

**RESTRICTIONS ON TRANSACTIONS BETWEEN
DEPOSITORY INSTITUTIONS AND THEIR AFFILIATES**

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INTRODUCTION

On December 12, 2002, the Board of Governors of the Federal Reserve System (the "Board") published a final rule, "Transactions Between Member Banks and Their Affiliates (Regulation W),"¹ which will be codified at 12 C.F.R. Part 223. Regulation W was promulgated pursuant to sections 23A and 23B of the Federal Reserve Act,² which are intended to prevent banks from being harmed by transactions with their affiliates. Although section 23A was enacted in 1933 and section 23B in 1987, this is the first time that the Board has issued a regulation pursuant to section 23A or section 23B. The Board presented Regulation W as an attempt to simplify application of sections 23A and 23B by codifying prior Board and Board staff interpretations and addressing certain matters on which the Board had not previously provided guidance. It remains to be seen whether this long and complex regulation³ will simplify the application of sections 23A and 23B. What is already clear is that, as the Board recognized, Regulation W "tightens a number of traditional Board and staff interpretations."⁴

Regulation W generally takes effect on April 1, 2003, but certain types of transactions will not have to comply until July 1, 2003 and others are permanently grandfathered. The extent to which the Board has tightened prior interpretations makes the grandfather provisions especially important.

¹ *Transactions Between Member Banks and Their Affiliates*, 67 Fed. Reg. 76560 (2002).

² Sections 23A and 23B are codified at 12 U.S.C. §§ 371c and 371c-1.

³ Sections 23A and 23B together they would take up no more than three pages of the Federal Register. The Federal Register notice containing the final Regulation W is fifty seven pages long.

⁴ 67 Fed. Reg. at 76601.

On December 20, 2002, the Office of Thrift Supervision, which regulates federal savings banks and federal and state savings associations (collectively, "thrift institutions"), published an interim final rule (the "OTS Affiliate Rule") that provides for the application of sections 23A and 23B, as well as certain affiliate restrictions contained in the Home Owner's Loan Act, to thrift institutions.

This memorandum provides an analysis of Regulation W and the OTS Affiliate Rule. Any questions concerning this memorandum may be directed to Gary Rice (212-455-7345, grice@stblaw.com), Lee Meyerson (212-455-3675, lmeyerson@stblaw.com), or John L. Walker (212-455-7365, jwalker@stblaw.com). If you did not receive this memorandum by e-mail and would like to receive this or future memoranda by e-mail, please provide your e-mail address to Sue Bussy (sbussy@stblaw.com).

**THE INCREASING IMPORTANCE OF
SECTIONS 23A AND 23B**

Section 23A was originally enacted in 1933, in tandem with the creation of the Federal Deposit Insurance Corporation (the "FDIC"), to protect depository institutions (and, ultimately, depositors) in their dealings with nonbank companies that control them or are under common control with them. Sections 23A and 23B by their terms only apply to banks that are members of the Federal Reserve System, but subsequently enacted statutes make them applicable to all depository institutions (including thrift institutions) the deposits of which are insured by the FDIC. For ease of discussion, such depository institutions are referred to in this memorandum as "banks".

The Board also is authorized to apply sections 23A and 23B to transactions between certain U.S. nonbank affiliates of foreign banks, on the one hand, and the U.S. branches and agencies of such foreign banks, on the other. In reliance upon this authority the Board included in Regulation W provisions that restrict transactions between U.S. branches and agencies of foreign banks and certain types of U.S. affiliates. As discussed below, Regulation W does not restrict transactions between such U.S. branches and agencies and most affiliates, including other offices of the foreign bank.

A cursory outline of section 23A may be useful for understanding the more detailed discussion of Regulation W that follows. Section 23A applies to "covered transactions" between banks and their "affiliates". The term "affiliate", which the Board significantly expanded in Regulation W, is critical in determining the scope of the statute. The term is generally defined to include any company, such as a bank holding company, that controls or is under common control with a bank, but the term excludes most bank subsidiaries, which are treated as part of the bank. The term "covered transaction" is defined to include a loan to an affiliate, a purchase of securities issued by an affiliate, a purchase of assets from an affiliate, the acceptance of securities issued by an affiliate as collateral for a loan to a third party, and the issuance of a

guarantee or letter of credit on behalf of an affiliate. Section 23A requires most covered transactions to be fully collateralized. The statute also limits the aggregate amount of covered transactions between a bank and any one affiliate to ten percent of the bank's capital and limits the aggregate amount of covered transactions between a bank and all of its affiliates to twenty percent of the bank's capital. Although banks are able to engage in many transactions with their affiliates notwithstanding section 23A, the statute prevents them from providing substantial funding to their nonbank affiliates, which would be desirable because banks are able to raise funds more cheaply than nonbank affiliates.

Section 23B, which was enacted in 1987, overlays a qualitative restriction on the largely quantitative restrictions of section 23A, by requiring that all covered transactions (as well as certain other transactions⁵) be on terms and conditions that are arm's length or better from the perspective of the bank. Most of the key definitions in section 23A, including the definitions of "bank", "subsidiary" and "covered transaction", are incorporated by reference into section 23B. The term "affiliate" is also incorporated by reference, except that (as discussed below) for purposes of section 23B the term "affiliate" excludes banks.

The importance of sections 23A and 23B has increased over time. Prior to 1965, none of the major banks were controlled by holding companies. The Board issued a small flurry of interpretations after section 23A was enacted in 1933, but then found it unnecessary to issue more than a handful of interpretations over the next thirty years. The statute became more important in the late 1960s when all of the major banks formed holding companies in an attempt order to expand into nonbanking activities that the regulators and the courts had prevented them from conducting in the bank itself. However, bank transactions with the most important nonbank affiliates, the "Section 20 affiliates" that the Board authorized to engage in securities underwriting and dealing activities, were largely prohibited by a long list of "firewalls" interposed by the Board between banks and Section 20 affiliates. It was not until the firewalls were removed in 1997 that sections 23A and 23B assumed the primary role of protecting banks in their transactions with Section 20 affiliates.

The importance of sections 23A and 23B was further increased by the enactment of the Gramm-Leach-Bliley Act (the "GLBA") in 1999 because the GLBA: allowed qualifying bank holding companies to affiliate with companies engaged in a broader range of activities; enacted a "functional" regulation scheme, which limited the authority of the Board to protect banks by imposing restrictions on affiliates that are under the jurisdiction of other regulators, such as the Securities and Exchange Commission and state insurance regulators; authorized the Board to subject U.S. branches and agencies of foreign banks to sections 23A and 23B; and required the

⁵ Section 23B applies to covered transactions, the sale of securities or other assets to affiliates, furnishing services to an affiliate, transactions in which the affiliate acts as agent or broker, and transactions with a third party if an affiliate has a financial interest in the third party or is a participant in the transaction. 12 U.S.C. § 371c-1(a)(2).

Board to address intraday credit and derivative transactions under sections 23A and 23B, something that Board staff had discussed for over two decades but never acted upon.

The Board has unusually broad authority to administer sections 23A and 23B. The Board is responsible for implementing these statutes for all insured depository institutions, not just those for which it is the primary federal regulator. It has the authority to expand the reach of the statutes by issuing definitions consistent with the statute; in particular, as discussed below, it has very broad authority to determine what is an “affiliate”. The Board also has the authority to curtail the reach of the statute by exempting transactions and relationships if it finds such exemptions to be in the public interest and consistent with the purposes of the statutes.

