BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

April 22, 2009

Paul E. Glotzer, Esq.
Cleary Gottlieb Steen & Hamilton LLP
One Liberty Plaza
New York, NewYork 10006

Dear Mr. Glotzer:

This is in response to your request on behalf of Morgan Stanley Bank, N.A. ("MS Bank"), Salt Lake City, Utah, for exemptions from section 23A of the Federal Reserve Act and the Board's Regulation W[1] and an exception from the anti-tying restrictions in section 106 of the Bank Holding Company Act Amendments of 1970.[2] Granting these requests would permit MS Bank to acquire assets from certain affiliates in connection with a proposed internal reorganization.

You have indicated that Morgan Stanley ("Morgan Stanley"), New York, New York, proposes to reorganize its business in connection with MS Bank's conversion from an industrial loan company to a national bank.[3] As part of that reorganization, MS Bank proposes to acquire certain assets ("Assets") from Morgan Stanley and other affiliates to expand its banking book and investment portfolio. The Assets include commercial and consumer loans; corporate, municipal, and sovereign bonds; commercial paper; and asset-backed securities. MS Bank also proposes to extend credit to affiliates secured by the Assets. The Assets may include loans that contain conditions that would have

[1] 12 U.S.C. § 371c; 12 CFR part 223.

[2] 12 U.S.C. § 1971 et seq.

[3] The Office of the Comptroller of the Currency ("OCC") approved MS Bank's application to convert from a Utah state-chartered industrial bank to a national banking association on September 23, 2008.

violated the anti-tying restrictions in section 106 if the loans had been extended by a bank.

Section 23A Exemption Requests

Section 23A and Regulation W limit the amount of "covered transactions" between a bank and any single affiliate to 10 percent of the bank's capital stock and surplus and limit the amount of covered transactions between a bank and all its affiliates to 20 percent of the bank's capital stock and surplus.[4] "Covered transactions" include the purchase of assets by a bank from an affiliate, the extension of credit by a bank to an affiliate, the issuance of a guarantee by a bank on behalf of an affiliate, and certain other transactions.[5] The statute and regulation also require a bank to secure its extensions of credit to, and guarantees on behalf of, affiliates with prescribed amounts of collateral.[6] In addition, section 23A and Regulation W prohibit a bank from purchasing low-quality assets from an affiliate[7] and require that all covered transactions between a bank and an affiliate be on terms and conditions that are consistent with safe and sound banking practices.[8]

MS Bank's purchase of the Assets from affiliates and its extensions of credit secured by the Assets to affiliates would be covered transactions subject to the quantitative limits and qualitative requirements of section 23A and Regulation W.[9] The aggregate value of these covered transactions for purposes of Regulation W would be up to [ ].[10] This amount would exceed MS Bank's quantitative limits under the statute and rule.

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[4] 12 U.S.C. § 371c(a)(1) and 12 CFR 223.11 and 223.12.

[5] 12 U.S.C. § 371c(b)(7) and 12 CFR 223.3(h).

[6] 12 U.S.C. § 371c(c) and 12 CFR 223.14.

[7] 12 U.S.C. § 371c(a)(3) and 12 CFR 223.15.

[8] 12 U.S.C. § 371c(a)(4) and 12 CFR 223.13.

[9] See 12 U.S.C. § 371c(b)(7)(A) and (C); 12 CFR 223.3(h)(1) and (3).

[10] See 12 CFR 223.22(a).

To facilitate the reorganization, MS Bank has requested exemptions from section 23A and Regulation W. Section 23A and Regulation W specifically authorize the Board to exempt, in its discretion, transactions or relationships from the requirements of the statute and rule if the Board finds the exemption to be in the public interest and consistent with the purposes of section 23A.[11] The Board previously has indicated that the twin purposes of section 23A are (i) to protect against a depository institution suffering losses in transactions with affiliates; and (ii) to limit the ability of an institution to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net.[12]

A. Asset Purchase Exemption Request

The Board previously has granted to other banks exemptions from section 23A and Regulation W that are similar to the exemptions requested by MS Bank. The Board has routinely approved exemptions under section 23A for one-time asset transfers that are part of a corporate reorganization and that are structured to ensure the quality of the transferred assets.[13] To ensure the quality of the transferred Assets and to protect MS Bank, the Board has determined to impose several conditions in connection with this exemption:

- The Assets must be externally rated B- or higher by a nationally registered statistical rating organization ("NSRO") or, if unrated, of equivalent credit quality under the bank's internal rating system. In addition, the Assets must not include low-quality assets (as defined in Regulation W).
- Morgan Stanley must, at the request of the Federal Reserve or the OCC, in either supervisor's full discretion, repurchase any transferred Asset from the bank at the bank's original purchase price.
- For the life of each transferred Asset, Morgan Stanley must (i) reimburse the bank for any credit-related loss upon sale by the bank of a transferred

[11] 12 U.S.C. § 371c(f)(2); 12 CFR 223.43(a).

