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: Final rule.

SUMMARY: Section 23A of the Federal Reserve Act restricts the ability of a member bank to fund its affiliates through investments, loans, asset acquisitions, 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 adopting an interpretation and exemptions from section 23A for certain loans made by an insured depository institution ("depository institution") to customers who use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution acting exclusively as a broker or riskless principal in the transaction.

First, the Board is adopting an interpretation confirming that section 23A does not apply to extensions of credit by an insured depository institution to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as the affiliate is acting exclusively as a broker in the transaction, and the affiliate retains no portion of the loan proceeds. The Board also is exempting from section 23A that portion of a loan to a third party that an affiliate retains as a market-rate brokerage commission or agency fee.

In addition, the Board is adopting an exemption from section 23A for extensions of credit by an insured depository institution to customers that use the

loan proceeds to purchase a security issued by third parties through a broker-dealer affiliate of the institution that is acting as riskless principal in the securities transaction. Finally, the Board is adopting an exemption for extensions of credit by an insured depository institution to customers that use the credit to purchase securities from a broker-dealer affiliate of the institution when that extension of credit was made pursuant to a preexisting line of credit not entered into in contemplation of the purchase of securities from an affiliate of the depository institution.

EFFECTIVE DATE: The final rule is effective June 11, 2001.

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SUPPLEMENTARY INFORMATION:

Background

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 limits "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

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[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 insured savings associations in the same manner as it applies to member banks. See 12 U.S.C. 1828(j); 12 U.S.C. 1468.

surplus.[2/] Covered transactions include extensions of credit, investments, and certain other transactions that expose the member bank to the credit risk of an affiliate. 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 by a member bank with any person to be a transaction with an affiliate to the extent that the proceeds of the transaction are "used for the benefit of, or transferred to," that affiliate.[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/] The Board and its staff have taken the position that 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/]

Section 23A also gives the Board authority to grant exemptions from the statute's restrictions. Specifically, the statute permits the Board to exempt

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[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 C.F.R. 250.242.

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

[4/] 12 U.S.C. 371c(a)(2). Section 23A defines an affiliate to include, among other things, “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).

[6/] See, e.g., Letter from 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).

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/]

In August 1997, the Board adopted Operating Standards governing the activities of section 20 subsidiaries.[8/] Operating Standard # 6 allows a bank to extend credit to a customer to purchase securities from a section 20 affiliate during the underwriting period for the securities, pursuant to a preexisting line of credit not entered into in contemplation of the purchase of affiliate-underwritten securities. In adopting Operating Standard # 6, the Board stated that it would consider whether an exemption from section 23A for transactions permitted under the Operating Standard would be appropriate.

Proposal

On June 10, 1998, the Board proposed two exemptions from the quantitative limitations and collateral restrictions of section 23A for loans 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.[9/] The first exemption proposed by the Board applied to loans made by a depository institution to its customers for the purpose of purchasing third-party securities through a registered broker-dealer affiliate of the institution that is acting as broker or riskless principal[10/] in the securities transaction ("Broker/Riskless Principal Exemption"). As proposed, the exemption was applicable even if the broker-dealer affiliate of the depository institution retained part of the loan proceeds as a

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

[8/] 12 CFR 225.200.

[9/] 63 FR 32,766 (1998).

[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. See, e.g., 12 CFR 225.28(b)(7)(ii); The Bank of New York Company, Inc., 82 Federal Reserve Bulletin 748 (1996).

brokerage commission or, in the case of a riskless principal transaction, a mark-up for effecting the securities transaction.

The second proposed exemption applied to extensions of credit by a depository institution to a customer made pursuant to a preexisting line of credit, the proceeds of which were used to purchase securities underwritten or sold as principal by a registered broker-dealer affiliate of the institution ("Preexisting Line of Credit Exemption"). The proposal also required that the line of credit not have been entered into in contemplation of the purchase of securities from an affiliate and that either the line of credit be unrestricted or the extension of credit be clearly consistent with any restrictions imposed under the line.[11/]

Summary of Comments and Final Rule

The Board received approximately 14 comments on the proposed exemptions. The commenters included ten banks or bank holding companies, and four trade associations that represent the banking industry. The Board also received seven comments from the Federal Reserve Banks. The commenters overwhelmingly supported the goals of the Board's proposals, which they believed would provide benefits to both consumers and depository institutions without raising the types of concerns that section 23A was intended to address, but many commenters argued that the Board should achieve its goals through alternative means.

Broker/Riskless Principal Exemption

Commenters generally agreed with the position taken in the Board's proposal that loans by an insured depository institution to a third party to purchase securities through a broker-dealer affiliate of the depository institution that is acting exclusively in a brokerage or riskless principal capacity should not be within the ambit of section 23A. Many commenters, however, argued that the Board should not adopt an exemption to section 23A that applies only to broker-dealers and

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[11/] For example, if the customer had a preexisting line of credit limited to purchases of rated securities, then the bank would continue to be prohibited from lending to purchase unrated securities underwritten by an affiliate.

securities. These commenters contended that a better course of action would be for the Board to issue an interpretation broader in scope than the proposed exemption. The interpretation suggested by the commenters would confirm that in no case is a loan from a depository institution to a third party subject to section 23A when the third party purchases assets through a bank affiliate acting exclusively as broker or agent for the third party (regardless of the affiliate's retention of brokerage or agency fees).

The commenters argued that adoption of a specific exemption for securities brokerage transactions involving broker-dealer affiliates implies that, absent a grant of exemption, the Board considers brokerage or agency transactions involving other types of affiliates and assets to be covered by section 23A. The commenters contended that, if an affiliate is acting only as broker or agent in a transaction, the affiliate does not receive a "benefit" from the transaction, and the transaction cannot be viewed as fitting within section 23A. One commenter, however, found support for the Board's decision to issue an exemption for riskless principal transactions, noting that there could be disagreement as to whether riskless principal transactions should be viewed as within the scope of section 23A.

The exemption from section 23A proposed by the Board would have applied when an insured depository institution lends to its customers for the purpose of purchasing third-party securities through a registered broker-dealer affiliate acting solely as broker or riskless principal in a securities transaction with the customer. The Board believed that the exemption would be consistent with the purposes of section 23A because of the negligible risk that loans made pursuant to the exemption would be used as a source of funding from an insured depository institution to its broker-dealer affiliate. As proposed, the exemption only would have been available when the securities being sold were not in the inventory of the broker-dealer. Accordingly, the loan proceeds, although initially transferred to the affiliate to purchase the securities, would be transferred in turn (minus a brokerage fee or riskless principal mark-up) to the seller of the securities, which would not be an affiliate of the depository institution.

The Board concurs with the commenters that extensions of credit by a depository institution to customers to purchase third-party securities and assets through an affiliate of the depository institution that is acting exclusively in a brokerage or agency capacity fall outside of the reach of section 23A to the extent

that the affiliate retains no part of the loan proceeds. Accordingly, rather than issuing the proposed exemption from section 23A to cover certain types of brokerage transactions, the Board is issuing a broader interpretation, as requested by the commenters. The interpretation confirms that section 23A does not apply when a depository institution's borrower uses loan proceeds to enter into agency transactions with an affiliate of the depository institution so long as the securities or other assets being purchased by the borrower are not issued by, or sold from the inventory of, any affiliate of the depository institution and to the extent that no affiliate retains any portion of the loan proceeds.

A somewhat different analysis under section 23A is required, however, when an affiliate retains a portion of a depository institution's loan to a third party as a brokerage commission or agency fee. The portion of the loan used by the borrower to pay the affiliate's commission or fee would be subject to section 23A because that transaction fee represents the proceeds of a loan retained and used for the benefit of an affiliate under the attribution rule.

In accordance with its original proposal, the Board has determined to exempt from section 23A that portion of a loan from a depository institution to an unaffiliated customer that is retained by an affiliate of the institution as a market-rate brokerage fee or agency commission; that is, a fee or commission no greater than that prevailing at the same time for comparable agency transactions entered into by the affiliate with persons who are neither affiliates nor borrowers from an affiliated depository institution, as required by section 23B of the Federal Reserve Act (12 U.S.C. 371c-1). The Board expects that such transaction fees will be nominal amounts and will represent a small percentage of the overall agency transaction and, accordingly, believes that these fees present little opportunity for a depository institution to benefit its broker-dealer affiliate.

Finally, a loan from a depository institution to a customer who engages in a riskless principal trade through a broker-dealer affiliate of the depository institution would be covered transactions under section 23A. Riskless principal trades--although the functional equivalent of securities brokerage transactions--involve the purchase of a security by the depository institution's broker-dealer affiliate. Accordingly, the broker-dealer retains the loan proceeds at

least for some moment in time.[12/] As noted in the proposing release, there is negligible risk that loans made by a depository institution to borrowers to engage in riskless principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, the Board believes that it is appropriate to adopt the proposed exemption from section 23A to cover riskless principal securities transactions engaged in by depository institution borrowers through broker-dealer affiliates of the depository institution.[13/] This grant of exemption is applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate mark-up for executing the riskless principal securities trade.

Preexisting Line of Credit Exemption

Approximately a dozen commenters offered specific comments on the proposed preexisting line of credit exemption. A majority of these commenters supported the Board's proposed exemption and concurred with the Board's view that exempting an extension of credit pursuant to a preexisting credit line from section 23A would not raise safety and soundness concerns.

Several commenters expressed concern about the requirement that the credit line be "preexisting." The commenters urged the Board to adopt other safeguards in lieu of the "preexisting" requirement. For example, one commenter

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[12/] For this reason, riskless principal trades involve risks that are different from securities brokerage transactions. See, e.g., Exchange Act Rel. No. 33,743, reprinted in [1993-1994] Fed. Sec. L. Rep. (CCH) 85,326 (March 9, 1984).

[13/] As in the proposed rule, the final rule would make clear that the exemption for riskless principal transactions would not apply if the broker-dealer affiliate sold securities to the third-party borrower out of its own inventory or out of the inventory of another affiliate of the depository institution. This condition is not intended to make the exemption unavailable when the broker-dealer affiliate sells as principal to the third-party borrower a security that it purchased immediately prior to the sale in order to effect the riskless principal transaction requested by the borrower, so long as the broker-dealer affiliate did not purchase the security from another affiliate of the depository institution.

argued that the Board should only require that banks conduct independent credit analyses before granting credit. Other commenters offered alternative standards.

The Board is adopting the exemption for preexisting lines of credit substantially as proposed. As noted above, the exemption applies to extensions of credit by a depository institution made pursuant to a preexisting line of credit, the proceeds of which are used to buy securities underwritten or held as principal by a registered broker-dealer affiliate of the depository institution. Under the exemption, extensions of credit must be made by a depository institution pursuant to a preexisting line of credit that was not entered into in contemplation of the purchase of securities by the borrower from an affiliate of the institution, and the extension of credit must be consistent with any restrictions imposed by the line. The Board believes that the "preexisting" and other requirements for such lines of credit are important safeguards to ensure that the credit was not extended by the depository institution for the purpose of inducing a borrower to purchase securities from or issued by an affiliate.

Several of the commenters that opposed the requirement that the line of credit be "preexisting" argued that, if, despite their objections, the Board decided to use a "preexisting" requirement as part of this exemption, the Board should adopt a safe harbor. These commenters urged the adoption of a five-day safe harbor, in which the credit line would meet the "preexisting" requirement if the line were established at least five days prior to the customer's securities transaction with the bank's broker-dealer affiliate.

The Board does not regard as necessary or appropriate a five-day safe harbor for determining whether a line of credit is truly "preexisting." The Board intends that this exemption be used in good faith by depository institutions. As noted in the proposing release, in determining whether the exemption is being used in good faith, examiners will consider the timing of the line of credit. In addition, examiners will consider the conditions imposed on the credit line and whether the line of credit has been used for purposes other than the purchase of securities from an affiliate. The Board will issue additional examiner guidance regarding the "preexisting" requirement should such guidance prove necessary.

Some commenters objected that the proposed Preexisting Line of Credit Exemption was not necessary to cover a borrower's purchases of bank-

eligible securities from an affiliate, which the commenters apparently believed fall outside the purview of section 23A. The attribution rule of section 23A does not, however, distinguish between bank-eligible and bank-ineligible securities: A loan from a depository institution, the proceeds of which are used by the borrower to buy securities underwritten or held as principal by an affiliate of the depository institution, would be covered by section 23A regardless of whether the securities purchased are bank-eligible or bank-ineligible. To avoid having the loan covered by the quantitative limits of section 23A, the loan would need to qualify for an exemption under the statute--either the Preexisting Line of Credit Exemption being adopted by the Board today or some other exemption (e.g., the exemption in section 23A(d)(4) for obligations fully secured by deposit accounts or U.S. government obligations).

At the request of one commenter, the Board also is clarifying that the Preexisting Line of Credit Exemption may not be used in circumstances in which the line has been merely pre-approved. Accordingly, for an extension of credit to qualify for this exemption, the credit line must be, in fact, "preexisting" and not merely "preapproved."

Regulatory Flexibility Act

The Board certifies that adoption of these rules 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 the Board's action creates exemptions and clarifies certain interpretations under section 23A of the Federal Reserve Act. Accordingly, the Board's action does not impose more burdensome requirements on depository institutions, their holding companies, or their affiliates than are currently applicable.

Administrative Procedure Act

Subject to certain exceptions, 12 U.S.C. 4801(b)(1) provides that new regulations and amendments to regulations prescribed by a Federal banking agency that impose additional reporting, disclosure, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. These rules are not subject to this delayed effective date requirement because the

rules impose no new requirements on existing operations of depository institutions. The rules only exempt transactions that were previously subject to the restrictions of section 23A.

Paperwork Reduction Act

The Board has determined that the 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

12 CFR Part 250

Banks, Banking; Federal Reserve System.

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

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

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

2. Section 250.243 is added to read as follows:

§ 250.243 Applicability of section 23A of the Federal Reserve Act to loans and extensions of credit by an insured depository institution to a nonaffiliate to enable the nonaffiliate to purchase an asset through an affiliate of the institution that is acting exclusively in an agency or brokerage capacity in the transaction.

(a) The attribution rule of section 23A provides that "a transaction by a member bank with any person shall be deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or

transferred to, that affiliate."[14/] The Board has considered the question of whether a loan or extension of credit by an insured depository institution ("depository institution") to an unaffiliated borrower who uses the proceeds of the transaction to purchase an asset through an affiliate of the institution that is acting exclusively as an agent or broker in the transaction should be subject to the attribution rule because of the limited benefit that the affiliate receives when it acts only as an agent or broker in the transaction. The Board believes that a loan by a depository institution to an unaffiliated borrower who uses the proceeds of the loan to purchase an asset through an affiliate of the institution that is acting exclusively in an agency or brokerage capacity is not covered by section 23A if the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

(b) A somewhat different analysis is required when the affiliate acting as agent or broker in the transaction retains a portion of the loan proceeds as a fee or commission. In such a case, the portion of the loan not retained by the affiliate as a fee or commission still would be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board hereby grants an exemption from section 23A for such fees and commissions.

(c) The Board notes that this interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold out of the inventory of, another affiliate of the depository institution. In such a case, proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the asset on a principal basis to the third party.

(d) The Board also notes that the transactions described above (including the loan to the third-party borrower and any fee or commission paid to the affiliate of the depository institution out of the loan proceeds) would be subject to the market terms requirement of section 23B, which applies to "any transaction in which an

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[14/] 12 U.S.C. 371c(a)(2).

affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person."[15/]

3. 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 by an insured depository institution to a nonaffiliate to enable the nonaffiliate to purchase securities through a registered broker-dealer affiliate of the institution that is acting exclusively as riskless principal in the securities transaction.

(a) A loan or extension of credit by an insured depository institution ("depository institution") to any person other than an affiliate of such depository institution is exempted from section 23A of the Federal Reserve Act (12 U.S.C. 371c) if–

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

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

(i) The affiliate is acting exclusively as a riskless principal in the securities transaction; and

(ii) The security is not issued or underwritten by, or sold out of the inventory of, any affiliate of the depository institution.

(b) This grant of exemption is applicable to a loan or extension of credit covered by paragraph (a) of this section even if a portion of the proceeds of the loan or extension of credit is used by the borrower to pay a riskless principal mark-up to the affiliate, provided that the mark-up is substantially the same as, or lower than, those prevailing at the same time for comparable transactions with or

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[15/] 12 U.S.C. 371c-1(a)(2)(D).

involving other nonaffiliated companies, in accordance with section 23B of the Federal Reserve Act (12 U.S.C. 371c-1).

4. Section 250.245 is added to read as follows:

§ 250.245 Exemption from section 23A of the Federal Reserve Act for certain loans and extensions of credit by an insured depository institution to a nonaffiliate made pursuant to a preexisting 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 ("depository institution") to any person other than an affiliate of such depository institution if–

(a) The proceeds of the loan or extension of credit are used to purchase a security from or through an affiliate of the depository institution that is a broker-dealer registered with the Securities and Exchange Commission; and

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

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

(Signed) Jennifer J. Johnson

Jennifer J. Johnson,
Secretary of the Board.