



Securities Industry Association

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Delivery by Hand and Electronic Mail

Jennifer J. Johnson, Esq.
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave., NW
Washington, D.C. 20551

Re: Transactions between Banks and their Affiliates
(Docket Nos. R-1103 and R-1104)

Dear Ms. Johnson:

The Securities Industry Association (“SIA”)¹ appreciates the opportunity to comment on the proposed and interim rules issued by the Board of Governors of the Federal Reserve System (“Board”) implementing sections 23A and 23B of the Federal Reserve Act. SIA first offers a few general observations and then presents comments about particular aspects of the Board’s rulemaking.

I. General Comments

To begin with, SIA and its members support the Board’s efforts to establish a comprehensive Regulation W to implement the statutory requirements of sections 23A and 23B, 12 U.S.C. §§ 371c, 371c-1. SIA believes that an all-inclusive bank-affiliate transactions rule will add needed legal certainty to the evaluation and treatment of many types of transactions under sections 23A and 23B. SIA also believes that, by bringing together in one regulation the formal and informal guidance on bank-affiliate transactions developed over many years by the Board and its staff, the Board’s rulemaking will facilitate compliance with the standards of sections 23A and 23B, particularly for those

¹ SIA brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts for nearly 80-million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2000, the industry generated \$314 billion of revenue directly in the U.S. economy and an additional \$100 billion overseas. Securities firms employ approximately 770,000 individuals in the United States. (More information about SIA is available on its home page: <http://www.sia.com>).

firms that may be newly affiliated with banks under the Gramm-Leach-Bliley Act (“GLB Act”).

SIA supports the Board’s attempt to clarify, in several places, the ambiguities in its or its staff’s existing interpretations of and exemptions from sections 23A and 23B. SIA also applauds the Board for recognizing particular instances in which its or its staff’s past interpretations of section 23A have been needlessly strict. For example, SIA supports the Board’s determination not to apply the collateral requirements of section 23A to the undrawn portion of a bank’s extension of credit to an affiliate. In addition, SIA endorses the Board’s determination to classify several new types of transactions as exempt from section 23A, such as a bank’s purchase of municipal securities from an affiliate.

As the Board moves forward with this rulemaking, SIA urges it to make the final Regulation W less restrictive. For instance, the Board notes at several points that its new rules merely “codify” existing staff interpretations or guidance. SIA cautions that the Board should not assume that the industry was in each instance fully aware of, or necessarily agreed with, this existing staff guidance, particularly when such guidance was informally rendered and not made public in the Federal Reserve Regulatory Service or elsewhere. For this reason, SIA urges the Board to use the opportunity of this rulemaking to re-examine the merits of such guidance and to re-assess carefully whether the policy positions embodied in the staff’s prior determinations can be achieved through less burdensome and restrictive means.

The Board should strive in this rulemaking process to achieve two fundamental goals: allow maximum flexibility for banks and their affiliates to comply with sections 23A and 23B and, wherever possible, reduce the regulatory burdens associated with such compliance. The Board can, in SIA’s view, achieve these goals by recognizing and endorsing successful and widely adopted industry practices that reduce risks from affiliate transactions and, thereby, safeguard insured depository institutions.

SIA respectfully submits – particularly in light of the ever-evolving and increasingly complex nature of financial transactions – that the Board should vigilantly avoid rigid, costly, and inflexible requirements for and limitations on bank-affiliate transactions. Indeed, an approach that maximizes flexibility and reduces compliance burdens will best ensure that the bank-affiliate transaction rules achieve the statutory goals of sections 23A and 23B without needlessly stifling financial innovation and increasing compliance and legal costs for banks and their affiliated firms. Perhaps most importantly, the rule should not deter banks and/or their affiliates from properly using various types of affiliate transactions to meet customer demands, promote operating efficiencies, and manage their exposures to market, cash flow, and other risks arising out of their on-going business operations.

II. Specific Issues

A. Derivative Transactions

The GLB Act required the Board to adopt rules under section 23A to “address as covered transactions credit exposures arising out of derivative transactions between

[insured depository institutions] and their affiliates.”² The Board appropriately recognized that determining the suitable treatment for derivative transactions under section 23A is a “complex and important endeavor” and, in light of these complexities, chose to satisfy the statutory mandate by adopting an interim final rule that requires banks to establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from derivative transactions with their affiliates. In addition, the rule clarifies that bank-affiliate derivative transactions are subject to the requirements of section 23B.

In SIA’s view, the Board’s action fully and completely meets the requirements of the GLB Act. The interim final rule provides appropriate standards under section 23A according to which banks must manage the risks associated with derivative transactions with their affiliates.