THE DEFINITION OF “AFFILIATE”

Because sections 23A and 23B restrict transactions between banks and their “affiliates”, the definition of “affiliate” is critical to the application of the statute. Although the definition of “affiliate” in section 23A generally includes any company that controls or is under common control with the bank, the statute provides the Board with the authority to include other companies within the definition of affiliate, even in the absence of control. Regulation W expands the reach of sections 23A and 23B by defining “control” broadly and by adding to the definition of affiliate certain types of companies that do not control banks and are not under common control with them.

THE DEFINITION OF CONTROL

For many years the Board has interpreted the concept of “control” in connection with regulating the acquisition of control of banks and nonbank companies under the Bank Holding Company Act of 1956, as amended (the “BHC Act”), and under Regulation Y, which the Board adopted pursuant to sections 3 and 4 of the BHC Act. The BHC Act conclusively presumes control to exist if a company owns twenty-five percent of the voting shares of another company – even if an unaffiliated party holds the remaining seventy five percent. As a result, for purposes of the BHC Act, “control” has come to mean the ability to significantly influence, rather than the ability to direct.

The definition of control in section 23A is similar to the definition of control in the BHC Act and Regulation Y. In the past, the Board and Board staff interpreted control under the BHC Act and under section 23A in a similar manner. Regulation W, however, defines control more broadly in two respects. First, Regulation W provides that a holder of options, warrants and other instruments that are convertible into securities controls the securities unless it demonstrates otherwise to the Board. This is not an issue that the Board has previously addressed under section 23A. Regulation Y provides that a holder of securities that are *immediately convertible* at the option of the holder into voting securities of a company is deemed

to control the *voting* securities.⁶ The Board declined to include the phrase “immediately convertible” in the Regulation W definition of control, stating that it would be inconsistent with the Board’s interpretation of the provision in Regulation Y and that establishing a safe harbor for instruments that cannot be exercised for “some short period of time” is likely to facilitate evasion of the presumption. The Board did not cite any interpretation in support of the contention that the words “immediately convertible” in Regulation Y have not been given their ordinary meaning. Nor did it explain why the presumption should apply to securities that cannot be converted for a significant period of time, or why the presumption should be extended to instruments that are convertible into nonvoting securities.

Regulation W also provides that a company that owns or controls twenty five percent or more of the equity capital of another company controls the company unless it demonstrates otherwise to the Board. This provision was not included in the proposed Regulation W. The supplemental information to the final regulation states that this is “similar” to a presumption applied under the control provisions of the BHC Act, citing the Board Policy Statement on Nonvoting Equity Investments. The Policy Statement does not contain such a presumption; rather, the “guideline” provided in the Policy Statement is that “agreements that involve rights to less than twenty five percent of the *voting* shares, with a requirement for a dispersed public distribution in the event of sale, have a much greater prospect of achieving consistency with the [BHC Act]”.⁷ Board staff has informally advised banking organizations that the acquisition of twenty five percent or more of the equity of a company will raise a control issue, but the Board has never established a presumption of control based on acquiring twenty five percent or more of the equity of a company. Although the presumptions regarding convertible instruments and nonvoting equity are rebuttable, the Board is notoriously slow in responding to issues arising under section 23A and the opportunity to rebut these presumptions may be of little practical significance.

The term control is part of the section 23A definition of affiliate and, as discussed below, the language of section 23A(b)(1)(E) appears to give the Board broad authority to define the term affiliate. Therefore, the statutory language appears to grant the Board sufficient authority to define control in Regulation W to include companies in which bank affiliates have relatively little influence. However, this approach does not appear to be consistent with the legislative history of section 23A(b)(1)(E), which was to allow the Board to include as affiliates companies with which banks or their affiliates are involved to a significant degree.

UNREGISTERED INVESTMENT COMPANIES

Section 23A(b)(1)(E) provides the Board with the authority to treat a company as an affiliate if the Board determines that its “relationship” with a bank is such that covered transactions

⁶ 12 C.F.R. § 225.31(d)(1)(i).

⁷ 12 C.F.R. § 225.143 (1984) (emphasis added).

between the two may be to the detriment of the bank.⁸ The statute does not define or otherwise provide guidance on what is meant by the words “relationship” or “detriment”. This provision was added in 1982 when section 23A was comprehensively revised, but it was not discussed in any of the committee reports relating to the legislation. The provision originated in the Board’s request that real estate investment trusts (“REITs”) that are advised and sponsored by a bank or an affiliate of the bank be treated as affiliates for purposes of section 23A. At the time, banks had incurred significant losses bailing out REITs with which they were associated. The Board believed that a “non-arm’s length” relationship existed in such cases because the bank was the investment advisor to the REIT, selected the REITs initial trustees (which typically included several bank representatives), and gave the REIT a name similar to that of the bank. In addition to amending section 23A to specifically include REITs and other companies that are sponsored and advised on a contractual basis by a bank or a bank affiliate, the Board stated that it would be prudent to amend section 23A to cover other such “non-arm’s length” relationships. However, the Board stated that “it is difficult, if not impossible, at this juncture to amend the statute to include all the possible organizations that might fall into this category. Accordingly, the Board recommends that no such listing be attempted, but that the Board be authorized to add to the definition of affiliate from time to time such organization that it determines to have a ‘non-arm’s length’ relationship with a bank or a subsidiary or affiliate of the bank”.⁹

The 1982 amendments also added to the definition of affiliate, at the request of the Treasury Department, any investment company with respect to which a member bank or any affiliate thereof is an investment adviser as defined in the Investment Company Act of 1940 (the “ICA”).¹⁰ This definition excludes from the definition of affiliate investment companies that are not required to register under the ICA because, for example, they have fewer than one hundred holders, all the holders are qualified purchasers, or all the holders are outside the United States.

Regulation W expands the definition of affiliate to include any investment fund for which the bank or an affiliate acts as an investment advisor, if the bank or an affiliate owns or controls more than five percent of any class of voting interests of the fund.¹¹ The Board stated that it did not regard the difference between registered and unregistered funds to be significant for affiliate status under Section 23A because it did not affect “the conflicts of interest present in the advisory relationship”.¹² There is no indication that, in relying upon section 23A(b)(1)(E) to

⁸ 12 U.S.C. § 371c(b)(1)(E).

⁹ Federal Reserve Board, *A Discussion of Amendments to Section 23A of the Federal Reserve Act Proposed by the Board of Governors of the Federal Reserve System* (Sept. 1981) at pages 23-25.

¹⁰ The Treasury Department amendment was a vestige of a broader proposal to allow the establishment of bank securities affiliates. See Rose and Talley, *Bank Transactions with Affiliates: The New Section 23A*, -- *Banking Law Journal* 423, 429 n.16 (1983).

¹¹ Any company controlled by such an investment fund would be treated as an affiliate of the bank as well.

¹² 67 Fed. Reg. at 76562.

expand the definition of affiliate, the Board considered the history of that provision, which was enacted to permit the Board to include as affiliates investment funds as to which the bank, due to its close involvement with the fund, may have significant reputational risk. This purpose clearly is affected by whether the fund is public or private. The suggestion that “the conflicts of interest present in the advisory relationship” is a sufficient basis for treating a fund as an affiliate is belied by the new provision, which treats a fund as an affiliate only if, in addition to the advisory relationship, the bank or an affiliate owns more than five percent of a voting interest in the fund. The conclusion that a five percent voting interest should tip the scales for affiliate status is not explained, is at odds with the general rule that a twenty five percent interest causes a company to become an affiliate under Section 23A, and bears no relation to the original purpose for treating certain investment funds as affiliates.

