



# Restrictions on Bank Affiliate Transactions: Sections 23A and 23B of the Federal Reserve Act and Regulation W

A Lexis Practice Advisor® Practice Note by  
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This practice note covers Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. §§ 371c and 371c-1), which establish certain quantitative limits and other prudential requirements for loans, purchases of assets, and certain other transactions between a member bank and its affiliates. Regulation W (12 C.F.R. pt. 223) promulgated by the Board of Governors of the Federal Reserve System (Federal Reserve) implements Sections 23A and 23B of the Federal Reserve Act.

Specifically, this practice note reviews:

- Overview of Sections 23A and 23B of the Federal Reserve Act
- Who and What Are Covered by Regulation W Restrictions?
- Valuation and Timing Rules
- Applicability to U.S. Branches and Agencies of Foreign Banks
- Special Rules and Exemptions under Regulation W
- Penalties for Violations

For an overview of bank lending limits and related regulatory restrictions, see [Lending Limits and Restrictions](#). For a checklist concerning affiliate transactions and compliance with Regulation W, see [Affiliate Transactions Checklist for Insured Depository Institutions](#). For more information regarding Regulation W generally, see 4 Regulatory Compliance Training Program § 5.03.

## OVERVIEW OF SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT

Section 23A and Section 23B of the Federal Reserve Act establish certain quantitative limits and other prudential requirements for loans, purchases of assets, and certain other transactions between a member bank and its affiliates. The term “member bank” includes national banks, state-chartered banks, trust companies, and institutions that are members of the Federal Reserve. Member banks also include state-chartered banks that are not members of the Federal Reserve as the Federal Deposit Insurance Act as 12 U.S.C. § 1828(j) applies Sections 23A and 23B to insured state nonmember banks in the same manner and to the same extent as if they were Federal Reserve member banks.

The principal regulatory policy behind these restrictive provisions is to reduce the risk exposure of member banks, which take deposits that are insured, up to a \$250,000 limit, by the Federal Deposit Insurance Corporation (FDIC)

to the balance sheet and activities of their non-FDIC-insured affiliates. The regulatory objective, in other words, is to shield the taxpayer-funded deposit insurance fund from potential losses that may result from activities of insured depository institutions that may enter into transactions with their affiliates without due regard to conflicts of interest-related concerns.

### **Overview of Section 23A**

Section 23A prohibits a bank from entering into a “covered transaction” with an affiliate if, after the transaction, (1) the aggregate amount of the bank’s covered transactions with that particular affiliate would exceed 10% of the bank’s capital stock and surplus, or (2) the aggregate amount of the bank’s covered transactions with all of its affiliates would exceed 20% of the bank’s capital stock and surplus.

As more fully described in Definition of Covered Transactions below in Who and What Are Covered by Regulation W Restrictions?, covered transactions include loans and other extensions of credit to an affiliate, investments in the securities of an affiliate, purchases of assets from an affiliate, and certain other transactions that expose the bank to the risks posed by its affiliates. A bank’s “capital stock and surplus” means the sum of the bank’s tier 1 and tier 2 capital under the risk-based capital guidelines, plus the balance of the allowance for loan and lease losses (ALLL) not included in tier 2 capital, based on the bank’s most recent Call Report. 12 C.F.R. § 223.3(d).

Section 23A requires all covered transactions between a bank and its affiliate to be on terms and conditions consistent with safe and sound banking practices (Safety and Soundness Requirement ), subject to certain exemptions discussed below in Special Rules and Exemptions under Regulation W, and prohibits a bank from purchasing a low-quality asset from an affiliate.

A low-quality asset includes an asset that is classified or treated as “special mention” or “other transfer risk problems” in an examination report or pursuant to the bank’s or the affiliate’s own internal asset classification system, an asset in a nonaccrual status, or an asset on which payments are more than 30 days past due. In addition, an asset whose terms have been renegotiated or compromised as a result of the obligor’s deteriorating financial condition, and any asset acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted that has not been satisfactorily reviewed in an examination or inspection, are included within the definition of a “low-quality asset.” See 12 C.F.R. § 223.3(u).

Extensions of credit to an affiliate and guarantees, letters of credit, and acceptances issued on behalf of an affiliate (credit transactions) must be secured by a statutorily defined amount of collateral, ranging from 100% to 130% of the covered transaction amount. Securities issued by an affiliate and low-quality assets are not acceptable collateral for any credit transaction with an affiliate.

### **Overview of Section 23B**

Section 23B of the Federal Reserve Act requires that certain transactions, including all covered transactions, be on market terms and conditions (Market Terms Requirement). In addition to covered transactions, the Market Terms Requirement applies to:

- Any sale of assets by a bank to an affiliate
- Any payment of money or furnishing of services by a bank to an affiliate
- Any transaction in which an affiliate acts as agent or broker for the bank or any other person if the bank is a participant in the transaction –and–
- Any transaction by a bank with a third party if an affiliate has a financial interest in the third party or if the affiliate is a participant in the transaction

In the absence of comparable transactions for identifying market terms, the bank must use terms (including credit standards) that are at least as favorable to the bank as those that would be offered in good faith to nonaffiliated companies.

If you are representing a bank that is engaged in what is, or may be, a covered transaction with one of its affiliates, you should consider carefully on behalf of your client the Safety and Soundness Requirement, the Market Terms Requirements, and other limitations applicable to such transaction under the Federal Reserve Act Sections 23A and 23B and Federal Reserve Regulation W.

As noted in Penalties for Violations below, severe civil money penalties may be imposed for violating the aforementioned provisions, not only on the bank itself but also on an “institution-affiliated party” (or IAP), as such term is defined under 12 U.S.C. § 1813(u), can include an attorney who knowingly or recklessly counsels, or aids or abets, a violation.

### **WHO AND WHAT ARE COVERED BY REGULATION W RESTRICTIONS?**

Two threshold questions need to be answered in determining whether a transaction is subject to Federal Reserve Act Section 23A/23B and Regulation W. The first question is whether the transaction is between a bank and an “affiliate” of the bank. The second question is whether the transaction is a “covered transaction.”

#### **Definition of “Affiliate”**

Regulation W applies to covered transactions between a bank and a bank affiliate. The definition of affiliate for purposes of Regulation W, set forth in Section 223.2, is broad, and includes:

- Any company that controls the bank
- Any company that is controlled by a company that controls the bank
- Any company that is controlled, directly or indirectly, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by the bank or any company that controls the bank
- Any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the bank or an affiliate of the bank
- Any registered investment company for which the bank or any affiliate of the bank serves as an investment adviser
- Any unregistered investment fund for which the bank or any affiliate of the bank serves as an investment adviser, if the bank and its affiliates own or control in the aggregate more than 5% of any class of voting securities or more than 5% of the equity capital of the fund
  - Note that private equity funds, foreign investment funds, and commodities funds that currently escape treatment as an affiliate because they are not registered under the Investment Company Act of 1940 (1940 Act) may be covered under this definition. (The Federal Reserve is of the stated view that the advisory relationship of a bank or affiliate with an investment fund presents the same potential for conflicts of interest, regardless of whether the fund is an investment company registered with the Securities and Exchange Commission (SEC) under the 1940 Act).
- An insured depository institution that is a subsidiary of the bank
- A financial subsidiary of the bank
- Any subsidiary of the bank that is an employee stock option plan or similar entity established for the benefit of the shareholders, partners, members, or employees of the bank or an affiliate of the bank

- Any subsidiary of the bank, if affiliates (other than insured depository institution affiliates) or controlling shareholders of the bank also control the subsidiary through a nonbank chain of ownership
- Subject to certain safe harbors, any portfolio company in which a holding company of the bank owns or controls, directly or indirectly, or through one or more other persons, 15% or more of the equity capital of the company under the merchant banking or insurance company investment authority of the Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act (GLBA)
- Any partnership for which the bank or any affiliate of the bank serves as general partner or for which the bank or affiliate causes any director, officer, or employee to serve as general partner
- Any subsidiary of an affiliate of the bank –and–
- Any company that the Federal Reserve (or other appropriate federal banking agency) determines to have a relationship with the bank or an affiliate of the bank such that covered transactions by the bank with the company may have a detrimental effect on the bank

### **Definition of “Covered Transaction”**

Once a determination has been made that a bank indeed proposes to enter into a transaction with an affiliate, then the next step is to see whether the transaction is covered under Section 23A or 23B and under Regulation W.

Under Section 223.3(h) of Regulation W, a covered transaction includes:

- An extension of credit to an affiliate
- A purchase of, or investment in, a security issued by an affiliate
- A purchase of an asset from an affiliate, including an asset subject to recourse or an agreement to repurchase
- The acceptance of a security issued by an affiliate as collateral for an extension of credit to any person or company –and–
- The issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate; a confirmation of a letter of credit issued by an affiliate; and a cross-affiliate netting arrangement (cross-affiliate netting arrangements are defined in Section 223.3(j) of Regulation W as arrangements among a bank, one or more affiliates of the bank, and one or more nonaffiliates, where the nonaffiliate is permitted to deduct obligations of the affiliate to the nonaffiliate in settling its obligations to the bank, or a bank is required or permitted to add affiliate obligations to a nonaffiliate when determining the bank’s total obligations to the nonaffiliate)

An extension of credit to an affiliate is broadly defined in Section 223.3(o) of Regulation W as the making or renewal of a loan, the granting of a line of credit, or the extending of credit in any manner whatsoever (examples include advance to an affiliate by means of an overdraft, cash item, or otherwise; a sale of federal funds to an affiliate; a lease that is the functional equivalent of an extension of credit to an affiliate; an acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or debt securities, of an affiliate; any increase in the amount of, extension of the maturity of, or adjustment to the interest rate term or other material term of an extension of credit to an affiliate; and any other similar transaction as a result of which an affiliate becomes obligated to pay money or its equivalent), including on an intraday basis, to an affiliate.

