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August 15, 2001

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington D.C. 20551

Docket Nos. R-1103; R-1104; & R-1015
regs.comments@federalreserve.gov

Re: Proposed Regulation W and the Interim Final Rules on Intraday Extensions of Credit

Dear Ladies and Gentlemen:

The Bond Market Association ("Association" or "TBMA") 1 welcomes this opportunity to comment on the Board of Governors of the Federal Reserve System's ("Board") proposed new Regulation W ("Proposed Regulation W") addressing the treatment of transactions between a depository institution ("Bank") and its affiliates for purposes of Sections 23A and 23B of the Federal Reserve Act ("FRA"). The Association also appreciates this opportunity to comment on the interim rules ("Interim Rule," and together with Proposed Regulation W, the "Proposal") that address the applicability of Sections 23A and 23B of the FRA to intraday extensions of credit by a Bank to its affiliates.

Although this letter addresses a number of areas where the Association has specific concerns about the Proposal, TBMA is strongly supportive of the Board's overall efforts to clarify the regulatory treatment of transactions under Sections 23A and 23B of the Federal Reserve Act. 2 Banks would certainly benefit from being able to determine more precisely whether a particular transaction is subject to the limitations contained in Sections 23A and 23B.

A. Executive Summary

While the Association generally supports the Board's Proposal, we would urge the Board to modify the Proposal in the following respects:

The Interim Rule, addressing intraday extension of credit to affiliates, should be adopted as a final rule in lieu of the more burdensome and duplicative proposal contained in Proposed Regulation W.

The Board should clarify that purchases of U.S. government and agency securities from an affiliate at or below the securities' current market quotations are currently permissible and are otherwise limited by the Board's Ready Market Rule or Proposed Regulation W.

Given that fixed-income instruments do not generally trade on a formal exchange, the use of multiple dealer quotes should be more fully recognized in Proposed Regulation W as a valid method for identifying the prevailing market price for a debt security.

Proposed Regulation W should provide that cross-affiliate netting arrangements that do not make the Bank liable for the obligations of its affiliates or otherwise cause any detriment to the Bank are not subject to the requirements of Section 23A.

Securitization-related SPEs should not be treated as Bank affiliates under Proposed Regulation W because such activities are already subject to extensive regulatory treatment.

Proposed Regulation W should provide that the borrowing of securities by a Bank from an affiliate in connection with providing a customer with securities clearing and settlement services is not a covered transaction under Section 23A.

B. Intraday Extensions of Credit to Affiliates

1. The Association supports the Board's Interim Rule and recommends that it be adopted as a final rule instead of the approach contemplated in Proposed Regulation W.

The Association is generally supportive of the Board's Interim Rule on the treatment of intraday extensions of credit by Banks to their affiliates as described in the Proposal. As the Board correctly notes in its release, Banks regularly engage in broad range of affiliate transactions in conjunction with providing their affiliates with payment and securities clearing services. 3 While these clearing and settlement arrangements can give rise to intraday overdrafts (that we understand in most instances are repaid in the ordinary course of business), these overdrafts are not incurred for the purpose of providing credit or balance sheet support to an affiliate. Instead, they arise as an operational consequence of mismatches between the timing of funds transfers and/or securities settlement transactions. While there is always some remote risk that an intraday credit exposure arising from these arrangements could turn into an overnight funding of an affiliate, we agree with the Board's conclusion that the full application of Section 23A to these exposures is not appropriate. Few, if any, Banks currently have the capability to measure and collateralize such exposures intraday and across multiple accounts, time zones and legal entities without incurring substantial costs. We, therefore, support the Board's Interim Rule and urge the Board to consider adopting it as a final rule in lieu of the approach contemplated in its Proposed Regulation W. 4

2. The more detailed monitoring requirements in the Proposed Intraday Rule for intraday extensions of credit are duplicative, burdensome and unnecessary.

The Board has also asked for comments on a more detailed rule proposal (the "Proposed Intraday Rule") addressing intraday credit extensions by Banks to affiliates that is contained in Proposed Regulation W. 5 Because any intraday exposure that became an overnight extension of credit to an affiliate would be fully subject to the requirements of Section 23A, the Association views the more detailed monitoring requirements in the Proposed Intraday Rule as duplicative, unduly burdensome and completely unnecessary. The minimal benefits that would be derived from requiring Banks to monitor their exposures to all affiliates on an intraday basis cannot justify the substantial compliance costs that would be involved in setting up the sorts of systems contemplated by the Proposed Intraday Rule.

