April 25, 2001

To: Board of Governors

From: Staff[1]

Subject: Final rules regarding interpretations of and exemptions from section 23A of the Federal Reserve Act.

Action Requested: Approval to issue final rules containing interpretations of and exemptions from section 23A of the Federal Reserve Act[2] in three areas:

(1) An exemption from section 23A (and related interpretation) for certain loans by an insured depository institution to an unaffiliated customer that uses the loan proceeds to purchase securities or other assets through an affiliate of the institution that acts exclusively as a broker or riskless principal in the transaction.

(2) An exemption from section 23A for certain loans by an insured depository institution to an unaffiliated customer that uses the loan proceeds to purchase securities from a broker-dealer affiliate of the institution, if the loan is made pursuant to a preexisting line of credit granted by the institution to the customer.

(3) An interpretation that would expand the range of securities that an insured depository institution may purchase from an affiliate under the "readily identifiable and publicly available market quotation" exemption in section 23A.[3]

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[1] Legal Division (Messrs. Mattingly and Alvarez, Ms. Nardolilli, and Mr. Van Der Weide); Division of Banking Supervision and Regulation (Mr. Martinson, Ms. Wassom, and Mr. Schoenfeld); and Division of Research and Statistics (Ms. Liang).

[2] 12 U.S.C. § 371c.

[3] 12 U.S.C. § 371c(d)(6).

Staff recommends that the Board adopt these exemptions and interpretations as final rules at this time, separate from the Regulation W proposal, because the Board already has received public comment on these rules and the issuance of these rules in final form will permit insured depository institutions to take immediate advantage of the relief granted by the rules. In addition, the content of the rules is incorporated in the proposed Regulation W, which will give the public an additional opportunity to comment.

Background: Section 23A establishes quantitative limits on the ability of an insured depository institution ("depository institution") to extend credit to, or purchase assets from, an affiliate and establishes collateral requirements for credit transactions between a depository institution and an affiliate.[4] Section 23A gives the Board broad authority to grant exemptions from the statute's restrictions, if such exemptions are "in the public interest and consistent with the purposes of this section."[5]

On June 11, 1998, the Board proposed two exemptions from, and an interpretation of, section 23A.[6] The first proposed exemption applied to loans made by an insured depository institution to an unaffiliated borrower that uses the proceeds of the loan to purchase third-party securities through a registered broker-dealer affiliate of the bank that is acting exclusively as a broker or riskless principal

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[4] 12 U.S.C. § 371c. Although section 23A originally applied only to member banks, Congress has since applied the section to insured nonmember banks and insured savings associations in the same manner as it applies to member banks. See 12 U.S.C. § 1828(j); 12 U.S.C. § 1468.

[5] 12 U.S.C. § 371c(e).

[6] 63 Federal Register 32,766 (1998).

in the securities transaction ("Brokerage/Riskless Principal Exemption"). As proposed, the exemption applied even if the broker-dealer affiliate retained part of the loan proceeds as a fee for effecting the securities transaction.

The second proposed exemption applied to loans by an insured depository institution to an unaffiliated borrower that uses the loan proceeds to purchase securities underwritten or sold as principal by a registered broker-dealer affiliate of the institution, so long as the loan was made pursuant to a preexisting line of credit not established in contemplation of the borrower's purchase of securities from an affiliate of the depository institution ("Preexisting Line of Credit Exemption"). The proposed exemption also required that the loan be clearly consistent with any restrictions imposed under the terms of the line of credit.

Third, the Board proposed to issue an interpretation of section 23A that would expand the ability of depository institutions to purchase from a registered broker-dealer affiliate securities that have a ready market and prices that can be verified from a reliable, independent source. Section 23A(d)(6) exempts from the statute's quantitative limits a bank's purchase from an affiliate of assets that have a "readily identifiable and publicly available market quotation" (the "(d)(6) exemption").[7] Under the proposed interpretation, a purchase of securities by an insured depository institution from a 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 SEC;

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[7] 12 U.S.C. § 371c(d)(6). Although such purchases are exempt from the quantitative limits of section 23A, section 23A requires that the bank's purchase be consistent with safe and sound banking practices. See 12 U.S.C. § 371c(a)(4).

