FEDERAL RESERVE SYSTEM

12 CFR Part 223

[Regulation W; Docket No. R-1103]

Transactions between Banks and their Affiliates

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is proposing a new rule (Regulation W) to implement comprehensively sections 23A and 23B of the Federal Reserve Act. The proposed rule would combine statutory restrictions on transactions between a bank and its affiliates with numerous existing and proposed Board interpretations and exemptions in an effort to simplify compliance with sections 23A and 23B.

DATES: Comments must be submitted on or before August 15, 2001.

ADDRESSES: Comments should refer to Docket No. R-1103 and should be sent to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551 (or mailed electronically to *regs.comments@federalreserve.gov*). Comments addressed to Ms. Johnson also may be delivered to the Board's mail room between the hours of 8:45 a.m. and 5:15 p.m. weekdays and, outside of those hours, to the Board's security control room. Both the mail room and the security control room are accessible from the Eccles Building courtyard entrance, located on 20th Street, N.W., between Constitution Avenue and C Street, N.W. Members of the public may inspect comments in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in section 261.14 of the Board's Rules Regarding Availability of Information (12 CFR 261.14).

FOR FURTHER INFORMATION CONTACT: Pamela G. Nardolilli, Senior Counsel (202/452-3289), or Mark E. Van Der Weide, Counsel (202/452-2263), Legal Division; or Michael G. Martinson, Associate Director (202/452-3640), or Molly S. Wassom, Associate Director (202/452-2305), Division of Banking Supervision and Regulation; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION:

Introduction

Sections 23A and 23B of the Federal Reserve Act are two of the most important statutory protections against a bank suffering losses because of its transactions with affiliates and, correspondingly, are two of the most effective means of limiting the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the Federal safety net. Although sections 23A and 23B of the Federal Reserve Act each explicitly grant the Board broad authority to issue regulations to administer the section,[1/] the Board has never issued a regulation fully implementing either section. Instead, banks seeking guidance on how to comply with sections 23A and 23B have relied on a series of Board interpretations and informal staff guidance. Banks 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 financial holding companies and the growing complexities of the U.S. financial markets.

The Board now believes that adoption of a comprehensive regulation implementing sections 23A and 23B would be appropriate for several reasons. First, the new regulatory framework established by the Gramm-Leach-Bliley Act ("GLB Act")[2/] emphasizes the importance of sections 23A and 23B as a means to protect banks from losses in connection with the newly authorized affiliates under the GLB Act. In addition, the GLB Act amended section 23A in several important respects and requires the Board to address by rule under section 23A the credit exposure arising from derivative transactions and intraday credit extensions.

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

2/ Pub. L. No. 106-102, 113 Stat. 1338 (1999).

Moreover, the Board believes that adoption of a comprehensive regulation would 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. Finally, issuing a proposed regulation would allow 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 a public comment process.

The proposed regulation would supersede outdated Board and staff interpretations concerning sections 23A and 23B and would incorporate other existing interpretations. In addition, the regulation would incorporate the results of the Board's earlier proposals to clarify the scope of the attribution rule, expand the section 23A(d)(6) exemption for purchases of readily marketable assets, and, consistent with the GLB Act, extend the coverage of section 23A to subsidiaries of a bank engaged in activities that the bank cannot conduct directly.[3/] Finally, the proposed regulation would answer questions that have arisen frequently in the Board's administration of the statutory provisions and in their enforcement by each of the Federal banking agencies.

The Board emphasizes that Regulation W is a proposed rule and expects to make changes to the rule to reflect public comments as appropriate. Until Regulation W is finalized, all previously issued valid Board interpretations and staff opinions regarding sections 23A and 23B will remain in full force and effect. After the Board issues the regulation in final form, any Board interpretations or staff opinions on the statute that are inconsistent with the regulation will be deemed superseded by the rule.

Background

As noted above, sections 23A and 23B of the Federal Reserve Act are designed to limit the risks to a bank (and the Federal deposit insurance funds) from transactions between the bank and its affiliates and to limit the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the Federal safety net. Section 23A achieves these goals in three major ways. First, it limits a

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[3/] See 63 FR 32766, June 16, 1998; 62 FR 37744, July 15, 1997.

bank's "covered transactions" with any single "affiliate" to no more than 10 percent of the bank's capital and surplus, and transactions with all affiliates combined to no more than 20 percent of capital 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 bank to an affiliate's credit or investment risk. A 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 bank and its affiliates to be on terms and conditions that are consistent with safe and sound banking practices, and prohibits a bank from purchasing low-quality assets from its affiliates. Finally, the statute requires that a 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 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 the sale of securities or other assets to an affiliate and the payment of money or furnishing of services to an affiliate.

Section 23A originally was enacted as part of the Banking Act of 1933 and applied only to banks that were members of the Federal Reserve System ("member banks"). Since 1933, Congress has amended the statute several times, including a comprehensive revision in 1982.[4/] Congress also amended the Federal Deposit Insurance Act in 1966 to extend section 23A to cover insured nonmember banks.[5/] In 1989, Congress further extended the coverage of section 23A to insured savings

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[4/] 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).

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

associations.[6/] Congress enacted section 23B of the Federal Reserve Act as part of the Competitive Equality Banking Act of 1987,[7/] 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.

As part of its comprehensive revision of section 23A in 1982, Congress amended the statute to exempt transactions between a bank and its subsidiaries.[8/] In 1982, a subsidiary of a bank generally was permitted to engage only in activities that its parent bank could conduct. Since 1982, however, some subsidiaries of banks have begun to engage in activities impermissible to the banks themselves.[9/] In 1997, to address these subsidiaries, the Board issued for comment a proposal to extend sections 23A and 23B to transactions between a bank and a subsidiary of the bank engaged in activities not permissible for the bank to engage in directly.[10/] Consistent with this proposal, the GLB Act recently amended the Federal Reserve Act 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.[11/] This statutory provision defines a financial subsidiary of a national bank as a subsidiary of an insured depository institution that engages in activities that are not permissible for a national bank to engage in directly (unless a national bank is authorized by the express terms of a Federal statute (other than the GLB Act) to

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[6/] 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) ("FIRREA").

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

[8/] Section 23A excludes from the definition of "affiliate" most subsidiaries of a bank. See 12 U.S.C. 371c(b)(2)(A).

[9/] See 12 U.S.C. 24a, 1464(c)(4)(B), and 1831a; 12 CFR 5.39 and 362.4.

[10/] 62 FR 37744, July 15, 1997.

[11/] See 12 U.S.C. 24a.

own or control the subsidiary). The GLB Act provides that a financial subsidiary of a bank is considered an "affiliate" of the bank for purposes of sections 23A and 23B and requires, with certain limited exceptions, that any covered transactions between a bank and its financial subsidiaries comply with the same quantitative, collateral, and other restrictions imposed by sections 23A and 23B on other affiliates.

The GLB Act also establishes certain special rules for financial subsidiaries. For example, the GLB Act extends the restrictions of sections 23A and 23B to investments by a bank's affiliate in securities issued by any financial subsidiary of the bank. The GLB Act also authorizes the Board to extend sections 23A and 23B to loans and other extensions of credit made by a bank's other affiliates to any financial subsidiary of the bank, if the Board determines that such action is necessary or appropriate to prevent evasions of the Federal Reserve Act or the GLB Act. Finally, the GLB Act provides that the 10 percent restriction on covered transactions with any individual affiliate does not apply to transactions between a bank and any individual financial subsidiary of the bank.[12/] The proposed regulation addresses these provisions of the GLB Act.

In addition, the GLB Act requires the Board to adopt, by May 12, 2001, final rules to address as a covered transaction the credit exposure arising out of derivative transactions between banks and their affiliates and intraday extensions of credit by banks to their affiliates.[13/] Concurrently with proposed Regulation W, the Board is issuing interim final rules that address these credit exposures to affiliates as covered transactions under section 23A, in accordance with this statutory requirement, by requiring banks to adopt policies and procedures to manage the credit exposures. The interim final rules also require banks to ensure that their intraday extensions of credit to an affiliate and their derivative transactions with affiliates comply with the market terms requirement of section 23B.

[12/] Covered transactions between a bank and any of its financial subsidiaries would count toward the bank's 20 percent limit for covered transactions with all affiliates in the aggregate.

[13/] GLB Act § 121(e)(3) (codified at 12 U.S.C. 371c(f)(3)).

The proposed Regulation W sets forth a more comprehensive proposal on the treatment of intraday extensions of credit under section 23A than is contained in the interim final rules and includes a detailed request for comment on the appropriate treatment of credit exposure arising from bank-affiliate derivative transactions under section 23A. If, after further analysis and review of the comments received on this regulation and the interim final rule on derivatives, the Board believes that additional measures are needed to address credit exposure on derivative transactions under section 23A, the Board will develop a specific proposal and seek comment on that proposal.

Explanation of Proposed Rule

I. Format of Regulation

The proposed Regulation W seeks to provide users with a single, comprehensive reference tool for complying with and analyzing issues arising under sections 23A and 23B. Accordingly, the regulation includes Board interpretations of the sections and also restates the statutory definitions, restrictions, and exemptions. Although including the statutory language lengthens the text of the regulation, the Board believes that eliminating the need to cross-reference the statute should make understanding and using the regulation easier.

The regulation first sets forth, in subpart B, 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, bank-affiliate derivative transactions, and certain bank-affiliate merger and acquisition transactions. Subpart E sets forth available exemptions from certain of the restrictions and requirements of section 23A. Subpart F lays out the operative provisions of section 23B. Subpart G discusses the application of the statutory provisions and rule to U.S. branches and agencies of foreign banks. Subpart H provides a comprehensive glossary of the terms used in the regulation and sections 23A and 23B.

The proposed 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.

The Board requests comment on the proposed format of the regulation, including the Board's decision to restate and reorganize the statutory provisions and include examples in the rule. The Board also requests comment on whether additional examples should be added to the rule and, if so, in what areas. In addition, the Board requests comment on whether there are additional methods for making the regulation more user-friendly or for reducing unnecessary regulatory burden.

II. Scope of Regulation

As proposed, Regulation W applies to all "banks." As noted above, although sections 23A and 23B apply by their terms only to member banks, the Federal Deposit Insurance Act subjects insured nonmember banks to the restrictions of sections 23A and 23B as if they were member banks. Referring to banks (rather than member banks) should clarify the scope of the regulation for the reader. By using the defined term "bank," the Board does not intend to expand the scope of sections 23A and 23B beyond member banks and insured nonmember banks.[14]

The Home Owners' Loan Act ("HOLA") also subjects insured savings associations to sections 23A and 23B as if they were member banks. HOLA imposes several restrictions on transactions between an insured savings association

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[14] 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 banks and their affiliates that may be applicable under other provisions of law, including those that may apply to banks subject to prompt corrective action under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

and certain of its affiliates that are not contained in section 23A[15/] and provides the Office of Thrift Supervision ("OTS") with authority to impose additional restrictions on transactions between an insured savings association and its affiliates.[16/] In light of the stricter regulatory regime governing transactions between an insured savings association and its affiliates and in light of a request by the OTS that the proposed Regulation W not specifically cover such institutions, the proposed rule does not apply by its terms to savings associations. The Board notes, however, that because insured savings associations are subject to sections 23A and 23B as if they were member banks, 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 banks.

[15/] 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) purchasing or investing in shares issued by any affiliate other than a subsidiary of the savings association. 12 U.S.C. 1468(a)(1).

[16/] 12 U.S.C. 1468(a)(4).

III. General Provisions of Section 23A–Subpart B

Subpart B of the proposed regulation sets forth the principal restrictions of section 23A. These restrictions include:

(i) the quantitative limits on covered transactions by a bank with any individual affiliate and all affiliates in the aggregate;

(ii) the requirement that all transactions with an affiliate be on terms and conditions that are consistent with safe and sound banking practices;

(iii) the collateral requirements for extensions of credit and similar transactions with an affiliate;

(iv) the prohibition on the purchase of low-quality assets from an affiliate; and

(v) the attribution rule, which provides that any transaction with any person that is not an affiliate 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.

Subpart B also incorporates previous Board and staff interpretations of these provisions. In addition, the subpart includes a few new interpretations of the statute's quantitative limits, collateral requirements, and attribution rule. These clarifications of the statute are discussed below.

A. Quantitative limits–223.2 and 223.3

Section 23A(a)(1) provides that a 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.[17/] Sections 223.2 and 223.3 of the proposed regulation set forth these quantitative limits. The quantitative limits of Regulation W (consistent with section 23A) only prohibit a bank from engaging in a new covered transaction if the bank would be in excess of the 10 or 20 percent thresholds after consummation of the new transaction. The regulation (consistent with section 23A) generally does not require a bank to unwind existing covered transactions if the bank exceeds the 10 or 20 percent limits because its capital declined or a pre-existing covered transaction increased in value.

Section 23A(a)(1)(A) states that a 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 will not exceed 10 percent of the capital stock and surplus of the bank. Regulation W makes clear that this limitation prevents a 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. This interpretation of the section is consistent with the statutory language and would have the salutary effect of encouraging 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.

B. Collateral requirements–223.5

Section 223.5 of the proposed 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 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

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[17/] 12 U.S.C. 371c(a)(1).

or U.S. government securities) to 130 percent of the credit extended (when the collateral is stock, leases, or certain other "real or personal property").[18]

1. Deposit account as collateral–223.5(b)(1)(iv)

Under section 23A(c)(1)(A)(iv), a 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. The proposed regulation clarifies that to satisfy the statute's "earmarked" requirement, the account must exist for the sole purpose of securing the credit extended and be so identified.

2. Ineligible collateral–223.5(c)

The purpose of section 23A's collateral requirements is to ensure that banks that engage in credit transactions with an affiliate 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.[19]

In light of the purposes of section 23A, the Board believes that intangible assets (as defined by generally accepted accounting principles ("GAAP")) – including mortgage servicing assets and other servicing assets – are not acceptable collateral to secure credit transactions with an affiliate. Intangible assets are particularly hard to value, and a bank may have significant difficulty in collecting and selling such assets in a reasonable period of time. For these reasons, Board staff opined in 1987 that mortgage servicing rights may not be used to satisfy the collateral requirements of section 23A.[20] The Board believes that these reasons

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[18] 12 U.S.C. 371c(c)(1).

[19] 12 U.S.C. 371c(c)(3) and (4).

[20] See Letter dated Aug. 31, 1987, from Michael Bradfield, General Counsel of the

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continue to justify the exclusion of mortgage servicing assets, as well as other intangible assets, from the types of collateral eligible to satisfy the requirements of section 23A. The Board seeks comment on whether banks should be permitted to use any particular types of intangible assets to meet section 23A's collateral requirements.

In addition, the Board does not consider guarantees and letters of credit to be eligible collateral for section 23A purposes. These agreements 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 be "secured" by collateral. A credit transaction between a 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.

As noted above, section 23A prohibits a bank from accepting securities issued by an affiliate as collateral for an extension of credit to an affiliate. The Board also proposes to clarify that securities issued by the bank itself are not eligible collateral to secure a credit transaction with an affiliate. If the bank were forced to foreclose on such a credit transaction, the bank may be unwilling to liquidate its own securities 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 bank is unable or unwilling to sell its own securities acquired through foreclosure, the transaction may result in a reduction in the bank's capital, thereby offsetting any potential benefit provided by the collateral. The Board seeks comment on whether this exclusion should apply to debt and equity securities issued by the bank or whether the exclusion should apply only to bank-issued equity securities.

3. Perfection and priority required–223.5(d)

To ensure that the bank has good access to the assets serving as collateral for its transactions with affiliates, the proposed regulation also provides that a

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Board, to Gail Runnfeldt.

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[21/] and ensures that the bank has the legal right to realize on the collateral in case of default, including one resulting from the affiliate's insolvency, liquidation, or similar circumstances.

For similar reasons, the proposed regulation requires that a bank either must obtain a first priority security interest in the required collateral or must 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 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).