In so doing, the Board affords individual institutions an appropriate degree of flexibility to design their own policies and procedures to comply with the rule. Affording banks and their affiliated securities firms precisely such flexibility is warranted because of the diversity of derivative transactions and the varied participation of banks in the derivatives market. Individual firms are in the best position – within the parameters established by the interim final rule – to monitor and manage their exposures to derivative contracts with their affiliates.

The rule’s section 23A standards also accord with industry practice; indeed, SIA believes that many banks have in place practices that would meet the rule’s requirements and – through pricing, risk management, and other measures – minimize the credit risks associated with derivative transactions (both with respect to transactions with affiliates and non-affiliated companies). The Board has not presented any evidence, and SIA is not aware of any, to suggest that these established measures are unsuitable or deficient under the standards established by section 23A such that they need to be supplemented with additional requirements.

The interim rule’s application of section 23B’s comprehensive prohibition on non-arm’s length transactions to derivative contracts with affiliates offers significant additional protection against abuse. As the Board notes in the ‘Supplementary Information’ that accompanies its interim final rule, the application of section 23B means that banks may not favor their affiliates in derivatives transactions and, instead, will need to maintain equal policies and procedures – including credit and exposure limits, risk management requirements, and pricing – for derivative transactions involving similarly situated unaffiliated and affiliated counterparties. In short, the section 23B safeguards will prevent banks from manipulating the terms of derivatives agreements in a manner that places them at risk and favors their affiliates.

Regulation W poses a series of questions on additional measures that could be applied to bank-affiliate derivative transactions. SIA urges the Board, for the reasons stated above, not to adopt additional restrictions and regulatory measures and to rely instead on internal policies and procedures as the appropriate risk management tool for bank-affiliate derivative transactions. Additional regulatory requirements are

² Section 121(b)(3) of the GLB Act (codified at 12 U.S.C. § 371c(f)(3)).

unnecessary given the fully adequate procedures that banks currently have in place and will be required to maintain under the standards established by the interim final rule. Of course, where specific depository institutions lack adequate policies and procedures or otherwise afford favorable treatment to their affiliates, the Board has ample authority to take appropriate supervisory actions on a case-by-case basis.

Not only are additional measures unnecessary, but they also may give rise to adverse consequences. For instance, additional regulatory requirements could reduce the ability of banks to enter into derivative instruments that meet the needs of the marketplace, increase the costs for banks to manage and off-set exposures to various operational risks, and reduce the ability of banks to derive needed fee revenues from profitable, and prudently managed, derivative contracts involving their affiliates.

Notwithstanding its strong opposition to any additional regulatory requirements, SIA provides the following comments on the specific questions posed by the Board regarding derivative transactions. Because of the complexity of the questions that the Board has posed and the various additional measures that it is considering, SIA supports the Board's decision not to impose any further regulatory requirements without first soliciting public comments on a specific proposed rule governing derivative instruments.

1. *Definition of Derivative Instruments*

The first question the Board poses is how to define the term "derivative instrument." SIA recommends that the Board define derivative instrument for purposes of sections 23A and 23B by using the terms "qualified financial contract" and "swap agreement," as set forth in the Federal Deposit Insurance Act ("FDI Act"), 12 U.S.C. § 1821(e)(8)(D)(i) and (vi). SIA believes that the FDI Act's definitions adequately cover the most widely traded derivative contracts by type and product, including interest rate, foreign exchange, equity, commodity and credit derivative products.

The Board asks about the possibility of adopting a broader, functional definition for derivative instrument. As the Board acknowledges in its rulemaking, such a functional definition (or a definition that includes a functional component) risks being over-inclusive and would create complexities and uncertainty for the banking and securities industries in evaluating the proper treatment for transactions. The Board notes that use of a functional definition may give it greater flexibility; however, SIA does not believe that using the FDI Act's definitions sacrifice the Board's ability to respond to market trends. If the Board adopts the FDI Act's definitions and later determines that the definitions need to be extended to cover new kinds of contracts, the Board would always have the option of engaging in a new rulemaking to expand the types of instruments that are covered by section 23A. To this end, SIA believes strongly that the Board should engage in a rulemaking process, with the benefit of public notice and comment, before expanding the definition of derivative instrument for section 23A purposes.

While SIA recommends using the FDI Act's definitions, whatever definition the Board ultimately adopts should provide the industry with clear and definitive guidance regarding the types of contracts that will be treated as derivatives for purposes of sections 23A and 23B. SIA believes that the aforementioned definitions in the FDI Act meet these goals.