The Proposed Intraday Rule attempts to provide relief from Section 23A's quantitative limits and collateral requirements by exempting certain intraday exposures arising out of a Bank's performance of either securities clearing and settlement transactions or payment transactions on behalf of an affiliate. However, the proposed exemption is overly prescriptive in its approach and in all likelihood will lead to few, if any, firms having any meaningful opportunity to rely on the safe harbor. Accordingly, the Association urges the Board not to adopt the Proposed Intraday Rule as written.

While the Interim Rule would continue to leave the method of monitoring intraday exposure up the Bank's senior management, the Proposed Intraday Rule's more detailed five-pronged test is unnecessary given that there will be little or no added benefit derived from being expressly required to evaluate these exposures a few hours earlier in the business day. It could also prove to be quite difficult and costly for a Bank to monitor intraday its exposures to all of its affiliates on a worldwide basis in real time. Even local limits may be difficult to enforce on an intraday basis where a Bank participates in a real time delivery against payment clearing system on the affiliate's behalf. Indeed, the Federal Reserve itself has found it impractical at times to enforce rigid limits on clearing banks participating in the Federal Reserve's book entry system. 6 Finally, as a practical matter, Banks already have substantial incentives to monitor each affiliate's intraday exposure to ensure compliance with the applicable Section 23A limits on overnight exposures. Bank managers remain in the best position to decide how best to achieve this compliance objective and should be given greater flexibility to tailor their compliance systems to take into account their institution's unique operating environment and the overall organizational structure of its business units.

C. Exemptions--Government Securities and Dealer Quotes

Government Securities

1. The Association strongly supports the exemption in the Proposed Regulation W for purchases of U.S. government and federal agency securities.

The Association supports the exemption in Subsection 223.16(e)(1)(ii) of Proposed Regulation W. Proposed Regulation W would exempt from the quantitative limits and collateral requirements of Section 23A the purchase of a United States Treasury or federal agency security if the security is purchased at or below the asset's "current market quotation." We view this exemption as fully consistent with Section 23A(d)(4) of the FRA, which exempts extensions of credit fully secured by government and agency securities from these same limitations.

2. The Board should clarify that purchases of U.S. government and agency securities from an affiliate at or below the securities' current market quotations are currently permissible and are not otherwise limited by the Board's Ready Market Rule or Proposed Regulation W.

Notwithstanding our general support for the exemption in Subsection 223.16(e)(1)(ii), our members believe that certain aspects of Proposed Regulation W are likely to create confusion about the general availability of the 23A(d)(6) exemption for purchases of government and agency securities. As the release accompanying Proposed Regulation W acknowledges, the Board has historically interpreted Section 23A(d)(6)'s exemption for purchases of assets having a readily identifiable and publicly available market quotation as applicable to all purchases of government and agency securities. 7 However, the language in the Board's recent final rule codifying the ready market exception 8 as well as Subsection 223.16(e)(2) of Proposed Regulation W 9 could be construed as being inconsistent with the general availability of the 23A(d)(6) exemption for purchases of government and agency securities. Our members believe that the additional exemptions provided for federal agency securities in subsection 223.16(e)(2)(iv) and (vi) are redundant and therefore unnecessary. We urge the Board to clarify in its final version of Regulation W that purchases of government securities from an affiliate at or below the securities' current market quotations are permissible and are not meant to be limited by either the Board's Ready Market Rule or subsection 223.16(e)(2) of Proposed Regulation W.

Price Quotes from an Unaffiliated Service

3. The Association supports the exemption provided by the Board's Ready Market Rule and Proposed Regulation W, including allowing the use of price quotations from an unaffiliated electronic service that provides indicative data from real-time financial networks.

Both the Board's Ready Market Rule and subsection 223.16(e)(2) of the Proposed Regulation W would exempt from Section 23A's quantitative limits and the collateral requirements the purchase of a security from a securities affiliate if the transaction meets certain requirements. The Association supports this exemption, including the criterion allowing the use of price quotations from an unaffiliated 10 electronic service that provides indicative data from real-time financial networks.

In certain circumstances, a Bank's broker-dealer affiliate will have available blocks of debt securities that are suitable for purchase by the Bank, including as a result of the affiliate's role as the only or principal underwriter of an issue of debt securities. In addition, competitive execution is often available from the Bank's broker-dealer affiliate acting in a principal capacity especially in circumstances where the debt security in question either may not otherwise be available at all or only at a price that is not as competitive as the one offered by the Bank's affiliate. Finally, the ability to rely on indicative quotes is important to our members, as the most recent trade of a particular security may not necessarily reflect the prevailing market price.

Dealer Quotes

4. Dealer quotes should be fully recognized in Proposed Regulation W as a legitimate alternative to valuations based on quotations from an electronic service.