4. <u>Undrawn portion of an extension of credit–223.5(g)</u>

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 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 bank to satisfy the collateral requirements of section 23A by securing only the portion of a credit line that has been drawn down by the affiliate. The Board acknowledges that this treatment may be too strict for some lines of credit. Accordingly, the regulation provides that the collateral requirements of section 23A do not apply to the undrawn portion of an extension of credit to an affiliate so long as the 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 drawn portion of the extension of credit.[22/] In such credit arrangements, securing the undrawn

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[21/] <u>See</u> <u>Fitzpatrick v. FDIC</u>, 765 F.2d 569 (6th Cir. 1985).

[22/] This proposed treatment would not apply to guarantees, acceptances, and

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portion of the credit line is unnecessary from a safety and soundness perspective because the affiliate can never require the bank to advance additional funds without posting the additional collateral required by section 23A. If a bank voluntarily advanced additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire drawn 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.

C. Prohibition on the purchase of low-quality assets–223.6

Section 223.6 of the proposed regulation restates the statute's general prohibition on a bank purchasing low-quality assets from an affiliate.[23/] This section also provides an exception to the general prohibition, which is based on a long-standing staff interpretation.[24/] The exception allows a 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 has become a low-quality asset, so long as certain criteria are met. These renewals or additional credit extensions may enable both the affiliate and the participating bank to avoid or minimize potential losses. It would be inconsistent with the purposes of section 23A to bar a participating 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.

The exception is available only if the underlying loan was not a low-quality asset at the time the bank purchased its participation, and the proposed transaction does not increase the bank's proportional share of the credit facility. The

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[22/](...continued)
letters of credit issued on behalf of an affiliate, which must be fully collateralized at inception.

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

[24/] See Letter dated Aug. 10, 1984, from Michael Bradfield, General Counsel of the Board, to Margie Goris.

transaction also must be approved by the bank's board of directors, and the bank must provide its appropriate Federal banking agency with 20 days' prior notice of the transaction. The notice requirement represents an additional condition to the exception that is not contained in the staff's outstanding interpretive letter on the exception. The Board proposes to add this condition at the request of a Federal banking agency that expressed an interest in monitoring these transactions.

The Board believes that this exception allows banks appropriate flexibility to resolve problems associated with a troubled loan participation.

D. Attribution rule–223.7

Section 23A(a)(2) provides that any transaction between a bank and a third party 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.[25/] For example, a 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 bank from evading the restrictions in the section by using intermediaries and to limit the exposure that a bank has to customers of affiliates of the bank. Section 223.7 of the proposed regulation restates this provision and provides interpretive guidance and exemptions on the following topics.

[25/] 12 U.S.C. 371c(a)(2).

1. Agency and riskless principal transactions–223.7(b)(1) and (2)

In June 1998, the Board proposed several exemptions for covered transactions between a bank and its securities affiliates (the "1998 Proposal").[26] In the 1998 Proposal, the Board proposed to exempt from section 23A loans by a bank to an unaffiliated customer who uses the proceeds to purchase securities through a broker-dealer affiliate of the bank that is acting solely in an agency or riskless-principal capacity. The Board is adopting an expanded form of this exemption in a separate final rule issued concurrently with Regulation W. The exemptive aspects of the final rule also are contained in Regulation W, and the Board asks for further comment on the exemption. In particular, the Board asks whether the riskless principal exemption should be expanded to cover purchases of assets other than securities.

2. Preexisting lines of credit–223.7(b)(3)

In the 1998 Proposal, the Board also proposed an exemption from section 23A for extensions of credit by a bank to an unaffiliated customer that uses the credit to purchase securities underwritten by or held in the inventory of a broker-dealer affiliate of the bank when that extension of credit was made pursuant to a preexisting line of credit (the "Preexisting Line of Credit Exemption"). The Board is adopting this exemption substantially as proposed in another separate final rule issued concurrently with Regulation W. The exemption is also included in Regulation W, thus allowing an opportunity for further comment on the exemption.

3. General purpose credit cards–223.7(b)(4)

Section 23A's attribution rule, by its terms, would cover an extension of credit by a bank to a nonaffiliate where the proceeds of the extension of credit are used by the nonaffiliate to purchase products or services from an affiliate of the bank. Regulation W would exempt such an extension of credit from the attribution rule if the extension is made pursuant to a general purpose credit card issued by the bank to the nonaffiliate. The regulation defines a general purpose credit card as a credit card issued by a bank, if (i) the card may be used to buy products or

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[26] 63 FR 32766, June 11, 1998, and 63 FR 32768, June 11, 1998.

services from a nonaffiliate of the bank, (ii) the card is widely accepted by merchants that are not affiliates of the bank, and (iii) less than 25 percent of the aggregate amount of products and services purchased with the card by all cardholders are products or services purchased from affiliates of the bank (see § 223.26(n)). In these circumstances, the funding benefit received by the affiliate from the unaffiliated borrower's use of the general purpose credit card is likely to be minimal, and a bank's decision to issue a general purpose credit card (and make loans pursuant to such credit card) to an unaffiliated borrower likely would be based on independent credit standards unrelated to any possible affiliate transaction. 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 or services from affiliates of the bank), however, would continue to be subject to the attribution rule because the affiliate would be a significant and intended beneficiary of the bank's credit extensions pursuant to the cards.

IV. Valuation and Timing Principles under Section 23A–Subpart C

Subpart C of the proposed regulation sets forth the rules that 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 banks must employ to determine when a transaction becomes or ceases to be a covered transaction. Although most of these valuation and timing rules are consistent with previous advice given by Board staff on these issues, certain of the principles represent new positions. The rules are discussed below.

A. Credit transactions–223.8

The regulation provides generally that a credit transaction initially must be valued at the amount of funds provided by the 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. 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.

The regulation also would make clear that a bank has entered into a credit transaction with an affiliate at the time <u>during the day</u> 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, an affiliate. This timing rule represents a departure from the industry practice of complying with section 23A only with respect to overnight positions. The rule is consistent, however, with the regulation's proposal to incorporate intraday credit extensions into section 23A, as described below. This timing rule also clarifies that a covered transaction occurs at the moment that the bank executes a legally valid, binding, and enforceable credit agreement or guarantee document, and does not occur only when a bank funds a credit facility or makes payment on a guarantee.

Under section 23A and the proposed regulation, a 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 regulation refers to this type of transaction as an "indirect" credit transaction. In these circumstances, the bank must value the credit 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 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. The lower covered transaction amount reflects the fact that the bank's maximum loss on the transaction is $90 rather than the original principal amount of the loan. If a 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). For these indirect credit transactions, the regulation deems a bank to engage in a covered transaction at the moment during the day that the bank acquires the credit transaction from the third party.

Although a bank's purchase of, or investment in, a debt security issued by an affiliate is considered an "extension of credit" 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 223.10 of the rule, which is discussed in Part IV.C. below.

Banks sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the bank. The regulation provides that credit transactions with a nonaffiliate become covered transactions at the time that the nonaffiliate becomes an affiliate of the bank. The Board does not believe that section 23A should be read to prevent the affiliation or to require that the indebtedness be reduced to meet the applicable section 23A quantitative limits before the affiliation occurs or thereafter. The bank must ensure, however, that any such credit transaction satisfies the collateral requirements of section 23A promptly after the nonaffiliate becomes an affiliate. The bank also must include the amount of any such transaction in the aggregate amount of its covered transactions for purposes of determining whether any future covered transactions would comply with the quantitative limits of section 23A.

In cases where the bank entered into the credit transaction with the nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank, however, there is an additional requirement. In such cases, the bank must, at or prior to the time the nonaffiliate becomes an affiliate, reduce the aggregate amount of its covered transactions with affiliates if necessary so as not to exceed the quantitative limits of section 23A. The regulation provides an example of how section 23A applies in these circumstances.

B. Asset purchases–223.9

Regulation W provides that a purchase of assets by a 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 bank.[27/] The regulation also indicates that an asset purchase remains a covered transaction for a bank for as long as the bank holds the asset, and that the value of the covered

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[27/] The purchase by a bank of a security issued by an affiliate is addressed in Part IV.C. below, and the purchase by a bank of any other note or obligation of an affiliate is addressed in Part IV.A. above.

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.[28]

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 bank. However, as set forth in the proposed rule, if a bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the 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 that the nonaffiliate becomes an affiliate.

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

C. Purchases of and investments in securities issued by an affiliate–223.10

Section 23A includes as a covered transaction a bank's purchase of, or investment in, securities issued by an affiliate. Regulation W would require a bank to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary, which is subject to special rules under the GLB Act) at the greater of the bank's purchase price or carrying value of the securities.[29] Under the rule, a bank that pays no consideration in exchange for affiliate securities must nevertheless value the covered transaction at no less than the bank's carrying value for the securities.[30] In addition, under the rule, if the bank's carrying value of the

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[28] The Board also has determined to treat certain bank-affiliate merger and acquisition transactions as constructive asset purchases. These transactions are discussed in Part V.A. below.

[29] The valuation rule for investments in securities issued by a financial subsidiary is discussed in Part V.B.2. below.

[30] Carrying value refers to the amount at which the securities are carried on the
(continued...)

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.

The Board believes several considerations support the approach contained in the proposed regulation. First, the approach is generally consistent with GAAP, which would require the 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 for the securities.

Second, the definition of covered transaction in section 23A includes both a "purchase of" and an "investment in" securities issued by an affiliate. Accordingly, the statute by its terms appears to cover situations where a bank purchases securities of an affiliate and situations where a bank receives affiliate securities and pays no consideration. If the rule permitted banks to value these transactions only at purchase price, the "investment in" language of the statute would be rendered superfluous. The Board believes, moreover, that the statute's "investment in" language indicates that Congress was concerned with a bank's continuing exposure to an affiliate through an ongoing investment in securities issued by the affiliate. The best way to give effect to this concern and the "investments in" prong of the statutory definition is to base the value of a bank's investment in the securities of an affiliate on the bank's actual financial exposure to the investment (as reflected on the bank's GAAP financial statements), even if the bank paid nothing to acquire the securities.

Third, amendments to section 23A made by the GLB Act indicate that the value of an investment in the securities of an affiliate under section 23A should reflect increases (or decreases) in the value of the securities caused by earnings (or losses) at the affiliate. In particular, 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 the securities of a financial subsidiary does not include retained earnings of the subsidiary. The negative implication from this provision is

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[30/](...continued)
GAAP financial statements of the bank.

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 proposed valuation rule.

Finally, this valuation rule is consistent with the purposes of section 23A – limiting the financial exposure of banks to their affiliates and promoting safety and soundness. The proposed rule would require a bank to revalue upwards the amount of an investment in affiliate securities only when the bank's exposure to the financial condition of the affiliate has increased (as reflected on the bank's financial statements) and the bank's capital has increased to reflect the higher value of the investment. In these circumstances, the valuation rule merely reflects the bank's greater financial exposure to the affiliate and promotes 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, the proposed rule provides that the section 23A value of a bank's investment in affiliate securities can be no less than the amount paid by the bank for the securities, even if the carrying value of the securities declines below that amount. The Board believes that this approach, although not consistent with GAAP, is reasonable because it establishes as a floor the amount of funds actually paid by the bank for the affiliate securities. Using the bank's purchase price for the securities as a floor for valuing the covered transaction also limits the ability of a 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 bank could lend more funds to the affiliate as the affiliate's financial condition worsened, because the carrying value of the affiliate's securities also would decline and thereby increase the bank's ability to provide additional funding 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 banks in valuing purchases of and investments in the securities of an affiliate.

D. Posting securities issued by an affiliate as collateral–223.11

Section 23A defines as a covered transaction a bank's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company.[31] 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 would value 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 proposes 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.[32]

Regulation W would value 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

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[31] 12 U.S.C. 371c(b)(7)(D). This covered transaction only arises when the 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 third party 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 bank to an affiliate.

[32] In either case, the transaction must comply with section 23B; that is, the 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.

the other collateral and (ii) the fair market value of the affiliate securities (if the securities have a ready market). Until 1999, staff advised banks to value this class of covered transactions at the total amount of the extension of credit. In January 1999, the staff modified its position on mixed collateral loans to permit banks to value these transactions in a manner similar to the proposed rule.[33/]

The Board believes that in situations in which 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 towards the bank's section 23A quantitative limits. Under the proposed 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 bank's quantitative limits for purposes of section 23A. If the loan is not fully secured by other collateral, then the maximum amount that the 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. This methodology takes account of the bank's reliance on the value of nonaffiliate collateral in a loan transaction, while also recognizing that a portion of the loan may be supported by securities issued by an affiliate.

The approach taken in Regulation W, however, is different from that of the 1999 interpretation in two respects. First, although the 1999 interpretation allows 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 would allow banks to use the value of the affiliate securities as an upper limit if the affiliate securities have a ready market. If the affiliate securities do not have a ready market, a bank could understate the market value of the securities in order to shrink the size of the covered transaction. Second, the regulation's ready market requirement would replace an implicit condition of the 1999

[33/] See Letter dated January 21, 1999, from J. Virgil Mattingly, 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 (2) the fair market value of the affiliate's securities that are used as collateral.

interpretation that only a small amount of the total collateral could be affiliate securities. The valuation rule in Regulation W would apply regardless of the amount of affiliate collateral.

The Board also notes that, under section 23A, a loan that is secured with any amount of an affiliate's securities must be consistent with safe and sound banking practices.[34]

V. Other Considerations under Section 23A–Subpart D

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

A. Bank-affiliate merger and acquisition transactions–223.12

Section 23A includes a purchase of assets from an affiliate and the 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 bank directly or indirectly acquires an affiliate. There are three principal methods by which a bank acquires an affiliate. The first method is where a bank (or one of its subsidiaries that is not treated as an affiliate of the bank under section 23A (an "operations subsidiary")) 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 paid by the bank for the affiliate's assets plus the amount of any liabilities assumed by the bank in the transaction.

The second method is where a bank (or its operations subsidiary) acquires an affiliate by merger. Because a merger with an affiliate generally results in the 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

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[34] 12 U.S.C. 371c(a)(4).

transaction also is treated as a purchase of assets, and the covered transaction amount is again equal to the amount paid by the bank for the affiliate's assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.

The third method involves the contribution or sale of an affiliate's shares by the affiliate's parent to the bank (or its operations subsidiary). The Board previously has treated these transactions as a purchase of assets covered by section 23A where the bank paid consideration for the shares or the affiliate whose shares were contributed to the bank had liabilities to any affiliate of the bank.[35]

The proposed rule does not alter the treatment of the first two types of transaction described above. The proposed rule does provide, however, a new treatment, which is consistent with the structure of section 23A, for the third type of transaction. The rule provides that the acquisition by a bank of securities issued by a company that was an affiliate of the bank before the acquisition is treated as a purchase of the assets of the company if (i) as a result of the transaction, the company becomes a subsidiary of the bank and ceases to be an affiliate of the bank; and (ii) the company has liabilities, or the bank gives cash or any other consideration in exchange for the securities. The rule also provides that such transactions must be valued initially at the sum of (i) the total amount of consideration given by the bank in exchange for the securities; and (ii) the total liabilities of the company whose securities have been acquired by the bank through the contribution or purchase. In effect, the rule requires banks to treat these sorts

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[35] See, e.g., Letter dated June 11, 1999, from Robert deV. Frierson, Associate Secretary of the Board, to Mr. Robert L. Anderson. Some institutions have argued that this treatment is too strict and that a covered transaction should be deemed to occur in connection with a share contribution only if there is a net transfer of value from the bank to the affiliate (that is, if the liabilities of the transferred company exceed the value of the assets of the company). In many internal reorganizations, the Board has found that the value of the assets of the transferred company was uncertain. In addition, the transactions often were motivated by funding problems at the transferred affiliate 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 bank.

of share donations and purchases in the same manner as if the 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).

This treatment for affiliate share transfers would be consistent with the approach that section 23A takes on subsidiaries of banks and with economic and marketplace realities. Section 23A treats banks and their operations subsidiaries as a single unit. Transactions between a bank and its operations subsidiaries are not treated as covered transactions between a bank and an affiliate under section 23A; rather, they are treated as transactions entirely inside the bank. Similarly, a transaction between a bank's operations subsidiary and an affiliate of the bank is treated as a covered transaction between the bank itself and an affiliate under section 23A. Ignoring the separate corporate form of subsidiaries of banks and treating the assets and liabilities of subsidiaries of banks as assets and liabilities of the bank itself is, therefore, consistent with the structure of section 23A. Accordingly, under section 23A, these share transfers in which an affiliate of a bank becomes a 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.