2. *Derivative Transactions that Are the Functional Equivalent of a Loan*

The Board suggests that it may be appropriate to treat a derivative transaction that is the functional equivalent of a loan (or the relevant part of the transaction that functions like a loan) as an extension of credit for purposes of section 23A. The Board's fear appears to be that banks may use derivatives, such as deep-in-the-money options or swaps with an exchange of principal on different dates, to hide transfers of funds to their affiliates.

SIA and its members do not believe that banks and their affiliates enter into such "credit" derivatives to fund their affiliates; in fact, the Board's staff acknowledges as much in its memo to the Board that accompanied this rulemaking. Accordingly, SIA believes that it is premature and unnecessary at this juncture for the Board to craft rules that address such transactions; in short, SIA sees no need for the Board to attempt to guard against a problem that, by the Board staff's own admission, does not exist. If, in the future, depository institutions do enter into such transactions with their affiliates, the Board may then wish to consider appropriate regulatory guidance. At that time, the Board would be engaged in a regulatory initiative designed to address a then-existing practice with the benefit of seeing how such bank-affiliate transactions actually function.

In addition, SIA notes that, once again, many of the Board's concerns about "credit" derivatives may be allayed by the application of section 23B to such transactions. Indeed, section 23B safeguards against the abuse of derivative contracts to conceal funds transfers by banks to affiliates. For example, the presence of atypical and non-market terms – of the sort that create opportunities for banks to fund affiliates in the way that the Board fears – would violate the arm's length requirements of section 23B and would be susceptible to detection by examiners.

The Board also asks how it should identify derivative transactions that function as loans and whether it should utilize standards adopted by the Internal Revenue Service ("IRS").³ As SIA understands them, the IRS's regulations generally require a swap with "significant" nonperiodic payments to be treated as two separate transactions consisting of an on-market, level payment swap and a loan. Different tax treatment applies to the swap and loan portion of the transaction. The IRS's regulations provide certain examples for how this rule should be applied, but they do not define "significant." Moreover, the IRS's letter opinions that consider whether a specific nonperiodic payment is "significant" do not provide additional guidance or standards for determining what is "significant," thus providing little certainty for taxpayers on this issue.⁴

SIA submits that there are several problems with importing the IRS's definitions for the purposes of section 23A. First, while taxpayers generally have the option of seeking clarification from the IRS on whether a particular nonperiodic payment is "significant" before their annual tax payments become due, banks must be in a position to comply with section 23A at the time they enter into and throughout the life of a

³ 26 C.F.R. 1.446-3.

⁴ Cf. I.R.S. Advisory on Yen Swap Agreement (June 21, 1996).

transaction, not a year later. Second, implementation of the IRS's standards in the section 23A context would appear to require continual evaluation of each swap entered between a bank and its affiliates. Accordingly, SIA does not believe that the IRS's standards are suitable for application in the context of section 23A.

3. *Additional Policies and Procedures Governing Derivative Transactions*

The Board seeks comment on the appropriateness of requiring banks to follow a set of prescribed policies and procedures, so-called "best practices," with respect to their derivative transactions with affiliates. To be sure, SIA and its members believe that banks should always follow best industry practices in their derivative and other transactions with both affiliates and non-affiliates; however, SIA cautions the Board against mandating the adoption of a "one-size-fits-all" approach that fails to accommodate the diversity of firms and their derivatives contracts and the varied risks that banks are hedging with derivatives transactions.

As noted above, SIA firmly believes that banks should be given the flexibility to adopt those policies and procedures that are best suited to their individual derivative portfolios and risk exposures. As the Board is well aware, the risks attendant in a different types of derivative instruments vary widely depending on an array of factors, such as the volatility of the currencies, interest rates or other benchmarks used to determine contract payments and the maturity and liquidity of the contracts. Accordingly, banks will be exposed to different degrees and types of risk depending on their underlying operations, their individual derivative holdings, and the extent of their participation in the derivatives market. For example, a bank that engages in derivative transactions predominately to hedge against interest rate risk should adopt different risk management policies and procedures than a bank that holds derivative contracts primarily for trading purposes.

For these reasons, SIA contends that there is no one set of generic "best practices" suitable for derivative transactions between banks and their affiliate securities firms. Instead, each bank should be able to choose those practices most suited to the bank's individual credit exposure in fashioning its own internal policies and procedures. The Board's examination and supervision process should be used to address situations in which either (a) an individual institution's policies and procedures are not sufficient in light of that institution's overall exposure to market, cash flow, and other operational risks and to derivatives activities, or (b) an institution has entered into non-market transactions with its affiliates, in violation of section 23B.