In the release accompanying Proposed Regulation W, the Board asked for comments on whether it would be appropriate to use independent dealer quotations to establish the prevailing market price for a security under the exemption. 11 The Association believes that Banks should be able to rely on quotes from independent dealers as an appropriate source to establish the prevailing market price for a security under the exemption. When the Ready Market Rule was initially proposed in 1998, the Board included "[t]wo or more actual independent dealer quotes on the exact securities to be purchased, where the price paid was not higher than the average of the price quotes obtained from the unaffiliated broker-dealers...." as an alternative to prices from an electronic service. 12 Dealer quotes are used routinely as a determinant of the value of a fixed-income security for trading purposes because certain "seasoned" corporate, municipal and MBS securities can sometimes trade rather infrequently. The use of dealer quotes is sometimes required by NASD rules for certain securities where multiple quotations from interdealer quotation systems are not available. 13 Further, dealer quotes are referenced in industry standard agreements for establishing the value of securities for close out and netting purposes. 14 As a well-established means of valuing securities, dealer quotes should, therefore, be fully recognized in Proposed Regulation W as a legitimate alternative to valuations based on quotations from an electronic service.

Purchases from Non-U.S. Broker Dealers under the Ready Market Exception

5. The Board should expand also this exemption to permit purchases from a broker-dealer affiliate that is registered abroad and subject to adequate regulatory oversight.

In the supplementary information to Proposed Regulation W, the Board asked for comments on whether this exemption should also be available for purchases from a non-U.S. broker/dealer. 15 Given that many Banks have securities affiliates abroad in other financial centers and the increasingly global nature of the fixed income securities markets, the Association urges the Board to expand this exemption to permit purchases from a broker-dealer affiliate that is registered abroad and subject to adequate regulatory oversight. The Association can see no policy reason why the exemption should be limited to U.S. registered securities broker-dealers.

Widely Disseminated Quotations

6. The Association supports the provision in Proposed Regulation W that would exempt the purchase of a security the price of which is quoted routinely in a widely disseminated news source.

Subsection 223.16(e)(1)(i) of Proposed Regulation W would exempt from Section 23A's quantitative limits and collateral requirements the purchase of an asset the price of which is quoted routinely in a widely disseminated news source. The Association supports this exemption. However, TBMA is very concerned about language in the release accompanying Proposed Regulation W that seems to imply that only the price of exchange-traded assets are recorded in such media.

Widely disseminated sources of financial news obviously provide prices for the over-the-counter markets as well as the exchange traded markets. 16 The critical factor in determining whether an asset's price is quoted routinely in a widely disseminated news source for the purposes of Proposed Regulation W should be whether the written or electronic news source publishes the quotation for the purpose of providing information to market participants generally and not whether or not the asset is exchange traded. The Association strongly urges the Board to clarify this point in the final version it releases of Proposed Regulation W.

Municipal Securities

7. The Association supports this exemption, amended as indicated below, as consistent with the Board's existing guidance in this area and thereby helping foster greater regulatory certainty as to the status of these transactions under Section 23A.

Finally, subsection 223.16(f) of Proposed Regulation W would exempt from the quantitative limits and collateral requirements of Section 23A the purchase of a municipal security from an affiliate so long as certain requirements are met including that the security is rated by a nationally recognized statistical rating agency, the security is eligible for purchase by a state member Bank and either (A) the security's price is routinely quoted on an unaffiliated electronic service; (B) the actual purchase price paid can be verified by price quotes from two or more unaffiliated broker-dealers; or (C) the actual purchase price paid can be verified by reference to the written summary provided by the syndicate manager. 17 We recommend that the Proposed Regulation W be amended to permit Banks to purchase municipal securities during the underwriting period, including underwritings for which there is no syndicate, if the sales are made at or below prices at which sales are made to unaffiliated purchasers. The Association fully supports this exemption, amended as indicated above, as consistent with the Board's existing guidance in this area thereby helping foster greater certainty as to the status of these transactions under Section 23A.

D. Proposed Treatment of Cross-Affiliate Master Netting Arrangements

1. The Board should clarify that cross-affiliate netting arrangements that do not make the Bank liable for the obligations of its affiliates or otherwise cause any financial detriment to the Bank are not subject to the requirements of Section 23A.

The release accompanying Proposed Regulation W also invites comments on the Board's proposed treatment of cross-affiliate netting arrangements ("CANAs") under Section 23A. The Association would urge the Board to clarify in its final version of its Proposed Regulation W that cross-affiliate netting arrangements that do not make the Bank liable for the obligations of its affiliates or otherwise cause any detriment to the Bank are not subject to the requirements of Section 23A. The Association would also urge the Board to reserve judgement generally on this issue with respect to all CANA arrangements until standardized documentation practices in this area are more fully developed.