[12] 67 Federal Register 76560 (Dec. 12, 2002).

[13] See, e.g., Board letters dated July 1, 2008, to Kathryn V. McCulloch, Esq. (JPMorgan Chase & Co.); March 25, 2008, to Karen Grandstrand, Esq. (Minnwest Corporation); December 21, 2007, to Andres L. Navarette, Esq. (Capital One Financial Corporation); and June 30, 2007, to Carl Howard, Esq. (Citigroup Inc).

Asset and (ii) repurchase any transferred Asset that becomes a low-quality asset (as defined in Regulation W) at the bank's original purchase price.[14] Such reimbursements and repurchases must occur quarterly or more frequently.

- In support of its guarantee, Morgan Stanley must pledge to MS Bank collateral that is acceptable to the Federal Reserve and in an amount equal to [ ] percent of the aggregate covered-transaction amount for the life of the transferred Assets.[15] If a decline in value of the collateral causes Morgan Stanley to breach the [ ] percent collateral requirement, additional collateral must be pledged promptly to return Morgan Stanley to compliance with this requirement.[16]
- MS Bank must maintain a tier 1 leverage capital ratio of at least [ ] percent, a tier 1 risk-based capital ratio of at least [ ] percent, and a total risk-based capital ratio of at least [ ] percent until the OCC approves a capital plan for the bank.
- The Assets must be transferred to MS Bank by October 8, 2009.

B. Financing Transactions Exemption Request

MS Bank also proposes to engage in certain financing transactions with affiliates (secured by the Assets) in connection with the reorganization. These

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[14] Some of the Assets may be transferred with credit default swap ("CDS") protection from Morgan Stanley or another affiliate of the bank, or the bank may decide to obtain CDS protection for an Asset from an affiliate after it is transferred. Although the bank may obtain CDS protection from Morgan Stanley or another affiliate with respect to the transferred Asset, the bank may not pay for this protection because the bank would already receive credit protection for the transferred Asset from Morgan Stanley under the guarantee described above. Morgan Stanley may, however, net payments to the bank under the CDS against any payment obligations to the bank under the guarantee.

[15] The aggregate covered-transaction amount generally is equal to the bank's purchase price for transferred Assets plus the face amount of committed but unfunded credit lines transferred to the bank.

[16] Morgan Stanley may release collateral to the extent that transferred Assets are sold or mature.

transactions would include loan participations, assignments from affiliates, repurchase agreements, securities-borrowing transactions, and other qualified financial contracts (collectively, "Financing Transactions"). Consistent with previous exemptions from section 23A that the Board has granted to permit a bank to engage in similar financing transactions with its affiliates,[17] MS Bank may only engage in Financing Transactions with affiliates that meet the following conditions:

- The Financing Transactions must be overnight financing transactions that are fully secured, marked-to-market daily, and subject to daily margin-maintenance requirements.
- Collateral for the Financing Transactions must be obligations that are externally rated B- or higher by an NSRO or, for unrated assets, of equivalent credit quality and must not include any "low-quality asset" (as defined in Regulation W).
- Morgan Stanley must fully guarantee the prompt and full payment of all obligations of the affiliate counterparty to each Financing Transaction.
- In support of the guarantee, Morgan Stanley must provide collateral equal to [ ] percent of the amount of the affiliate's obligation for each Financing Transaction.
- MS Bank must be able to promptly liquidate transactions, even in the event of bankruptcy of the borrowing affiliate.

C. Certain Loans with CDS Protection Exemption Request

MS Bank would acquire certain loans that have existing CDS protection provided by an affiliate. Under its credit policy, the bank would not have been allowed to purchase some of these loans without the CDS protection. Because the CDS protection would be necessary to justify the bank's extension of

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[17] See, e.g., Board letters dated October 23, 2007, to Carl Howard, Esq. (Citigroup Inc.); October 12, 2007, to Jay Levine (The Royal Bank of Scotland plc); October 11, 2007, to Alan B. Kaplan, Esq. (Barclays Bank PLC); September 12, 2007, to Michael L. Kadish, Esq. (Deutsche Bank AG); August 20, 2007, to Kathleen A. Juhase, Esq. (JPMorgan Chase & Co.); August 20, 2007, to Patrick S. Antrim, Esq. (Bank of America Corporation); and August 20, 2007, to Carl Howard, Esq. (Citigroup Inc.).

credit, the bank's acquisition of such a loan would be considered an extension of credit by the bank to the affiliate selling the CDS for purposes of section 23A and Regulation W.

