and surplus (or such higher amount, up to 25 percent of the member bank's capital stock and surplus, as may be permitted by the member bank's appropriate Federal banking agency after conducting a review of the member bank's financial condition and the quality of the assets transferred to the member bank); and

(7) The holding company and all its subsidiary member banks and other subsidiary depository institutions are well capitalized and well managed and would remain well capitalized upon consummation of the transaction.

**§ 223.42 What covered transactions are exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition?**

The following transactions are not subject to the quantitative limits of §§ 223.11 and 223.12, the collateral requirements of § 223.14, or the prohibition on the purchase of a low-quality asset of § 223.15. The transactions are, however, subject to the safety and soundness requirement of § 223.13.

(a) Making correspondent banking deposits. Making a deposit in an affiliated depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) or affiliated foreign bank that represents an ongoing, working balance maintained in the ordinary course of correspondent business.

(b) Giving credit for uncollected items. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.

(c) Transactions secured by cash or U.S. government securities.

(1) In general. Engaging in a credit transaction with an affiliate to the extent that the transaction is and remains secured by:

(i) Obligations of the United States or its agencies;

(ii) Obligations fully guaranteed by the United States or its agencies as to principal and interest; or

(iii) A segregated, earmarked deposit account with the member bank that is for the sole purpose of securing credit transactions between the member bank and its affiliates and is identified as such.

(2) Example. A member bank makes a \$100 non-amortizing term loan to an affiliate secured by U.S. Treasury securities with a market value of \$50 and real estate with a market value of \$75. The value of the covered transaction is \$50. If the market value of the U.S. Treasury securities falls to \$45 during the life of the loan, the value of the covered transaction would increase to \$55.

(d) Purchasing securities of a servicing affiliate. Purchasing a security issued by any company engaged solely in providing services described in section 4(c)(1) of the Bank Holding Company Act (12 U.S.C. 1843(c)(1)).

(e) Purchasing certain liquid assets. Purchasing an asset having a readily identifiable and publicly available market quotation and purchased at or below the asset's current market quotation. An asset has a readily identifiable and publicly available market quotation if the asset's price is quoted routinely in a widely disseminated publication that is readily available to the general public.

(f) Purchasing certain marketable securities. Purchasing a security from a securities affiliate, 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 member bank records the transaction as a purchase of a security for purposes of its Call Report, consistent with the requirements for a State member bank;

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

(4) The member bank does not purchase the security 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 member bank is at or below the current market quotation for the security; and

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

(6) The member bank maintains, for a period of two years, records and supporting information that are sufficient to enable the appropriate Federal banking agency to ensure the member bank's compliance with the terms of this exemption.

(g) Purchasing municipal securities. Purchasing a municipal security from a securities affiliate if:

(1) The security is rated by a nationally recognized statistical rating organization or is part of an issue of securities that does not exceed \$25 million;

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

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

(A) The price paid by the member bank is at or below the current market quotation for the security; and

(B) The size of the transaction executed by the member bank does not cast material doubt on the appropriateness of relying on the current market quotation for the security; or

(ii) The price paid for the security can be verified by reference to two or more actual, current price quotes from unaffiliated broker-dealers on the exact security to be purchased or a security comparable to the security to be purchased, where:

(A) The price quotes obtained from the unaffiliated broker-dealers are based on a transaction similar in size to the transaction that is actually executed; and

(B) The price paid is no higher than the average of the price quotes; or

(iii) The price paid for the security can be verified by reference to the written summary provided by the syndicate manager to syndicate members that discloses the aggregate par values and prices of all bonds sold from the syndicate account, if the member bank:

(A) Purchases the municipal security during the underwriting period at a price that is at or below that indicated in the summary; and

(B) Obtains a copy of the summary from its securities affiliate and retains the summary for three years.



(h) Purchasing an extension of credit subject to a repurchase agreement. Purchasing from an affiliate an extension of credit that was originated by the member bank and sold to the affiliate subject to a repurchase agreement or with recourse.

(i) Asset purchases by a newly formed member bank. The purchase of an asset from an affiliate by a newly formed member bank, if the appropriate Federal banking agency for the member bank has approved the asset purchase in writing in connection with its review of the formation of the member bank.

