FEDERAL RESERVE SYSTEM

12 CFR Part 250

[Miscellaneous Interpretations; Docket R-1015]

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

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

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

EFFECTIVE DATE: [Insert 30 days from publication].

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SUPPLEMENTARY INFORMATION:

Background

Restrictions of Section 23A

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purchase on an exempt basis from its registered broker-dealer affiliate.[1/] Section 23A of the Federal Reserve Act, originally enacted as part of the Banking Act of 1933, is designed to prevent the misuse of a member bank's resources through "non-arm's length" transactions with its affiliates.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

Section 23A also contains several exemptions from the statute's quantitative and collateral limitations. One exemption is contained in section 23A(d)(6), which exempts from the statute's quantitative limits a purchase of an asset that has "a

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

readily identifiable and publicly available market quotation" ("(d)(6) exemption").[2/] In the past, institutions have been advised that the (d)(6) exemption was available only for the purchase of assets, the price of which were recorded in widely disseminated publications that were readily available to the general public. Such assets included obligations of the United States, securities traded on exchanges, foreign exchange, certain mutual fund shares, and precious metals. Other marketable assets could not meet this standard, however.

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

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

SUMMARY OF COMMENTS AND DESCRIPTION OF THE RULE

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

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

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

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

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

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

(i) A widely disseminated news source;

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

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

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

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

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

(1) <u>The Securities Must be Purchased from a Broker-Dealer Registered with the Securities and Exchange Commission</u>

In order for the purchase of securities to meet the (d)(6) exemption, and therefore be exempt from the quantitative limits of section 23A, the Board

proposed that the transaction be limited to the purchase of securities from a broker-dealer registered with the SEC.

One commenter specifically supported the Board's proposed requirement that the broker-dealer affiliate be registered with the SEC. Several other commenters, however, urged the Board to broaden the requirement. One commenter argued that the Board should allow depository institutions to buy securities under the exemption from broker-dealers registered with foreign authorities. Several other commenters argued that there is no reason to limit the exemption to broker-dealers. These commenters expressed the view that non-broker-dealers may hold securities that would qualify under the terms of the proposed interpretation of the (d)(6) exemption, and these commenters argued that there is no policy reason for prohibiting these non-broker-dealer affiliates from using the proposed interpretation.

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

The Board does not believe it is appropriate at this time to expand the exemption to include securities purchases from foreign broker-dealers because such entities may be subject to different levels of supervision and regulation and

because of the increased difficulties associated with monitoring compliance by foreign entities. An insured depository institution can, however, request that the Board exempt securities purchases from a foreign broker-dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.

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

2. The Securities must have a "Ready Market" as Defined by the SEC

The 1998 Rulemaking provided that, in order to meet the expanded (d)(6) exemption, the assets must have a "ready market," as defined by the SEC, and the assets must be purchased at publicly available market quotations.[3/]

Based on public comments, the Board considered various alternative marketability definitions. Some commenters noted that the Office of the

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

Comptroller of the Currency ("OCC") defines "marketable" under its Investment Securities regulations to include those securities that can be sold with reasonable promptness at a price that corresponds reasonably to fair value.[4/] The commenters submitted that banks would be comfortable with this alternative definition of "ready market."

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

In the proposed interpretation, the Board employed the "ready market" test because it believed that this definition would help ensure that a ready, competitive market exists for the securities that the bank purchases. Under the SEC's net capital rules, a registered broker-dealer must deduct 100 percent of the carrying value of securities and certain other assets if there is not a "ready market" for the assets. The purpose of the "ready market" test is to identify securities with a liquid market to ensure that a broker-dealer promptly can sell a security and receive its value. The types of securities that meet this definition include obligations of the

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

United States and its agencies, as well as many asset-backed, corporate debt, and sovereign debt securities. It is a standard understood by SEC-registered broker-dealers and monitored by the SEC, and if the bank is unsure of the status of a security, it can determine the status by asking how the security is treated by the broker-dealer affiliate for its own capital purposes.