(2) The securities had a "ready market," as defined by the SEC in its regulation codified at 17 C.F.R. 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 securities;

(5) The price paid for the securities could be verified by (i) a widely disseminated news source; (ii) an electronic service that provided indicative data from real-time financial networks; or (iii) two or more actual independent dealer quotes on the exact securities to be purchased; and

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

Summary of Comments: Commenters on the proposal included ten banks or bank holding companies, four trade associations that represent the banking industry, and eight Federal Reserve Banks. The commenters overwhelmingly supported the goals of the Board's proposals, which they believed would provide benefits to both consumers and depository institutions without raising the types of concerns that section 23A was intended to address.

Analysis of Comments and Recommendations Regarding Final Rules:

A. Brokerage/Riskless Principal Exemption

Commenters generally agreed with the position taken in the Board's proposal that loans by a depository institution to a third party to purchase securities through a broker-dealer affiliate of the depository institution that is acting

exclusively in a brokerage or riskless principal capacity should not be subject to section 23A. Many commenters, however, argued that the Board should not adopt an exemption to section 23A that applies only to securities purchased from a broker-dealer affiliate. These commenters contended that a better course of action would be for the Board to issue an interpretation broader in scope than the proposed exemption. The commenters argued that adoption of a specific exemption for securities brokerage transactions by broker-dealer affiliates implies that, absent a grant of exemption, the Board considers brokerage or agency transactions involving other types of affiliates and assets to be covered by section 23A. The commenters contended that, if an affiliate is acting only as broker or agent in a transaction, the affiliate does not receive a "benefit" from the transaction, and the transaction cannot be viewed as fitting within section 23A.

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

depository institution and to the extent that no affiliate retains any portion of the loan proceeds.[8]

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

Staff recommends that the Board exempt from section 23A that portion of a loan that is retained by an affiliate of a depository institution as a market-rate brokerage fee or agency commission, that is, a fee or commission no greater than that prevailing at the same time for comparable agency transactions entered into by the affiliate with persons who are neither affiliates nor borrowers from an affiliated depository institution. Staff expects that such transaction fees will be nominal amounts and will represent a small percentage of the overall agency transaction and, accordingly, believes that these fees present little opportunity for a depository institution to provide a substantial benefit to its affiliate.[9]

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[8] For example, this interpretation would apply to a depository institution's extension of credit to a customer who uses the loan proceeds to purchase an insurance policy from an insurance agency affiliate of the depository institution, as long as the customer's insurance policy is not underwritten by an affiliate of the depository institution.

[9] If a depository institution extends credit to a customer to purchase assets or securities from an affiliate ("Affiliate A") and another affiliate ("Affiliate B") is used as agent to facilitate the transaction, then the loan, less Affiliate B's agency fee, counts against Affiliate A's quantitative limit and must meet the collateral

Finally, loans from a depository institution to customers who engage in riskless principal trades through a broker-dealer affiliate of the depository institution would be covered transactions under section 23A. Riskless principal trades--although the functional equivalent of securities brokerage transactions--involve the purchase of a security by the broker-dealer affiliate. Accordingly, the broker-dealer retains the loan proceeds at least for some moment in time.[10] There appears to be negligible risk that loans made by a bank to borrowers that engage in riskless principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, staff believes that the Board should adopt the proposed exemption to cover such transactions. This grant of exemption would be applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate mark-up for executing the riskless principal securities trade.

B. Preexisting Line of Credit Exemption

Approximately a dozen commenters offered specific comments on the proposed Preexisting Line of Credit Exemption. A majority of these commenters supported the Board's proposed exemption and concurred with the Board's view that granting the exemption would raise no safety and soundness concerns.

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requirements under section 23A because the loan's proceeds have directly benefited Affiliate A outside of an agency context.

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

Several commenters expressed concern about the requirement that the credit line be "preexisting." The commenters urged the Board to adopt other safeguards in lieu of the "preexisting" requirement.

Staff recommends that the Board adopt the Preexisting Line of Credit Exemption substantially as proposed. Staff believes that the "preexisting" line of credit requirement is an important safeguard to ensure that credit was not extended by the depository institution for the purpose of inducing a borrower to purchase securities from or issued by an affiliate.

Staff recommends that the Board emphasize that this exemption is to be used in good faith by depository institutions. In determining whether the exemption is being used in good faith, examiners should consider the timing of the line of credit, the conditions imposed on the credit line, and whether the line of credit has been used for purposes other than the purchase of securities from an affiliate. The Board may want to consider issuing additional examiner guidance regarding the "preexisting" requirement.