FINANCIAL SUBSIDIARIES

Section 23A, as amended in 1982, excludes subsidiaries of banks from the definition of affiliate, with certain exceptions. At the time of the amendment such subsidiaries consisted of foreign subsidiaries that were subject to a separate regulatory regime and domestic operating subsidiaries that were limited to activities in which the bank itself may engage and that were treated as equivalent to departments or divisions of the bank rather than as separate companies. However, the 1982 amendments included a provision indicating that under section 23A(b)(1)(E) the Board may treat a bank subsidiary as an affiliate if the Board determines that its relationship with a member bank is such that covered transactions between the two may be to the detriment of the member bank.

One of the most important issues that was resolved by the GLBA was whether a bank would be permitted to conduct in a subsidiary of the bank financial activities that the bank is not permitted to engage in directly. The GLBA permits banks to establish “financial subsidiaries” to engage in such activities, excluding insurance underwriting, real estate investment and development and merchant banking, subject to a number of restrictions, including a requirement that financial subsidiaries be treated as affiliates for purposes of section 23A. Section 23A defines “financial subsidiary” as any company that “would be a financial subsidiary of a national bank”. Regulation W defines “financial subsidiary” to mean any company that is engaged in financial activities that a national bank may not engage in directly. The Regulation W definition includes companies, such as a subsidiary of a state nonmember bank that has been authorized by the FDIC to engage in real estate development activities, which “would [not] be a financial subsidiary of a national bank” for the simple reason that a financial subsidiary is not permitted to engage in real estate development activities. The Board’s approach does not appear to be consistent with the definition of financial subsidiary in section 23A. However, as noted above the Board has authority to treat any subsidiary of a bank as an affiliate if it concludes that the relationship may be detrimental to the bank. A court would not be likely to reject the Board’s determination that such a threat may be posed by subsidiaries engaged in insurance underwriting, real estate investment and development or merchant banking even if the FDIC had permitted such activities.

MERCHANT BANKING INVESTMENTS

Prior to the GLBA, bank holding companies generally could not acquire control of, or acquire more than five percent of any class of voting securities of, a second company unless the latter was a bank or engaged in activities that the Board had determined were “so closely related to banking as to be a proper incident thereto”. Section 4(k)(4)(H) was added to the BHC Act by the GLBA and it permits bank holding companies that qualify as financial holding companies to make merchant banking investments in up to one hundred percent of the voting securities of a nonfinancial company, subject to certain restrictions, including divestiture of the investment within ten years and not exercising day-to-day control over the nonfinancial company. The GLBA added Section 4(k)(4)(I) to permit insurance company affiliates of financial holding companies to make similar investments.

In connection with granting this authority, the GLBA amended section 23A to rebuttably presume that a financial holding company controls a company in which, pursuant to section 4(k)(4)(H) or section 4(k)(4)(I), it has acquired 15 percent or more of the equity capital. In amending Regulation Y in 2001 to include merchant banking and other activities permitted for financial holding companies, the Board added three safe harbors in which this presumption is rebutted (without Board review or approval). The Board has included the same safe harbors in Regulation W. The three circumstances in which a financial holding company is not presumed to control a company in which it has acquired, pursuant to section 4(k)(4)(H) and 4(k)(4)(I), fifteen percent or more but less than twenty five percent of the equity, are as follows: no director, officer, or employee of the financial holding company serves as a director of the portfolio company; one officer or employee serves as a director of the portfolio company but a third party has a greater equity stake in the portfolio company; and officers and employees do not constitute a majority of the portfolio company board and a third party controls more than fifty percent of the voting shares of the portfolio company. In the absence of these circumstances it is likely to be difficult to rebut the presumption.

If none of the safe harbors are applicable (and the presumption is not otherwise rebutted), then the company in which the investment is made would be an affiliate for purposes of Section 23A, and the same rule would apply to investments held by that company. For example, if FHC acquires fifteen percent of the equity of company A and company A acquires fifteen percent of the equity of company B, and none of the safe harbors apply to either investment, then both companies A and B would be presumed to be affiliates of each bank subsidiary of FHC. However, there is a special rule for “private equity funds”.¹³ The rebuttable presumption does not apply to investments by private equity funds unless a financial holding company controls the private equity fund and, for this purpose, “control” means owning twenty five percent or

¹³ A “private equity fund” is an investment fund that is not an operating company, has a term of not more than fifteen years, and no more than twenty five percent of the equity of which is held by the financial holding company in question (or its directors, officers, employees and principal shareholders). 12 C.F.R. § 225.173(a).

more of the *voting* shares, being the general partner of the fund, controlling a majority of its board, or owning more than five percent of its voting shares while serving as its investment advisor.¹⁴ In the example above, if company A was a private equity fund and FHC was not the advisor to the fund, then company B would not be an affiliate for purposes of Regulation W.

JOINT VENTURES AND ESOPS

As discussed above, section 23A defines the term affiliate to exclude subsidiaries of banks, with certain exceptions, such as financial subsidiaries. Under the language of section 23A, if a bank owns twenty five percent of the voting securities of a company then the company is a bank subsidiary and not an affiliate even if the remaining seventy five percent are owned by the holding company for the bank. The Board used its broad authority in section 23A to treat other bank subsidiaries as affiliates to include a provision in Regulation W that treats a bank subsidiary as an affiliate if the company is also controlled by an affiliate (or a person who is a controlling shareholder) of the bank. Regulation W also includes as an affiliate of a bank any employee stock option plan that the bank controls.

PARTNERSHIPS FOR WHICH A BANK SERVES AS GENERAL PARTNER

The definition of affiliate in section 223.2(a) of Regulation W includes partnerships for which a bank (or any director, officer or employee of the bank) serves as a general partner. However, unless the partnership is controlled by an affiliate, it will be excluded from the definition of affiliate because it will be a bank subsidiary.

AFFILIATED DEPOSITORY INSTITUTIONS

For purposes of section 23A, the term affiliate includes depository institutions that are under common control with the bank. The significance of this result is largely eliminated by a separate exemption from all aspects of section 23A (other than the prohibition on purchasing low-quality assets from an affiliate) for transactions between depository institutions each of which is at least eighty percent owned by the same company. Section 23B, which applies to a broader range of transactions than section 23A,¹⁵ does not contain a “sister bank” exemption. Instead, “banks” are excluded from the definition of affiliate in section 23B, which otherwise is the same as the definition of affiliate in section 23A. Regulation W achieves the same result by adding a provision to the end of the definition of affiliate in Regulation W that provides: “For purposes of Subpart F (implementing section 23B), ‘affiliate’ with respect to a member bank also does not include any depository institution.”¹⁶

¹⁴ 12 C.F.R. § 225.173(d)(4).

¹⁵ See footnote 5.

¹⁶ 12 C.F.R. § 223.2(c).

COVERED TRANSACTIONS

THE ATTRIBUTION RULE

Section 23A provides that any transaction between a member bank and any person is 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.¹⁷ There is little legislative history relating to this provision. A number of commenters on the proposed Regulation W argued that it was intended to prevent sham transactions and should not prohibit transactions where the bank does not know and has no reason to believe that the proceeds of a loan will be transferred to an affiliate. In such a case there is no reason to suppose that the bank would be influenced by an affiliate to provide terms that are unfavorable to the bank; also, the bank's exposure would be to the third party rather than an affiliate. However, the Board responded that such an approach would be too "broad". The Board provided no further explanation for rejecting this approach, which it used elsewhere in Regulation W,¹⁸ but it presumably did not want to establish an exemption that could be relied upon by special purpose credit card banks.

Instead, the Board decided to interpret the attribution rule in a literal manner and include a series of exemptions for transactions that the Board does not regard raising a safety and soundness issue. One set of exemptions permits a bank to make a loan to a third party that uses the proceeds of the loan to purchase a security from an affiliate of the bank, provided that the affiliate acts either as an agent or riskless principal in the transaction. In the case of riskless principal transactions, this exemption is not available for assets other than securities.¹⁹ Regulation W also contains an exemption for credit extended to a third party that is used to purchase securities underwritten by an affiliate, provided that the extension of credit is made pursuant to a preexisting line of credit not entered into in contemplation of transactions with an affiliate of the bank.

Perhaps the greatest difficulty caused by the Board's literal interpretation of the attribution rule arises in the area of credit cards. Final Regulation W exempts from the attribution rule loans made pursuant to general purpose credit cards that are widely accepted by unaffiliated merchants if less than twenty five percent of the aggregate amount of all purchases with the card are purchases from an affiliate of the bank. In response to objections to the burden of

¹⁷ 12 U.S.C. § 371c(a)(2).

¹⁸ As discussed below, the "knows or has reason to know" standard is used in connection with whether affiliated mutual fund shares are treated as securities issued by an affiliate. 12 C.F.R. § 223.24(c).

¹⁹ For purposes of Regulation W, riskless principal transactions are limited to ones in which the affiliate acquires (or sells) a security in the secondary market. The term does not include transactions in which the affiliate sells a security that it already owns or purchases a security for its own account. 67 Fed. Reg. at 76576.

monitoring such purchases, the final rule provides that no monitoring is required if a bank has no reason to believe it would fail the test and if the bank has no commercial affiliates. Nonfinancial companies acquired pursuant to the merchant banking authority of Section 4(k)(4)(H) are not considered commercial affiliates for this purpose. Banks with commercial affiliates (such as credit card banks affiliated with retail enterprises) would be required to establish compliance systems²⁰ or demonstrate to the Board that they are unnecessary, such as by showing that aggregate sales by the bank's commercial affiliates amount to less than twenty five percent of aggregate credit card loans. Banks that fail the test would have three months to return to compliance.

The exemption will not be of any use to credit card banks that are established for the purpose of issuing special purpose credit cards to the customers of affiliated retail businesses. As at present, those credit card banks will be permitted to extend such credit on an intraday basis but will need to sell the receivables to a nonbank affiliate at the end of the day and obtain collateral from an affiliate to the extent that any receivables are held overnight.

DETERMINING THE AMOUNT OF THE COVERED TRANSACTION

Credit Transactions with Affiliates

In the past, Board staff took the position that if a line of credit was granted to an affiliate, the amount of the covered transactions that needed to be secured was the amount of the line, rather than the portion that had been drawn. Regulation W provides that the undrawn portion need not be collateralized, as long as the bank is not required to fund until sufficient collateral is provided.²¹ Although the unused portion of a line of credit need not be collateralized, it is treated as a covered transaction for purposes of the quantitative limits. This treatment is unaffected by the inclusion of a material adverse change clause in the line of credit because the Board does not believe that a bank would invoke such a clause against an affiliate.

A credit transaction with a non-affiliate that becomes an affiliate not less than a year later is not treated as a covered transaction unless the transaction was entered into in contemplation of the affiliation. If it is a covered transaction, it must be brought into compliance with the collateral requirements "promptly after" the affiliation and be included in the quantitative limit for purposes of *future* transactions.

Asset Purchases from Affiliates

Under Regulation W, an asset purchased from a non-affiliate that later becomes an affiliate is not a covered transaction unless it was entered into in contemplation of affiliation. In an asset

²⁰ Compliance is to be ascertained on a monthly basis, based on cardholder purchases that were financed by all such credit cards for the prior twelve months.

²¹ 67 Fed. Reg. at 76574.

purchase (other than the purchase of an extension of credit to, or a security issued by, an affiliate) the initial amount of the covered transaction is the amount of the consideration given (including any liabilities assumed). This amount may be reduced in the future to the extent that of any amortization or depreciation in accordance with generally accepted accounting principles (“GAAP”).

Section 23A generally prohibits a bank from purchasing a low-quality asset from an affiliate. Under a longstanding Board staff interpretation, this prohibition did not prohibit a bank from renewing a loan participation that it had purchased from an affiliate prior to it becoming a low-quality asset. The proposed Regulation W would have limited such transactions to those with affiliated depository institutions and would have imposed a number of procedural restrictions on such transactions, including prior board of directors approval and notice to the bank’s primary federal bank regulator twenty days prior to the transaction. In response to a barrage of critical comments, the Board revised the proposal so that the final rule permits a bank to increase its share of the loan by up to five percent, permits such transactions with any affiliate, and requires only after the fact notice to the regulators. In the case of transactions with affiliated depository institutions, the Board also provided alternative means for internal approval short of prior approval by the board of directors.

Securities Issued by Affiliates

Purchases of, and Investments in, Securities Issued by Affiliates

One of the most peculiar aspects of Regulation W is its valuation of transactions involving securities issued by affiliates. In the past, Board staff valued purchases of affiliate securities at the purchase price and did not treat contributions of affiliate securities as covered transactions.²² Regulation W requires that contributions of affiliate securities, which it treats as “investments”, be treated as a covered transaction in an amount equal to the carrying value of the securities under GAAP. Purchases of affiliate securities are to be valued at the higher of the purchase price or the GAAP carrying value of the security.²³ If a bank purchased a security for \$100 and its value later rose to \$150, the bank would be required to include it as a covered transaction in the amount of \$150. If the security declined in value to \$75, the bank would still be required to include it as a covered transaction in the amount of \$100.²⁴

²² It does not appear that such contributions require collateral because they do not appear to fall within the definition of “extension of credit”. See 12 C.F.R. §223.3(o)(4).

²³ Purchases of debt (but not equity) securities also must be collateralized unless the bank purchases the security from a third party in a *bona fide* secondary market transaction.

²⁴ Although the amount of the covered transaction increases, it is not necessary to add more collateral in connection with the purchase of debt securities if the carrying value rises because the sufficiency of collateral is determined at the time of the initial purchase. 12 C.F.R. § 223.14(a). If collateral is substituted,

In support of the new rule regarding contributions the Board states it is consistent with GAAP, which requires a security to be carried on the books of the bank at its carrying value even though nothing was paid for it, and that it is consistent with the purposes of section 23A, which is to limit bank exposures to affiliates.²⁵ It is unclear why the Board thinks GAAP is relevant to section 23A – particularly when it acknowledges that its valuation rule for purchases of securities is contrary to GAAP. The second rationale is unsupported by the language of the statute: section 23A imposes limits on “covered transactions”, the definition of which does not refer to either contributions or “exposure”. The Board’s interpretation of the term “investments” to include contributions is also inconsistent with the ordinary meaning of that term.

The rationales offered for the new rule regarding purchases of affiliate securities are also weak. The Board correctly points out that the balance sheet exposure of the bank rises if the value of an affiliate security purchased by the bank increases, but it is unclear why Regulation W should penalize a bank for having made a good investment. It is also unclear why the Board is concerned about balance sheet exposure. If the carrying values of a purchased affiliate security falls below its purchase price, reducing balance sheet exposure to the affiliate, the Board disregards the balance sheet exposure and values the covered transaction at the purchase price. The Board contends that this “heads I win, tails you lose” position is required so that Regulation W does not enable banks to purchase more securities from an affiliate whose condition is worsening. This contention does not take into account section 23B’s requirement that such purchases be on arm’s length terms or better from the perspective of the bank, which would make it difficult to continue to purchase securities from an affiliate as its financial condition deteriorates.

Affiliate Securities as Collateral for a Loan to an Unaffiliated Party

Section 23A does not permit a bank to accept securities issued by an affiliate as collateral for a loan to the affiliate.²⁶ A bank may accept affiliate securities as collateral for a loan to a third party, but such a loan is a covered transaction and is subject to the quantitative restrictions of Section 23A. Regulation W provides specific rules for valuing such a transaction. If all of the collateral consists of affiliate securities, then the general rule is that the amount of the covered transaction is the amount of the loan. If the affiliate securities have a “ready market”, then the amount of the covered transaction is the fair market value of the affiliate securities.

the replacement collateral must equal the amount required at the beginning of the transaction, not the amount that would have been required if a new transaction occurred at the time of the substitution.

²⁵ 67 Fed. Reg. at 76581.

²⁶ Proposed Regulation W would have treated securities issued by the bank itself as subject to this prohibition. Final Regulation W provides that only equity securities issued by a bank and debt securities issued by the lending bank that count as regulatory capital of the bank are ineligible collateral for a loan to an affiliate. 67 Fed. Reg. 76574.

If only a portion of the collateral consists of affiliate securities, then the amount of the transaction is the *lesser* of (i) the amount of the loan less the fair market value of the other collateral or (ii) the fair market value of the affiliate securities, provided that the affiliate securities have a ready market. This treatment is similar to that permitted by a 1999 Board staff interpretation. The interpretation was less stringent in that it did not require that there be a ready market for the affiliate securities,²⁷ but was more stringent in that it was available only if affiliate securities constituted a small portion of the collateral. The Regulation W valuation rule is not subject to that constraint.

Regulation W also provides that affiliate securities that collateralize a loan to a third party do not give rise to a covered transaction if they are “eligible affiliated mutual fund securities”²⁸ and the bank does not know, or have reason to know, that the proceeds of the loan are used to purchase such securities. This is an implicit exception to the general rule of Regulation W that a loan to third party the proceeds of which are transferred to an affiliate – whether or not the bank has reason to know of such transfer – is regarded as a loan to an affiliate. Without the exception, such a loan would not only be a covered transaction but it would be prohibited due to the section 23A prohibition on affiliate securities being used to collateralize a loan to an affiliate.

Merger and Acquisition Transactions Involving a Bank and an Affiliate

The definition of covered transaction in section 23A does not refer to transactions in which a controlling interest in an affiliate is contributed to a bank or an affiliate is merged into a bank. Regulation W generally treats a transaction in which an affiliate is merged into a bank or a controlling interest in an affiliate is contributed to a bank as if the bank had purchased the assets of the affiliate at a price equal to the liabilities of the affiliate assumed, plus any consideration paid by the bank. In the final rule, the Board modified this valuation principle to address transactions in which the former affiliate had transactions with other affiliates that, after the former affiliate was merged into or acquired by the bank, became covered transactions. Under the final rule, a merger of an affiliate into a bank or a contribution of a controlling interest in an affiliate to a bank is valued at the greater of (i) the consideration paid by the bank plus liabilities of the affiliate assumed or (ii) the amount of covered transactions acquired as a result of the transaction.

²⁷ For this purpose a “ready market” means either (i) the security has a public and readily identifiable market quotation (e.g., daily prices are printed in the Wall Street Journal); or (ii) there is a ready market for the affiliate security, as defined in the SEC’s net capital rule, and the security is quoted routinely on an unaffiliated electronic service.

²⁸ The term “eligible affiliated mutual fund security” is defined as a security (i) for which there is a “ready market” (see preceding footnote), or closing prices for which are available through a mutual fund supermarket website maintained by an unaffiliated broker-dealer or distributor, and (ii) that is issued by a fund in which the member bank and its affiliates hold five percent or less of the voting shares.

The Board believes that this treatment of affiliate mergers is justified because it views a merger as equivalent to a purchase of assets accompanied by the assumption of liabilities. The Board applies the same approach to a contribution of the shares of an affiliate to a bank, even though the former affiliate remains a separate corporation, on the grounds that, for purposes of section 23A, bank subsidiaries are generally treated as part of the bank. Therefore, in the Board's view it is equivalent to a merger, which is equivalent to a purchase of assets. The Board acknowledged that this treatment of contributions is a departure from past practice.²⁹ As discussed below under "Regulation W Transition Rules", transactions of this type that occurred prior to December 12, 2002 should be treated as asset purchases and, as such, permanently grandfathered.

The amount of the covered transaction arising from a merger with, or contribution of a controlling interest in, an affiliate would decline over time as the assets acquired are sold, amortized, or depreciated in accordance with GAAP. Repayment by a bank of liabilities acquired in such a transaction would not affect the amount of the covered transaction. The Board did not address the effect of terminating off-balance sheet covered transactions, but presumably the termination of such transactions would reduce the amount of the covered transaction to the extent that such amount was based on covered transactions acquired from the affiliates rather than on the sum of the amount of assets acquired and the consideration paid by the bank.

The Board provided an exemption from this treatment for cases in which a company is acquired by a bank holding company and then immediately contributed to the bank, even though the momentary holding would cause the company to be an affiliate. If the company is held for more than a day, then the bank must obtain the approval of its primary federal bank regulatory agency in order to rely on this exemption and the agency must be notified of the bank's intent at or prior to the time the company becomes an affiliate. The exemption is not available if the company is an affiliate for more than three months. The exemption is also conditioned on the bank acquiring all of the company and on the absence of a material deterioration in the condition of the company between the date it was acquired by the holding company and the date it was transferred to the bank.

DERIVATIVE TRANSACTIONS

The status of derivative transactions under sections 23A and 23B has been unclear from the time interest rate swaps were introduced in the late 1970s. The term "covered transaction" does not explicitly include credit exposure arising from swaps and other derivatives and, if the credit exposure arising from derivative transactions was to be treated as an extension of credit, it was unclear whether the amount of the covered transaction was the notional amount of the

²⁹ In a Supervisory Letter SR 03-2, which was released on January 9, 2003, the Board stated: "In the past, the Board has considered these transactions to be covered transactions only to the extent that the transferred company has liabilities to another *affiliate* of the bank at the time of the transaction."

transaction, the amount of current credit exposure, or something else. While Board staff debated the issue internally for over two decades, banks booked a large amount of derivative transactions with affiliates and did not treat them as covered transactions.

The GLBA required the Board to adopt, by May 12, 2001, a final rule “to address as covered transactions credit exposure arising out of derivative transactions” between banks and their affiliates. The GLBA appears to require that the credit exposures arising from affiliate derivative transactions be treated as covered transactions, which would subject them to both the quantitative limits and the collateral requirements of section 23A. However, when the Board adopted an interim final rule in May 2001 that “addressed” derivatives under section 23A, it did not require that credit exposures from affiliate derivative transactions be treated as covered transactions or explain why it was not required to do so by the GLBA.³⁰ The Board appears to believe that it has the authority to treat credit exposures arising from affiliate derivative transactions as extensions of credit under section 23A, but, with exceptions for certain types of derivatives, neither the interim rule nor final Regulation W goes that far.

The interim rule required only that banks establish policies reasonably designed to manage the credit exposure arising from derivative transactions with affiliates. The interim rule also confirmed the view of most banks that derivative transactions with affiliates are subject to the market terms requirements of section 23B. The supplementary information accompanying the interim rule noted that larger banks that participate in the derivative markets increasingly manage credit risk by requiring collateral for current credit exposure, which is calculated based on daily marks to market. The Board requested information on this practice but it did not suggest that it was required by the interim rule or by section 23B.

In proposing Regulation W, the Board asked for comment on a series of issues, including whether derivative transactions should be subject to quantitative limits and collateral requirements, and whether they should be valued based on the current credit exposure, potential future exposure, or in some other manner.