(j) Transactions approved under the Bank Merger Act. Any merger or consolidation between a member bank and an affiliated depository institution or U.S. branch or agency of a foreign bank, or any acquisition of assets or assumption of deposit liabilities by a member bank from an affiliated depository institution or U.S. branch or agency of a foreign bank, if the transaction has been approved by the responsible Federal banking agency pursuant to the Bank Merger Act (12 U.S.C. 1828(c)).

(k) Purchasing an extension of credit from an affiliate. Purchasing from an affiliate, on a nonrecourse basis, an extension of credit, if:

(1) The extension of credit was originated by the affiliate;

(2) The member bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit;

(3) The member bank commits to purchase the extension of credit before the affiliate makes or commits to make the extension of credit;

(4) The member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate; and

(5) The dollar amount of the extension of credit, when aggregated with the dollar amount of all other extensions of credit purchased from the affiliate during the preceding 12 calendar months by the member bank and its depository institution affiliates, does not represent more than 50 percent (or such lower percent as is imposed by the member bank's appropriate Federal banking agency) of the dollar amount of extensions of credit originated by the affiliate during the preceding 12 calendar months.

(l) Intraday extensions of credit.

(1) In general. An intraday extension of credit to an affiliate, if the member bank:

(i) Has established and maintains policies and procedures reasonably designed to manage the credit exposure arising from the member bank's intraday extensions of credit to affiliates in a safe and sound manner, including policies and procedures for:

(A) Monitoring and controlling the credit exposure arising at any one time from the member bank's intraday extensions of credit to each affiliate and all affiliates in the aggregate; and

(B) Ensuring that any intraday extension of credit by the member bank to an affiliate complies with the market terms requirement of § 223.51;

(ii) Has no reason to believe that the affiliate will have difficulty repaying the extension of credit in accordance with its terms; and

(iii) Ceases to treat any such extension of credit (regardless of jurisdiction) as an intraday extension of credit at the end of the member bank's business day in the United States.

(2) Definition. "Intraday extension of credit" by a member bank to an affiliate means an extension of credit by a member bank to an affiliate that the member bank expects to be repaid, sold, or terminated, or to qualify for a complete exemption under this regulation, by the end of its business day in the United States.

(m) Riskless principal transactions. Purchasing a security from a securities affiliate of the member bank if:

(1) The member bank or the securities affiliate is acting exclusively as a riskless principal in the transaction; and

(2) The security purchased is not issued, underwritten, or sold as principal (other than as riskless principal) by any affiliate of the member bank.

**§ 223.43 What are the standards under which the Board may grant additional exemptions from the requirements of section 23A?**

(a) The standards. The Board may, at its discretion, by regulation or order, exempt transactions or relationships from the requirements of section 23A and subparts B, C, and D of this regulation if it finds such exemptions to be in the public interest and consistent with the purposes of section 23A.

(b) Procedure. A member bank may request an exemption from the requirements of section 23A and subparts B, C, and D of this regulation by submitting a written request to the General Counsel of the Board. Such a request must:

(1) Describe in detail the transaction or relationship for which the member bank seeks exemption;

(2) Explain why the Board should exempt the transaction or relationship; and

(3) Explain how the exemption would be in the public interest and consistent with the purposes of section 23A.

## **Subpart F—General Provisions of Section 23B**

### **§ 223.51 What is the market terms requirement of section 23B?**

A member bank may not engage in a transaction described in § 223.52 unless the transaction is:

(a) On terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the member bank, as those prevailing at the time for comparable transactions with or involving nonaffiliates; or

(b) In the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliates.

### **§ 223.52 What transactions with affiliates or others must comply with section 23B's market terms requirement?**

(a) The market terms requirement of § 223.51 applies to the following transactions:

(1) Any covered transaction with an affiliate, unless the transaction is exempt under paragraphs (a) through (c) of § 223.41 or paragraphs (a) through (e) or (h) through (j) of § 223.42;

(2) The sale of a security or other asset to an affiliate, including an asset subject to an agreement to repurchase;

(3) The payment of money or the furnishing of a service to an affiliate under contract, lease, or otherwise;

(4) Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the member bank or to any other person; and

(5) Any transaction or series of transactions with a nonaffiliate, if an affiliate:

(i) Has a financial interest in the nonaffiliate; or

(ii) Is a participant in the transaction or series of transactions.