Only a limited number of loans that depend on the CDS protection would be transferred to MS Bank, and the CDS are governed by a derivatives contract that limits MS Bank's unsecured credit exposure to any affiliate to no more than [ ]. As a result, the Board has determined that it is appropriate to grant an exemption that permits MS Bank to acquire the loans included in the transferred Assets that depend on CDS protection provided by an affiliate without requiring the bank to subject such loans to the quantitative limits and qualitative requirements of section 23A and Regulation W. Going forward, however, if MS Bank makes a loan where CDS protection provided by an affiliate is necessary to justify the bank's making the loan, the loan must be treated as an extension of credit to the affiliate seller of the CDS.

D. Other Statutory Standards for the Section 23A Exemption Requests

As noted, section 23A and Regulation W specifically authorize the Board to exempt transactions or relationships from the statute and rule if the Board finds the exemption to be in the public interest and consistent with the purposes of section 23A. According to MS Bank, these exemptions are in the public interest because the reorganization would allow it to operate more profitably and efficiently, thereby allowing the bank to extend additional credit in a more cost-effective manner and to serve its customers better. As with previous exemption requests, and consistent with the requirements for certain internal corporate reorganizations in Regulation W,[18] the board of directors of MS Bank has reviewed and approved the transactions described above.

The proposed asset purchase and securities financing transactions by MS Bank would be subject to the market-terms requirement of section 23B of the Federal Reserve Act. Section 23B generally requires that transactions between a bank and its affiliates be on terms that are at least as favorable to the bank as the terms of comparable transactions between the bank and a third party.[19]

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[18] 12 CFR 223.41(d).

[19] 12 U.S.C. § 371c-1(a).

In light of these considerations and all the facts and circumstances of this case, the proposed transactions appear to be consistent with safe and sound banking practices and on terms that will ensure the quality of the transferred Assets. Accordingly, the proposed transactions appear to be in the public interest and consistent with the purposes of section 23A. The Board, after consultation with staffs of the OCC and the Federal Deposit Insurance Corporation, hereby grants the requested exemptions.

Anti-Tying Exception Request

Section 106 of the Bank Holding Company Act Amendments of 1970 generally prohibits a bank from conditioning the availability or price of a product on a requirement that the customer obtain another separate product from, or provide another separate product to, the bank or an affiliate of the bank. This statutory prohibition did not apply to products and services provided by the nonbank subsidiaries of Morgan Stanley that were offered or provided without reference to the products or services of MS Bank. A small number of loans included in the Assets to be transferred to MS Bank might contain conditions that would have violated the anti-tying restrictions of section 106 if the loans had been extended by a bank. As a general matter, it is a violation of section 106 for a bank to acquire such loans from an affiliate. Section 106 authorizes the Board to grant exceptions to the prohibition if the exception is not contrary to the purposes of this section.[20] In light of all the facts and circumstances of this case, the Board grants an exemption from section 106 to permit MS Bank to acquire the Assets. Going forward, however, the bank would not be permitted to extend or renew any loans on terms that would violate the anti-tying restrictions in section 106.

Conclusion

The Board's determinations are specifically conditioned on compliance by MS Bank and Morgan Stanley with all the commitments and representations made in connection with the requests and with the conditions discussed above. These commitments, representations, and conditions are deemed to be conditions imposed in writing in connection with granting the requests and, as such, may be enforced in proceedings under applicable law. The determinations are also based on the specific facts and circumstances surrounding the proposed transactions and may be revoked in the event of any material change in those facts

[20] 12 U.S.C. § 1972(1).

and circumstances or any failure by MS Bank or Morgan Stanley to observe any of these commitments, representations, or conditions. Granting the requests does not represent a determination concerning the permissibility of any other transactions engaged in by MS Bank or Morgan Stanley that are subject to section 23A, Regulation W, or section 106.

Sincerely,

(signed)

Robert deV. Frierson
Deputy Secretary of the Board

cc: Ivan J. Hurwitz, Vice President
Federal Reserve Bank of New York
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency