Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FEDERAL RESERVE SYSTEM

12 CFR Part 250

[Miscellaneous Interpretations; Docket R–1016]

Applicability of Section 23A of the Federal Reserve Act to Loans and Extensions of Credit Made by a Member Bank to a Third Party

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: Section 23A of the Federal Reserve Act restricts the ability of a member bank to fund its affiliates through direct investments, loans, or certain other transactions (covered transactions). Section 23A deems transactions between a member bank and a nonaffiliated third party as covered transactions between the bank and its affiliate to the extent that proceeds of the transactions are used for the benefit of or transferred to the affiliate. The Board is proposing to grant two exemptions from section 23A for certain loans and extensions of credit made by an insured depository institution to customers that use the proceeds to purchase certain securities from or through the depository institution's registered broker-dealer affiliate. The first exemption would apply when the affiliate is acting solely as a broker or riskless principal in the securities transaction. The second exemption would apply when the extension of credit is made pursuant to a pre-existing line of credit that was not established for the purpose of buying securities from or through an affiliate. The Board proposes to grant these exemptions from section 23A to permit customers to gain more flexible use of the services of insured depository institutions and their registered broker-dealer affiliates, while still ensuring that the credit 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–1016, 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 section 261.12 of the Board's Rules Regarding Availability of Information.

FOR FURTHER INFORMATION CONTACT: Thomas M. Corsi, Senior Counsel (202/452–3275), 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 for 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] To achieve this purpose, section 23A establishes both quantitative limits and qualitative restrictions on transactions by a member bank with its affiliates. The statute places limits on ''covered transactions'' between a member bank and any single affiliate to no more than 10 percent of the bank's capital and surplus and limits aggregate covered transactions with all affiliates to no more than 20 percent of the bank's capital and surplus.[2] Covered transactions include extensions of credit, investments, and certain other transactions that expose the member bank to risk. Section 23A also requires that credit exposures to an affiliate be secured by collateral, the amount of which is statutorily defined.[3]

In addition to regulating direct transactions between a bank and its affiliates, section 23A deems any transaction between a member bank and any person to be a transaction between a member bank and an affiliate to the extent that the proceeds of the transaction are ''used for the benefit of, or transferred to,'' that affiliate.[4] This provision of the statute, commonly referred to as the ''attribution rule,'' is designed to prevent an evasion of the quantitative limits and collateral requirements of section 23A through the use of a third party that serves as a conduit for the flow of funds from the bank to its affiliates.[5]

Both the Board and Board staff have taken the position that, by means of the attribution rule, section 23A applies to loans made by a bank to a third party, where the proceeds of the loans are used to purchase various types of assets from the bank's affiliate.[6] In transactions in which a bank provides funds to a borrower to finance the purchase of assets from an affiliate of the bank, the Board and its staff have been concerned that the affiliate's need for cash or need

[1] 12 U.S.C. 371c. Although section 23A originally applied only to member banks, Congress has since applied the section to insured nonmember banks and savings associations in the same manner as it applies to member banks. *See* 12 U.S.C. 1828(j); 12 U.S.C. 1468.

[2] ''Capital and surplus'' has been defined by the Board as tier 1 and tier 2 capital plus the balance of an institution's allowance for loan and lease losses not included in tier 2 capital. 12 CFR 250.242.

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

[4] 12 U.S.C. 371c(a)(2). Section 23A defines an affiliate to include ''any company that controls the member bank and any other company that is controlled by the company that controls the member bank.'' 12 U.S.C. 371c(b)(1).

[5] *See A Discussion of Amendments to Section 23A of the Federal Reserve Act Proposed by the Board of Governors of the Federal Reserve System* 36 n.1 (September 1981) (attached as an appendix to correspondence from Chairman Paul Volcker to the Chairman and Ranking Members of the House and Senate Committees on Banking, Housing and Urban Affairs, October 2, 1981).

[6] *See, e.g.*, Letter from J. Virgil Mattingly, General Counsel of the Board, to Ms. Charla Jackson (August 26, 1996) (crop-production loan to farmer who leases farm land from a bank's affiliate is covered by section 23A); F.R.R.S. ¶ 3–1146.5 (bank loan to finance a prospective purchaser's acquisition of an affiliate covered by section 23A); F.R.R.S. ¶ 3–1167.3 (bank loan to finance the purchase of shares issued by an affiliate deemed a covered transaction subject to section 23A).

to sell assets may improperly influence the bank's decision to extend credit.