Final Regulation W continues the approach of the interim rule, with some refinements. The Board stated that it is not prepared at this time to subject credit exposure from affiliate derivative transactions to all of the requirements of section 23A. Instead, it will continue, for the time being, to rely upon the market terms requirement of section 23B and upon the requirement that banks establish policies designed to manage credit exposure arising from derivative transactions with affiliates. The market terms requirement of section 23B means that credit limits on affiliate derivative transactions must be at least as strict as those imposed on unaffiliated counterparties of equivalent credit quality and that pricing and any collateral requirements in affiliate derivative transactions be equivalent to what would be required of unaffiliated parties.

³⁰ *Application of Section 23A and 23B of the Federal Reserve Act to Derivative Transactions With Affiliate and Intraday Extensions of Credit to Affiliates*, 66 Fed. Reg. 24229 (2001).

Section 23B requires a bank's transactions with affiliates to be at least as favorable as the bank's transactions with nonaffiliates. However, the Board appears to be trying to substitute a "best practices" standard for a bank's own standard:

Because a bank generally has the strongest credit rating within a holding company, the Board generally would not expect an affiliate to obtain better terms and conditions from a member bank than the member bank receives from its major unaffiliated counterparties. In addition, the Board notes that market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a relatively small exposure threshold.³¹

Imposing this standard on the credit exposure arising from affiliate derivative transactions is not much different from subjecting them to the collateral requirements of Section 23A. The Board underscored the point by revising the language of the interim rule on derivatives as it relates to monitoring and controlling credit exposure arising from such transactions. This aspect of the interim rule did not refer to marks to market or collateral. As incorporated into Regulation W, the rule regarding derivatives refers to monitoring and controlling credit exposure arising from affiliate derivative transactions "through, among other things, imposing appropriate credit limits, mark-to-market requirements, and collateral requirements".³²

The Board adopted a special rule for derivatives that are the functional equivalent of guarantees, treating them as guarantees for purposes of section 23A. This rule applies to derivatives under which a bank agrees to compensate a third party for any default of an affiliate on an obligation of the affiliate, as well as total return swaps with third parties relating to affiliate obligations in which the bank is obligated to pay the third party for depreciation in the value of the affiliate obligation. The amount of the covered transaction in such cases is the notional value of the derivative. However, if affiliate obligations constitute only a portion of the referenced assets, then the Board will treat the derivative as a covered transaction "only to the extent that the derivative provides credit protection with respect to obligations of an affiliate".³³

EXEMPTIONS

INTERNAL CORPORATE REORGANIZATIONS

In the past, the Board has used its authority to exempt transactions from sections 23A and 23B in order to permit internal corporate reorganizations (typically after a time consuming

³¹ 67 Fed. Reg. at 76588.

³² 67 Fed. Reg. at 76614.

³³ 67 Fed. Reg. at 76588.

review process). Regulation W includes an exemption for such transactions. Although the circumstances in which a bank may rely upon the exemption are likely to arise quite infrequently, the ability to avoid an extended Board review is a significant benefit. The exemption is subject to a number of conditions, including the following: the transaction must involve all or substantially all the of the shares or assets of an affiliate, or of a division or department of an affiliate; the bank must provide the Board with contemporaneous notice of the transaction; the bank holding company must commit to make the bank whole for any transferred asset that becomes a low-quality asset within the next two years; the value of the covered transaction must be less than ten percent of the bank's capital and surplus; and all of the holding company's depository institution subsidiaries must be well capitalized and well managed.

SECURED CREDIT TRANACTIONS

Section 23A exempts transactions that are fully secured by U.S. government obligations. In the past, the Board has not reduced the size of the covered transaction to take into account transactions that were only partially secured by U.S. government obligations. Regulation W provides an exemption "to the extent" that a covered transaction is secured by U.S. government obligations.

PURCHASES OF ASSETS AT READILY IDENTIFIABLE MARKET QUOTES

Section 23A(d)(6) exempts from section 23A the purchase of assets from an affiliate where the assets have a readily identifiable and publicly available market quotation and are purchased at or below such quotation. The Board has interpreted this exemption (the "Statutory Exemption") provision to apply only where prices are quoted in publications that are widely available to the public. In 2001, the Board adopted an exemption (the "Board Exemption"), which would make certain transactions eligible for the Section 23A(d)(6) exemption despite the fact that prices for them were quoted on an unaffiliated electronic service rather in publications that are widely available to the public.³⁴ In the course of adopting the Board Exemption, the Board stated that where a bank purchased from an affiliate an asset that was a security issued by a second affiliate, the bank had engaged in two covered transactions, a purchase of assets from the first affiliate, which might qualify for the Board Exemption, and an investment in securities issued by the second affiliate, which would not qualify for the Board Exemption. In the Board's view, safety and soundness considerations require this result, in order to "prevent a bank from acquiring an unlimited credit exposure to its affiliates".³⁵ The Board stated that it

³⁴ The interpretation was incorporated into Regulation W, essentially unchanged, at 12 C.F.R. § 223.42(f).

³⁵ 66 Fed. Reg. at 24224.

would consider whether asset-backed securities issued by an affiliate and affiliate issued mutual fund securities should be eligible for a more liberal treatment.³⁶

In final Regulation W, the Board removed the requirement, for both the Statutory Exemption³⁷ and the Board Exemption,³⁸ that the asset not be a security issued by an affiliate. However, the Board added an interpretation which states that in such transactions: “Although an asset purchase exemption may suffice to exempt the member bank’s asset purchase from the first affiliate, the asset purchase exemption does not exempt the member bank’s resulting covered transaction with the second affiliate.”³⁹

Final Regulation W does not specifically address how these exemptions apply to affiliate issued asset-backed securities. The Board noted that commenters had raised the question, but it did not offer a response to them.⁴⁰ If an asset-backed security is purchased directly from the affiliate that issued the security, then it appears that there would be only one covered transaction, not two. Also, the Board’s concern over “unlimited credit exposure” to affiliates is inapplicable to asset-backed securities that are not credit enhanced by an affiliate. In such a case, it appears more appropriate to treat the transaction as equivalent to the purchase of the underlying assets.

Board staff took that position in the past. In 1988, Citibank requested the concurrence of the Office of the Comptroller of the Currency (the “OCC”) with Citibank’s opinion that the Statutory Exemption exempted the purchase of certain asset-backed securities issued by a Citibank affiliate, referred to in the interpretation as “CHI”. Citibank expressed the view that the purchase of asset-backed securities issued by an affiliate should be viewed as equivalent to the purchase of assets and therefore eligible for the exemption. The OCC concurred. The OCC first noted that there were many precedents for treating asset-backed securities as transparent for purposes of the Glass-Steagall Act. The OCC continued:

The same argument can be applied in analyzing the definition of “assets” under Section 23A(d)(6). The mortgage-backed securities issued by CHI are a vehicle conveying the legal rights, liabilities, and risks associated with the mortgage assets. Thus, in purchasing the securities, the Bank is effectively purchasing the assets underlying those securities for the purposes of the (d)(6) exemption. ...The

³⁶ *Applicability of Section 23A of the Federal Reserve Act to the Purchase of Securities From Certain Affiliates*, 66 Fed. Reg. 24220 (2001).

³⁷ 12 C.F.R. § 223.42(e).

³⁸ 12 C.F.R. § 223.42(f).

³⁹ 12 C.F.R. § 223.71(a).

