FEDERAL RESERVE SYSTEM

12 CFR Part 250
[Miscellaneous Interpretations; Docket R-1015]

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

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice; request for comments.

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

DATES: Comments must be submitted on or before July 21, 1998.

ADDRESSES: Comments, which should refer to Docket No. R-1015, may be mailed to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. Comments addressed to Ms. Johnson also may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, N.W. Comments may be inspected in Room MP-500 between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in § 261.12 of the Board's Rules Regarding Availability of Information.

FOR FURTHER INFORMATION CONTACT: Pamela G. Nardolilli, Senior Counsel (202/452-3289) or Satish M. Kini, Senior Attorney (202/452-3818), Legal Division; or Molly S. Wassom, Deputy Associate Director, Banking Supervision and Regulation (202/452-2305), Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunications Device of the Deaf (TDD), Diane Jenkins (202/452-3254).

SUPPLEMENTARY INFORMATION:

Background

Restrictions of Section 23A

Section 23A of the Federal Reserve Act, originally enacted as part of the Banking Act of 1933, is designed to prevent the misuse of a member bank's resources through "non-arm's length" transactions with its affiliates.[1/] Section 23A limits covered transactions between a member bank and its subsidiaries and an affiliate to 10 percent of the institution's capital stock and surplus, and limits the aggregate amount of all transactions between a member bank and its subsidiaries and all of its affiliates to 20 percent of capital stock and surplus. The purchase of assets by a bank from its affiliates, including assets subject to repurchase, is included in the definition of covered transactions and is subject to the statute's quantitative limitation.

Section 23A also contains several exemptions from the statute's quantitative and collateral limitations. One exemption is contained in section 23A(d)(6), which exempts from the statute's quantitative limits, a purchase of an asset that has "a readily identifiable and publicly available market quotation" ((d)(6) exemption).[2/] In addition, section 23A gives the Board broad authority to issue regulations and orders as may be necessary to administer and carry out the purposes of section 23A.[3/]

In the past, institutions have been advised that the (d)(6) exemption was available for the purchase of assets, the

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

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

[3/] 12 U.S.C. 371c(e)(1).

price of which were recorded in widely disseminated publications that were readily available to the general public. Such assets included obligations of the United States, securities traded on exchanges, foreign exchange, certain mutual share funds, and precious metals. Other marketable assets could not meet this standard, however.

Proposal

The Board has received several requests from organizations (Petitioners) regarding the interpretation of the (d)(6) exemption. These requests were prompted, in part, by the Board's removal of the section 20 firewalls, which had prohibited many transactions between an insured depository institution and its affiliated section 20 subsidiary. Several Petitioners have stated that, although the removal of the firewall was welcomed, section 23A continues to limit certain transactions with their section 20 subsidiaries. Petitioners argue that certain prohibited transactions do not raise significant safety and soundness issues and impedes the efficient operations of the insured depository institution and the section 20 affiliate. In particular, Petitioners were concerned about the ability of the insured depository institution to purchase securities under the (d)(6) exemption because of the narrow reading that had been imposed on the exemption, which prevented the purchase of otherwise marketable assets.

In light of technological and market changes and to address concerns of the Petitioners, the Board is proposing to expand the kind of assets that may be eligible for the (d)(6) exemption to include other securities that, although not so widely traded as to warrant publication of their activity in publications of general circulation, are actively traded and whose price can be obtained from independent reliable sources, if the securities are purchased from a registered broker-dealer. The Board is proposing that this test can be met for certain assets that are treated as having a "ready market," as defined by the Securities and Exchange Commission (SEC), and where such assets are purchased at publicly available market quotations from a registered broker-dealer.[4/]

This "ready market" definition ensures that a ready, competitive market exists for that asset. In addition, the

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[4/] 17 CFR 240.15c3-1(c)(11)(i). The SEC defines a ready market as including a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.

marketability of the asset meets a standard already used by registered broker-dealers and that is monitored by the SEC. Under the SEC net capital requirements, a registered broker-dealer must deduct 100 percent of the carrying value of securities and certain other assets if there is not a "ready market" for the asset. The purpose of the ready market test is to identify securities with a liquid market to ensure that a broker-dealer can liquidate a security and receive its value. The type of securities that meet this definition include obligations of the United States, including agency-issued securities, as well as many asset-backed, corporate debt, and sovereign debt securities.

In addition to meeting the "ready market" standard, the Board proposes that any security that is purchased as exempt under (d)(6) receive an investment grade rating from a nationally recognized statistical rating organization (NRSRO). Ratings that are stated by a NRSRO to be "under review" for a possible downgrade to below investment grade would not be viewed as "investment grade for meeting this requirement."

In addition to requiring that a security have a ready market, the Board believes that the price of each security must be established from sources other than the purchasing bank and its affiliates. Thus, in addition to demonstrating that the security has a ready market and is rated by a NRSRO, the Board believes that the bank must be able to demonstrate that the price paid by the bank for the security was a competitive price that examiners can verify.