Section 23A also gives the Board broad authority to grant exemptions from the statute's restrictions. Specifically, the statute permits the Board to exempt transactions or relationships, by regulation or by order, if such exemptions are ''in the public interest and consistent with the purposes of this section.'' [7]

Section 20 Operating Standards and Application of Section 23A

In August 1997, the Board revised the prudential limitations governing the activities of section 20 subsidiaries of bank holding companies and adopted Operating Standards to replace the existing firewalls.[8] One of the firewalls had prohibited a bank holding company and its subsidiaries (other than the underwriting subsidiary) from knowingly extending credit to customers to purchase (a) a bank-ineligible security underwritten by a section 20 subsidiary during the period of the underwriting or for 30 days thereafter, or (b) a bank-ineligible security in which the section 20 subsidiary makes a market.

In place of this firewall, the Board adopted Operating Standard # 6, which prohibits a bank from knowingly extending credit to a customer to purchase bank-ineligible securities that a section 20 subsidiary is underwriting or has underwritten within the past 30 days. The Operating Standard, however, allows an extension of credit to be made by a bank to a customer to purchase securities from a section 20 affiliate during the underwriting period, pursuant to a pre-existing line of credit not entered into in contemplation of the purchase of affiliate-underwritten securities. Operating Standard #6 does not otherwise prohibit a bank from lending to a customer to purchase securities from a section 20 affiliate.

At the same time that it adopted the Operating Standards, the Board affirmed that section 23A would apply to the types of credit transactions that Operating Standard #6 does not prohibit to the extent that the proceeds of the transactions would be used for the benefit of, or transferred to, an affiliate. Several commenters on the Board's proposal to adopt the Operating Standards raised concerns about the compliance and economic burdens associated with applying section 23A to the extensions of credit now permitted under Operating Standard #6.[9] The commenters argued that these burdens would cause banks to avoid making the types of loans permitted by the new Operating Standard, thereby minimizing the practical effect of eliminating the firewall. In response, the Board stated that it would consider whether an exemption from section 23A for those transactions to which the Operating Standard does not apply would be appropriate.

Proposal

The Board is proposing to grant two exemptions from the quantitative limitations and collateral restrictions of section 23A for certain loans and extensions of credit made by an insured depository institution, the proceeds of which are used to buy securities from a registered broker-dealer affiliate of the depository institution. The first proposed exemption from section 23A would apply when an insured depository institution lends to its customers for the purpose of purchasing third-party securities through a registered broker-dealer affiliate that is acting solely as broker (but not as principal) in the securities transaction with the customer or as riskless principal in the transaction with the customer.[10] In such circumstances, the customer would be purchasing securities through the depository institution's affiliated broker-dealer, which would be acting only on an agency or agency-equivalent basis, and the seller of the securities would be required to be a nonaffiliated third-party. The exemption would be applicable even if the broker-dealer affiliate of the insured depository institution retained part of the loan proceeds as a brokerage commission or, in the case of a riskless principal transaction, a mark-up for effecting the securities transaction.

The second proposed exemption would apply to extensions of credit that are made pursuant to a pre-existing line of credit, the proceeds of which are used to purchase securities from or through an affiliate that is a registered-broker dealer. Under the proposed exemption, the extensions of credit must be made by an insured depository institution pursuant to a pre-existing line of credit that (1) was not entered into in contemplation of the purchase of securities from or through an affiliate, and (2) is either unrestricted or the extension of credit is clearly consistent with any restrictions imposed. (For example, if the customer had a pre-existing line of credit limited to purchases of rated securities from an unaffiliated party, then the exemption would not apply to an extension of credit used to purchase unrated securities from or through an affiliate.) In determining whether the line of credit is truly pre-existing, examiners will consider the timing of the line of credit, the conditions imposed on the line of credit, and whether the line of credit has been used for purposes other than the purchase of securities from an affiliate.

The Board believes that the two proposed exemptions from the restrictions of section 23A are consistent with the purposes of the Federal Reserve Act. The exemptions would pose minimal risk to insured depository institutions. Under the first exemption, there is negligible risk that loans made would be used as a source of funding from an insured depository institution to its affiliates. The exemption may be used only when the depository institution's broker-dealer affiliate acts as a broker or riskless principal in a securities transaction. Accordingly, the securities being sold through the registered broker-dealer would not be carried in the inventory of the broker-dealer or an affiliate, and the loan proceeds, which would be initially transferred to the affiliate to purchase the securities, would be transferred in turn to the seller of the securities, which also would not be an affiliate of the insured depository institution.