Background on Cross-Product & Cross-Affiliate Netting

As the Board is well aware, in the aftermath of the near-failure of Long Term Capital Management ("LTCM") and the market disruptions of 1998 and 1999, the President's Working Group ("PWG") issued a report identifying certain areas where market participants needed to improve their practices including in the area of documenting over-the-counter financial transactions. 18 The PWG Report contained various recommendations including greater disclosure by hedge funds of their financial condition and prompt Congressional enactment of legislation previously endorsed by the PWG that would facilitate cross-product and cross-affiliate close-out and netting of outstanding financial contracts upon the bankruptcy or insolvency of a counter-party.

Shortly thereafter, a private sector group, the Counter-Party Risk Management Policy Group also published a report ("The CRMPG Report") suggesting how market participants might improve their counterparty credit risk management practices and endorsing the use of master netting agreements as a method of reducing counter-party credit exposures. 19 The CRMPG Report also specifically expressed support for the Association's efforts to develop its cross product master agreement ("CPMA") and encouraged other trade associations to endorse the final document.

The CPMA

Subsequently, the CPMA was formally published by the Association along with a number of other sponsoring trade associations in February of 2000. 20 The CPMA offers one approach to managing counterparty credit risk on a bilateral basis that allows market participants to continue using their preferred form of product/transaction specific contract for each type of financial transaction. 21 Today, the CPMA is recognized around the globe as a valuable tool for reducing credit exposures arising under multiple industry sponsored master agreements with the same counterparty. 22

As the trade association responsible for initially developing the CPMA, the Association, therefore, is uniquely qualified to provide the Board with guidance on the potential usage of cross-affiliate netting arrangements between market participants. Indeed, as a follow-up to the publication of the CPMA, the Association is currently developing a version of the CPMA that would be a model agreement designed to facilitate cross-affiliate netting. 23 This more advanced version of the CPMA is expected to significantly enhance the usefulness of the CPMA for large financial institutions that book different products in different legal entities within their corporate group structure. The Association is more than happy to meet with Board staff in order to brief them on our efforts to develop the cross-affiliate version of the CPMA.

Proposed Regulation W

In its release accompanying Proposed Regulation W, the Board indicated that it considers a CANA to be an arrangement between a Bank, one or more Bank affiliates ("Affiliates"), and one or more non-affiliates of the Bank ("Non-affiliates"), where a Non-affiliate is permitted to net obligations of an Affiliate to a Non-affiliate when settling the Non-affiliate's obligations to the Bank. 24 The release goes on to state that "[t]hese arrangements also would include agreements where a Bank is required to add the obligations of an affiliate of the bank to a nonaffiliate when determining the bank's obligations to the nonaffiliate." 25

As an initial matter, the Association would emphasize that there are a number of other types of cross-affiliate netting arrangements among Banks and their affiliates that have not been (nor should be) subject to the quantitative limits and collateral requirements of Section 23A. Banks, for instance, might also choose to enter into a more limited cross-affiliate netting arrangements with a single non-Bank counterparty whereby the netting of exposures only benefits the Bank and its affiliates.

Attached as Appendix A are examples of two common types of cross-affiliate netting arrangements that might be used by a Bank and that would only improve the position of the Bank and its affiliates upon the default and close-out of a single counter-party. 26 These examples are intended to help highlight for the Board why these sorts of netting arrangement would in no way threaten the safety and soundness of Bank or otherwise raise the sorts of public policy concerns that underlie the protections afforded insured depository institutions by Section 23A of the FRA.

In neither of the examples provided in Appendix A is Party A/the Bank in any way guaranteeing its affiliate's obligations to Party B. In fact, these sorts of limited CANA arrangements actually benefit the Bank and help reduce the Bank's exposure to losses arising from a counterparty's default under an over-the-counter financial contract. While it is true that, by analogy, a loan made by a Bank to a third-party that is collateralized by the pledge of an affiliate's security may be a covered transaction for purposes of Section 23A, 27 the Board has been willing to take into considerations the particular circumstances of a transaction in interpreting the scope of Section 23A. 28 A cross affiliate netting arrangement where the Bank merely accepts additional collateral that can improve its position should not be treated as a covered transaction under Section 23A. In short, the Association recommends that the Board clarify in any final rule that these and other CANA arrangements that do not make the Bank liable for the obligations of its affiliates and that improve the Bank's position as a creditor are not subject to the requirements of Section 23A. The Association also urges the Board to reserve judgement generally on this issue with respect to all CANA arrangements until standardized documentation practices in this area are more fully developed.

E. Proposed Treatment of Securitization-related Special Purpose Vehicles as Affiliates

In the area of securitizations, the Board specifically requests comment regarding whether securitization-related bankruptcy remote special purpose entities ("SPEs") should in any circumstance be deemed bank affiliates for purposes of Section 23A, and if so, which specific transactions between an SPE and a Bank should be considered covered transactions under Section 23A.

The Association believes that Proposed Regulation W should not treat securitization-related SPEs as Bank affiliates for the following reasons:

The use of securitization-related SPEs by Banks does not raise the public policy concerns underlying the issuance of Proposed Regulation W with respect to Bank transactions with affiliates.

Affiliate treatment would have unintended negative consequences for Banks engaged in securitization activities and for the broader securitization market.

Bank securitization activities are already subject to extensive regulatory and supervisory oversight to address the specific types of risks that such activities may present to banking institutions. There is no evidence to suggest that this comprehensive oversight framework is deficient in a way that would specifically justify treating securitization-related SPEs as affiliates.

As a preliminary matter, the Board and the other bank regulatory agencies have consistently recognized the significant efficiency, risk reduction, balance sheet management and other benefits that Banks derive from securitization activities. 29 Largely because of these benefits, the breadth and volume of Bank securitization activities have increased dramatically in recent years. This expansion in Bank securitization activities has enhanced the competitiveness and efficiency of individual institutions, and of the banking system as a whole. As the secondary securitization markets have become increasingly deep and liquid, business and retail clients of Banks have benefited from a wider availability and reduced cost of credit. Accordingly, any revision to the basic regulatory and supervisory oversight framework applicable to such activities should be undertaken very carefully, and only in response to a clearly demonstrated need.

1. The use of securitization-related SPEs by Banks does not raise the public policy concerns underlying the promulgation of Proposed Regulation W with respect to Bank transactions with affiliates.

In setting forth a regulatory implementation scheme for Sections 23A and 23B, Proposed Regulation W is intended to prohibit Banks from utilizing affiliates to engage in transactions that would improperly expand a Bank's access to the federal safety net, including transactions that would not be permissible for the Bank itself. As discussed below, however, the use of SPEs by Banks in connection with securitization activities does not generally raise this underlying public policy concern.

Securitization-related SPEs essentially function as structural conduits through which Banks may engage in certain types of financing or risk/balance sheet management transactions. They are formed exclusively for the purpose of facilitating securitization transactions, by effecting the segregation of assets that support payments on related asset-backed securities. As such, the SPE does not engage in any activities or business enterprises other than holding assets and issuing liabilities - activities that also could as a general matter be performed by the Bank directly. In this way, SPEs resemble operating subsidiaries that the Board long has characterized as a convenient alternative organizational arrangement which consequently should be excluded from the definition of affiliate in Proposed Regulation W.

2. Affiliate treatment would have unintended negative consequences for the Banks engaged in securitization activities and for the broader securitization market.

Treating securitization related SPEs as affiliates would effectively limit the total amount of guarantees, including standby letters of credit, that a Bank could issue in support of, and securities that a Bank could purchase from, all of its SPE affiliates, to 20 percent of the capital stock and surplus of the Bank. This constraint would artificially limit the total amount of assets that could be securitized involving these support arrangements. Perhaps more importantly, the SPE would be required to collateralize the full amount of any such guarantees, standby letters of credit or purchases of securities. The need to post collateral consequently would reduce the assets available to back the securities issued to the market and therefore would reduce the amount of funds, and/or increase the cost of funds, raised through the securitization process. These constraints could, in turn, increase the costs, or reduce the availability of loans subject to securitization, thereby unnecessarily sacrificing liquidity.

3. Bank securitization activities are already subject to extensive regulatory and supervisory oversight to address the specific types of risks that such activities may present to banking institutions. There is no evidence to suggest that this comprehensive oversight framework is deficient in a way that would specifically justify treating securitization-related SPEs as affiliates.

Finally, asset-backed securitization, and the related risks and benefits to Banks, have long been recognized and scrutinized by bank supervisors, both domestically and internationally. For example, the Board's Trading and Capital-Markets Activities Manual already addresses the credit, reputational and liquidity risks that would presumably be addressed by treating SPEs as affiliates for purposes of Section 23A. Similar scrutiny of these activities is exercised by the other bank supervisory agencies as well.

In December of 1999, the Bank supervisory agencies, including the Board, issued comprehensive Interagency Guidance on Asset Securitization Activities. 30 This guidance addresses all aspects of the securitization process from the standpoint of the Bank, including the risk management function, the valuation and modeling process, the use of outside parties, internal controls, audit and internal review, regulatory reporting, market discipline and disclosures, concentration limits and capital.

Further, asset securitization and capital requirements currently are the subject of an extended and comprehensive review, both internationally and domestically. In January of this year, the Basel Committee on Banking Supervision proposed for comment the New Basel Capital Accord that included and extensive consultative document devoted exclusively to asset securitization. 31 The New Capital Accord represents a complete review of the capital requirements for securitization on an international basis. Similarly, in March, 2000, the constituent agencies of the Federal Financial Institutions Examination Council (FFIEC) issued proposed risk-based capital standards addressing, among other matters, recourse arrangements and direct credit substitutes. 32 The agencies of the FFIEC subsequently issued separate proposals addressing the risk-based capital treatment of residual interests retained by Banks in connection with their securitization activities. 33

There is no evidence to suggest that this comprehensive regulatory and supervisory oversight framework is deficient in a way that would require treating SPEs as affiliates in order to protect Banks and the larger banking system from the specific types of risks that securitization activities may present. Moreover, treating securitization SPEs as affiliates for purposes of Proposed Regulation W would not be an effective means of addressing such risks, but would instead curtail the structural flexibility and efficiency that Banks achieve by employing SPEs in securitization transactions.

In conclusion, the Association believes that the application of Section 23A to Bank SPEs would establish needless artificial limits and produce adverse unintended consequences for the securitization process, which overall has demonstrated its value and benefits to banking institutions. Such action would upset the comprehensive supervisory framework already in place, which we believe effectively balances the benefits of securitization with the risks involved to Banks. Particularly given the increasingly global character of both banking and securitization activities, implementing this regulatory change would also place U.S. Banks at a disadvantage with respect to their foreign competitors. For all of the foregoing reasons, we strongly urge the Board not to deem securitization-related SPEs as "affiliates" for any purpose under Sections 23A and 23B.

F. Clarifying the Treatment of Transactions Where the Bank Borrows Securities For its Own Purposes

1. Proposed Regulation W should be modified to provide that the borrowing of securities by a Bank for its own operational needs is not an extension of credit or otherwise a covered transaction

Lastly, the Association urges the Board to clarify that the borrowing of securities by a Bank either for its own operational needs or for further delivery to another party is not an extension of credit or otherwise a covered transaction for the purposes of Section 23A or Proposed Regulation W. If a Bank initiates a securities borrowing or reverse repurchase transaction for its own operational needs whereby it receives securities from an affiliate, such a transaction should not be treated as a covered transaction simply because the affiliate requires the Bank to deliver cash or other collateral to secure the Bank's borrowing. 34 Such transactions arise in the Bank's normal course of business and allow the Bank to make delivery of securities when there is a failure to receive securities required to be delivered or other similar situation. 35

As an initial matter, securities lending and reverse repurchase transactions obviously play a crucial role in preventing fails and maintaining efficient and liquid markets. The Federal Open Market Committee has itself recognized this role in its annual authorization for the lending of U.S. Government securities held in the System Open Market Account. 36 The Board has also long recognized the importance of securities lending transactions in the special provisions on borrowing and lending in Board's Regulation T. 37 Effective in 1998, the Board significantly liberalized the provisions of Regulation T applicable to the borrowing and lending of securities, implicitly recognizing the important of these transactions in the securities markets. Finally, in their recent interim rule on the capital treatment for cash collateral, the Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency noted that: "[s]ecurities borrowing enhances market efficiency and provides an important source of liquidity to the securities market." 38

For example, in some cases a Bank's foreign subsidiary may need to borrow other types of securities in order to complete a delivery. In such circumstances, cash collateral may be posted by the Bank in connection with the transaction. While a similarly structured transaction might be undertaken in order to provide liquidity or credit support to the affiliate of the Bank thereby raising concerns under Section 23A, the fact that the transaction is undertaken by the Bank to satisfy its own operational requirements, together with the application of Section 23B to these transactions, should adequately protect the Bank. Any divergence from market terms in such a transaction should be readily apparent by comparing the amount of cash collateral with the price of other market transactions such as the transaction that would otherwise give rise to the fail.

Therefore, we would recommend that the Board clarify that a securities lending transaction undertaken in order to meet a delivery obligation on the part of the Bank or one of its customers that meets the standards required by Section 23B is not an extension of credit by a Bank and is thus exempt from the requirements of Section 23A.

In addition, many securities borrowing and lending transactions already should be exempt under the provisions of proposed Section 223.16 including subsection 223.16(c) (transactions secured by cash or U.S. government securities); subsection 223.16(e) (purchasing certain liquid assets); and subsection 223.16(f) (purchasing municipal securities). The Association asks that the Board confirm that, where appropriate, securities borrowing and lending transactions fit within these exemptions, regardless of whether they are documented as a secured loan, repurchase agreement or matched purchase and sale, as the economic effect of such transactions is the same.