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

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

believes that it would be inconsistent with safe and sound banking practices to allow a depository institution to purchase from an affiliate unlimited amounts of a security for which no "ready market" exists.

(3) The Securities must be Eligible for Purchase by a State member bank and must not be Low-quality Assets

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

The Board received one comment supporting the Board's proposed requirement that the security being purchased under the (d)(6) exemption have an investment grade rating from an NRSRO. The commenter argued that this requirement would help ensure bank safety and soundness. Approximately ten commenters, however, opposed or proposed modifications to this requirement. Several commenters argued that this condition is unnecessary and overly restrictive, especially in light of the protections afforded by the Board's other proposed criteria. One commenter noted that the focus of the (d)(6) exemption is liquidity and market information, and the commenter argued that a security can have substantial liquidity and be the subject of significant market information even if it is

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

not investment grade. Several commenters also contended that section 23A separately addresses the question of depository institution purchases of low-quality assets from affiliates, and they contended that there is no statutory basis for importing the investment grade requirement into the (d)(6) exemption.

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

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

9 of the Federal Reserve Act and is not a low-quality asset, as defined by section 23A.[6/]

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

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

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

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

[9/] See 12 CFR 1.3.

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

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

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

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

The Board's proposed interpretation would disqualify from the (d)(6) exemption an insured depository institution's purchase of a security from an affiliate during the underwriting period for the security and for 30 days thereafter. Approximately 11 commenters expressed opposition to this criterion. The

commenters believed that a 30-day underwriting exclusion is unnecessary. The commenters believed that the proposed restriction was based on misperceptions on the part of the Board about pricing volatility and conflicts of interest in the underwriting of securities.

Several commenters also argued that the Board's concerns regarding potential conflicts of interest between underwriting affiliates and depository institutions were unfounded. Commenters argued that the Board had not identified any conflicts and could not demonstrate that conflicts were sufficiently serious to require the proposed 30-day underwriting exclusion.

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

A number of commenters argued that, at a minimum, the 30-day waiting period after the underwriting should not be required. Some commenters argued that the 30-day buffer should be deleted, if in no other circumstances, in those

situations in which an affiliate has been able to sell all of its allotted securities to third parties during the underwriting. Commenters also urged the Board to eliminate the 30-day waiting period for investment-grade securities.

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

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

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

The Board also has reviewed the restriction imposed by section 23B and its relationship to the (d)(6) exemption. As noted above, the requirements of section 23B are in addition to the requirements of section 23A. Section 23B requires the approval of a majority of the insured depository institution's directors

prior to the purchase of securities from an affiliate during an underwriting. Even with the directors' vote, however, the insured depository institution's purchase would be subject to the quantitative limits of section 23A. If the securities are exempt under (d)(6), however, there is no quantitative limit imposed on the insured depository institution. The Board believes that given the expansion of the types of securities that insured depository institutions can purchase under (d)(6), a vote of the directors is not sufficient protection to the insured depository institution if it is permitted to purchase unlimited amounts of a security before it has even been offered for sale to the public.

(5) Price Verification Methods

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

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

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

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

One commenter argued that there should be a mechanism that allows Board staff to evaluate the use of comparable securities on a case-by-case basis. Such a procedure, the commenter noted, would allow depository institutions to present the question of comparable in the context of a specific security. Another commenter suggested that the Board adopt a method by which Board staff may consider the

permissibility of new dependable pricing mechanisms to be considered as they become available. The commenter noted that rapid developments and enhancements of information systems may produce equally dependable price verification methods in the future, which, the commenter argued, should then be included in the scope of the proposed interpretation.

The 1998 Proposal included a price verification test because of the statutory requirement that the asset have a "readily identifiable and publicly available market quotation" and the Board's belief that the proposed criteria would meet the statutory requirement. Prior to publication of the proposal, the Board reviewed the use of matrices and the use of comparable securities and did not believe that those price verification methods would meet the statutory standard that the quotation be "publicly available." In addition, the Board believed that the value of a security should be independently determined and not by a method that was subject to manipulation by the insured depository institution or its affiliated broker-dealer.