The proposed treatment for 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 actually 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 Board proposes to treat the assets and liabilities of a subsidiary of a bank as assets and liabilities of the bank itself for purposes of section 23A.[36/]

[36/] Affiliate share transfers to a bank often are functionally equivalent to transactions in which a bank directly acquires the assets and assumes the liabilities of an affiliate, because a bank can usually merge the newly acquired subsidiary into itself. 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

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The proposed rule only imposes asset purchase treatment on affiliate share transfers where the company whose shares are being transferred to the bank was an affiliate of the bank before the transfer. If the transferred company were not an affiliate prior to transfer, it would not be appropriate to treat the share transfer as a purchase of the assets of an affiliate. Similarly, the rule only requires asset purchase treatment for share transfers where the transferred company becomes a subsidiary and not an affiliate of the bank through the transfer. If the company were not a subsidiary of the 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 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 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 bank and the transferred company as a single unit.

The Board solicits comment on whether this method of treating affiliate share transfers is appropriate.

The Board notes that it has granted numerous section 23A exemptions, on a case-by-case basis, for transactions involving the transfer (by merger, purchase and assumption transaction, or otherwise) by a holding company of one of its nonbank subsidiaries to a subsidiary bank.[37/] The Board typically has approved such exemptions only if certain conditions are met, including (i) the transfer of the affiliate must be the result of a one-time corporate reorganization, (ii) the entity transferring the shares to the bank must provide certain assurances concerning the quality of the assets being transferred, (iii) the disinterested directors of the bank must approve the transaction in advance, (iv) the transfer must not include any low-quality assets, and (v) the bank's appropriate Federal banking agency and the

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[36/](...continued)
liabilities assumed by the bank.

[37/] 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.

Federal Deposit Insurance Corporation must inform the Board that they have no objection to the transaction. Banks may continue to apply to the Board for such case-by-case exemptions.

The proposed regulation also contains a regulatory exemption for certain merger and acquisition transactions that result in the transfer of an affiliate to a bank. Section 223.12(d) of the regulation provides an exemption from the requirements of section 23A (other than the safety and soundness requirement) for transactions in which, for example, a bank holding company 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 bank. Although these transactions technically would be subject to the asset purchase treatment discussed in this section – and the bank would be required to value the covered transaction at the total amount of the liabilities of the acquired company (plus any consideration paid by the bank for the company) – the Board believes that it would be inappropriate to treat this transaction as a covered transaction. If the bank had acquired the unaffiliated company directly, there would be 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.

Accordingly, the regulation exempts these "step" transactions as long as certain conditions are met. First, the bank must acquire the target company immediately after the company becomes an affiliate (by being acquired by the bank's holding company, for example). To the extent that the 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. Second, the bank must acquire the entire ownership position in the target company that its holding company acquired. If the bank were to acquire less than all the shares or assets of the target company that its holding company acquired, the transaction again would not, in effect, involve the purchase of the company by the bank. Finally, the entire transaction must comply with the market terms requirement of section 23B.

B. Financial subsidiaries–223.13

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 proposed 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–223.13(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 bank and any individual financial subsidiary of the bank. Accordingly, a bank's aggregate amount of covered transactions with any individual financial subsidiary may exceed 10 percent of the bank's capital stock and surplus. A bank's covered transactions with its financial subsidiaries, however, are subject to the statutory and regulatory 20 percent quantitative limit. Thus, a 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.

2. Valuation of investments in the securities of a financial subsidiary–223.13(b)

Because financial subsidiaries of a bank are considered affiliates of the bank for purposes of section 23A, purchases of and investments in the securities of a financial subsidiary are covered transactions under the statute. The GLB Act provides that a bank's investment in its financial subsidiary, for purposes of section 23A, shall not include the retained earnings of the financial subsidiary.[38] In light of this statutory provision, the regulation contains a special valuation rule for investments in the securities of a financial subsidiary. Such investments must be valued at the greater of (i) the price paid by the bank for the securities; and (ii) the carrying value of the securities on the financial statements of the bank (determined in accordance with GAAP but without reflecting the bank's pro rata share of any

[38] GLB Act § 121(b)(1) (codified at 12 U.S.C. 371c(e)(3)(B)).

earnings retained or losses incurred by the financial subsidiary after the bank's acquisition of the securities).[39/]

This valuation rule differs from the general "investment in the securities of an affiliate" valuation rule 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 bank's investment. As a result of this rule, the covered transaction amount for a bank's investment in the securities of its financial subsidiary would not increase except in the event that the bank made an additional capital contribution to the subsidiary or purchased additional securities of the subsidiary.

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

3. Anti-evasion rules–223.13(c)

Section 23A generally applies only to transactions between a bank and an affiliate of the bank and transactions between a bank and a third party where some benefit of the transactions 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 bank and another affiliate of the bank.[40/] First, the GLB Act provides that any purchase of, or investment in, the securities of a 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 a loan or other extension of credit made by a 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.

[39/] The regulation also makes clear that if a financial subsidiary is consolidated with its parent 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.

[40/] GLB Act § 121(b)(1) (codified at 12 U.S.C. 371c(e)(4)).

The proposed regulation incorporates both of these provisions.[41/] The regulation also exercises the Board's authority under the second anti-evasion rule by stating that an extension of credit to a financial subsidiary of a 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. The Board believes that such treatment is appropriate in these circumstances 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 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. The Board seeks comment on the appropriateness of considering other classes of credit extensions by an affiliate to a financial subsidiary as extensions of credit by the bank to the financial subsidiary.

C. Derivative Transactions–223.14

As noted above, the GLB Act requires the Board to address as covered transactions under section 23A credit exposure arising out of derivative transactions between banks and their affiliates.

Determining the appropriate treatment for derivative transactions under section 23A is a complex and important endeavor. In light of the complexities of the subject matter and in light of the May 12, 2001, statutory schedule in the GLB

[41/] The proposed regulation also provides an exception to the anti-evasion rules for transactions between a bank's financial subsidiary and another affiliate if the other affiliate is itself a bank or savings association subject to section 23A. In that event, the anti-evasion rules are not needed because the transaction will count as a covered transaction for the affiliated bank or savings association. Without this exception, the same transaction would double count as a covered transaction both for the parent bank of the financial subsidiary and for the other affiliated institution.

Act, the Board is taking two steps to address credit exposure on bank-affiliate derivative transactions under sections 23A and 23B. First, the Board is publishing an interim rule, concurrently with Regulation W, that (i) requires, under section 23A as amended by the GLB Act, that a bank establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from the bank's derivative transactions with affiliates and (ii) clarifies that bank-affiliate derivative transactions are subject to the market terms requirement of section 23B. The policies and procedures must at a minimum provide for monitoring and controlling the credit exposure arising from the bank's derivative transactions with each affiliate, and all affiliates in the aggregate, and ensuring that the bank's derivative transactions with affiliates comply with section 23B.

The second step that the Board is taking to address the credit exposure arising from bank-affiliate derivative transactions under section 23A is contained in this section of the preamble to Regulation W. This section sets forth a set of questions regarding the appropriate treatment of these transactions under section 23A. In connection with the interim rule and proposed Regulation W, the Board solicits public comment on the most appropriate treatment under section 23A of the credit exposure arising from bank-affiliate derivative transactions.

In deciding how to address under section 23A credit exposure arising from derivative transactions, the initial question to be answered is how to define the term "derivative transaction." The Board's interim rule on bank-affiliate derivatives defines the term by reference to the definition of "derivative contract" in the capital guidelines of the Federal banking agencies ("Capital Guidelines").[42/] The definition contained in the Capital Guidelines covers swaps, forwards, options, and other similar contracts on an interest rate, currency, equity, or commodity. The interim rule supplements the definition contained in the Capital Guidelines by also including "any similar derivative contract, including credit derivative contracts." This supplementation recognizes that derivative instruments evolve in response to the needs of the financial marketplace.

[42/] 12 CFR part 225, appendix A.III.E.1.a-d.

Other options would include defining derivative transaction by reference to the definition of "qualified financial contract" or "swap agreement" in the Federal Deposit Insurance Act[43/] or to borrow from definitions contained in the Bankruptcy Code. Another option would involve taking a broad, functional approach that defines a derivative transaction as "a bilateral contract the value of which derives from the value of some underlying security, financial instrument, rate, index, event, commodity, or other asset or indicator." Although such a broad definition may be somewhat overinclusive and more ambiguous in scope than a targeted definition, it also may provide the Board with more flexibility in responding to market trends.

The remainder of this section seeks comment on a set of questions regarding how the Board should address bank-affiliate derivative transactions under section 23A.

First, the Board notes that some derivative transactions – like deep in-the-money options or swaps with an exchange of principal on different dates – are the functional equivalent of a loan, which is an explicit type of covered transaction under section 23A. Although the Board is not aware that banks and their affiliates are entering into these types of derivative transactions, the Board expects that it may need to address these derivatives separately from the other types of derivatives because of their functional equivalence to an existing type of covered transaction under the statute. In this regard, the Board solicits comment on how to determine when a derivative transaction is (or contains an aspect that is) the functional equivalent of a loan by a bank to an affiliate. The Board believes that it may be appropriate to treat such a derivative transaction (or the relevant part of the transaction that functions as a loan) as a loan from the bank to the affiliate for purposes of section 23A.

The Board requests comment on whether and how Regulation W should provide additional guidance for banks on identifying derivative transactions that are, or have aspects that are, the functional equivalent of a loan. The Board understands that the Internal Revenue Service has adopted a regulation that requires financial institutions, for tax purposes, to recharacterize as loans portions of certain swap and other derivative transactions based on the significance of any nonperiodic

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[43/] <u>See</u> 12 U.S.C. 1821(e)(8)(D)(i) and (vi).

payments provided for under the terms of the transaction.[44] The Board requests comment on whether the standards used by the Internal Revenue Service to determine the inherent loan elements of a swap transaction also would be appropriate for the Board to use for section 23A purposes. The Board also solicits comment on whether the regulation should treat the entirety of a bank-affiliate derivative transaction as a loan under section 23A if any portion of the transaction is the functional equivalent of a loan or should impose loan treatment only on that portion of the transaction that functions as a loan.

The Board also asks for public comment on whether Regulation W should provide a separate treatment for any other specific types of derivatives. In particular, the Board seeks comment on whether a credit derivative between a bank and an affiliate in which the bank provides credit protection to the affiliate with respect to the affiliate's assets should be treated as a covered transaction and made subject to all the requirements of section 23A. Such a credit derivative generates risks for the bank that closely resemble the risks incurred by a bank when it purchases assets from an affiliate. The Board notes that a credit derivative transaction between a bank and an unaffiliated company that references the obligations of an affiliate of the bank and is the functional equivalent of a guarantee by the bank on behalf of the affiliate is a guarantee by the bank on behalf of an affiliate for purposes of section 23A.

Second, the Board asks whether banks should be required to adopt any specific policies and procedures with respect to their derivative transactions with affiliates. These policies and procedures might include provisions that require a bank to adopt the following "best practices": (i) entering into a legally enforceable bilateral netting agreement with each of its affiliated derivatives counterparties; (ii) revaluing its derivative transactions with affiliates on a daily basis; and (iii) collateralizing its net mark-to-market credit exposure on derivative transactions with affiliates. The Board asks for comment on the appropriateness of requiring these types of policies and procedures and on whether additional policies or procedures should be required to ensure that a bank's derivative transactions with affiliates are conducted safely and soundly.

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[44] 26 CFR 1.446-3.

Third, the Board solicits comment on whether banks should be required to disclose to Federal bank supervisors or the public, on a quarterly or other periodic basis, their net credit exposure to affiliates on derivative transactions. The Board solicits comment on the types of disclosures that banks reasonably could be required to provide with respect to their derivative transactions with affiliates in order to assist the Federal banking agencies in monitoring and supervising such transactions.

Fourth, the Board invites comment on whether any final rule addressing bank-affiliate derivatives should impose a quantitative limit on the aggregate amount of a bank's net credit exposure on such transactions. The rule could require that the aggregate amount of a bank's net credit exposure on derivative transactions with affiliates not exceed some percentage of the capital stock and surplus of the bank, unless the bank obtains the prior approval of its appropriate Federal banking agency. Such a separate limit for derivatives would be in addition to the general 20 percent limit for covered transactions with all affiliates under section 23A. The Board asks for comment on whether 10 percent of the bank's capital stock and surplus would be an appropriate size for a separate cap on net derivatives credit exposure that a bank has to affiliates. Instead of establishing a separate limit, the rule could require that a bank incorporate its net credit exposure arising from derivative transactions with affiliates into its overall section 23A quantitative limits. The Board seeks comment on the appropriateness of either of these alternatives.

Fifth, the Board asks whether banks should be required to collateralize their net derivatives credit exposure to affiliates in accordance with the collateral requirements of section 23A.

Finally, in the event that the Board were to impose a quantitative limit on bank-affiliate derivative transactions (whether by establishing a separate limit for derivatives or by requiring banks to include derivatives in their overall section 23A limits), the Board seeks comment on how banks should be required to determine the amount of their derivative transactions with affiliates. One valuation option would be to require banks to value a derivative transaction with an affiliate at the current exposure of the bank to the affiliate on the transaction. Under this option, the amount of a bank's section 23A exposure to an affiliate on a derivative transaction would be based on the mark-to-market value of the transaction for the bank. If the mark-to-market value of the transaction were positive, then the current exposure would be that mark-to-market value. If the mark-to-market value were zero or negative, the current exposure would be zero. The Board specifically asks for comment on whether these mark-to-market values should be adjusted to reflect counterparty credit quality.

Another valuation option would require banks to value a derivative transaction with an affiliate at the current exposure of the bank to the affiliate on the transaction plus an estimate of the bank's potential future exposure ("PFE") to the affiliate on the transaction. This is the approach to measuring derivatives exposure that most banks take with third parties and that the Federal banking agencies have taken in the Capital Guidelines.[45] The Board seeks comment on whether banks should be required to include an estimate of PFE when determining the amount of their credit exposure on bank-affiliate derivative transactions and, if so, how banks should be required to calculate PFE.

PFE could be measured in a wide variety of ways. The Capital Guidelines provide one possible methodology. Under the Capital Guidelines, a bank calculates its PFE by multiplying the notional principal amount of the derivative transaction times a conversion factor specified in the Guidelines that varies depending upon the remaining maturity of the derivative transaction and the nature of the asset underlying the derivative transaction. This methodology has the benefits of being easy to calculate and of being a method that is already employed by banks for regulatory capital purposes and, consequently, eliminates the burden that would attend a requirement for a different calculation method. The methodology has the drawback of being rather insensitive to gradations of risk and rather conservative in its estimates of PFE. Another possible PFE computation methodology would be to permit banks with sophisticated internal models to use those models to calculate their PFE on bank-affiliate derivative transactions. The Board also seeks comment on whether the appropriate time horizon for estimating PFE on a derivative transaction is the remaining maturity of the transaction or some shorter "close-out" period.

The Board also invites comment on whether and how banks should be allowed to take into account credit risk mitigators such as collateral in determining

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[45] See, e.g., 12 CFR part 225, appendix A.III.E.2.

the amount of their derivative transactions with affiliates. Under section 23A, transactions <u>fully</u> secured by cash on deposit or U.S. government or agency securities are generally exempt from the requirements of the statute. Outside of this exemption, the statute does not allow banks to reduce the amount of a covered transaction by securing the transaction with collateral or obtaining a third-party guarantee of the transaction. Transactions secured by municipal securities, corporate debt or equity securities, or real estate, for example, are treated the same as unsecured transactions for purposes of the quantitative limits of the statute.