(b) For the purpose of this section, any transaction by a member bank with any person will be deemed to be a transaction with an affiliate of the member bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.

### **§ 223.53 What asset purchases are prohibited by section 23B?**

(a) Fiduciary purchases of assets from an affiliate. A member bank may not purchase as fiduciary any security or other asset from any affiliate unless the purchase is permitted:

(1) Under the instrument creating the fiduciary relationship;

(2) By court order; or

(3) By law of the jurisdiction governing the fiduciary relationship.

(b) Purchase of a security underwritten by an affiliate. (1) A member bank, whether acting as principal or fiduciary, may not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of the member bank.

(2) Paragraph (b)(1) of this section does not apply if the purchase or acquisition of the security has been approved, before the security is initially offered for sale to the public, by a majority of the directors of the member bank based on a determination that the purchase is a sound investment for the member bank, or for the person on whose behalf the member bank is acting as fiduciary, as the case may be, irrespective of the fact that an affiliate of the member bank is a principal underwriter of the security.

(3) The approval requirement of paragraph (b)(2) of this section may be met if:

(i) A majority of the directors of the member bank approves standards for the member bank's acquisitions of securities described in paragraph (b)(1) of this section, based on the determination set forth in paragraph (b)(2) of this section;

(ii) Each acquisition described in paragraph (b)(1) of this section meets the standards; and

(iii) A majority of the directors of the member bank periodically reviews acquisitions described in paragraph (b)(1) of this section to ensure that they meet the standards and periodically reviews the standards to ensure that they continue to meet the criterion set forth in paragraph (b)(2) of this section.

(4) A U.S. branch, agency, or commercial lending company of a foreign bank may comply with paragraphs (b)(2) and (b)(3) of this section by obtaining the approvals and reviews required by paragraphs (b)(2) and (b)(3) from either:

(i) A majority of the directors of the foreign bank; or

(ii) A majority of the senior executive officers of the foreign bank.

(c) Special definitions. For purposes of this section:

(1) "Principal underwriter" means any underwriter who, in connection with a primary distribution of securities:

(i) Is in privity of contract with the issuer or an affiliated person of the issuer;

(ii) Acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate; or

(iii) Is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

(2) “Security” has the same meaning as in section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)).

#### **§ 223.54 What advertisements and statements are prohibited by section 23B?**

(a) In general. A member bank and its affiliates may not publish any advertisement or enter into any agreement stating or suggesting that the member bank will in any way be responsible for the obligations of its affiliates.

(b) Guarantees, acceptances, letters of credit, and cross-affiliate netting arrangements subject to section 23A. Paragraph (a) of this section does not prohibit a member bank from:

(1) Issuing a guarantee, acceptance, or letter of credit on behalf of an affiliate, confirming a letter of credit issued by an affiliate, or entering into a cross-affiliate netting arrangement, to the extent such transaction satisfies the quantitative limits of §§ 223.11 and 223.12 and the collateral requirements of § 223.14, and is otherwise permitted under this regulation; or

(2) Making reference to such a guarantee, acceptance, letter of credit, or cross-affiliate netting arrangement if otherwise required by law.

#### **§ 223.55 What are the standards under which the Board may grant exemptions from the requirements of section 23B?**

The Board may prescribe regulations to exempt transactions or relationships from the requirements of section 23B and subpart F of this regulation if it finds such exemptions to be in the public interest and consistent with the purposes of section 23B.

#### **Subpart G—Application of Sections 23A and 23B to U.S. Branches and Agencies of Foreign Banks**

#### **§ 223.61 How do sections 23A and 23B apply to U.S. branches and agencies of foreign banks?**

(a) Applicability of sections 23A and 23B to foreign banks engaged in underwriting insurance, underwriting or dealing in securities, merchant banking, or insurance company investment in the United States. Except as provided in this subpart, sections 23A and 23B of the Federal Reserve Act and the provisions of this regulation apply to each U.S. branch, agency, or commercial lending company of a foreign bank in the same manner and to the same extent as if the branch, agency, or commercial lending company were a member bank.