⁴⁰ 67 Fed. Reg. at 76592.

determination that the Bank's purchase of CHI's mortgage-backed securities qualifies as "purchasing assets" for purposes of the (d)(6) exemption is also consistent with the articulated position of the Federal Reserve Board on this matter.⁴¹

The OCC then discussed a 1986 Board staff opinion that drew a distinction between the purchase from an affiliate of securities issued by an unaffiliated company, which were viewed as constituting assets of the affiliate, and the purchase from an affiliate of securities issued by that affiliate, which were viewed as constituting capital of the affiliate.⁴² The Board staff interpretation concluded that the Statutory Exemption only applied to purchases of assets, not to investments in the capital of an affiliate. The interpretation did not specifically address asset-backed securities. The OCC stated that the Board interpretation "acknowledged, however, that certain securities purchases are included within the meaning of asset purchase for purposes of the (d)(6) exemption." The OCC continued:

Although not mentioned in the letter, the Federal Reserve Board's legal staff has confirmed that one such securities purchase which could qualify for the (d)(6) exemption is the purchase of asset-backed affiliate-issued securities, such as the mortgage-backed securities in the present proposal. Such securities do not represent the capital of the affiliate but instead represent and, as has been stated previously in this discussion, convey the rights, liabilities, and risks associated with the underlying assets. Thus, the mortgage-backed securities qualify as "assets" for purposes of the (d)(6) exemption.

THE "250.250" EXEMPTION

In 1974 the Board issued an interpretation exempting from section 23A the purchase of mortgage loans from an affiliate provided that the bank made an independent credit evaluation of the creditworthiness of the borrower before the affiliate committed to making the loan and the bank committed to purchase the loan before it was made by the affiliate. This became known as the "250.250" exemption because it was codified at 12 C.F.R. § 250.250. The interpretation stated that, in the circumstances it described, the bank "would be taking advantage of an investment opportunity rather than being impelled by any improper incentive to alleviate the working capital needs of the affiliate." In 1995, concerned that the exemption was being used to fund affiliates rather than to provide investment opportunities for banks, Board staff issued a qualification, stating that the exemption was not available if the purchases represented more than fifty percent of the loans originated by the affiliate. This percentage qualification is consistent with the language of the original interpretation quoted above. The

⁴¹ No Objection Letter, No. 88-4 (February 5, 1988) (Letter to Citibank from Peter Liebesman, Assistant Director of the Legal Advisory Services Division).

⁴² A summary of the interpretation is published at Fed. Res. Reg. Serv. 3-1167.

Board incorporated the 250.250 exemption, including the fifty percent limitation, into Regulation W.

In incorporating the 250.250 exemption into Regulation W, the Board stated that the requirement of an independent credit evaluation by the bank could not be satisfied by having the affiliate or another delegate apply standards established by the bank. Instead, the bank itself must review and approve each extension of credit. This stringent interpretation of the independent credit evaluation requirement may make it impractical for banks to rely on the exemption to purchase from affiliates mortgage loans, equipment leases and other relatively small assets for which it is impractical to have two separate credit evaluations.

When it adopted final Regulation W the Board also discussed whether it would be appropriate to add a limitation on the 250.250 exemption that is based on the size of the bank. The Board's concern is not that the affiliate is too dependent on the bank for funding, but that the bank is too dependent on the affiliate for assets. This concern was not traceable to the original 250.250 interpretation. It stemmed from a 2001 bank holding company application in which a leasing company proposed to establish a bank and use the 250.250 exemption to sell equipment leases to the bank. The Board conditioned approval on such leases not constituting more than fifty percent of the assets of the bank.⁴³ The Board decided not to address this issue in connection with finalizing Regulation W because it had not previously proposed a specific limit. However, concurrently with the adoption of Regulation W, the Board proposed an amendment that would deny the 250.250 exemption in cases where the assets purchased from an affiliate equaled more than one hundred percent of the capital and surplus of the bank – or roughly one fifth of what it had permitted in the 2001 bank holding company approval order it cited.⁴⁴

INTRADAY EXTENSIONS OF CREDIT

The GLBA, in addition to requiring the Board to address derivatives as covered transactions, required the Board to address as covered transactions the credit exposure arising from intraday extensions of credit by a bank to its affiliates. At the time the GLBA was enacted, most banking organizations did not regard intraday extensions of credit as subject to section 23A or 23B and the Board had not taken a position on the issue. As in the case of derivatives, the Board responded to the 2001 deadline imposed by the GLBA by issuing an interim final rule that required banks to establish policies reasonably designed to manage the credit exposure arising from intraday extensions of credit and clarifying that such extensions of credit are subject to the market terms requirement of section 23B. At the time, the Board observed that intraday extensions of credit are typically used to facilitate the settlement of transactions rather than to

⁴³ 67 Fed. Reg. at 76618. The issue is discussed in the relevant Board order, but the order does not disclose the specific limit imposed. *Amplicon Inc.*, 67 Fed. Res. Bull. 421 (2001).

⁴⁴ *Transactions Between Member Banks and Their Affiliates*, 67 Fed. Reg. 76618 (2001) (proposed rule).

fund affiliates and that the benefits in risk reduction of treating intraday credit exposures as covered transactions may not be justified by the cost, which “would require banks to measure exposures across multiple accounts, offices, and systems on a global basis and to adjust collateral holding in real time throughout the day”.⁴⁵

However, when it proposed Regulation W, the Board proposed to treat intraday credit extensions as covered transactions and then to exempt those that arise in the course of payment transactions and securities clearing and settlement transactions. The comments submitted on the proposal included objections to the cost of implementing monitoring procedures as well as the difficulty the proposal would create for special purpose credit card companies, which would be required to sell receivables as they are generated rather than at the end of the day. When it finalized Regulation W the Board concluded that the cost of implementing the proposal would exceed the benefit in risk reduction and retained the approach taken in the interim rule, requiring banks to establish policies to monitor and control such credit exposure but not treating it as a covered transaction. The final rule conditions the exemption on the bank having no reason to believe that the affiliate will have difficulty repaying the extension of credit in accordance with its terms. The Board also clarified that a loan to an affiliate that is not expected to be repaid at the end of the day must satisfy the collateral and other requirements when it is made, not merely by the end of the day.

**APPLICATION TO U.S. BRANCHES AND
AGENCIES OF FOREIGN BANKS**

A U.S. branch or agency of a foreign bank is not a “bank” for purposes of sections 23A and 23B. This reflects the purpose of sections 23A and 23B, which is to protect institutions that benefit from federal deposit insurance and other aspects of the federal safety net from the risks associated with the activities of their nonbank affiliates. The deposits of U.S. branches of foreign banks are generally not insured by the FDIC, and, in any case, such branches are part of a larger bank the deposits of which are not insured by the FDIC and which does not otherwise benefit from the federal safety net. Also, it would be impractical to treat a foreign bank as an affiliate of its U.S. branch or agency and subject transactions between them to the requirements of section 23A.

However, when the Board authorized foreign banks to establish Section 20 affiliates in the U.S. to engage in securities underwriting and dealing activities, it was concerned that the ability to fund such affiliates with low-cost funds raised by U.S. branches would provide a competitive advantage to foreign banks over U.S. banks, which were prohibited from funding their Section 20 affiliates by of the firewalls. For that reason, the Board used its authority under Section 4(c)(8) of the BHC Act over nonbanking activities to subject transactions between U.S. branches and agencies of foreign banks and their Section 20 affiliates to sections 23A and 23B.

⁴⁵ 66 Fed. Reg. at 24200.

Section 114 of the GLBA authorized the Board to impose restrictions on transactions between U.S. branches and agencies of a foreign bank and U.S. affiliates of the foreign bank that the Board finds are, among other things, appropriate to prevent unfair competition. The Board used this authority in 2001 to apply sections 23A and 23B to transactions between U.S. branches and agencies (as if they were “banks”) and U.S. affiliates engaged in merchant banking activities (including portfolio companies controlled by such affiliates). In Regulation W the Board extended this treatment to U.S. affiliates that are engaged in underwriting and dealing activities, insurance underwriting or insurance company investment activities pursuant to section 4(k)(4) of the BHC Act. The Board determined that the ability to fund such affiliates through a U.S. branch would give a foreign bank a competitive advantage over U.S. banking organizations. The Board believes this potential advantage is limited to the four activities it identified because most of the other activities that are permissible for financial holding companies are also permissible for U.S. banks to engage in directly or through a subsidiary free of the restrictions of sections 23A and 23B.

