FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

DALLAS, TEXAS
75265-5906

July 6, 1998

Notice 98-58

TO: The Chief Executive Officer of each financial institution and others concerned in the Eleventh Federal Reserve District

SUBJECT

Request for Public Comment on the Applicability of Section 23A to Loans and Extensions of Credit Made by a Member Bank to a Third Party and the Applicability of Section 23A to the Purchase of Securities From Certain Affiliates

DETAILS

The Board of Governors of the Federal Reserve System has requested public comment on a proposal to grant two exemptions from section 23A for certain loans and extensions of credit made by an insured depository institution to customers who use the proceeds to purchase certain securities from or through the depository institution's registered broker-dealer affiliate. The exemptions would 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 consistent with safe and sound banking practices.

The Board has also requested public comment on expanding the types of asset purchases 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 consistent with safe and sound banking practices.

The Board must receive comments by July 21, 1998. Please address comments to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. All comments should refer to Docket No. R-1016 (for the first proposal) and Docket No. R-1015 (for the second proposal).

For additional copies, bankers and others are encouraged to use one of the following toll-free numbers in contacting the Federal Reserve Bank of Dallas: Dallas Office (800) 333-4460; El Paso Branch *Intrastate* (800) 592-1631, *Interstate* (800) 351-1012; Houston Branch *Intrastate* (800) 392-4162, *Interstate* (800) 221-0363; San Antonio Branch *Intrastate* (800) 292-5810.

ATTACHMENTS

Copies of the Board's notices as they appear on pages 32766–70, Vol. 63, No. 115 of the *Federal Register* dated June 16, 1998, are attached.

MORE INFORMATION

For more information, please contact Jane Anne Schmoker at (214) 922-5101. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

Federal Register

Tuesday
June 16, 1998

Federal Reserve System
12 CFR Part 250

Applicability of Section 23A of the Federal Reserve Act to Loans and Extensions of Credit Made by a Member Bank to a Third Party (Docket No. R-1016)

Applicability of Section 23A of the Federal Reserve Act to the Purchase of Securities from Certain Affiliates (Docket No. R-1015)

Proposed Rules

Federal Register
Vol. 63, No. 115
Tuesday, June 16, 1998

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).

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 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 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 an 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 an 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 *exact* 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 *actual* 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

[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).

[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.

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 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.

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. 317 c(d)(6)) if:

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

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

(c) 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;

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

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

(1) A widely disseminated news source;

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

(3) 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;

(f) 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.

Jennifer J. Johnson,

Secretary of the Board.

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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.