4. *Reporting Requirements*

The Board seeks comment on whether banks should be required to disclose to federal bank supervisors or to the public, on a quarterly or other periodic basis, their net credit exposure to affiliates on derivative transactions. Banks already are required to disclose, on a quarterly basis, detailed information concerning their derivative transactions in Schedule RC-L of their Call Report. SIA believes that the current Call Report disclosures are sufficient to monitor bank derivative transactions, and SIA urges the Board to be mindful of the burdens imposed on industry by additional reporting obligations. The Board should not impose new requirements without a prior careful

analysis of the increased costs and regulatory burdens of such additional reporting (and a comparison of those increased costs to what benefits, if any, accrue to regulators from such reporting). SIA also believes that the Call Report continues to be the best means for gathering information concerning the derivative transactions of their affiliated member banks and encourages the Board to solicit any additional information that it may require through the Call Report.

5. *Quantitative Limits and Collateral Requirements*

The Board invites comment on whether it should impose quantitative limits or collateral requirements on derivative transactions between banks and their affiliates under section 23A. In line with SIA's position that the Board should rely principally on banks' internal policies and procedures for regulating bank-affiliate derivative transactions, SIA strongly opposes the imposition of any section 23A quantitative limits or collateral restrictions on bank-affiliate derivative transactions.

The imposition of quantitative limits would create numerous problems. To begin with, many derivative transactions between banks and affiliates are entered into by banks for their own risk management needs. Accordingly, establishment of quantitative limits could hamper banks from entering into derivatives transactions with their affiliates and, thereby, make it more costly and less efficient for banks to protect against interest-rate, foreign exchange, cash flow and other risks. If limits were imposed, banks likely would rely on non-affiliated counterparties to enter into the very same derivative transactions that they currently enter into with their affiliates. Thus, the principal effect of the quantitative limits would be to increase the transactions costs for banks engaging in necessary hedging and other risk-management transactions.

Moreover, if the Board were to impose quantitative limits on derivative transactions, the Board and the industry would be faced with an array of exceedingly difficult questions as to how to value derivative contracts for the application of such limits. As the Board well recognizes, each of the alternative methodologies that could be applied is complex and is a highly imperfect measure of a bank's potential exposure to an affiliate from derivative transactions. In addition, such requirements would impose a significant compliance burden on banks and their affiliate securities firms. Banks would need to engage in the continual evaluation of the swaps (and other derivative transactions) entered into with their affiliates to ensure that they remained below the quantitative limits of section 23A. (Banks also would need to adjust continuously the amount of collateral that they maintain from their affiliates.)

An example illustrates the difficulties that would arise: a bank and its affiliate may decide to swap two payment streams, which are derived from foreign exchange or interest rates. Payments may be made by netting the amounts owed by each counterparty to the other, and by payment of the difference from the net payor to the net receiver. Because the payment streams will vary based on an underlying currency or interest calculation, it will not be apparent *a priori* whether the bank will – on any given day – be the payor or the receiver of funds. Thus, the bank would be exposed to significant uncertainty about the amount of this transaction that would be applied to its section 23A limits and the amount of collateral required to be maintained. (For this reason, SIA urges that, if the Board determines to apply a quantitative limit to derivative transactions, this

limit should exist separate and apart from the 20 percent limit for covered transactions under section 23A.)

SIA also submits that the application of section 23B requirements on bank-affiliate derivative transactions obviates the need for imposing the collateral requirements of section 23A on these transactions. Under section 23B, as the Board itself has noted, banks must utilize risk-management techniques in derivatives transactions with their affiliates to the same extent as in comparable transactions with similarly situated unaffiliated counterparties. Thus, to the extent that banks are engaged in arm's length transactions with their affiliates, SIA submits that there is no need from a safety and soundness perspective to impose the additional collateral requirements of section 23A on bank-affiliate derivative transactions.

6. *Grandfathering Existing Derivative Transactions*

SIA strongly believes that the Board should grandfather all existing bank-affiliate derivative transactions from any special quantitative, collateral, or other requirements that the Board determines to impose under section 23A. As the Board recognizes, bringing existing derivative contracts into compliance with whatever rules are ultimately adopted could require expensive and time-consuming adjustments to positions and re-negotiation of agreements. In addition, as noted above, if existing derivative contracts exceed any quantitative limits established under Regulation W, banks could be prohibited from entering into any new derivative contracts with affiliates in the future. This might impair the ability of banks to hedge efficiently against interest rate, market, and other risks – a result that, SIA submits, does not make any sense.

B. Intraday Extensions of Credit

The GLB Act required the Board to adopt a rule to address under section 23A the credit exposures arising out of intraday extensions of credit by banks to their affiliates.⁵ The Board issued an interim final rule that requires banks to adopt policies and procedures to manage such intraday credit exposures. In addition, the interim rule requires banks' intraday extensions of credit to affiliates to comply with the market terms requirements of section 23B.