The Board solicits comment on whether Regulation W should provide banks with partial credit for partially securing derivative transactions with affiliates. The Board also solicits comment on what types of collateral the regulation should recognize for the purpose of reducing the section 23A credit exposure of a bank to its affiliates on derivative transactions. As noted, the only types of collateral that have an impact on a bank's quantitative limits under the terms of section 23A are cash on deposit and U.S. government and agency securities. The Board could use this same limited list of collateral with respect to bank-affiliate derivative transactions. The Board seeks comment on whether it should expand the list of collateral acceptable for reducing the section 23A amount of these transactions and, if so, what kinds of other collateral should be acceptable as credit risk mitigators for the transactions, and what haircuts should apply to any added collateral types.

The Board also solicits the public's view on how, if the general 10 and 20 percent quantitative limits of section 23A are applied to bank-affiliate derivative transactions, increased credit exposure of the bank to an affiliate on a pre-existing derivative transaction should be treated. For example, a bank could be required promptly to unwind existing derivatives or other covered transactions or otherwise promptly reduce the amount of its exposure to affiliates in order to restore itself to compliance with the quantitative limits of section 23A in the event that the credit exposure on a derivative transaction causes the bank to exceed the limits. Alternatively, a bank could be allowed to retain existing derivative transactions and only be required to cease engaging in new covered transactions until the bank's aggregate amount of covered transactions falls below the statute's quantitative limits.

If the Board were to determine that bank-affiliate derivative transactions are subject to some sort of quantitative limit under section 23A, the Board would have to address the question of whether and how to recognize netting agreements. The Board solicits comment on whether it should recognize bilateral netting agreements when computing the amount of a bank's derivatives credit exposure to an affiliate and, if so, whether the principles set forth in the Capital Guidelines are appropriate minimum requirements for determining what is a qualifying netting agreement.[46]

In addition, the Board solicits comment on how often a bank should mark to market its derivative transactions with affiliates. The Board requests information on how often banks mark to market their derivative transactions with third parties and on the potential burden and benefits of requiring banks to mark to market their derivative transactions with affiliates on a daily basis.

As a more general matter, the Board invites comment on whether it is necessary or appropriate to grandfather existing derivative transactions between banks and their affiliates. The Board understands that, depending on the approach ultimately taken on bank-affiliate derivatives, bringing existing derivative transactions into compliance with Regulation W may require expensive and time-consuming adjustments to positions or renegotiation of agreements and, if existing exposures are above any quantitative limits established by Regulation W, may prevent banks from engaging in future derivative transactions with affiliates.

The Board will analyze comments on this proposal and the concurrently issued interim final rule on derivative transactions. If, based on that analysis, the Board believes additional measures are needed in this area, the Board will issue a detailed proposed rule for public comment.

VI. Exemptions–Subpart E

Section 23A specifies several types of transaction that are exempt from the statute's quantitative and collateral requirements and other types of transaction that are exempt from the statute's quantitative, collateral, and low-quality asset requirements.[47] The proposed regulation sets forth the statutory exemptions,

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[46] See, e.g., 12 CFR part 225, appendix A.III.E.3.

[47] 12 U.S.C. 371c(d).

clarifies certain of these exemptions, and exempts several additional types of transactions. The clarifications and additional exemptions are discussed below.

A. Sister-bank exemption–223.15(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.[48] 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.[49] 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.[50]

Regulation W proposes to clarify that the sister-bank exemption generally applies only to transactions between a bank (as defined in the regulation to mean a member bank or an insured nonmember bank), on the one hand, and an insured depository institution, on the other hand. Such an interpretation is consistent with the legislative intent behind the sister-bank 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 Federal Deposit Insurance Act, an insured depository institution is generally liable for any loss incurred by the FDIC in connection with the default

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[48] The sister-bank exemption in section 23A does not allow a 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 Federal Deposit Insurance Act (12 U.S.C. 1831o) and regulations adopted thereunder by the bank's appropriate Federal banking agency.

[49] 12 U.S.C. 371c(b)(5), 1468(a)(2).

[50] 12 U.S.C. 371c(f)(1).

of a commonly controlled insured depository institution.[51] Without such an interpretation of the sister-bank exemption, a bank would be able to engage in unlimited covered transactions with certain uninsured depository affiliates. Permitting a bank to provide an unlimited amount of funding to an uninsured depository affiliate would contravene one of the principal purposes of the statute–protecting the deposit insurance funds from loss.[52]

B. Purchases of loans on a nonrecourse basis–223.15(c)

Under section 23A(d)(6), a 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 under section 23A(d)(1). The proposed rule clarifies that the scope of this exemption parallels that of the sister-bank exemption by stating that this exemption applies to a bank's purchase of a loan on a nonrecourse basis 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.

C. Correspondent banking–223.16(a)

Section 23A exempts from its quantitative limits and collateral requirements any deposit by a 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.[53] The proposed rule provides that such deposits must represent ongoing, working balances maintained by the bank in the ordinary course

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[51] See 12 U.S.C. 1815(e).

[52] As noted above, a bank and its operations subsidiaries are considered a single unit for purposes of section 23A. Accordingly, under the statute and the proposed regulation, transactions between a bank (or its operations subsidiary) and the operations subsidiary of a sister insured depository institution generally are exempt under the sister-bank exemption.

[53] 12 U.S.C. 371c(d)(2).

of conducting the correspondent business. An occasional deposit in an affiliated institution would not be in the ordinary course of correspondent business. The proposed rule also indicates that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

D. Fully secured credit transactions–223.16(c)

Section 23A exempts any credit transaction by a bank with an affiliate that is fully secured by obligations issued or guaranteed by the United States or its agencies or by a "segregated, earmarked" deposit account.[54] The proposed rule clarifies that a deposit account meets the "segregated, earmarked" requirement only if the account exists for the sole purpose of securing the extension of credit and is so identified. This requirement would parallel the provision in section 223.5(b)(1)(iv) of the rule relating to which deposits count toward the collateral requirements of section 23A. Thus, if an earmarked deposit is sufficient to fully secure the transaction, then the transaction is exempt under this section; if the deposit represents less than full security, then the amount of the deposit counts toward the required collateral under section 223.5(b).

E. Purchases of assets with readily identifiable market quotes–223.16(e)(1)

Section 23A(d)(6) exempts the purchase of assets from an affiliate if the assets have a "readily identifiable and publicly available market quotation" and are purchased at their current market quotation.[55] The Board generally has limited the availability of this exemption (the "(d)(6) exemption") to purchases of U.S. Treasury securities, securities issued by a U.S. government agency, and assets with market prices that are recorded in widely disseminated publications such as newspapers with a national circulation. Because only exchange-traded assets are recorded in such publications, the test ensures 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

[54] 12 U.S.C. 371c(d)(4).

[55] 12 U.S.C. 371c(d)(6).

applies to a bank's purchase of assets having a readily identifiable and publicly available market quotation if the assets are purchased at or below the asset's current market quotation.

F. Purchases of securities with a ready market from a securities affiliate—223.16(e)(2)

The Board proposed in its 1998 Proposal to exempt from section 23A the purchase by a bank of certain types of securities from a securities affiliate.[56] The Board has determined to adopt a somewhat revised form of this expanded (d)(6) exemption in a separate final rule being issued concurrently with Regulation W. Regulation W also contains this exemption, and the Board seeks further comment on the scope and conditions of the exemption. In particular, the Board solicits the views of the public on (i) whether the exemption should be limited to purchases from registered U.S. securities broker-dealers; (ii) whether it would be appropriate to use independent dealer quotations to establish a market price for a security under the exemption; and (iii) whether it would be appropriate to allow a bank to use the exemption to purchase asset-backed securities issued by an affiliate of the bank or to purchase securities issued by a mutual fund advised by the bank or an affiliate of the bank.

G. Purchasing municipal securities–223.16(f)

The Board also proposes to exempt a bank's purchase of municipal securities from an affiliate, if the purchase meets a revised and somewhat shorter version of the requirements applicable to the expanded (d)(6) exemption contained in section 223.16(e)(2) of the proposed rule.[57] First, as in the expanded (d)(6) exemption, the bank must purchase the municipal securities from a broker-dealer affiliate that is registered with the SEC. Second, also as in the expanded

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[56] 63 FR 32768, June 11, 1998.

[57] 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. 17 U.S.C. 78c(a)(29).

(d)(6) exemption, the municipal securities must be eligible for purchase by a State member bank and the 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.[58] Under any of the three pricing options, the bank must purchase the municipal securities at or below the quoted or verified price.

The Board believes that this streamlined set of requirements for purchases of municipal securities is appropriate because municipal obligations generally have a lower default risk than the other instruments whose quotations would be difficult to obtain, such as emerging market and high yield debt. 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.

H. Purchases of assets by de novo banks–223.16(h)

The proposed rule would exempt a purchase of assets by a newly chartered bank from an affiliate if the appropriate Federal banking agency for the bank approved the transfer. This exemption would allow companies to charter a de novo bank and to transfer assets to the bank from its affiliates outside the restrictions of section 23A.[59] Currently, if a company (usually a bank holding company) establishes a credit card bank or a trust company, the newly chartered

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[58] 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.

[59] The Board also would not consider such transfers to be subject to the requirements of section 23B.

institution cannot acquire a critical mass of assets from an affiliate because of the quantitative limits and other requirements of section 23A. The Board has received many comments that these restrictions are burdensome and unnecessary because the chartering authority for the new bank reviews the transaction (and, in the case of a bank holding company, the Board also reviews the transaction) to ensure that the transfer does not result in any safety or soundness problems. For this reason, the Board has proposed the exemption.

I. Transactions approved under the Bank Merger Act–223.16(i)

The Board previously has exempted from section 23A any merger or consolidation transaction between affiliated insured depository institutions if the transaction has been approved by the appropriate Federal banking agency pursuant to the Bank Merger Act.[60/] The proposed rule includes this exemption.

J. Purchases of extensions of credit–223.16(j)

Section 23A includes as a covered transaction a purchase of assets from an affiliate, except such purchases of real and personal property as may be specifically exempted by the Board by order or regulation.[61/] In 1979, the Board issued a formal interpretation that exempted a bank's purchase of a mortgage note or participation therein from a mortgage banking affiliate, provided that the bank's commitment to purchase is (i) obtained by the affiliate within the context of each proposed loan, (ii) obtained prior to the affiliate's commitment to make each loan, and (iii) based upon the bank's independent evaluation of the creditworthiness of each mortgagor (the "250.250 exemption").[62/] Although this interpretation did not impose a strict dollar limit on the amount of an affiliate's mortgage loans that a bank could purchase under the exemption, the interpretation cautioned that the purpose of the exemption was to allow a bank to take advantage of an investment opportunity and not to provide all the working capital needed by an affiliate.

[60/] 12 CFR 241.

[61/] 12 U.S.C. 371c(b)(7)(C).

[62/] 12 CFR 250.250.

By 1995, some bank holding companies were using the 250.250 exemption extensively to fund their lending affiliates. In these cases, banks were providing all or nearly all of their affiliates' funding needs. 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 represented more than 50 percent of the total dollar amount of loans originated by the affiliate.[63/] Staff reasoned that, in these circumstances, the asset purchases look less like the bank taking advantage of an investment opportunity brought to it by the affiliate and more like the bank providing an ongoing funding mechanism for the affiliate. Staff intended that this restriction would require the affiliate to have alternative funding sources and reduce the pressure on the bank to purchase the affiliate's extensions of credit.

The proposed rule incorporates the 250.250 exemption and formally expands the exemption to cover the purchase of any type of loan or extension of credit from an affiliate. Regulation W also includes staff's 50 percent test and another test designed to ensure that the bank is not a principal ongoing funding source for the affiliate. In particular, the rule provides that the 250.250 exemption is unavailable if (i) the amount of the bank's total purchases from the affiliate, when aggregated with all other assets purchased from the affiliate by affiliated banks and insured savings associations, represents more than 50 percent of the credit portfolio of the affiliate; or (ii) the bank and its affiliated banks and insured savings associations provide substantial, ongoing funding to the affiliate. The Board recognizes that the "substantial, ongoing funding" condition may create some uncertainty for banks, but believes that the condition would provide examiners with additional 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. The Board seeks comment on whether the regulation should contain staff's 50 percent test or the "substantial, ongoing funding" test.

The Board also seeks comment on whether the rule should limit the amount of assets that a bank may purchase from an affiliate pursuant to the 250.250 exemption to some percentage of the <u>bank</u>'s total assets. The Board

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[63/] <u>See</u> Letter dated April 24, 1995, from J. Virgil Mattingly, General Counsel of the Board, to William F. Kroener, III; <u>see</u> <u>also</u> Letter dated January 21, 1987, from Michael Bradfield, General Counsel of the Board, to Jeffrey C. Gerrish.

recently reviewed a case where a nonbanking company proposed to charter a bank for the sole purpose of purchasing loans or leases from the nonbanking company. In these circumstances, a bank's credit underwriting process may be compromised as a result of the complete dependence of the bank on the affiliate for asset growth. Prohibiting a bank from using the 250.250 exemption to accumulate a substantial percentage of its assets may help prevent such compromises.

The Board notes that the 250.250 exemption only applies to the initial purchase of assets by the bank and not any covered transaction that may result from the bank's ongoing holding of the asset purchased. For example, if a bank purchases from the selling affiliate a loan originated by the selling affiliate to a second affiliate, the exemption may exempt the bank's purchase of the loan, but it would not exempt the ongoing extension of credit by the bank to the second affiliate that results from the purchase.

To qualify for this exemption, a bank must independently review the creditworthiness of each obligor prior to committing to purchase each loan. The Board does not believe that a bank can satisfy this requirement by simply having its affiliates use the bank's underwriting standards or the underwriting standards of the Federal National Mortgage Association or any other government agency or government-sponsored enterprise. The bank must itself review and approve each loan prior to giving a purchase commitment to its affiliate. Consistent with the Board's published interpretation on this exemption, the bank also must not make a legally enforceable blanket advance commitment to purchase a stipulated amount of loans from the affiliate.

K. Intraday Extensions of Credit–223.16(k)

As noted above, the GLB Act requires the Board to "address as covered transactions credit exposure arising out of . . . intraday extensions of credit" by banks to their affiliates. Banks regularly provide transaction accounts to their affiliates in conjunction with providing payment and securities clearing services. As in the case of unaffiliated commercial customers, these accounts are subject to overdrafts during the day that are repaid in the ordinary course of business. The Board has not to date ruled on whether these or other types of intraday credit extensions are covered transactions under section 23A or are subject to the market terms requirement of section 23B. Industry practice does not treat an intraday credit extension as subject to sections 23A or 23B unless the extension remains outstanding at the end of the day.[64/]

Existing business practices indicate that the potential risk reduction benefits afforded by full application of the requirements of section 23A to intraday credit exposures may not justify the costs to banking organizations of implementing these requirements at this time. Intraday overdrafts and other forms of intraday credit extensions are generally 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 may be sufficiently remote that 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 could require banks to measure exposures across multiple accounts, offices, and systems on a global basis and to adjust collateral holdings in real time throughout the day. The Board seeks comment on whether banks currently have these capabilities and, if not, whether they would be costly to implement.

Regulation W would provide that an intraday extension of credit is not subject to the quantitative limits or collateral requirements of section 23A if the credit extension arises in connection with the performance by a bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions (for example, wire transfers, check clearing, and ACH transactions) on behalf of an affiliate, and the bank (i) has no reason to believe that the affiliate will have difficulty repaying the extension of credit in the ordinary course of business; (ii) establishes limits on the net amount of intraday credit that the bank may extend to affiliates; and (iii) establishes and maintains policies and procedures for assessing affiliate credit quality, monitoring each affiliate's compliance with the established limits, reviewing intraday credit extensions to an affiliate in the event of the affiliate's violation of the limits, and ensuring that intraday credit received by each affiliate complies with section 23B. The bank also

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[64/] The text of section 23A in no way suggests that a transaction must extend overnight to qualify as an extension of credit.

must maintain records and supporting information that are sufficient to enable the appropriate Federal banking agency for the bank to review the position limits and required policies and procedures.