The second exemption also presents little opportunity for a depository institution to benefit its affiliates. In circumstances in which there is a pre-existing line of credit that has been established for a purpose other than buying securities from or through an affiliate, there is little risk that the

[7] 12 U.S.C. 371c(e)(2).

[8] *See* 62 FR 45295, 45307 (1997) (codified at 12 CFR 225.200). Section 20 subsidiaries are companies that underwrite and deal in, to a limited extent, bank-ineligible securities. A bank-ineligible security is a security in which a member bank may not underwrite or deal.

[9] For example, commenters noted that a bank making a loan for the purchase of securities from its section 20 affiliate would need to monitor (1) whether the stocks being purchased by its customers were issues in which its section 20 affiliate was making a market, (2) the appropriate amount of collateral, (3) the length of time the collateral would need to be posted, and (4) whether there was room for the loan under the bank's section 23A quantitative limit on covered transactions.

[10] ''Riskless principal'' is the term used in the securities business to refer to a transaction in which a broker-dealer, after receiving an order to buy (or sell) a security for a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer. A broker-dealer acting as a riskless principal is not obligated to buy (or sell) a security for its customer until after the broker-dealer executes the offsetting purchase (or sale) for its own account. *See, e.g.*, 12 CFR 225.28(b)(7)(ii); *The Bank of New York Company, Inc.*, 82 Fed. Res. Bull. 748 (1996). Accordingly, riskless principal transaction are an alternative means for executing buy or sell orders on behalf of customers in a manner equivalent to an agency transaction.

depository institution either will be using a credit transaction to direct money to its affiliates in violation of section 23A or will ease its credit standards to benefit its affiliate.

The Board also believes that the proposed exemptions from section 23A are consistent with the public interest. The two exemptions would provide greater convenience to customers to gain more flexible use of the services of insured depository institutions and their registered broker-dealer affiliates, while still ensuring that the safety and soundness concerns of section 23A are met. In addition, the exemption that applies to pre-existing lines of credit would alleviate the compliance burdens associated with applying section 23A to extensions of credit that were not made in contemplation of a purchase of securities from a depository institution's section 20 affiliate.

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.*). Many small bank holding companies do not have registered broker-dealer affiliates. Many small banking organizations, therefore, would not be affected by the proposed rule.

In addition, the proposed rule would create an exemption from section 23A of the Federal Reserve Act for bank holding companies and insured depository institutions that have registered broker-dealer affiliates. Accordingly, the proposal may be expected to alleviate (rather than increase) compliance for affected small bank holding companies and their affiliates.

Paperwork Reduction Act

The Board has determined that the proposed rules do 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 250.244 is added to read as follows:

§ 250.244 Exemption from section 23A of the Federal Reserve Act for certain loans and extensions of credit made by an insured depository institution to a third party to purchase securities from an affiliate.

(a) Section 23A of the Federal Reserve Act (12 U.S.C. 371c) shall not apply to a loan or extension of credit by an insured depository institution to any person other than an affiliate if—

(1) The terms of the loan or extension of credit are consistent with safe and sound banking practices; and

(2) The proceeds of the loan or extension of credit are used to purchase securities through an affiliate that is a broker-dealer registered with the Securities and Exchange Commission, where

(i) The affiliate is acting solely as broker (but not as principal) in the securities transaction or as riskless principal in the securities transaction; and

(ii) The securities are not issued or sold by companies that are affiliates of the insured depository institution.

(b) This grant of exemption is applicable to a loan or extension of credit even if a portion of the proceeds are used by a borrower to pay brokerage commissions or, in the case of riskless principal transactions, mark-ups to the affiliate.

3. Section 250.245 is added to read as follows:

§ 250.245 Exemption from section 23A of the Federal Reserve Act for certain extensions of credit by an insured depository institution to a third party made pursuant to a pre-existing line of credit.

Section 23A of the Federal Reserve Act (12 U.S.C. 371c) shall not apply to an extension of credit by an insured depository institution to any person other than an affiliate if—

(a) The proceeds of the extension of credit are used to purchase securities from or through an affiliate that is a registered broker-dealer; and

(b) The extension of credit is made pursuant to, and consistent with any conditions imposed in, a pre-existing line of credit that was not established in contemplation of the purchase of securities from or through an affiliate.

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

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc. 98–15934 Filed 6–15–98; 8:45 am]

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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 of proposed rulemaking.

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).