Securities that meet the "ready market" standard may not always be verifiable through a widely disseminated news source, however. Accordingly, the Board proposes to allow alternative reliable pricing sources, such as electronic services from real-time financial networks that provide indicative data to determine that the price that the bank pays is on market terms. Such pricing services could be used to qualify a bank’s purchase from a registered broker-dealer under the (d)(6) exemption so long as the bank is able to obtain a quote on the <u>exact</u> security it wishes to purchase. In the alternative, if a security was so thinly traded that a quote from a "screen" or other similar source was not available, the Board is proposing to adopt a standard that an insured depository institution could purchase the security as an exempt transaction if the insured depository institution obtained at least two <u>actual</u> independent dealer quotes for the particular security from unaffiliated registered broker-dealers, which must be based, in part, on the amount of the security that the bank proposes to purchase. The insured depository institution could purchase the security from the registered broker-dealer at a price no higher than the average of the prices obtained from the unaffiliated broker-dealers. To assist examiners in verifying the price paid, documentation for (d)(6) transactions must be maintained in the insured depository institution's file for five years.

The Board's proposal would not allow, however, an insured depository institution to purchase certain securities under the (d)(6) exemption even if the proposed criteria are met. The proposed interpretations would prohibit the purchase under the (d)(6) exemption of any securities issued by an affiliate, which would include the capital stock of an affiliate, asset-backed securities issued by an affiliate, of shares of mutual funds advised by the bank or an affiliate, unless those instruments are obligations of the United States or fully guaranteed by the United States or its agencies as to principal and interest. The Board believes that safety and soundness requires restrictions on an insured depository institution's ability to purchase an affiliate's securities to help prevent the unlimited funding of its affiliates, and the restriction is consistent with other provisions of section 23A, which limit the insured depository institution's ability to lend to an affiliate or accept the affiliate's securities as collateral.[5]

In addition, bank-ineligible securities that are underwritten by an affiliate would not qualify for the (d)(6) exemption during the period of the underwriting or for 30 days thereafter. This restriction is similar to Operating Standard 6 that the Board has imposed on section 20 subsidiaries, which prohibits an insured depository institution from extending credit to a customer secured by, or for the purpose of purchasing, any bank-ineligible security that a section 20 affiliate is underwriting or has underwritten within the past 30 days.[6] The Board believes that the market value of securities may be uncertain during the underwriting period and that the conflicts of interest that may arise during the underwriting period cause enough concern to require this limitation. Banks, of course, could continue to buy nonexempt securities from an affiliate subject to the quantitative limits of section 23A and could buy such securities from unaffiliated parties without any section 23A limit, so long as the purchase was otherwise authorized by law. In addition, this interpretation of (d)(6) does not interfere with the ability of an insured depository institution to purchase assets from affiliates other than the registered broker-dealer so long as the price of such assets are recorded in widely disseminated publications that are readily available to the general public.

The Board understands that these criteria are more restrictive than the criteria proposed by some Petitioners in their request for the Board's review of the (d)(6) exemption. For example, it has been proposed that if the bank cannot obtain a quote on the exact security, the bank should be able to rely on quotes for "comparable securities" - securities with the same rating and other similar characteristics - to determine the correct price and to permit the bank to exclude the purchase from its quantitative limits. The purchase of such securities, which would be without any type of quantitative limit if purchased as a (d)(6) exempt asset, would raise significant safety and soundness concerns, however, because it would be difficult for examiners to verify compliance with the (d)(6) exemption requirement that the price paid was determined by reference to a competitive market

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[5] For example, if the restriction on the purchase of an affiliate's securities is not imposed, an insured depository institution could purchase the debt securities of an affiliate without limit, but a collateralized loan to the affiliate would be limited to 10 percent of the institution's capital and surplus.

[6] Amendments to Restrictions in the Board's Section 20 Orders number 6, 62 F.R. 45295, 45307 (1997) (to be codified at 12 CFR 225.200). A bank-ineligible security is a security that a member bank may not deal in or underwrite.

for the security.

Although the Board believes that the expansion of the types of assets that are eligible for the (d)(6) exemption is warranted, the Board believes it is prudent to limit expansion at this time. The Board, as part of its review of the public comments on this proposal, will consider other suggested pricing mechanisms if such mechanisms can meet the statutory standards.

Regulatory Flexibility Act Analysis

The Board certifies that adoption of this proposal is not expected to have a significant economic impact on a substantial number of small business entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.) because most small bank holding companies and insured depository institutions do not have registered broker-dealer affiliates. For this reason, small bank holding companies would not be affected by the proposed rule.

In addition, the proposed rule would expand the type of transactions that an insured depository institution may engage in with its affiliate. Accordingly, the proposal does not impose more burdensome requirements on depository institutions, their holding companies, and their affiliates than are currently applicable.

Paperwork Reduction Act

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

List of Subjects in 12 CFR Part 250

Federal Reserve System.

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

Part 250 - Miscellaneous Interpretations

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

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

2. Section 250.246 is added to read as follows:

§ 250.246 Applicability of section 23A of the Federal Reserve Act to the purchase of securities by an insured depository institution.

(a) The purchase of securities by an insured depository institution from an affiliate that is a broker-dealer is exempt under section 23A(d)(6) of the Federal Reserve Act (12 U.S.C. 371c(d)(6)) if:

(1) The broker-dealer is registered with the Securities and Exchange Commission;

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

(3) The securities have received an investment grade rating from a nationally recognized statistical rating organization (NRSRO), and a NRSRO has not stated that the rating is under review for a possible downgrade to below investment grade;

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

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

(i) A widely disseminated news source;

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

(iii) Two or more actual independent dealer quotes on the exact security to be purchased, where the price paid is no higher than the average of the price quotes obtained from the unaffiliated broker-dealers;

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

By order of the Board of Governors of the Federal Reserve System, June 10, 1998.

(Signed) Jennifer J. Johnson

Jennifer J. Johnson,
Secretary of the Board.