C. (d)(6) Exemption for Purchases of Assets with a Readily Identifiable and Publicly Available Market Quotation

The Board received thirteen comments on the proposed interpretation expanding the (d)(6) exemption: nine from banks and bank holding companies, three from trade associations, and one from a clearing house. In addition, the Board received comments 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 ensuring that asset purchases from affiliates are conducted in a safe and sound manner.

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 and in more detail in the Federal Register notices attached hereto.

(1) The Securities Must be Purchased from a Broker-Dealer Registered with the SEC

In order for a 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.

The Board proposed limiting the expansion of the (d)(6) exemption to broker-dealers registered with the SEC because such broker-dealers are regulated by and subject to SEC requirements. Staff believes that the added federal supervision of the selling party, the registered broker-dealer, provides extra protection to help ensure that transactions are conducted on terms that are consistent with safe and sound banking practices. Staff does not believe it is appropriate to expand the exemption to foreign broker-dealers, as requested by several commenters, because the level of supervision over these companies is not clear in all cases. Staff recommends that the final rule provide that a company can, however, request that the Board exempt (d)(6) transactions between an insured depository institution and a foreign broker-dealer, and the Board would consider these requests on a case-by-case basis.

The final rule provides that the Board will review this criterion in the future, after it evaluates the overall experience of institutions making exempt asset purchases under this interpretation of the (d)(6) exemption, to determine if an

expansion to other types of affiliates is warranted and consistent with safe and sound banking practices.

(2) <u>The Securities have a "Ready Market" as Defined by the SEC</u>

The proposed interpretation provided that, in order to meet the (d)(6) exemption, the securities must have a "ready market," as defined by the SEC.[11]

Several commenters supported the Board's use of the "ready market" criterion to ensure that a ready, competitive market exists for securities purchased from a broker-dealer affiliate under the (d)(6) exemption. Other commenters, although not opposing the Board's proposal to use the SEC's "ready market" concept, noted that the Board may wish to consider an alternative definition. The commenters noted that the Office of the Comptroller of the Currency ("OCC") defines "marketable securities" 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."[12] Another commenter suggested that the exemption be available for any type of security that has a "fair market price," as defined in National Association of Securities Dealers ("NASD") Rule 2730.

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[11] 17 C.F.R. 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 <u>bona fide</u> offers to buy and sell so that a price reasonably related to the last sales price or current <u>bona</u> <u>fide</u> 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.

[12] 12 C.F.R. 1.2(f)(4).

In the proposed interpretation, staff 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 insured depository institution purchases. The types of securities that meet this definition include obligations of the United States, including agency-issued securities, as well as many asset-backed, corporate debt, and sovereign debt securities. The “ready market” standard already is used by registered broker-dealers and is monitored by the SEC. 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 liquidate a security and receive its value. 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

Staff recommends that the Board adopt the “ready market” standard as proposed, because after considering the comments and alternative standards, staff believes that it provides the best standard that is well understood by the banking and securities industries.

In addition, staff does not believe that the NASD Rule is appropriate for the exemption because the NASD Rule is concerned primarily with the price at which a security is bought. Staff 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. Staff 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. Staff believes that it would be inconsistent with safe and sound banking practices to allow an insured depository institution to purchase from an affiliate unlimited amounts of a security for which no "ready market" exists.

(3) Investment Grade Rating

The third criterion in the Board's proposal required that the security have received an investment grade rating by an NRSRO. Approximately ten commenters 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.

The Board originally proposed that a security must be rated investment grade 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.[13] In light of the comments, however, staff recommends that the Board eliminate the requirement that a security receive an investment grade rating from an NRSRO. Instead, the Board should require that a security (1) be eligible for purchase by a State member bank under section 9 of the Federal Reserve Act, and (2) not be a low-quality asset (as

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[13] 12 U.S.C. § 371c(a)(3). The criteria used to define "low-quality asset" for purposes of section 23A generally appear to relate only to loans and not to other types of assets. 12 U.S.C. § 371c(c)(10).

defined by section 23A).[14] 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.[15] 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.[16] Moreover, State member banks' 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.

Staff 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.

Staff also recommends that the Board 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

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[14] 12 U.S.C. § 335.

[15] 12 U.S.C. § 24(7).

[16] 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.

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 disqualified 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 ("30-Day Restriction"). Approximately 11 commenters expressed opposition to this criterion. 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.

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.

Staff believes that the Board should adopt the proposed 30-Day Restriction, with one exception, because of uncertain market values of securities during an underwriting period and for 30 days thereafter 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.

Staff believes, however, that the 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 insured depository institution.

(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;[17] and (3) two independent dealer quotes on the exact securities purchased. These commenters believed the use of 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, which are discussed in pages 17-20 of the preamble to the final (d)(6) interpretation attached hereto.

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[17] Examples of such services include FIPS (see 58 Federal Register 16,428 (March 19, 1993)), and TRACE (see 66 Federal Register 8131 (January 29, 2001)), as well as systems run by private networks.

The interpretation originally proposed a price verification test because of the statutory requirement that the asset have a "readily identifiable and publicly available market quotation" and staff's belief that the proposed criteria would meet the statutory requirement. Prior to publication of the proposal, staff reviewed the use of matrices and the use of prices on comparable securities and did not believe that those price verification methods would meet the statutory standard that the quotation be "publicly available." In addition, staff 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.

Staff has reviewed its position in light of the comments received on the 1998 Proposal and further analysis of the reliability of the various pricing methodologies set forth in the 1998 proposal and 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.

Moreover, staff 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. Staff 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 bank to purchase unlimited amounts of such security from an affiliate. Staff now recommends that the Board remove this pricing method from the final (d)(6) interpretation.

The final rule 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 institution does not cast material doubt on the appropriateness of relying on the current market quotation for the security.

Staff agrees with commenters that there should be procedures in place for staff to review new dependable market pricing mechanisms as they become available. Staff will continue to assess the appropriateness of new methodologies for pricing securities or other assets.

(6) Securities Not 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 bank or affiliate, unless such securities are guaranteed by the U.S. government.

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 a depository institution's purchase of asset-backed securities issued by a broker-dealer affiliate, 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 sponsored by their affiliated broker-dealer.

The proposal prohibited the applicability of the (d)(6) exemption to most affiliate-issued securities because a contrary determination would permit a depository institution to acquire an unlimited credit exposure to affiliates in contradiction to the purposes of section 23A. In addition, if a purchase of assets from an affiliate is also a purchase of affiliate-issued securities (if, for example, an institution purchases securities issued by one affiliate from the inventory of another affiliate), the institution 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.[18]

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[18] For example, if the restriction on the purchase of an affiliate's securities is not imposed, an insured depository institution 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 institution's capital and surplus.

In light of the comments received on this issue, staff recommends that the Board request comment in connection with the Regulation W proposal on the possibility of making the purchase of interests in affiliate-advised mutual funds and affiliate-issued asset-backed securities (where the underlying assets were originated or purchased by the depository institution prior to the securitization) 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.

In the final interpretation, staff recommends that the Board shorten the period of time necessary for the insured depository institution to retain the price verification information to two years. Staff 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. Staff does not believe that the documentation requirements are substantial, and insured depository institutions should contact their primary regulators to determine what specific documentation the primary regulator will require. At a minimum, however, staff 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

In response to public comments received on the (d)(6) exemption, staff recommends that the Board propose an additional exemption for an insured depository institution's purchase of municipal securities from an affiliate, if the purchase meets a revised set of requirements. The preamble to the proposed Regulation W discusses this provision in more detail.[19]

Several 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 and clarify the applicability of section 23A to certain asset-backed securities issued by affiliates of banks. The public is invited to provide comment on these issues during the public comment period for Regulation W.[20]

In conclusion, it is important to note that insured depository institutions 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 is otherwise authorized by law. In addition, the proposed interpretation of (d)(6) does not interfere with the ability of an insured depository institution to purchase securities

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[19] See section 223.16(f) of the proposed Regulation W and accompanying text in the preamble.

[20] Commenters also requested that the Board reverse an earlier interpretation that stated that, for purposes of the quantitative limits in section 23A, the value of an extension of credit that is secured in any part by an affiliate's securities is the amount of the entire loan. Commenters requested that the Board determine that the amount that should count against the section 23A limits generally is the value of the affiliate's securities pledged. On January 21, 1999, the Board issued a letter adopting this position. The proposed Regulation W includes this interpretation, with a modification, and requests public comment.

and other assets from affiliates pursuant to the statutory (d)(6) exemption, so long as the prices of such assets are recorded in a widely disseminated publication that is readily available to the general public.[21]

CONCLUSION: For the reasons discussed above, staff recommends that the Board authorize issuance of the final rules attached hereto providing interpretations of, and exemptions from, section 23A.

[21] For example, the purchase of precious metals and foreign exchange is still permitted under section (d)(6).