Intraday extensions of credit by a bank to an affiliate that do not meet the conditions set forth above would be subject to the quantitative, collateral, and other requirements of section 23A. All intraday extensions of credit by a bank to an affiliate, including those that meet the conditions set forth above, would be subject to the market terms requirement of section 23B.

Under Regulation W, all intraday credit extensions (on a worldwide basis) that exist at the end of the bank's business day in the United States would become subject to section 23A at that time. The Board requests comment on whether the regulation should adopt a different rule for determining when an "intraday" exposure become an "overnight" exposure. In particular, the regulation could provide that an "intraday" exposure becomes an "overnight" exposure at the end of the bank's business day in the local jurisdiction in which the credit was extended.[65]

The Board may adopt a different approach to intraday credit under section 23A if it finds that banks are not implementing satisfactory controls to measure, monitor, and limit intraday credit extensions to affiliates. The Board requests comment on prudent risk management measures for intraday credit exposures.

The Board also requests comment on whether the Board should find that other types of intraday credit, not related to payment transactions or securities clearing and settlement transactions effected through an affiliate's transaction accounts at the bank, should be exempt from the quantitative limits and collateral requirements of section 23A. In particular, the Board understands that some credit card banks issue special purpose credit cards that customers may use only at

[65] If the Board were to take this approach, the regulation may also have to require that a bank not transfer any intraday credit extensions to other jurisdictions. Such a requirement may be necessary to prevent a bank from cycling its "intraday" transactions around the world to prevent them from ever becoming "overnight" exposures.

affiliates of the bank. These banks extend credit on an intraday basis to their credit card customers to enable the customers to purchase goods or services from the banks' affiliates. At the end of the day, however, many of these banks sell their credit card receivables to a third party or to another affiliate to prevent the extensions of credit from becoming overnight credits subject to section 23A.[66/] These intraday credit extensions would be covered transactions subject to all the requirements of section 23A under Regulation W.[67/]

Finally, the Board requests comment on how long a transition period banks need to put the necessary policies and procedures in place in order to take advantage of the exemption for intraday credit extensions.

VII. General Provisions of Section 23B–Subpart F

Subpart F of the proposed regulation sets forth the principal restrictions of section 23B. These include (i) the requirement that certain transactions between a 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) the restriction on a bank's purchase as fiduciary of assets from an affiliate; (iii) the restriction on a 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) the prohibition on a bank's or its affiliate's publishing an advertisement or entering into an agreement stating that the bank will be responsible for the obligation 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 highlights four areas in which Regulation W provides additional guidance on section 23B.

A. Transactions exempt from section 23B–223.19(a)(1)

[66/] Other credit card banks avoid section 23A by securing their receivables with a segregated, earmarked deposit account.

[67/] Under section 23A and the proposed rule, an extension of credit by a bank to a third party where the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate of the bank is a covered transaction between the bank and the affiliate. 12 U.S.C. 371c(a)(2).

The market terms requirement of section 23B applies to, among other transactions, any "covered transaction" between a bank and an affiliate.[68] 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 securities, and purchases of assets from an affiliate at a readily identifiable and publicly available market quotation. The regulation also excludes from section 23B any covered transaction that is exempt from section 23A under section 223.17(h) or (i) of Regulation W (that is, asset purchases by a de novo bank and transactions approved as part of a bank merger). The Board is proposing to exclude from section 23B this additional set of transactions because, in each case, the appropriate Federal banking agency for the bank involved in the transaction would be expected to ensure that the terms of the transaction are not unfavorable to the bank.

B. Purchases of securities for which an affiliate is the principal underwriter–223.20(b)

The GLB Act amended section 23B in one respect. Since its passage in 1987, section 23B(b)(1)(B) has prohibited a 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.[69] Prior to the GLB Act, a bank could escape this prohibition only if a majority of the outside directors of the bank approved the securities purchase before the securities were initially offered to the public.[70] The GLB Act permits a 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 bank (with no distinction drawn between inside and outside directors) must approve the

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[68] 12 U.S.C. 371c-1(a)(2)(A).

[69] 12 U.S.C. 371c-1(b)(1)(B).

[70] 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.

securities purchase before the securities were initially offered to the public. Second, such approval must be based on a determination that the purchase would be a sound investment for the bank irrespective of the fact that an affiliate of the bank is a principal underwriter of the securities.[71/] The proposed regulation incorporates this new standard and clarifies that if a 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 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 bank also may satisfy this director approval requirement if a majority of the directors of the bank approve 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 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. The appropriate period of time between reviews would vary depending on the scope and nature of the bank's program, but such reviews should be conducted by the directors at least annually. Prior to the passage of the GLB Act, Board staff informally allowed 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 bank could use to obtain the requisite director approval.[72/]

[71/] GLB Act § 738 (codified at 12 U.S.C. 371c-1(b)(2)).

[72/] The Conference Report accompanying the Competitive Equality Banking Act of 1987 stated that the prior approval requirement of section 23B(b)(2) could be met "by the establishment 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." H.R. Conf. Rep. No. 100-261, at 133 (1987).

For these reasons, the proposed regulation would codify staff's preexisting approach to the director approval requirement. The Board seeks comment on whether this approach remains appropriate in light of the amendment made to section 23B by the GLB Act.

C. The definition of affiliate under section 23B–223.24(c)

Section 23B(d)(1) 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.[73/] Other federal law provides that an insured savings association should be treated as a "bank" for purposes of section 23B.[74/] As in the case of the sister-bank exemption, Regulation W proposes to clarify that the only companies that qualify for the "bank" exception to section 23B's definition of affiliate are insured banks and insured savings associations. Without such an interpretation, a 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 deposit insurance funds.

D. The advertising restriction–223.21

Section 23B(c), the "advertising restriction," prohibits a 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.[75/] Read literally, this provision appears to prohibit a bank from issuing a guarantee or letter of credit on behalf of an affiliate. Because section 23A includes as a covered transaction the issuance by a bank of a guarantee or letter of credit on behalf of its affiliates, Board staff traditionally has read the advertising restriction of section 23B in light of section 23A. That is, the Board does not believe that section 23B(c)

[73/] 12 U.S.C. 371c-1(d)(1).

[74/] 12 U.S.C. 1468(a)(2)(B).

[75/] 12 U.S.C. 371c-1(c).

prohibits a bank from issuing a guarantee, acceptance, or letter of credit on behalf of an affiliate to the extent permitted under section 23A.[76] The regulation contains this clarification.

VIII. 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 grants the Board authority 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 the Board 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.

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").[77] The Board also recently applied

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[76] The Board also believes that if a 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 obligations under the contract.

[77] 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

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sections 23A and 23B to 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.[78/]

The proposed regulation would fully apply sections 23A and 23B to covered transactions between a U.S. branch or agency of a foreign bank and any affiliate of such foreign bank directly engaged in the United States in the following financial activities newly authorized under the GLB Act: (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 investment activities pursuant to section 4(k)(4)(H) of the BHC Act; or (iv) insurance company investment activities pursuant to section 4(k)(4)(I) of the BHC Act.[79/]

The regulation also would apply these restrictions to transactions between a U.S. branch or agency of a foreign bank and any subsidiary of an affiliate directly engaged in the four activities set forth above (regardless of whether the subsidiary itself engages in any of the four activities).[80/] In addition, the regulation would

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[77/](...continued)
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.

[78/] See 12 CFR 225.176(b)(6); 66 FR 8466, Jan. 21, 2001.

[79/] See 12 U.S.C. 1843(k)(4)(B), (E), (H), and (I).

[80/] The regulation covers subsidiaries of affiliates directly engaged in the four activities in order to prevent evasion. If these subsidiaries were not covered, the U.S. branch of a foreign bank could fund the foreign bank's U.S. insurance underwriter outside the scope of sections 23A and 23B by, for example, lending
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apply sections 23A and 23B to transactions between a U.S. branch or agency of a foreign bank and any portfolio company controlled by the foreign bank under the GLB Act's merchant banking or insurance company investment authorities. The regulation would not apply sections 23A or 23B to transactions between a U.S. branch or agency and any other type of affiliate (e.g., foreign affiliates or U.S. affiliates engaged in nonbanking activities under section 4(c)(8) of the BHC Act), or to transactions between the foreign bank's non-U.S. offices and its U.S. affiliates.

Applying the restrictions of sections 23A and 23B to transactions between the U.S. branches and agencies of foreign banks and the indicated U.S. affiliates may 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 operations subsidiary. A U.S. bank may affiliate itself with a company engaged in the newly authorized financial activities listed above only if the company is a holding company affiliate of the bank or, in some cases, a financial subsidiary of the bank.[81/] 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 affiliates of U.S. banks.

[80/](...continued)
money to a subsidiary of the underwriter and having the subsidiary dividend or on-lend the loan proceeds to the underwriter.

[81/] Regulation W, consistent with the merchant banking rule, would impose 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.

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 bank holding companies 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 operations subsidiary) and, hence, may be funded by a U.S. bank in a manner that is not subject to sections 23A and 23B.

The potential scope, nature, and risk 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 is 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 may help ensure competitive equity between foreign banks and U.S. banking organizations in the funding of certain of their U.S. nonbank operations

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 financial holding companies.

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 recently adopted by the Board in its merchant banking rule,[82/]

[82/] See 66 FR 8466, 8482, Jan. 31, 2001.

and represents a relaxation from the Board's current position with respect to foreign banks that operate section 20 companies in the United States.[83/]

IX. Definitions–Subpart H

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

A. Definition of affiliate–223.24

1. Investment funds advised by the bank or a bank affiliate–223.24(a)(6)

Section 23A includes as an affiliate any company that is sponsored and advised by the bank or any of its affiliates.[84/] Section 23A also includes as an affiliate any investment company for which the bank or its affiliate serves as an investment advisor, as defined in the Investment Company Act of 1940 ("1940 Act").[85/] The proposed regulation sets forth these definitions and also includes as an affiliate any investment fund – even if not an investment company for purposes of the 1940 Act – for which the 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 of the fund.

[83/] The Board's position on section 20 companies 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.

[84/] 12 U.S.C. 371c(b)(1)(D)(i).

[85/] 12 U.S.C. 371c(b)(1)(D)(ii).

Most investment funds that are advised by a bank (or an affiliate of a 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 bank (or an affiliate of the bank).[86] In other instances, however, the 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 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."[87]

The Board believes that the advisory relationship of a bank or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is or is not treated as an investment company for purposes of the 1940 Act.[88] 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

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[86] Such a fund often is required to register under the Commodity Exchange Act, and a bank affiliate often registers as the fund's commodity pool operator (thereby sponsoring the fund) and commodity trading advisor (thereby advising the fund). See 7 U.S.C. 1a(4) (defining commodity pool operator); 7 U.S.C. 1a(5)(B)(i) (defining commodity trading advisor). Banks and trust companies are excluded from the definition of commodity trading advisor under the Commodity Exchange Act and, in certain circumstances, may be excluded from the definition of commodity pool operator. See 7 CFR 4.5.

[87] 12 U.S.C. 371c(b)(1)(E).

[88] In fact, a 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 than with a registered investment company because the 1940 Act restricts transactions between a registered investment company and entities affiliated with the company's investment adviser.

instruments that are not securities.[89] 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 bank or its affiliate and the fund.[90]

The Board seeks comment on the appropriateness of treating investment funds as affiliates of a bank under section 23A if the bank or its affiliate serves as investment advisor to the fund and owns more than 5 percent of any class of voting securities of the fund. The Board particularly seeks comment on whether such investment funds should be treated as affiliates only if the advising bank or affiliate owns more than 5 percent of a class of voting securities of the fund.

The Board is considering adding to the definition of "affiliate" any company controlled by an investment fund that is an affiliate of the bank. The conflicts of interest that exist between a 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 such a fund. The Board invites public comment on this issue.

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[89] 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).

[90] The Board also believes that investment funds organized outside the United States for which a 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, 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–223.24(a)(8); 223.26

Section 23A defines an affiliate of a bank to include any company that controls the bank and any company that is under common control with the bank. Since 1982, however, section 23A has excluded from the definition of affiliate any subsidiary of the bank (other than a bank subsidiary) unless the Board determines by regulation or order that the subsidiary should be considered an affiliate.[91/] In 1997, the Board issued for comment a proposal to extend section 23A to covered transactions between a bank and a subsidiary of the bank engaged in activities not permissible for the bank to engage in directly.[92/]

Consistent with this proposal, the GLB Act recently amended section 23A to cover transactions between a bank and its "financial subsidiaries." 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, in turn, defines a financial subsidiary of a national bank as any company that is controlled by one or more insured depository institutions, other than a subsidiary that (i) engages solely in activities that national banks are permitted to engage in directly (and subject to the same terms and conditions as apply to national banks) or (ii) a national bank is specifically authorized by the express terms of a federal statute (other than section 5136A), and not by implication or interpretation, to control.[93/] The GLB Act provides that a financial subsidiary of a bank is considered an affiliate of the bank for purposes of section 23A.

Regulation W specifically provides, consistent with the GLB Act, that a financial subsidiary of a bank is an affiliate of the bank. The proposed regulation includes a definition of financial subsidiary that is identical to the definition of financial subsidiary set forth in section 23A, as amended by the GLB Act. The Board notes that many state banks have authority to engage directly in activities that would not be permissible for a national bank and seeks comment on how the

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91/ See 12 U.S.C. 371c(b)(2)(A).

92/ 62 FR 37744, July 15, 1997.

93/ 12 U.S.C. 24a(g)(3).

definition of financial subsidiary should be applied to subsidiaries of state banks, including general insurance agency subsidiaries and real estate investment and development subsidiaries.

The definition of financial subsidiary in section 23A and Regulation W would cover some subsidiaries of banks that are engaged only in agency activities. The Board invites public comment on the appropriateness of exempting such subsidiaries from the definition of financial subsidiary in the regulation.

Regulation W also provides that any subsidiary of a bank's financial subsidiary will be considered a financial subsidiary of the bank, even if the subsidiary would not otherwise qualify as a financial subsidiary. The Board believes that treating such companies as financial subsidiaries is consistent with the anti-evasion provisions that the GLB Act added to section 23A and will help prevent banks from avoiding the special restrictions that the GLB Act placed on a bank's transactions with its financial subsidiaries.

3. Companies held under merchant banking or insurance company investment authority–223.24(a)(9)

The GLB Act amended the BHC Act to permit bank holding companies and foreign banks that qualify as financial holding companies to engage in merchant banking and insurance company investment activities.[94] If a financial holding company 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 bank controlled by the financial holding company 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 bank for purposes of section 23A if the bank is affiliated with a financial holding company and the financial holding company owns or controls 15 percent or more of the equity capital of the company pursuant to the financial holding company's merchant banking or insurance

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[94] GLB Act § 103(a); 12 U.S.C. 1843(k)(4)(H) and (I).

company investment authority.[95/] The proposed 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 of control would be deemed to be rebutted, and clarifies the application of the presumption to private equity funds.

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 perpetual preferred stock, common stock, capital surplus, retained earnings, and accumulated other comprehensive income, less treasury stock. 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 presumption of control. The Board asks for comment on whether the proposed definition of equity capital is appropriate.

The regulation also provides three specific regulatory safe harbors from the statute's presumption of affiliate status. 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

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[95/] GLB Act § 121(b)(2). As noted above, this rebuttable presumption applies only if the affiliated financial holding company 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 bank holding company may not own any shares of a company in reliance on sections 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.

the statutory definition of control). The three situations are substantially identical to those listed in the Board's merchant banking regulation.[96/]

The first exemption applies where no director, officer, or employee of the holding company serves as a director 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 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 employees of the holding company do not constitute a majority of the directors of the company.

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

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 presumption may be rebutted. The regulation also provides, consistent with the GLB Act, that a bank or company may rebut the presumption of affiliation with respect to a company by presenting information to the Board that demonstrates, to the Board's satisfaction, that the holding company does not control the portfolio company.