In closing, the Association appreciates this opportunity to comment on the Board's proposal. If you have any questions in respect to this letter please contact the undersigned at 212.440.9448 or by e-mail.

Sincerely,

Eric L. Foster Vice President & Assistant General Counsel

Attachment

cc: The Bond Market Association
Funding Division Legal Advisory Committee
Government Legal Advisory Committee
MBS/ABS Legal Advisory Committee
Municipal Legal Advisory Committee
Paul Saltzman, Executive Vice President and General Counsel
Legal & Professional Staff

The Board of Governors of the Federal Reserve System
The Honorable Alan Greenspan, Chairman
Roger W. Ferguson Jr., Vice Chairman
Edward M. Gramlich, Governor
Edward W. Kelley, Jr., Governor
Laurence H. Meyer, Governor

The Federal Reserve Bank of New York
William J. McDonough, President
Joyce Hansen, Senior Vice President and Deputy General Counsel

Securities and Exchange Commission
Annette Nazareth, Director, Division of Market Regulation

National Association of Securities Dealers
Robert R. Glauber, CEO and President

Municipal Securities Rulemaking Board
Diane G. Klinke, General Counsel

Appendix A

Example 1

Major Assumptions:
Bank (Party A) enters into financial transactions with a single non-Bank counterparty (Party B) under one or more product specific master agreements. At the same time, certain affiliates of Party A (Party A1 and Party A2) might also enter into financial transactions with Party B under a second separate master agreement.

Under this example, a cross affiliate netting arrangement ("CANA") might include the use of an additional cross product master agreement between Party A, Party A1 and Party B whereby Party A has the right (but not the obligation) to assign any amount or interest it is owed by Party B under a master agreement to Party A1 in exchange for immediate receipt of a cash purchase price equal to the full amount of the receivable thereby allowing Party A1 to ultimately set-off any final settlement amount it is owing to Party B against the assigned receivable. Thus, assuming Party A was owed $100 by Party B and Party A1 was owing $60 to Party B, the Bank/Party A would benefit since it would be better assured of receiving immediate payment of any net settlement amount it is owed upon the default of Party B. Here is how it might look:

Example 2

Alternatively, a cross affiliate netting agreement between the same three parties might provide that Party B pledges any amount otherwise payable to it by Party A1 to secure its obligations to Party A. In this instance, let's again assume Party A was owed $100 by Party B and Party A1 owed $60 to Party B. Party B would have pledged any amount payable to it by Party A1 to secure its obligations to the Bank/Party A. As a result, Party A/the Bank would have been ensured of receiving at least $60 of the $100 it was owed. Here is how this CANA might look:

Notes

The Association represents securities firms and banks that underwrite, distribute and trade in fixed income securities, both domestically and internationally, including all primary dealers recognized by the Federal Reserve Bank of New York. Our members are also actively involved in the funding markets for such securities, including the repurchase and securities lending markets. Further information regarding the Association, its members, and activities, can be obtained from our public website http://www.bondmarkets.com.

The Board's Proposal is generally consistent with one of the guiding concepts expressed in the Association's document entitled "Bond Markets 2000, A Conceptual Framework for Efficient Regulation of the Fixed Income Markets," which is to minimize regulatory costs by eliminating or modifying regulations that yield uncertain or minimal benefits. This document is available on the Association's Internet home page.

See 66 Fed Reg. at 24,231(May 11, 2001).

The Association would, however, urge the Board to clarify one aspect of the Interim Rule before it is released as a final rule. Specifically, Section 250.248(b) of the Interim Rule should more clearly indicate that a Bank's policies for monitoring intraday credit exposures to its affiliates can differ from those used to monitor credit exposures with non-affiliates. Compared to the typical financial information that a Bank receives from a customer for which it is providing payment and/or securities settlement transactions, Bank will almost always have access to much more (and better) information about the current financial condition of an affiliate.

See Proposed Section 223.16(k), 66 Fed. Reg. at 24,200 (May 11, 2001).

See Section I. F. of the Federal Reserve System Policy Statement on Payments System Risk.

See 66 Fed. Reg. 24,199 (May 11, 2001).

See 66 Fed. Reg. 24,225 (May 11, 2001) (interpreting the applicability of Section 23A of the Federal Reserve Act to the purchase of securities from certain affiliates (codified at 12 C.F.R. 250.246). ("Ready Market Rule").

See Proposed Rule 223.16(e)(2)(iv); 66 Fed. Reg. at 24,214 (May 11, 2001).

It is our understanding that the Board intends to make this exemption available in circumstances where a Bank or one of its affiliates is a minority stakeholder in a joint venture or consortium that owns the electronic service or utility providing the real-time price data. So long as neither the Bank nor any of its affiliates exercise day-to-day control over the joint venture service provider, we can see no reason why a Bank should not be able to utilize such an electronic service.

See 66 Fed. Reg. 24,199 (May 11, 2001).

Federal Reserve System, Docket No. R-1015 (June 11, 1998).

NASD Rule 2320(g).

See, e.g. 1992 ISDA Master Agreement (Multi-currency, Cross Border), Section 6(e).

See 66 Fed. Reg. 24,199 (May 11, 2001).

There has recently been a literal explosion in the amount of real-time pricing data that is available to participants in the fixed-income markets. See The Bond Market Association's "e-Commerce in the Fixed Income Markets" (Nov. 2000). The Association's web site contains additional information about the availability electronically of real-time price data.

See 66 Fed. Reg. 24,199 (May 11, 2001).

See "Hedge Funds, Leverage and the Lessons of Long-Term Capital Management," President's Working Group on Financial Markets (April 1999) at 40.

See Improving Counterparty Risk Management Practices pgs. 47- 48 published by The Counterparty Risk Management Policy Group (June 1999).

The CPMA was jointly published by the Association and the following other trade associations: the Emerging Markets Traders Association ("EMTA"), the British Bankers Association ("BBA"), the International Swaps and Derivatives Association ("ISDA"), the Foreign Exchange Committee ("FXC"), the Japan Securities Dealers Association ("JSDA"), the London Investment Banking Association ("LIBA"), the Investment Dealers Association of Canada ("IDA"), and the International Primary Market Association ("IPMA") (hereinafter, collectively referred to as the "Publishing Associations"). Subsequently, the International Securities Market Association ("ISMA") moved to separately endorse the CPMA. The CPMA is available on the Association's web site.

By providing what in effect is a super cross-default clause that makes a close-out event under one master agreement grounds to close out all other specified master agreements, and permitting set-off of settlement amounts arrived at under such agreements, the CPMA is designed to facilitate the greatest possible netting of exposures arising under financial contracts.

A. Gooch & L. Klein, Documentation for Derivatives: Cross Product Risk Management Supplement pgs. 28, 29 (Euromoney Books, 2000).

The Association's CPMA Working Group has been meeting regularly since January 2001 and has identified the most viable approaches to cross-affiliate netting under U.S. and U.K. law. The Association anticipates releasing a draft of the cross-affiliate version of its CPMA first to its co-publishing associations, and then to the public, for comment sometime in early 2002.

See 66 Fed. Reg. 24,206 (May 11,2001).

Id.

However, there are a number of other more complicated approaches that the Association would be happy to explain to the Board and its staff.

See 12 U.S.C.A. 371c(b)(7)(D); Proposed Subsection 223.11 (posting securities issued by an affiliate as collateral).

See Board Interpretation 3-1189.2, 3 F.R.R.S. 479, (Bank's advance to a customer of an affiliated Bank involving an affiliate guarantee not subject to Section 23A where, inter alia, the Bank has a credit file on the customer sufficient to independently justify the advance and the guarantee serves a legitimate business purpose); Board Interpretation 3-1130, 1934 Fed. Res. Bull. 391 (noting that when a member Bank makes a loan to a corporation the fact that the note bears an accommodation indorsement of an affiliate does not convert the transaction into a "loan or extension of credit" to such affiliate under Section 23A.)

See, e.g., "Interagency Guidance on Asset Securitization Activities," SR 99-37, December 13, 1999 ("For several years, large financial institutions, and a growing number of regional and community institutions, have been using asset securitization to access alternative funding sources, manage concentrations, improve financial performance ratios, and more efficiently meet customer needs. In many cases, the discipline imposed by investors who buy assets at their fair value has sharpened selling institutions' credit risk selection, underwriting and pricing practices.")

Id.

"The New Basel Capital Accord," consultative document issued by the Basel Committee on Banking Supervision of the Bank for International Settlements, January 2001.

65 Fed. Reg. 12,320.

65 Fed. Reg. 57,993.

In the past the Board has recognized efficiencies resulting from the inter-affiliate transfer of securities. See 90 Fed. Res. Bul.158 at 165.

Federal Reserve System, Docket No. R-1087.

See Authorization for Domestic Open Market Operations, amended January 30, 2001.

See 12 C.F.R. § 220.10.

See Federal Reserve System, Docket No. R-1087.