As with derivatives transactions, SIA strongly believes that the Board's interim rule on intraday credit fully satisfies the congressional mandate and that no additional measures are needed. SIA, instead, urges the Board to allow banks to rely on their own internal policies and procedures – so long as they meet the requirements of the interim final rule – to govern such transactions. SIA believes that, as is the case with derivative transactions, most banks already have in place comprehensive policies and procedures to address adequately the risks associated with affiliate daylight overdraft transactions and

⁵ Section 121(b)(3) of the GLB Act (codified at 12 U.S.C. §371c(f)(3)).

to comply with the interim rule. There is no evidence to suggest that such policies and procedures are inadequate; accordingly, SIA does not believe that further regulation is necessary with respect to such transactions.

In the proposed Regulation W, the Board solicits comment on a more comprehensive proposal on the treatment of intraday extensions of credit. The Board generally proposes to subject intraday extensions of credit to affiliates to the quantitative limits and collateral requirements of section 23A unless such extensions arise specifically in connection with a bank's performance of certain securities clearance and settlement or payment transactions on behalf of an affiliate and, among other requirements, the bank has no reason to believe that an affiliate will have difficulty repaying the extension of credit at the end of the day. (At the outset, SIA understands that, under the Board's proposal, *all* payment transactions – including those arising in the context of foreign exchange and derivative contracts – would be exempt from the quantitative and collateral requirements of section 23A.)

SIA respectfully urges the Board to abandon the proposed treatment of intraday extensions of credit under Regulation W. As the Board is aware, it is current industry practice to treat an extension of credit to an affiliate as subject to section 23A only if the extension remains outstanding at the end of the day. SIA submits that such treatment makes economic sense and raises virtually no safety and soundness concerns. Daylight overdrafts are not used as a means of funding or providing financial support to an affiliate in such manner as intended to be restricted by section 23A, but rather serve to accommodate the mis-timing of matching or boxed transactions and the common delays in the receipt and payment of funds on various types of transactions involving affiliates. Any risks associated with such daylight activities are significantly mitigated precisely because all daylight positions that become overnight positions are treated as covered transactions under section 23A. That is, as soon as the transaction turns from one that merely facilitates some daylight activities involving an affiliate to an overnight extension of credit to an affiliate, banks treat the transaction as one that is subject to and covered by section 23A.

Not only does the Board's proposal to subject daylight activity (outside the above-noted exemption) to section 23A present a major shift in policy, it also would impose significant compliance burdens on banks, which burdens (as Board staff readily admits in its memo to the Board that accompanies this rulemaking) are not supported by the risks associated with such transactions. SIA does not believe that large banks (let alone smaller ones) currently have the ability to measure their exposure to intraday extensions of credit across multiple accounts on a global basis or to adjust their collateral holdings in real time throughout the day, as would be required by the application of section 23A to such transactions. The costs associated with implementing such systems would be significant, and such costs are not warranted by the scant benefits of risk mitigation.

SIA suggests that, if the Board is determined to impose requirements on intraday extensions of credit beyond those that are in the interim final rule, the Board should only impose such restrictions when a bank has a reason to believe that an affiliate is likely to have difficulty repaying an extension of credit before the end of the day. This requirement and this requirement alone, in SIA's view, adequately addresses those instances in which there are legitimate concerns that an intraday credit extension to an

affiliate may turn into an overnight loan – a true covered transaction that should be subject to the requirements of section 23A.

C. Purchase of Debt Securities of an Affiliate

Regulation W provides that a bank that buys debt securities (including commercial paper) issued by an affiliate has made an extension of credit to an affiliate under section 23A. Accordingly, under the regulation, the Board would require a bank to collateralize the purchase of debt securities in accordance with the requirements of section 23A.

SIA respectfully submits that the Board's approach cannot be reconciled with the plain language of section 23A. Section 23A(c) requires that each "loan or extension of credit" to an affiliate be secured by a statutorily mandated amount of credit. The statute does not, however, impose any similar collateral requirements on any purchase of affiliate "securities," and the statute specifically defines the term "securities" to include not only equities but also "bonds, debentures, notes, or other similar obligations." 12 U.S.C. § 371c(b)(7). Accordingly, SIA believes that there is no statutory basis for the Board's requirement of collateral for purchases of affiliate-issued debt securities by banks.

The Board's interpretation also violates the structure of the statute. The Board's reading results in the term "securities" being confined only to equity securities. Yet, that approach has the practical effect of reading the term "securities" out of the statute because banks generally lack the authority to purchase equity securities.

In addition, the Board's tack appears to be a departure from both the staff's past practice and industry practice, pursuant to which banks have purchased commercial paper of their holding companies and their affiliates without collateralizing such purchases. SIA believes that this departure is not warranted by any evidence of safety and soundness concerns and, thus, should not be pursued.

The Board finally seeks comment on whether to permit any exemptions to its new general rule; in particular, the Board asks whether it should adopt an exemption from the collateralization requirements of section 23A when a bank purchases affiliate debt securities (a) from a third party in a bona fide secondary market transaction, or (b) pursuant to a public offering or private placement in which there is significant third party participation. If the Board determines to apply the general rule as proposed, which SIA hopes it will not, SIA fully supports the granting of an exemption to cover secondary market, public offering, and private placement transactions. SIA also believes that such an exemption should be applied more broadly to apply to the purchase by a bank of any marketable securities issued by its affiliate, so long as the purchase is at or below the market price. In all of these situations, safety and soundness concerns, to the extent that they exist, are fully addressed by the basic requirements of section 23B.

D. The Ready Market Exemption

Section 23A exempts from the statute's quantitative limits a bank's purchase from an affiliate of securities or assets that have a "readily identifiable and publicly available

market quotation.”⁶ In the past, the Board and its staff took the position that this exemption was available only for the purchases of assets whose prices were recorded in widely disseminated publications available to the general public. In 1998, the Board proposed to exempt from section 23A purchases by a bank from a securities affiliate of certain additional types of securities that have a “ready market.”⁷ The Board finalized this exemption in a separate final rule issued concurrently with Regulation W.

Under the final rule, a bank may purchase any security from a broker-dealer affiliate registered with the SEC in reliance on the ready market exemption, provided that the security: (1) has a “ready market,” as that term is defined under the SEC’s net capital rules; (2) is one that a state-member bank may purchase directly; (3) is not a low-quality asset; (4) is not purchased during an underwriting period or within 30 days thereof (unless it is a U.S. government security); and (5) is not issued by an affiliate. In addition, the security’s price must be quoted routinely on an electronic service that provides real-time data on price, and the price paid by the bank for the security must be no higher than the then-applicable market quotation for the security.

Regulation W also adopts and solicits comments on the new exemption for securities with a ready market. SIA supports the Board’s expansion of the exemption for purchases of securities with a ready market but urges the Board to reconsider several of the conditions that it has imposed on banks seeking to use the new exemption.

First, SIA believes the ready market exemption should not be limited to SEC-registered broker-dealers. SIA urges the Board to allow other broker-dealers that are registered with, and supervised by, appropriate foreign securities authorities to utilize the exemption. Many banks have such foreign broker-dealer affiliates, and SIA respectfully sees no safety and soundness reason why transactions with these affiliates should not be included within this exemption. The Board argues that some foreign entities may not be subject to appropriate supervision and regulation; if this is the case, SIA suggests that the Board exclude only broker-dealers from those particular jurisdictions that lack sufficient compliance and regulatory regimes.

Second, SIA believes that the ready market exemption should be available so that banks may purchase securities from affiliates during the underwriting period and the days immediately thereafter. In the preamble to its rulemaking, the Board declined to extend the exemption in this fashion, citing concerns about the uncertain market values of securities during and shortly after an underwriting period and the potential for conflicts of interests when banks buy securities from underwriting affiliates. SIA does not find the Board’s stated rationales compelling. As an initial matter, SIA believes that initial offerings of debt securities – which are the securities that banks are able to purchase – represent the easiest case for verifying a readily identifiable price and for confirming that the purchase was made at that price. SIA also submits that the potential conflicts of interest about which the Board is concerned would be addressed by the requirement in section 23B of having the board of directors of the bank pre-approve the transaction. SIA

⁶ 12 U.S.C. § 371c(d)(6) (the so-called “ready market exemption”).

⁷ 63 Fed. Reg. 32768 (June 11, 1998).

suggests that, as a further protective measure, the Board may consider permitting purchases during the underwriting period, only so long as the bank does not purchase more than 50 percent of the securities being underwritten.

Third, SIA strongly believes that the exclusion from the ready market exemption for securities issued by a bank affiliate should not apply to shares issued by registered investment companies (“mutual funds”) that are advised by banks or their affiliates (“proprietary mutual funds”). To begin with, it cannot be disputed that mutual fund share prices have a readily identifiable and publicly available market quotation; after all, mutual fund share prices are published daily in the *Wall Street Journal* and other widely read publications and are available from innumerable other sources on a real-time basis.

In addition, mutual fund shares are markedly different from the shares issued by other bank affiliates. Mutual funds, mutual fund share pricing, and mutual fund transactions with their affiliates are all subject to comprehensive regulation by the SEC under the Investment Company Act; mutual fund advisers also are subject to comprehensive regulation by the SEC under the Investment Advisers Act. Because the profits of an affiliated mutual fund do not flow directly to the bank or the bank’s affiliates (but, instead, flow to the fund’s investors), any incentives for banks to provide funding to their proprietary funds are not present to the same extent as there could be with other affiliates. Accordingly, SIA maintains that there is no justification for making the ready market exemption unavailable to purchases of affiliated mutual fund shares by banks.⁸

Fourth, SIA requests that the Board reconsider its position on the use of independent dealer quotations to establish a market price for a security. SIA believes strongly that it is entirely appropriate for banks to use independent dealer quotes to establish the market price. The existence of two or more independent dealers for a particular security who will give a quote on that security establishes, in SIA’s view, precisely the type of “ready market” that the section 23A exception was designed to encompass.

In addition, SIA notes that the SEC has allowed mutual funds to purchase securities from their affiliates on the basis of independent dealer quotes. Section 17(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-17(a), generally prohibits a mutual fund from purchasing securities from or selling securities to an affiliate. The SEC’s Rule 17a-17, however, offers an exemption to this general prohibition for securities that are, among other things, bought or sold at the “current market price.” See 17 C.F.R. 270.17a-7. Rule 17a-7 – which is closely analogous to the ready market exemption that the Board is considering here – contains a detailed definition of “current market price,” which includes the highest current independent bid and lowest current independent offer determined on the basis of “reasonable inquiry.” The SEC staff has stated that “reasonable inquiry,” as it is used in Rule 17a-7, contemplates that the investment company will solicit sufficient numbers of bid and offer prices from disinterested third parties to approximate the value of the security in the secondary

⁸ SIA also notes that mutual fund shares may not always be purchased from a broker-dealer, but may be acquired from the mutual fund itself. For this reason, SIA suggests that the Board not condition the availability of the ready market exemption for mutual fund shares on the involvement of a registered broker-dealer in the transaction.

market.⁹ SIA urges the Board to follow the SEC's example and to find that two independent dealer quotes constitute a sufficient number of quotes to establish the ready market price.

SIA also believes – contrary to the Board's suggestion – that the existence of two independent dealer quotes demonstrates the depth and liquidity of the market. Many debt securities, for example, may not be quoted on third-party electronic networks but may have several dealers who make a market in such securities and who stand ready to give quotes on (and to make purchases of) that security. In addition, as long as the multiple dealers from whom the quotations are obtained are – in fact – independent, SIA asserts that there is little risk that the quote received will not be reliable and demonstrative of the price at which the security could be purchased. For the reasons stated above, the SIA urges the Board to accept independent dealer quotes as a reliable indicator that a security has a “readily identifiable and publicly available market quotation” within the meaning of section 23A.

Finally, SIA respectfully suggests that the Board not limit the availability of the ready market exemption to those securities that a state member bank is allowed to purchase. There may be securities that are permissible investments for other types depository institutions (or Edge corporations) that are not permissible for a state member bank. As long as the depository institution that purchases a security is authorized to buy and own that security under the regulations that apply to that institution, it should not matter for section 23A purposes whether a state member bank also can buy the security.

E. Accepting Shares of Proprietary Mutual Funds as Collateral

In a supplemental release to proposed Regulation W, the Board asks whether extensions of credit to third parties that are secured by shares of a proprietary mutual fund should be exempt from the restrictions of section 23A. SIA offers its full support for such an exemption.

As discussed above, the SIA and its members strongly support the exemption of a bank's *purchase* of certain securities with a ready market, including shares of proprietary mutual funds, from the quantitative and collateral requirements of section 23A. For the very reasons noted above, SIA believes the Board also should exempt a bank's *acceptance* of proprietary mutual funds as collateral for a loan to a nonaffiliate. With the adoption of adequate safeguards, SIA sees no reason why proprietary mutual fund shares could not be viewed as just as stable and liquid a source of collateral as shares of nonproprietary mutual funds. To this end, SIA respectfully submits that acceptance of proprietary mutual fund shares as collateral does not expose banks to any greater risks than accepting non-proprietary fund shares as collateral.

SIA also does not object to three of the five conditions on the availability of this exemption proposed by the Board. SIA believes that it would be reasonable to require that (i) the price of the mutual fund shares be quoted routinely in a widely disseminated news source; (ii) the shares of the mutual fund be widely held by the public; and (iii) the

⁹ See Principal Preservation Tax-Exempt Fund and Tax-Exempt Portfolios, Inc., [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,386 (Dec. 8, 1986).

bank and its affiliates not own in the aggregate more than 5 percent of the shares of the mutual fund. SIA believes that these conditions will more than adequately protect the bank against potential conflicts of interest and other misuses of funds.

SIA, however, opposes the imposition of any condition on the use of the borrowed funds. Quite simply, SIA believes it is highly unlikely that the extension of credit for the purchase of proprietary mutual fund shares would be subject to potential abuse, such as schemes to inflate the value of proprietary mutual fund shares. In addition, SIA believes that it will be nearly impossible for banks to monitor whether borrowers use some proceeds of a general line of credit to buy proprietary mutual fund shares.

SIA also opposes the requirement that the borrower not be an executive officer of the bank or its affiliates. SIA respectfully submits that the conditions imposed on a borrower who is an executive officer are – and should continue to be – governed by the Board’s Regulation O, and not by section 23A.

F. Contributions of Securities to Banks

The Board has proposed to apply section 23A to transactions in which a holding company contributes all of the shares of a subsidiary to one of the holding company’s banks. The Board has proposed to require this transaction to be valued for section 23A purposes based on the total amount of liabilities owed by the contributed entity to any person. In effect, the Board’s rule requires the bank to treat a donation – for which it expends no cash – as if it were a purchase and to value the purchase at a price that is equal to the contributed entity’s total liabilities.

This treatment, as the Board recognizes, represents a departure from its past practice. In the past, the Board treated these contributions as covered transactions valued at the liabilities owed by the contributed company to *its affiliates*. SIA believed that the past practice itself was too strict, because it ignored the assets and positive value being contributed to the bank. SIA opposes the Board’s determination to change and to make stricter the valuation scheme, which will make it more difficult for these sorts of beneficial transactions to take place.

SIA believes that, in changing the valuation methodology, the Board has neglected the fact that contributions of shares have resulted in many valuable businesses being transferred (for no consideration) from holding companies to banks. The Board should not, in SIA’s view, create additional barriers to such beneficial transactions.

G. Low-Quality Assets

The Board notes that two provisions of section 23A restrict a bank’s ability to engage in affiliate transactions that involve low-quality assets. The statute restricts the ability of a bank to purchase low-quality assets from an affiliate and prohibits a bank from counting a low-quality asset toward section 23A’s collateral requirements.

The Board goes on to mention in a footnote to its release that low-quality assets include non-investment grade securities. SIA urges the Board to reconsider this

classification of non-investment grade securities, particularly for purposes of section 23A's collateral requirements. It is true that banks, in the normal course, cannot hold non-investment grade securities as investments but, provided that the securities are still performing, that restriction should not result in these securities being deemed low-quality for section 23A purposes. Classifying these securities as low quality will prevent an affiliate from ever pledging these securities as collateral to a bank to meet the section 23A collateralization requirements. Given the fact that much riskier assets can be pledged as section 23A collateral (including receivables from anyone, equities, and real estate), in SIA's view, the restriction on non-investment grades makes little sense.

H. The Treatment of Investment Funds as Affiliates

The Board has proposed to expand the definition of "affiliate" to include, for the first time, any investment fund – even if the fund is not a mutual fund – if a bank or an affiliate of the bank (a) serves as investment adviser to that fund, and (b) the bank or one of its affiliates owns or controls more than 5 percent of the voting shares of the fund. SIA opposes this extension of the definition of "affiliate," which a plain reading of section 23A does not support. SIA also does not believe that this extension of the statutory definition of affiliate is necessitated by demonstrated conflicts of interest or risks to bank safety and soundness.

I. Control and Convertible Securities

The Board has included a provision in Regulation W that provides that a company that controls securities that are convertible, at the option of the holder or owner, into other securities will be deemed to own those other securities. The Board's Regulation Y contains a similar provision, but Regulation Y provides a *rebuttable presumption* of control for securities that are *immediately convertible* into other securities. 12 C.F.R. 225.31(d)(1). SIA believes that the Board should adopt the Regulation Y definition and provide a mechanism by which banks and other companies may rebut a presumption of control.

J. Procedure for Exemptions

Finally, SIA believes that the Board should adopt a procedural section in Regulation W that sets forth how it will deal with requests for exemptions and interpretations under the rule. SIA believes that the Board should impose on itself a deadline (perhaps 60 days from the receipt of a request) for ruling on exemption or interpretive requests. Such a deadline would prevent inordinate delays in handling of such requests.

* * *

SIA would be happy to meet with you to discuss our comments and concerns regarding the Board's rulemaking. If you have any questions, please contact Alan E. Sorcher, Vice President and Associate General Counsel, at (202) 296-9410.

Sincerely,

James E. Reilly
Chair
Holding Company Committee