A financial holding company 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 financial holding company 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

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[96/] See 12 CFR 225.176(b)(2) and (3).

a company in which the fund has invested unless the financial holding company controls the private equity fund (as described in the Board's merchant banking rule).[97]

4. Certain joint venture companies–223.24(b)(1)(iii)

As noted above, under the terms of section 23A, subsidiaries of a bank generally are not treated as affiliates of the bank, even if they would otherwise qualify as affiliates.[98] The statute contains two specific exceptions to this general rule: financial subsidiaries of a bank and bank subsidiaries of a bank are treated as affiliates of the parent bank. The statute also provides that the Board may determine that other subsidiaries of a bank should be treated as affiliates if covered transactions between the bank and the subsidiary may be affected by the relationship between the companies to the detriment of the bank.[99]

Pursuant to this authority, the Board proposes to determine that two additional classes of subsidiaries of a bank should be treated as affiliates. First, the proposed regulation provides that any subsidiary of a 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, a joint venture company that is 50 percent owned by a bank holding company and 50 percent owned by one of its subsidiary banks, would be treated as an affiliate of the bank. In such circumstances, although the joint venture company qualifies as a subsidiary of the bank under section 23A because the bank owns more than 25 percent of the

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[97] See 12 CFR 225.176(b)(5).

[98] 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).

[99] 12 U.S.C. 371c(b)(2)(A).

company's voting stock, the holding company's substantial direct interest in the company creates the potential for conflicts of interest that may endanger the bank.

This proposed treatment of certain bank-affiliate joint ventures as affiliates does not apply to joint ventures between a bank and affiliated banks or insured savings associations. For example, if two affiliated banks each own 50 percent of the 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 bank and affiliated banks or insured savings associations 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 bank and a company that is wholly owned by the bank and its affiliated banks and insured savings associations 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.

5. <u>Employee benefit plans–223.24(b)(1)(iv)</u>

The second proposed regulatory exception to the general rule that subsidiaries of a 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 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 bank or bank holding company exceeds the statutory thresholds for determining that a company is an affiliate. Some institutions have argued, however, that ESOPs should be considered subsidiaries of the bank and therefore exempt from coverage.

The Board believes that the relationship between a bank and its or its affiliates' ESOP warrants coverage by sections 23A and 23B. In the past, banks have made unsecured loans to such 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 bank loan 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. Accordingly, the proposed rule provides that a bank or bank affiliate's ESOP cannot avoid classification as an affiliate of the bank by also qualifying as a subsidiary of the bank.

The Board asks for comment on whether other subsidiaries of a bank should be treated as affiliates of the bank under section 23A.

The Board notes that Regulation W also defines as an affiliate of a bank any partnership for which the bank or any affiliate of the bank serves as a general partner or for which the bank or any affiliate of the bank causes an officer or employee of the bank or affiliate to serve as a general partner.

B. <u>Definition of covered transaction–223.25</u>

The restrictions of section 23A do not apply to every transaction between a bank and its affiliates. The section only applies to "covered transactions" between a 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.[100] Among the transactions that generally are not subject to section 23A are dividends paid by a bank to its holding company, sales of assets by a bank to an affiliate, an affiliate's purchase of securities issued by a bank, and many service contracts between a bank and an affiliate. This section discusses several interpretive issues that have arisen in determining whether transactions between a bank and an affiliate are covered transactions for purposes of section 23A.

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[100] 12 U.S.C. 371c(b)(7).

1. Confirmation of a letter of credit issued by an affiliate

Section 23A(b)(7)(E) includes as a covered transaction the issuance of a letter of credit by a bank on behalf of an affiliate. The proposed regulation clarifies that the confirmation of a letter of credit issued by an affiliate is a covered transaction. 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.

2. Credit enhancements supporting a securities underwriting

The Board has confirmed previously that section 23A's definition of guarantee would not include a bank's issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the bank.[101] 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.[102] 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.

3. Cross-guarantee agreements and cross-affiliate netting arrangements

In addition, Board staff has confirmed previously that a cross-guarantee agreement among a 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.[103] The Board believes that such cross-guarantee arrangements among banks and their affiliates should be subject to the quantitative limits and collateral requirements of section 23A.

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[101] 62 FR 45295, Aug. 27, 1997.

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

[103] See Letter dated Aug. 6, 1993, from J. Virgil Mattingly, General Counsel of the Board, to Richard Lasner.

Similarly, the Board understands that some banks have entered into or are contemplating entering into cross-affiliate netting arrangements. These are arrangements among a bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank, where a nonaffiliate is permitted to net obligations of an affiliate of the bank to the nonaffiliate when settling the nonaffiliate's obligations to the bank. These arrangements also would include agreements where a bank is required to add the obligations of an affiliate of the bank to a nonaffiliate when determining the bank's obligations to the nonaffiliate.

Cross-affiliate netting arrangements expose a bank to the credit risk of its affiliates. Under these agreements, a bank may become obligated effectively to make good on the obligations of its affiliates. The exposure of a bank to its affiliates in such an arrangement resembles closely the exposure of a bank when it issues a guarantee on behalf of an affiliate or extends credit to an affiliate. Accordingly, the Board believes that cross-affiliate netting arrangements are credit transactions under section 23A. Accordingly, the quantitative limits of section 23A would prohibit a bank from entering into a cross-affiliate netting arrangement to the extent that the netting arrangement does not cap the potential exposure of the bank to the participating affiliate(s).

The Board asks for comment on whether alternative treatments of cross-guarantees or cross-affiliate netting arrangements under section 23A would be appropriate.

4. Keepwell agreements

Banks 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 bank and an affiliate, the bank typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the bank in entering into such a keepwell agreement is similar to the credit risk incurred by a bank in connection with issuing a guarantee on behalf of an affiliate. Accordingly, 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.

5. Securitization vehicles

The Board seeks comment on whether additional clarification is necessary in the area of securitizations. In the securitization process, a bank segregates certain of its or its customer's assets into a relatively homogenous pool and then transfers the pool to a bankruptcy-remote special purpose entity ("SPE"). The SPE, all of whose voting securities are generally held by a party other than the bank or the bank's customer, then issues securities to investors. The asset-backed securities issued by the SPE often receive some form of credit enhancement from the bank, the bank's customer, or a third-party guarantor. The Board requests comment on the question of whether such SPEs should in any circumstances be deemed to be affiliates of the bank involved in the securitization and, if so, what transactions between the bank and the SPE should be considered covered transactions under section 23A.

6. Loans and extensions of credit

Although section 23A includes a "loan or extension of credit" as a covered transaction, the statute does not define these terms. The proposed regulation defines "extension of credit" to mean an extension or renewal of a loan, a grant of a line of credit, or an extension of credit 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, including an advance by means of an overdraft, cash item, or otherwise; a lease that is the functional equivalent of an extension of credit; a purchase of a note or other obligation, including commercial paper or other debt securities; 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.[104]

As noted, the regulation proposes to clarify that a bank's purchase of a note or debt security, including commercial paper, issued by an affiliate is a loan or

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[104] 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 bank's prime rate) from which the loan's interest rate is calculated. If the 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.

extension of credit by the bank to the affiliate for purposes of section 23A.[105] The Board is aware that some banks have purchased or have proposed to purchase the commercial paper of their holding companies, and have done so or proposed to do so without collateralizing the purchase. These banks have argued that a purchase of commercial paper 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 and its collateral requirements.

Although the Board is aware that section 23A's definition of covered transaction separately includes a bank's purchase of securities issued by an affiliate and a bank's extension of credit 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 bank. Therefore, Regulation W provides that a 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 the section 23A collateral requirements applicable to extensions of credit.[106]

The Board seeks comment on whether the rule should permit banks in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. In particular, the Board seeks comment on whether it should require section 23A collateralization in circumstances where a 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. In these circumstances, the risk

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[105] This position is consistent with the Board's long-standing view that a purchase of an affiliate's note represents an extension of credit to the affiliate under section 23A. See 37 Federal Reserve Bulletin 960 (1951).

[106] As discussed above, however, the regulation requires a bank to value purchases of the debt securities of an affiliate, for purposes of computing compliance with the quantitative limits and collateral requirements of section 23A, in accordance with the valuation principles for purchases of debt securities and not those for extensions of credit.

that a bank's purchase of an affiliate's debt securities is designed to shore up an ailing affiliate may be reduced. Moreover, in both of these situations, the purchase of affiliate debt securities would be subject to the quantitative limits of section 23A and the market terms requirement of section 23B.

The Board asks for comment on whether other aspects of the definition of extension of credit are in need of clarification.

C. Other definitions-223.26

1. Bank–223.26(c)

Regulation W applies to all "banks." As discussed above, sections 23A and 23B apply by their terms to member banks of the Federal Reserve System, and the Federal Deposit Insurance Act subjects insured nonmember banks to the restrictions of sections 23A and 23B as if they were member banks. Accordingly, the proposed rule defines the term "bank" to include any "member bank," as defined in section 1 of the Federal Reserve Act, and any "insured bank" other than an "insured branch," as such terms are defined in section 3 of the Federal Deposit Insurance Act.[107/]

The definition of bank in the regulation also states that most subsidiaries of a bank are to be treated as the bank itself for purposes of sections 23A and 23B. The only subsidiaries of a bank that are excluded from this treatment are financial subsidiaries, depository institution subsidiaries, certain joint venture subsidiaries, and ESOPs – companies that are deemed affiliates of the 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 of the significant restrictions of the statute apply to actions taken by a member bank "and its subsidiaries." The Board believes that defining the term "bank" as described above and using the term "bank" wherever the statute says "member bank and its

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[107/] The carve-out for insured branches is explicitly required by the Federal Deposit Insurance Act, which provides that a foreign bank should not be treated as a member bank under section 23A solely because the foreign bank has an insured branch. 12 U.S.C. 1828(j)(3)(A).

subsidiaries" makes the regulation shorter and easier to understand while also reminding banks that certain subsidiaries of a bank should not be treated as part of the bank for purposes of the statute.

2. Capital stock and surplus–223.26(d)

Under section 23A, the quantitative limits on covered transactions are based on the "capital stock and surplus" of the bank.[108/] The proposed regulation includes a definition of capital stock and surplus that the Board previously adopted as an interpretation of section 23A.[109/] Capital stock and surplus is defined as the sum of the 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,[110/] and is consistent with the loans-to-one-borrower limits applicable to national banks[111/] and the Board's Regulation O, which limits lending to a bank's insiders.[112/] Use of a common definition across these rules should reduce compliance burden. The Board requests comment, however, on whether the balance of a bank's allowance for loan and lease losses not included in its tier 2 capital should be included in section 23A's "capital stock and surplus."

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.[113/] The Federal Deposit Insurance Act imposes the same capital deduction requirement on insured state banks that establish financial

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[108/] 12 U.S.C. 371c(a)(1).

[109/] 12 CFR 250.242.

[110/] See, e.g., 12 CFR part 225, appendix A.

[111/] 12 CFR 32.2(b).

[112/] 12 CFR 215.2(i); see also 61 FR 19805, May 3, 1996.

[113/] 12 U.S.C. 24a(c)(1).

subsidiaries.[114] 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 (the denominator of the fraction). Accordingly, a bank with a financial subsidiary may 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.

3. Control–223.26(f)

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.[115] 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 banks understand that a company or shareholder would be deemed to control another company (including a partnership, limited liability company, or other similar organization) if the company or shareholder controlled the election of a majority of the principal policymakers of such other company.

In addition, the regulation 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.[116] Second, a company that controls securities

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[114] 12 U.S.C. 1831w(a)(2).

[115] 12 U.S.C. 371c(b)(3)(A)(ii).

[116] See 12 CFR 225.2(e)(2)(i).

(including options and warrants) that are convertible, at the option of the holder or owner, into other securities, will be deemed to control the other securities.[117/]

4. Low-quality asset–223.26(q)

Two provisions of section 23A restrict a bank's ability to engage in transactions with affiliates that involve low-quality assets. First, the statute prohibits a bank from purchasing a low-quality asset from an affiliate unless the bank performed an independent credit evaluation and committed itself to purchase the asset prior to the asset's acquisition by the affiliate.[118/] Second, the statute prohibits a bank from counting a low-quality asset toward section 23A's collateral requirements for a credit transaction with an affiliate.[119/]

For purposes of these provisions, 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.[120/] The Board notes that any asset meeting one of the above four criteria, including securities and real property, is a low-quality asset.[121/]

[117/] See 12 CFR 225.31(d)(1)(i).

[118/] 12 U.S.C. 371c(a)(3).

[119/] 12 U.S.C. 371c(c)(3).

[120/] 12 U.S.C. 371c(b)(10).

[121/] 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 of Securities Held by Banks" (May 7, 1979); Federal Reserve Commercial Bank Examination Manual § 2020.1. The Board also notes that assets identified by examiners through the Shared National Credit and International Country Exposure Review Committee processes should be

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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. 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 such assets in their assessment of a bank's asset quality and capital adequacy.[122/] The Board asks for comment on the appropriateness of treating OTRP assets as low-quality assets under section 23A.

Second, the regulation reflects the increasing use by financial institutions of their own internal asset classification systems. A recent 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.[123/] Although there is considerable variance in how large banks rate performing assets, the banks generally 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 Board is proposing to include within the definition of low-quality asset not only assets classified during the last examination but also assets classified by the affiliate's internal classification system (or assets that received an internal rating that is substantially equivalent to classified in such an internal system). These assets generally have been renegotiated or compromised because the borrower is in financial distress and, thus, typically would meet the fourth prong of the statutory definition of low-quality

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[121/](...continued)
considered classified assets for purposes of section 23A.

[122/] See Federal Reserve Commercial Bank Examination Manual § 7040.1.

[123/] William F. Treacy & Mark S. Carey, Credit Risk Rating at Large U.S. Banks, 84 Federal Reserve Bulletin 897 (1998).

asset. Moreover, the purchase of such assets by a bank raises safety and soundness concerns.

The Board has some concern that this interpretation may induce companies to avoid or defer reclassification of an asset in order to allow its sale to an affiliated bank, 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 bank.

Finally, the proposed rule defines low-quality asset to include foreclosed property designated "other real estate owned," until it is reviewed by an examiner and receives a favorable classification. In the Board's experience, such property is often of such poor quality that its ownership poses the same risk to the bank as a low-quality loan that was purchased or taken as collateral.

5. Securities–223.26(w)

Section 23A defines "securities" to mean "stocks, bonds, debentures, notes, or other similar obligations."[124] In light of the ambiguous nature of this definition, the Board generally has looked to the 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,[125] the proposed regulation clarifies that commercial paper is a security for purposes of section 23A. Accordingly, as discussed in more detail above, when a bank purchases commercial paper issued by an affiliate, the bank makes an extension of credit to the affiliate (which must be secured in accordance with section 23A's collateral requirements) and purchases securities issued by the affiliate for purposes of section 23A.

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[124] 12 U.S.C. 371c(b)(9).

[125] See 15 U.S.C. 78c(a)(10).

6. Voting securities–223.26(aa)

Section 23A uses both the terms "voting shares" and "voting securities." To remove any ambiguity and to provide additional guidance to banks, the proposed regulation 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.[126]

Regulatory Flexibility Act

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)), the Board must publish an initial regulatory flexibility analysis with this rulemaking. Sections 23A and 23B of the Federal Reserve Act limit transactions between a bank and its affiliates and authorize the Board to issue regulations as may be necessary to administer and carry out the purposes of the sections. The proposed rule would comprehensively implement these sections of the Federal Reserve Act. The rule would simplify for banks the task of complying with the sections and would help ensure that the sections are consistently interpreted and applied by the Federal banking agencies and the banking industry. A description of the reasons why action by the Board is being considered and a statement of the objectives of, and legal basis for, the proposed rule are contained in the supplementary material provided above.

The proposed rule would apply to all banks regardless of their size. Although the rule potentially affects all banks, the regulation mainly codifies existing practice. The Board specifically seeks comment on the likely burden that the proposed rule would impose on banks.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 et seq.), the Board has reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in the proposed rule.

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[126] See 12 CFR 225.2(q).

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 invites comments about how to make the proposed rule easier to understand, including answers to 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?