(b) Affiliate defined. For purposes of this subpart, any company that would be an affiliate of a U.S. branch, agency, or commercial lending company of a foreign bank if such branch, agency, or commercial lending company were a member bank is an affiliate of the branch, agency, or commercial lending company if the company also is:

(1) Directly engaged in the United States in any of the following activities:

(i) Insurance underwriting pursuant to section 4(k)(4)(B) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(B));

(ii) Securities underwriting, dealing, or market making pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(E));

(iii) Merchant banking activities pursuant to section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) (but only to the extent that the proceeds of the transaction are used for the purpose of funding the affiliate's merchant banking activities);

(iv) Insurance company investment activities pursuant to section 4(k)(4)(I) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(I)); or

(v) Any other activity designated by the Board;

(2) A portfolio company (as defined in the merchant banking subpart of Regulation Y (12 CFR 225.177(c))) controlled by the foreign bank or an affiliate of the foreign bank or a company that would be an affiliate of the branch, agency, or commercial lending company of the foreign bank under paragraph (a)(9) of § 223.2 if such branch, agency, or commercial lending company were a member bank; or

(3) A subsidiary of an affiliate described in paragraph (b)(1) or (2) of this section.

(c) Capital stock and surplus. For purposes of this subpart, the “capital stock and surplus” of a U.S. branch, agency, or commercial lending company of a foreign bank will be determined by reference to the capital of the foreign bank as calculated under its home country capital standards.

## **Subpart H—Miscellaneous Interpretations**

### **§ 223.71 How do sections 23A and 23B apply to transactions in which a member bank purchases from one affiliate an asset relating to another affiliate?**

(a) In general. In some situations in which a member bank purchases an asset from an affiliate, the asset purchase qualifies for an exemption under this regulation, but the member bank's resulting ownership of the purchased asset also represents a covered transaction (which may or may not qualify for an exemption under this regulation). In these situations, the transaction engaged in by the member bank would qualify as two different types of covered transaction. Although an asset purchase exemption may suffice to exempt the member bank's asset purchase from the first affiliate, the asset purchase exemption does not exempt the member bank's resulting covered transaction with the second affiliate. The exemptions subject to this interpretation include §§ 223.31(e), 223.41(a) through (d), and 223.42(e), (f), (i), (j), (k), and (m).

(b) Examples. (1) The (d)(6) exemption. A member bank purchases from Affiliate A securities issued by Affiliate B in a purchase that qualifies for the (d)(6) exemption in

section 23A. The member bank's asset purchase from Affiliate A would be an exempt covered transaction under § 223.42(e); but the member bank also would have acquired an investment in securities issued by Affiliate B, which would be a covered transaction between the member bank and Affiliate B under § 223.3(h)(2) that does not qualify for the (d)(6) exemption. The (d)(6) exemption, by its terms, only exempts asset purchases by a member bank from an affiliate; hence, the (d)(6) exemption cannot exempt a member bank's investment in securities issued by an affiliate (even if the securities would qualify for the (d)(6) exemption).

(2) The sister-bank exemption. A member bank purchases from Sister-Bank Affiliate A a loan to Affiliate B in a purchase that qualifies for the sister-bank exemption in section 23A. The member bank's asset purchase from Sister-Bank Affiliate A would be an exempt covered transaction under § 223.41(b); but the member bank also would have acquired an extension of credit to Affiliate B, which would be a covered transaction between the member bank and Affiliate B under § 223.3(h)(1) that does not qualify for the sister-bank exemption. The sister-bank exemption, by its terms, only exempts transactions by a member bank with a sister-bank affiliate; hence, the sister-bank exemption cannot exempt a member bank's extension of credit to an affiliate that is not a sister bank (even if the extension of credit was purchased from a sister bank).

By order of the Board of Governors of the Federal Reserve System, November 27, 2002.

(signed) Jennifer J. Johnson  
Jennifer J. Johnson,  
Secretary of the Board.