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

believes that the use of third-party networks helps ensure that a market for the security exists and that the price the insured depository institution pays for the security is a fair market price.

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

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

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

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

(6) The Securities must not be Issued by an Affiliate

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

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

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

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

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

The Board continues to believe that safety and soundness requires restrictions on a bank's ability to purchase securities issued by an affiliate. Such restrictions help present a bank from acquiring an unlimited credit exposure to its affiliates, and are consistent with other provisions of section 23A, which limit the bank's ability to lend to an affiliate or accept the affiliate's securities as collateral.[11/]

[11/] For example, if the restriction on the purchase of an affiliate's securities is not imposed, a bank could purchase the debt securities of an affiliate without limit, but a collateralized loan to the affiliate would be limited to 10 percent of the bank's

(continued...)

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

(7) Document Retention

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

Another commenter requested that Board staff consult and work with market participants regarding what information can be made available without imposing an undue administrative burden. Other commenters requested that the Board clarify that the requirement applies to documentation concerning the actual price paid; the commenters believed that a simple notation of the price paid and source of price verification should be sufficient. The commenters argued that otherwise this requirement would be overly burdensome for depository institutions, especially in light of the fact that historical pricing data are available from other sources.

The Board proposed a five-year standard because it believed that it would provide examiners a basis to review how the exemption was applied over time by insured depository institutions. In its final interpretation, the Board has shortened

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[11/](...continued)
capital stock and surplus.

the period of time necessary for the insured depository institution to retain the price verification information to two years. The Board concurs with the commenters that this period of time is consistent with the exam schedules of the institutions in question and that further information retention is not necessary in order to ensure compliance with the law. The Board does not believe that the documentation requirements are substantial, and insured depository institutions should contact their primary regulators to determine what documentation the primary regulator will require. At a minimum, however, the Board believes that an institution's record should clearly show the security purchased, the seller, price and date of purchase, and evidence of the method used to determine the price.

(8) Other Issues

Approximately six commenters urged the Board to consider addressing several other issues arising under section 23A. Specifically, the commenters requested that the Board determine that, if affiliate securities serve as collateral for a loan to a third person, the loan is covered by section 23A only up to the value of the affiliate's securities pledged. The Board issued an interpretation accounting for collateral from unaffiliated sources in 1999 and is seeking comment on a valuation rule for these transactions as part of its proposed Regulation W. Finally, the commenters requested that the Board exempt from section 23A transactions in which a depository institution takes proprietary mutual fund shares as collateral for a loan.

The Board is currently reviewing these proposals. An insured depository institution, of course, can continue to buy nonexempt securities from an affiliate subject to the quantitative limits of section 23A and can buy such securities from

unaffiliated parties without any section 23A limit, so long as the purchase was otherwise authorized by law. In addition, this interpretation of (d)(6) does not interfere with the ability of an insured depository institution to purchase securities and other assets from affiliates other than the registered broker-dealer pursuant to the (d)(6) exemption so long as the prices of such assets are recorded in widely disseminated publications that are readily available to the general public.

Regulatory Flexibility Act Analysis

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

Administrative Procedures Act

Subject to certain exceptions, 12 U.S.C. 4801(b)(1) provides that new regulations and amendment to regulations prescribed by a federal banking agency that impose additional reporting, disclosures, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. This rule is not subject to this delayed effective date requirement because the rule

imposes no new requirements on existing operations of depository institutions. The rule only exempts transactions that were previously subject to the restrictions of section 23A.

Paperwork Reduction Act

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

List of Subjects

12 CFR Part 250

Banks, banking, Federal Reserve System.

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

Part 250 - Miscellaneous Interpretations

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

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

2. Section 250.246 is added to read as follows:

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

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

(1) The security has a "ready market," as defined by 17 CFR 240.15c3-1(c)(11)(i);

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

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

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

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

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

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

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

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

By order of the Board of Governors of the Federal Reserve System,

Jennifer J. Johnson,
Secretary of the Board.
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