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 BANKS AND THEIR AFFILIATES (REGULATION W)

Subpart A–Introduction

223.1 Authority, purpose, and scope.

Subpart B–General Provisions of Section 23A

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

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

223.4 What safety and soundness requirement applies to covered transactions?

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

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

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

Subpart C–Valuation and Timing Principles under Section 23A

223.8 What valuation and timing principles apply to credit transactions?

223.9 What valuation and timing principles apply to asset purchases?

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

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

Subpart D–Other Considerations under Section 23A

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

223.13 What rules apply to financial subsidiaries of a bank?

223.14 What rules apply to derivative contracts?

Subpart E–Exemptions from the Provisions of Section 23A

223.15 What covered transactions between a bank and an insured depository institution are exempt from the quantitative limits and collateral requirements?

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

223.17 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

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

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

Subpart A–Introduction

§ 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)(1) and 23B(e) of the Federal Reserve Act (12 U.S.C. 371c(f)(1), 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 bank and its affiliates. This regulation implements sections 23A and 23B by defining terms used in those sections, explaining the requirements of the sections, and exempting certain transactions from certain of the requirements.

(c) Scope. Sections 23A and 23B apply by their terms to “member banks” – that is, national banks, State banks, trust companies, and other institutions that are members of the Federal Reserve System. The Federal Deposit Insurance Act (12 U.S.C. 1828(j)) subjects insured nonmember banks to sections 23A and 23B as if they were member banks. Accordingly, this regulation applies to member banks and insured nonmember banks, and uses the term “banks” to describe the companies that are subject to its provisions. This regulation implements sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c-1); it does not contain every statutory or regulatory restriction on transactions between banks and their affiliates, including those that may apply to banks subject to prompt corrective action under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

Subpart B–General Provisions of Section 23A

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

A bank may not engage in a covered transaction with an affiliate if the aggregate amount of the bank’s covered transactions with any affiliate would exceed 10 percent of the capital stock and surplus of the bank.

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

A bank may not engage in a covered transaction with any affiliate if the aggregate amount of the bank’s covered transactions with all affiliates would exceed 20 percent of the capital stock and surplus of the bank.

§ 223.4 What safety and soundness requirement applies to covered transactions?

A bank may not engage in any covered transaction, including any covered transaction exempt under this regulation, unless the transaction is on terms and conditions that are consistent with safe and sound banking practices.

§ 223.5 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 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. A credit transaction described in paragraph (a) of this section must be secured by collateral having a market value equal to at least:

(1) 100 percent of the amount of the transaction, if the collateral is:

(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;

(iii) Notes, drafts, bills of exchange, or bankers' acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or

(iv) A segregated, earmarked deposit account with the bank that is for the sole purpose of securing the transaction and is so identified;

(2) 110 percent of the amount of the transaction, if the collateral is obligations of any State or political subdivision of any State;

(3) 120 percent of the amount of the transaction, if the collateral is other debt instruments, including loans and other receivables; or

(4) 130 percent of the amount of the transaction, if the collateral is stock, leases, or other real or personal property.

(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 or the bank;

(3) Intangible assets, including servicing assets; and

(4) Guarantees and letters of credit.

(d) Perfection and priority requirements for collateral. (1) A 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 insolvency, liquidation, or similar circumstances.

(2) A 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 bank the lesser of:

(i) The amount of any security interest in the collateral that is senior to that of the bank; or

(ii) The amount of any credit secured by the collateral that is senior to that of the bank.

(e) Replacement requirement for retired or amortized collateral. A bank must replace any required collateral that subsequently is retired or amortized 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 acceptances. The collateral requirements of this section do not apply to 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.

(g) Inapplicability of the collateral requirements to the undrawn portion of certain extensions of credit. The collateral requirements of this section do not apply to the undrawn portion of an extension of credit to an affiliate so long as the bank does not have any legal obligation to advance additional funds under the extension of credit until the affiliate posts the amount of collateral required by paragraph (b) of this section with respect to the entire drawn portion of the extension of credit.

§ 223.6 May a bank purchase a low-quality asset from an affiliate?

(a) In general. A bank may not purchase a low-quality asset from an affiliate unless the bank, pursuant to an independent credit evaluation, committed itself to purchase the asset prior to 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 bank's participation in a loan to a nonaffiliate that was originated by an affiliated depository institution if:

(1) The loan was not a low-quality asset at the time the bank purchased its participation;

(2) The renewal or extension of additional credit is approved by the board of directors of the participating bank as necessary to protect the bank's investment by enhancing the ultimate collection of the original indebtedness;

(3) The participating bank's share of the renewal or additional extension of credit does not exceed its proportional share of the original transaction; and

(4) The participating bank provides its appropriate Federal banking agency with 20 days' prior notice of the proposed renewal or additional extension of credit.

§ 223.7 What transactions by a bank with any person are treated as transactions with an affiliate?

(a) In general. A 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) Exemptions. Notwithstanding paragraph (a) of this section, the following transactions are not subject to the quantitative limits of §§ 223.2 and 223.3 or the collateral requirements of § 223.5. The transactions are, however, subject to the safety and soundness requirement of § 223.4, the prohibition on the purchase of a low-quality asset of § 223.6, and the market terms requirement and other provisions of subpart F.

(1) Certain riskless principal transactions. An extension of credit by a 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 bank, and the securities affiliate is acting exclusively as a riskless principal for the nonaffiliate in the transaction;

(ii) The security purchased by the nonaffiliate is not issued or underwritten by, or sold out of the inventory of, any affiliate of the bank; and

(iii) Any riskless principal mark-up or other compensation received by the affiliate from the proceeds of the extension of credit meets the market terms standard set forth in paragraph (b)(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)(1) of this section or in 12 CFR 250.243 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 § 223.18.

(3) Preexisting lines of credit. An extension of credit by a 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 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 bank.

(4) General purpose credit card transactions. An extension of credit by a bank to a nonaffiliate, if:

(i) The proceeds of the extension of credit are used by the nonaffiliate to purchase a product or service from an affiliate of the bank; and

(ii) The extension of credit is made pursuant to, and consistent with any conditions imposed in, a general purpose credit card issued by the bank to the nonaffiliate.

Subpart C–Valuation and Timing Principles under Section 23A

§ 223.8 What valuation and timing principles apply to credit transactions?

(a) Valuation. (1) Initial valuation of direct credit transactions. Except as provided in paragraph (a)(2) or (3) of this section, a credit transaction with an affiliate initially must be valued at the sum of:

(i) The amount provided to, or on behalf of, the affiliate in the transaction; and

(ii) Any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

(2) Initial valuation of indirect credit transactions. If a bank acquires 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 bank in exchange for the credit transaction; and

(ii) Any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

(3) <u>Debt securities</u>. The valuation principles of paragraphs (a)(1) and (2) of this section do not apply to a bank's purchase of or investment in a debt security issued by an affiliate, which is governed by § 223.10.

(b) <u>Timing</u>. (1) <u>In general</u>. A bank engages in a credit transaction with an affiliate:

(i) At the time during the day that the 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; and

(ii) At the time during the day that the bank acquires an extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate.

(2) <u>Credit transactions by a bank with a nonaffiliate that becomes an affiliate of the bank</u>.

(i) <u>In general</u>. A credit transaction with a nonaffiliate becomes a covered transaction at the time that the nonaffiliate becomes an affiliate of the bank. The bank must ensure that any such credit transaction complies with the collateral requirements of § 223.5 promptly after the nonaffiliate becomes an affiliate. The bank also must treat the amount of any such credit transaction as part of the aggregate amount of the bank's covered transactions for purposes of determining compliance with the quantitative limits of §§ 223.2 and 223.3 in connection with any future covered transactions. Except as described in paragraph (b)(2)(ii) of this section, the bank is not required to reduce the amount of its covered transactions with any affiliate because the nonaffiliate has become an affiliate.

(ii) <u>Credit transactions by a bank with a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank</u>. In addition to the provisions of paragraph (b)(2)(i) of this section, if a 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 aggregate amount of the bank's covered transactions (including any such transaction with the nonaffiliate) would not exceed the quantitative limits of § 223.2 or 223.3 at the time the nonaffiliate becomes an affiliate.

(iii) Example. A bank with capital stock and surplus of $1,000 and no outstanding covered transactions makes a $120 unsecured loan to a nonaffiliate. Several years later, the bank's holding company purchases all the stock of the nonaffiliate, thereby making the nonaffiliate an affiliate of the bank. Promptly after the time of the stock acquisition, the bank must ensure that the loan is in compliance with the collateral requirements of section 23A. The bank will not be in violation of the quantitative limits of section 23A at the time of the stock acquisition (unless the loan was made by the bank in contemplation of the nonaffiliate becoming an affiliate). The bank will, however, be prohibited from engaging in any additional covered transactions until such time as the value of the loan transaction falls below 10 percent of the bank's capital stock and surplus.

§ 223.9 What valuation and timing principles apply to asset purchases?

(a) Valuation. (1) In general. Unless the transaction is described in § 223.12, a purchase of an asset (other than a security issued by an affiliate or a note or obligation of an affiliate) by a bank from an affiliate must be valued initially at the total amount of consideration given (including liabilities assumed) by the 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) Examples of the valuation of asset purchases. The following are examples of how to value a bank's purchase of an asset from an affiliate.

(i) Cash purchase of assets. A bank purchases a pool of loans from an affiliate for $10 million. The bank initially must value the covered transaction at $10 million. Going forward, if the borrowers on the loans pay down $6 million of the principal amount of the loans, the bank may value the covered transaction at $4 million.

(ii) Purchase of assets through an assumption of liabilities. An affiliate of a bank contributes real property with a fair market value of $200,000 to the bank. The bank pays the affiliate no cash for the property, but assumes a $50,000 mortgage on the property. The bank has engaged in a covered transaction with the affiliate and initially must value the transaction at $50,000. Going forward, if the bank retains the real property but pays off the mortgage, the bank must continue to value the covered transaction at $50,000.

(b) Timing. (1) In general. A purchase of an asset remains a covered transaction for a bank for as long as the bank holds the asset.

(2) Asset purchases by a bank from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank. If a bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank, the asset purchase becomes a covered transaction at the time that the nonaffiliate becomes an affiliate of the bank. In addition, the bank must ensure that the aggregate amount of the bank's covered transactions (including any such transaction with the nonaffiliate) would not exceed the quantitative limits of § 223.2 or 223.3 at the time the nonaffiliate becomes an affiliate.

§ 223.10 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 § 223.13 with respect to securities issued by a financial subsidiary, a 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 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 on the financial statements of the bank, determined in accordance with GAAP.

(2) Examples of the valuation of purchases of and investments in the securities of an affiliate (other than a financial subsidiary). The following are examples of how to value a bank's purchase of or investment in securities issued by an affiliate (other than a financial subsidiary). Examples of how to value a bank's purchase of or investment in securities issued by a financial subsidiary are provided in paragraph (b)(3) of § 223.13.

(i) Purchase of the debt securities of an affiliate that is not a financial subsidiary. The parent holding company of a bank owns 100 percent of the shares of a mortgage company. The bank purchases debt securities issued by the mortgage company for $600. The initial carrying value of the securities on the bank's GAAP financial statements is $600. The bank initially must value the investment at $600.

(ii) Purchase of the shares of an affiliate that is not a financial subsidiary. The parent holding company of a bank owns 51 percent of the shares of a mortgage company. The 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 on the bank's GAAP financial statements is $100. The bank initially must value the investment at $100. Going forward, if the bank's carrying value of the shares declines to $40, the bank must continue to value the investment at $100.

(iii) Contribution of the shares of an affiliate that is not a financial subsidiary. The parent holding company of a bank owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the bank. The bank gives no consideration in exchange for the shares. If the initial carrying value of the shares on the bank's GAAP financial statements is $300, then the bank initially must value the investment at $300. Going forward, if the bank's carrying value of the shares increases to $500, the bank must value the investment at $500.

(b) Timing. A purchase of or investment in a security issued by an affiliate remains a covered transaction for a bank for as long as the bank holds the security.

§ 223.11 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 bank to a nonaffiliate secured exclusively by securities issued by an affiliate of the 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 affiliate's securities that are pledged as collateral, if such securities meet the market quotation standard contained in paragraph (e)(1) of § 223.16 or the standards set forth in paragraphs (e)(2)(i) and (v) of § 223.16.

(b) Valuation of extensions of credit secured by affiliate securities and other collateral. An extension of credit by a bank to a nonaffiliate secured in part by securities issued by an affiliate of the bank and in part by other 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 affiliate's securities that are pledged as collateral, if such securities meet the market quotation standard contained in paragraph (e)(1) of § 223.16 or the standards set forth in paragraphs (e)(2)(i) and (v) of § 223.16.

Subpart D–Other Considerations under Section 23A

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

(a) Certain acquisitions by a bank of securities issued by an affiliate are treated as a purchase of assets from an affiliate. A bank's acquisition of a security issued by a company that was an affiliate of the bank before the acquisition is treated as a purchase of the assets of an affiliate, if:

(1) As a result of the transaction, the company becomes a subsidiary of the bank and ceases to be an affiliate of the bank; and

(2) The company has liabilities, or the bank gives cash or any other consideration in exchange for the security.

(b) Valuation. A transaction described in paragraph (a) of this section but not exempt under paragraph (d) of this section must be valued initially at the sum of:

(1) The total amount of consideration given by the bank in exchange for the security; and

(2) The total liabilities of the company whose securities have been acquired by the bank, as of the time of the acquisition.

(c) Valuation example. The parent holding company of a bank contributes between 25 and 100 percent of the voting shares of a mortgage company to the bank. The bank gives no consideration in exchange for the shares. The mortgage company has total assets of $300,000 and total liabilities of $100,000. As a result of the transaction, the mortgage company becomes a subsidiary of the bank and ceases to be an affiliate of the bank. The transaction is treated as a purchase of the assets of the mortgage company by the bank from an affiliate under paragraph (a) of this section. The bank initially must value the transaction at $100,000, the total amount of the liabilities of the mortgage company.

(d) Exemption for step transactions. A transaction described in paragraph (a) of this section is not subject to the provisions of subpart B (other than the safety and soundness requirement of § 223.4) if:

(1) The bank acquires the securities issued by the company immediately after the company becomes an affiliate of the bank;

(2) The bank acquires all the securities of the company that were transferred in connection with the transaction that made the company an affiliate of the bank; and

(3) The acquisition complies with the market terms requirement of § 223.18.

§ 223.13 What rules apply to financial subsidiaries of a bank?

(a) Exemption from the 10 percent limit for covered transactions between a bank and a single financial subsidiary. The 10 percent quantitative limit contained in § 223.2 does not apply with respect to covered transactions between a bank and a financial subsidiary of the bank. The 20 percent quantitative limit contained in § 223.3 does apply to such transactions.

(b) Valuation of purchases of or investments in the securities of a financial subsidiary. (1) General rule. A bank's purchase of or investment in a security issued by a financial subsidiary must be valued at the greater of:

(i) The total amount of consideration given (including liabilities assumed) by the 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 on the financial statements of the bank, determined in accordance with GAAP but without reflecting the bank's pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the 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 bank under GAAP, the carrying value of the 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 bank, determined in accordance with GAAP but without reflecting the bank's pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the 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 bank must value its purchase of or investment in the securities of a financial subsidiary. Each example involves a securities underwriter that becomes a financial subsidiary of the bank after the transactions described below.

(i) Initial valuation. (A) Direct acquisition by a bank. A bank pays $500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the bank's parent-only GAAP financial statements is $500. The bank initially must value the investment at $500.

(B) Contribution of a financial subsidiary to a bank. The parent holding company of a bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500, and immediately contributes the shares to the bank. The bank gives no consideration in exchange for the shares. The bank initially must value the investment at the carrying value of the shares on the bank's parent-only GAAP financial statements. If the parent holding company's acquisition of the securities underwriter was accounted for as a purchase, the bank's initial carrying value of the shares would be $500. Alternatively, if the parent holding company's acquisition of the securities underwriter was accounted for as a pooling-of-interests, the bank's initial carrying value of the shares would equal the book value of the underwriter prior to the acquisition, which may be less than $500.