In the case of a U.S. branch or affiliate, the quantitative restrictions of section 23A are calculated with reference to the capital and surplus of the foreign bank, which generally means that they do constitute a significant restriction. However, the collateral requirements of section 23A and the market terms requirement of section 23B can be significant impediments to structuring transactions in the manner that is most desirable for internal regulatory purposes.

REGULATION W TRANSITION RULES

Regulation W generally becomes effective on April 1, 2003. However, any transaction that is consummated on or before December 12, 2002 and will become subject to section 23A or 23B solely as a result of this rule, or whose treatment under section 23A or 23B will change solely as a result of this rule, will not become subject to this rule until July 1, 2003, unless the transaction is renewed or materially altered on or after April 1, 2003. In addition, if such a transaction is a purchase of asset by a bank from an affiliate that was consummated on or before December 12, 2002, the transaction is permanently grandfathered.

The application of the transition rule is relatively simple in the case of a company that becomes an affiliate as a result of the adoption of Regulation W. For example, an unregistered investment fund for which a bank acts as adviser and the bank or an affiliate has a five percent or greater interest will become an affiliate as a result of the rule. If a bank purchased assets from such a fund prior to December 12, 2003, that asset purchase will be grandfathered and will never become subject to sections 23A or 23B.

A slightly more difficult case is presented by the contribution of securities to a bank. The Board acknowledges that treating a contribution of securities to a bank as a covered transaction is a new rule and such transactions, if entered into prior to December 12, 2002, clearly do not have to be brought into compliance until at least July 1, 2003. However, the rationale for

treating contributions as “covered transactions” was that they were equivalent to a purchase of assets. Based on that rationale, such transactions should be eligible for permanent grandfathering.

A 1986 Board staff interpretation stated that a purchase of affiliate securities does not qualify for the statutory exemption of Section 23A(d)(6). However, it appears to have been the Board’s position that a purchase of asset-backed securities issued by an affiliate could qualify for the statutory exemption. The Board’s position on this point after the adoption of Regulation W is not entirely clear, but it would be reasonable to take the position that transactions of this type that were consummated prior to December 12, 2002 are permanently grandfathered.

**TRANSACTIONS BETWEEN THRIFT
INSTITUTIONS AND THEIR AFFILIATES**

Section 11(a)(1) of the Home Owners’ Loan Act (“HOLA”) applies sections 23A and 23B to every thrift institution “in the same manner and to the same extent” as if the thrift institution were a bank.⁴⁶ In addition, section 11(a)(1) prohibits a savings association from (i) extending credit to an affiliate if the affiliate engages in an activity other than one that is permissible for bank holding companies under Section 4(c) of the BHC Act or (ii) purchasing securities issued by an affiliate (other than shares of a subsidiary). Section 11(a)(4) of HOLA authorizes the Office of Thrift Supervision (the “OTS”) to impose additional restrictions on transactions between a thrift institution and its affiliates as the OTS deems appropriate in the interest of safety and soundness.

On December 20, 2002, the OTS adopted an interim final rule that addresses the application of Regulation W and section 11(a) of HOLA to savings associations.⁴⁷ The Board rather than the OTS is authorized to adopt regulations pursuant to sections 23A and 23B for all insured depository institutions. The OTS acknowledged as much in adopting the OTS Affiliate Rule and generally proceeded by incorporating most of Regulation W by reference into the OTS Affiliate Rule. However, the OTS Affiliate Rule also substitutes a few OTS definitions for Regulation W definitions and makes other changes. The OTS justified most of these changes on the grounds that it is authorized by HOLA to impose restrictions on affiliate transactions by thrift institutions that are more stringent than those of section 23A.

However, not all of the changes result in more stringent treatment. For example, the OTS Affiliate Rule definition of affiliate follows the Regulation W definition by including companies

⁴⁶ The term “thrift institution” refers to federal savings banks and federal and state savings associations. It does not include state chartered savings banks. 12 U.S.C. §1813(b). State chartered savings banks are regulated by the FDIC and subject to sections 23A and 23B by the Federal Deposit Insurance Act.

⁴⁷ *Savings Associations – Transactions with Affiliates*, 67 Fed. Reg. 77909 (Dec. 20, 2002).

that control or are under common control with a thrift institution, but substitutes the OTS definition of “control” for the Regulation W definition. The OTS asserted that the OTS definition is more stringent and that its approach would enhance compliance by thrift institutions because they are more familiar with the OTS definition of control. In some respects the OTS control regulations are in fact more stringent than Regulation W, finding control, for example, if a holder owns ten percent of any class of voting shares and is one of two largest shareholders. However, in one important respect the OTS control regulations are less stringent. As discussed above, under Regulation W, a holder of convertible instruments (including options and warrants) is deemed to hold the underlying securities, even if such instruments are not convertible immediately.⁴⁸ Under the OTS control regulations, a holder of convertible securities is not deemed to control the underlying securities, even if they are immediately convertible, unless the holder has paid at least fifty percent of the consideration required to directly acquire the stock.⁴⁹

The OTS Affiliate Rule also excludes “financial subsidiaries” of savings associations from the definition of affiliate. The definition of financial subsidiary in Regulation W includes any subsidiary of a bank (i) that engages in activities that a national bank is not permitted to engage in directly and (ii) that is not a subsidiary that a national bank is expressly authorized to own by a federal statute other than 12 U.S.C. § 24a. Savings associations are authorized by statute to control service corporations that are engaged in activities, such as real estate development, that are not permissible for national banks. Although such subsidiaries technically come within the Regulation W definition of financial subsidiary, the OTS stated that the GLBA did not authorize savings associations to establish financial subsidiaries and the special provisions of section 23A applicable to such subsidiaries should not be applicable to savings associations’ service corporation subsidiaries, which are separately authorized by federal statute and on which federal statutes impose a number of restrictions, not including affiliate status under section 23A.

The OTS Affiliate Rule also substitutes the OTS definition of “capital and surplus” for the definition contained in Regulation W on the grounds that the two definitions are equivalent and it did not make sense to require savings associations to calculate their capital under unfamiliar rules applicable to banks.

In implementing the HOLA prohibition on a thrift institution extending credit to an affiliate if the affiliate engages in an activity other than those that permissible for bank holding companies under section 4(c) of the BHC Act, the OTS Affiliate Rule references activities permissible for bank holding companies under section 4(c)(8) of the BHC Act. This excludes servicing activities that are permissible for bank holding companies under section 4(c)(1), international activities that are permissible under section 4(c)(13) (and, as required by section 11(a)(1), insurance, merchant banking and securities underwriting and dealing activities that are

⁴⁸ 12 C.F.R. § 223.3(g)(5).

⁴⁹ 12 C.F.R. § 574.2(u)(3).

permissible under section 4(k)). A thrift institution may lend to a subsidiary of a company that is engaged in impermissible activities if the affiliate itself is not engaged in such activities, but it may not lend to a company that controls a company that is engaged in impermissible activities, even if the parent is not directly engaged in impermissible activities. This prohibition does not prohibit a loan to a non-affiliate where the proceeds are used for the benefit of, or transferred to, an affiliate that is engaged in activities that are impermissible for bank holding companies under section 4(c)(8).

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