(ii) Carrying value not adjusted for earnings and losses of the financial subsidiary. A bank and its parent holding company engage in the transaction described in paragraph (b)(3)(i)(B) of this section, and the 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 bank's carrying value of the shares of the underwriter is not adjusted for purposes of this part, and the bank must continue to value the investment at $500. If, however, the bank contributes $100 of additional capital to the securities underwriter, the bank must value the investment at $600.

(c) Treatment of an affiliate's investments in, and extensions of credit to, a financial subsidiary of a bank. (1) Investments. Any purchase of, or investment in, the securities of a financial subsidiary of a bank by an affiliate of the bank (other than an affiliate that is itself a bank or an insured savings association) will be treated as a purchase of or investment in such securities by the bank.

(2) Extensions of credit. Any extension of credit to a financial subsidiary of a bank by an affiliate of the bank (other than an affiliate that is itself a bank or an insured savings association) will be treated as an extension of credit by the 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.

(3) An extension of credit that is treated as regulatory capital of the financial subsidiary. The Board has determined, under the authority of paragraph (c)(2) of this section, that any extension of credit to a financial subsidiary of a bank by an affiliate of the bank (other than an affiliate that is itself a bank or an insured savings association) will be treated as an extension of credit by the 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.

§ 223.14 What rules apply to derivative contracts? [RESERVED.]

Subpart E–Exemptions from the Provisions of Section 23A

§ 223.15 What covered transactions between a bank and an insured depository institution are exempt from the quantitative limits and collateral requirements?

The following transactions are not subject to the quantitative limits of §§ 223.2 and 223.3 or the collateral requirements of § 223.5. The transactions are, however, subject to the safety and soundness requirement of § 223.4 and the prohibition on the purchase of a low-quality asset of § 223.6.

(a) Parent institution/subsidiary institution transactions. Transactions with an insured depository institution if the bank controls 80 percent or more of the voting securities of the insured depository institution or the insured depository institution controls 80 percent or more of the voting securities of the bank;

(b) Transactions between a bank and an insured depository institution owned by the same holding company. Transactions with an insured depository institution if the same company controls 80 percent or more of the voting securities of the bank and the insured depository institution; and

(c) Certain loan purchases from an affiliated insured depository institution. Purchasing a loan on a nonrecourse basis from an affiliated insured depository institution.

§ 223.16 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 §§ 223.2 and 223.3, the collateral requirements of § 223.5, or the prohibition on the purchase of a low-quality asset of § 223.6. The transactions are, however, subject to the safety and soundness requirement of § 223.4.

(a) Making correspondent banking deposits. Making a deposit in an affiliated depository institution 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. Engaging in a credit transaction with an affiliate that is fully secured by:

(1) Obligations of the United States or its agencies;

(2) Obligations fully guaranteed by the United States or its agencies as to principal and interest; or

(3) A segregated, earmarked deposit account with the bank that is for the sole purpose of securing the credit transaction and is identified as such;

(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 of 1956 (12 U.S.C. 1843(c)(1));

(e) Purchasing certain liquid assets. (1) Purchasing an asset (other than a security issued by an affiliate) 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:

(i) The asset's price is quoted routinely in a widely disseminated news source; or

(ii) The asset is an obligation of the United States or its agencies or an obligation fully guaranteed by the United States or its agencies as to principal and interest; or

(2) Purchasing a security from a securities affiliate, if:

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

(ii) 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 bank records the transaction as a purchase of a security for purposes of the bank Call Report, consistent with the requirements for a State member bank;

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

(iv) The 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;

(v) 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 bank is at or below the current market quotation for the security; and

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

(vi) 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.

(f) Purchasing municipal securities. Purchasing a municipal security from a securities affiliate if:

(1) The security is rated by a nationally recognized statistical rating agency 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 bank records the transaction as a purchase of a security for purposes of the bank 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 bank is at or below the current market quotation for the security; and

(B) The size of the transaction executed by the 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 bank:

(A) Purchases the municipal security during the underwriting period;

(B) Obtains a copy of the summary from its securities affiliate and retains the summary for three years; and

(C) Purchases the municipal security at a price that is at or below that indicated in the summary;

(g) Purchasing an extension of credit subject to a repurchase agreement. Purchasing from an affiliate an extension of credit that was originated by the bank and sold to the affiliate subject to a repurchase agreement or with recourse;

(h) Asset purchases by a de novo bank. The purchase of an asset from an affiliate by a de novo bank, if the appropriate Federal banking agency for the bank has approved the asset purchase in writing in connection with its review of the formation of the bank;

(i) Transactions approved under the Bank Merger Act. Any merger or consolidation between a bank and an affiliated insured depository institution, or any acquisition of assets or assumption of deposit liabilities by a bank from an affiliated insured depository institution, if the transaction has been approved by the responsible Federal banking agency pursuant to the Bank Merger Act (12 U.S.C. 1828(c));

(j) Purchasing an extension of credit from an affiliate. Purchasing an extension of credit from an affiliate, if:

(1) The bank makes an independent evaluation of the creditworthiness of the borrower prior to the affiliate making or committing to make the extension of credit;

(2) The bank commits to purchase the extension of credit prior to the affiliate making or committing to make the extension of credit;

(3) The bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate;

(4) The dollar amount of the bank's total accumulated purchases from the affiliate, when aggregated with all other assets purchased from the affiliate by banks and insured savings associations that are affiliates of the bank, does not represent more than 50 percent of the dollar amount of extensions of credit originated by the affiliate; and

(5) The bank and its affiliated banks and insured savings associations do not provide substantial, ongoing funding to the affiliate through this exemption.

(k) Certain intraday extensions of credit. (1) In general. An intraday extension of credit that arises in connection with the performance by a bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions on behalf of an affiliate and effected through one or more accounts that the affiliate holds with the bank, if the bank:

(i) Has no reason to believe that the affiliate will have difficulty repaying the extension of credit in the ordinary course of business;

(ii) Establishes and maintains prudent limits on the net amount of intraday credit that the bank may extend to each affiliate, and all affiliates in the aggregate, and integrates these limits into the bank's overall credit risk exposure limits and systems;

(iii) Establishes and maintains policies, procedures, and systems reasonably designed to:

(A) Assess the credit quality of each affiliate that obtains an intraday extension of credit from the bank and determine each such affiliate's ability to repay such credit extensions;

(B) Periodically monitor each such affiliate's compliance with the established limits during the business day;

(C) Review an affiliate's intraday extensions of credit in the event of the affiliate's violation of the established limits; and

(D) Ensure that any intraday extension of credit received by an affiliate complies with the market terms requirement of § 223.18;

(iv) Maintains records and supporting information that are sufficient to enable the appropriate Federal banking agency to review the position limits and the policies, procedures, and systems described in paragraph (k)(1)(iii) of this section; and

(v) Treats any such extension of credit (regardless of jurisdiction) that exists at the end of the bank's business day in the United States, as a nonexempt covered transaction as of the end of the bank's business day in the United States (assuming no other exemption applies to the transaction at such time).

(2) Definition of "payment transactions". For purposes of this paragraph (k), "payment transactions" means transactions undertaken for the purpose of transferring funds to another account of the affiliate or to a third party and includes funds transfers, ACH transactions, check transactions, and other similar transactions.

§ 223.17 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 subpart B 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 bank may request an exemption from the requirements of section 23A and subpart B of this regulation by submitting a written request to the General Counsel of the Board.

Subpart F–General Provisions of Section 23B

§ 223.18 What is the market terms requirement of section 23B?

A bank may not engage in a transaction described in § 223.19 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 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.

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

(a) The market terms requirement of § 223.18 applies to the following transactions:

(1) Any covered transaction with an affiliate, unless the transaction is:

(i) Exempt under § 223.15 or paragraphs (a) through (e)(1) or (g) through (i) of § 223.16; and

(ii) Consistent with the safety and soundness requirement of § 223.4;

(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 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 bank with any person will be deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.

§ 223.20 What asset purchases are prohibited by section 23B?

(a) Fiduciary purchases of assets from an affiliate. A 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 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 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 bank based on a determination that the purchase is a sound investment for the bank, or for the person on whose behalf the bank is acting as fiduciary, as the case may be, irrespective of the fact that an affiliate of the 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 bank approves standards for the 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 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.

(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)).

§ 223.21 What advertisements and statements are prohibited by section 23B?

(a) In general. A bank and its affiliates may not publish any advertisement or enter into any agreement stating or suggesting that the bank will in any way be responsible for the obligations of its affiliates.

(b) Guarantees, acceptances, and letters of credit subject to section 23A. Paragraph (a) of this section does not prohibit a bank from issuing a guarantee, acceptance, or letter of credit on behalf of an affiliate to the extent otherwise permitted under this regulation.

§ 223.22 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

§ 223.23 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. Sections 23A and 23B of the Federal Reserve Act and the provisions of this regulation apply to transactions between each U.S. branch, agency, or commercial lending company of a foreign bank and:

(1) Any affiliate of the foreign bank 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) Any subsidiary of an affiliate described in paragraph (a)(1) of this section; and

(3) Any portfolio company (as defined in 12 CFR 225.177(c)) that the foreign bank or affiliate controls (for purposes of 12 CFR 225.173(d)(4)) and any company that would be an affiliate of the branch, agency, or commercial lending company of the foreign bank under paragraph (a)(9) of § 223.24 if the branch, agency, or commercial lending company were a bank.

(b) Method of applying sections 23A and 23B to foreign banks. (1) In general. Sections 23A and 23B of the Federal Reserve Act and the provisions of this regulation will apply to transactions described in paragraph (a) of this section in the same manner and to the same extent as if the branch, agency, or commercial lending company of the foreign bank were a bank and the companies described in paragraphs (a)(1) through (3) of this section were affiliates of the branch, agency, or commercial lending company.

(2) Attribution rule. Sections 23A and 23B of the Federal Reserve Act and the provisions of this regulation will apply to transactions between each U.S. branch, agency, or commercial lending company of a foreign bank and any person to the extent that the proceeds of the transaction are used for the benefit of, or

transferred to, a company described in paragraphs (a)(1) through (3) of this section.

(3) Capital stock and surplus. For purposes of §§ 223.2 and 223.3, 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–Definitions of Terms

§ 223.24 What is an "affiliate" for purposes of sections 23A and 23B?

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

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

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

(3) Companies under other common ownership. Any company, including any subsidiary of the 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 bank or any company that controls the bank;

(4) Companies with interlocking directorates. Any company in which a majority of its directors or trustees (or individuals exercising similar functions) constitute a majority of the persons holding any such office with the bank or any company that controls the 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 bank or an affiliate of the bank;

(6) Investment companies.

(i) Any investment company for which the bank or any affiliate of the 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 bank or any affiliate of the bank serves as an investment advisor, if the bank or any affiliate of the bank owns or controls more than 5 percent of any class of voting shares or similar interests in the fund;

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

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

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

(i) In general. Any company in which a holding company that controls the bank (or a holding company that is controlled by shareholders that control the 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 may avoid affiliate status 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 may avoid affiliate status 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 12 CFR 225.173(a)) that owns or controls the equity capital of the company unless the holding company controls the private equity fund (as described in 12 CFR 225.173(d)(4)).

(v) Definition of "holding company". For purposes of this paragraph (a)(9), "holding company" means the holding company and all of its subsidiaries (including any subsidiary depository institution of the holding company);

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

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

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

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

(i) A depository institution;

(ii) A financial subsidiary;

(iii) A subsidiary in which any affiliate or affiliates of the bank (other than a bank or insured savings association) directly owns or controls 25 percent or more of any class of voting securities;

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

(v) Any other company determined to be an affiliate under paragraph (a)(11) of this section;

(2) Bank premises. Any company engaged solely in holding premises of the 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, "affiliate" with respect to a bank also does not include any insured depository institution.

§ 223.25 What transactions with affiliates are covered by section 23A?

For purposes of this part, a "covered transaction" with respect to an affiliate of a bank means:

(a) An extension of credit to the affiliate;

(b) A purchase of, or an investment in, a security issued by the affiliate;

(c) 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;

(d) The acceptance of a security issued by the affiliate as collateral for an extension of credit to any person or company; and

(e) The 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.

§ 223.26 What are the meanings of the other terms used in sections 23A and 23B?

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" has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(c) Bank. (1) In general. "Bank" means:

(i) Any member bank, as defined in section 1 of the Federal Reserve Act (12 U.S.C. 221); and

(ii) Any insured bank that is not an insured branch, as such terms are defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(2) Subsidiaries of banks. For purposes of paragraph (c)(1) of this section, a subsidiary of a bank (other than a subsidiary described in paragraphs (b)(1)(i) through (v) of § 223.24) is treated as the bank.

(d) "Capital stock and surplus" means the sum of:

(1) A bank's tier 1 and tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency, based on the bank's most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3); and

(2) The balance of a 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 bank's most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3).

(e) "Company" means a corporation, partnership, limited liability company, business trust, association, or similar organization and, unless specifically excluded, includes a bank and a depository institution.

(f) 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 § 223.24 or if the company owning or controlling the shares is a business trust.

(3) Ownership or control of shares by subsidiary. A company will be deemed to control securities, assets, or other ownership interests owned or controlled, directly or indirectly, by any subsidiary (including a bank) of the company.

(4) Ownership or control of convertible securities. A company that owns or controls securities (including options and warrants) that are convertible, at the option of the holder or owner, into other securities, controls the other securities.

(g) "Credit transaction" with an affiliate means:

(1) An extension of credit to the affiliate; and

(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.

(h) "Depository institution" means a State bank, national bank, banking association, or trust company, or an insured savings association.

(i) "Equity capital" means:

(1) With respect to a corporation, perpetual 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 (i)(1) of this section.

(j) "Extension of credit" means an extension or renewal of a loan, a grant of a line of credit, or an extension of credit in any manner whatsoever, including on an intraday basis. An extension of credit includes, without limitation:

(1) An advance by means of an overdraft, cash item, or otherwise;

(2) A lease that is the functional equivalent of an extension of credit;

(3) A purchase of a note or other obligation, including commercial paper or other debt securities (which is deemed an extension of credit to the obligor); and

(4) 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.

(k) "Financial subsidiary" means:

(1) 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 (12 U.S.C. 24a); and

(2) Any subsidiary of a company described in paragraph (k)(1) of this section.

(l) "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).

(m) "GAAP" means U.S. generally accepted accounting principles.

(n) "General purpose credit card" means a credit card issued by a bank if:

(1) The card may be used to purchase products or services from nonaffiliates of the bank;

(2) The card is widely accepted by merchants that are not affiliates of the bank for the purchase of products or services; and

(3) Less than 25 percent of the aggregate amount of products and services purchased with the card by all cardholders are purchases of products or services from an affiliate of the bank.

(o) "Insured depository institution" has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813), but (except for purposes of section 223.16(i)) does not include any branch or agency of a foreign bank or any commercial lending company owned or controlled by a foreign bank.

(p) "Insured savings association" means a savings association (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) the deposits of which are insured by the Federal Deposit Insurance Corporation.

(q) "Low-quality asset" means:

(1) An asset (including a security) classified as "substandard," "doubtful," or "loss" or treated as "other assets especially mentioned" 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 bank or the affiliate (including an asset that receives a rating that is substantially equivalent to classified in the internal system of the 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) A foreclosed asset designated as "other real estate owned" that has not yet been reviewed in an examination or inspection.

(r) "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)).

(s) "Nonaffiliate" with respect to a bank means any person that is not an affiliate of the bank.

(t) "Payment transactions" is defined in § 223.16(k)(2).

(u) "Principal underwriter" is defined in § 223.20(c)(1).

(v) "Purchase of assets" means the acquisition of an asset in exchange for cash or any other consideration, including an assumption of liabilities.

(w) "Securities" means stocks, bonds, debentures, notes, or similar obligations (including commercial paper).

(x) "Securities affiliate" means a broker or dealer that is an affiliate of the bank and is registered with the Securities and Exchange Commission.

(y) "State bank" has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(z) "Subsidiary" with respect to a specified company means a company that is controlled by the specified company.

(aa) "Voting securities" has the same meaning as the term "voting securities" found in 12 CFR 225.2(q).

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

(Signed) Jennifer J. Johnson

Jennifer J. Johnson,
Secretary of the Board.