A bank’s purchase of a debt security issued by an affiliate is an extension of credit by the bank to the affiliate for purposes of Section 23A. “Keepwell” agreements, under which a bank commits to maintain the capital levels or solvency of an affiliate, also are considered guarantees for purposes of Federal Reserve Act Section 23A and

Regulation W. The regulatory presumption here is that credit risk incurred by the bank in such arrangements is similar to the risk incurred by the bank when it issues a guarantee on behalf of an affiliate.

## **VALUATION AND TIMING RULES**

Sections 223.21 through 223.24 of Regulation W set forth valuation and timing rules that are designed to determine the amount of a covered transaction subject to the quantitative limitations and collateral requirements of the rule and the time at which a transaction becomes subject to such limitations and requirements.

### **Valuation Rules for Credit Transactions**

Credit transactions with affiliates generally are valued at the greatest of:

- The principal amount of the transaction
- The amount owed by the affiliate to the bank under the transaction –and–
- The sum of the amount provided to, or on behalf of, the affiliate in the transaction and any additional amount the bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction

The value of a loan to an affiliate purchased by the bank from a nonaffiliate is the total amount of consideration given by the bank in exchange for the loan and any additional amount the bank could be required to provide to, or on behalf of, the affiliate. Although a bank's purchase of, or investment in, a debt security issued by an affiliate is considered an extension of credit to the affiliate, these transactions are not valued like other extensions of credit. Purchases of, or investments in, securities issued by an affiliate are valued at the greater of the bank's purchase price or the carrying value of the securities.

### **Special Timing Rules for Credit Transactions**

A bank is deemed to enter into a credit transaction with an affiliate at the time during the day that the bank becomes legally obligated to enter into the transaction, not at the end of the day on which the loan agreement is signed or the loan is funded. Credit transactions with nonaffiliates generally become covered transactions when the nonaffiliate becomes an affiliate of the bank. If the nonaffiliate becomes an affiliate within one year after the bank has entered into the credit transaction with it, the bank must ensure that the collateral requirements of Regulation W are met "promptly" after the nonaffiliate becomes an affiliate. In all cases, the transaction must meet the Market Terms Requirement. However, leeway provided by the promptly standard is not available if the credit transaction is made in contemplation of the nonaffiliate becoming an affiliate of the bank.

### **Loans Secured by Affiliate Securities**

Loans by a bank to a third party that are secured exclusively by affiliate securities are valued at the lesser of:

- The total amount of the extension of credit –and–
- The fair market value of the pledged affiliate securities, if they have publicly available price quotes

On the other hand, loans by a bank to a third party that are secured by both affiliate and nonaffiliate securities are valued at the lesser of:

- The total amount of the extension of credit, minus the fair market value of nonaffiliate collateral –and–
- The fair market value of the pledged affiliate securities, if they have publicly available price quotes (Under this

valuation rule, the maximum amount that the bank must count against Regulation W's quantitative limits is the difference between the full amount of the loan and the fair market value of the nonaffiliate collateral.)

Securities of an eligible affiliated mutual fund are not considered securities issued by an affiliate for purposes of this valuation rule, subject to certain conditions designed to ensure liquidity and minimize the use of the exemption as a method of funding affiliates.

Eligible affiliated mutual fund securities are securities issued by an open-end investment company registered with the SEC under the 1940 Act if both of the following are true:

- The securities have publicly available price quotes.
- The bank and its affiliates do not own more than 5% of the fund's shares, excluding shares held in good faith in a fiduciary capacity.

Furthermore, the bank may not exclude affiliated mutual fund securities if it knows, or has reason to know, that the proceeds of the extension of credit will be used to purchase the affiliated mutual fund shares serving as collateral or otherwise will be used to benefit an affiliate.

### **Valuation Rules for Purchases of Assets from an Affiliate**

Purchases of assets by a bank from an affiliate generally are valued at the total consideration given, including liabilities assumed, by the bank in exchange for the asset. The value may be reduced after the purchase to reflect amortization or depreciation of the asset, consistent with GAAP.

Regulation W provides a special valuation rule for a bank's purchase of a line of credit or loan commitment from an affiliate. A bank must value such an asset at the purchase price paid, plus any additional amount that the bank is obligated to provide under the credit facility. Without this special rule, a company would be able to transfer substantial amounts of unfunded obligations to its affiliated bank without being subject to Section 23A's quantitative limitations.

### **Valuation Rules for Purchases of or Investments in Affiliate Securities**

As noted above, purchases of or investments in securities issued by an affiliate are valued at the greater of the bank's purchase price or carrying value of the securities. This approach reflects the risk of continuing exposure to an affiliate through an investment in securities, even if that investment was made at a price below the carrying value of the securities. On the other hand, if the carrying value of the investment declines below the purchase price as the affiliate's financial condition worsens, the rule limits the ability of the bank to provide additional funding as the affiliate approaches insolvency.

A bank may acquire securities of an affiliate in a transaction that results in the affiliate becoming an operating subsidiary of the bank. These transactions are treated as a purchase of assets and assumption of liabilities of an affiliate. The covered transaction amount for these transactions is the total amount of consideration given by the bank for the shares, plus the total liabilities of the transferred company. The value of the covered transaction may be subsequently reduced to reflect amortization or depreciation of the assets of the transferred company consistent with GAAP, and sales of assets of the transferred company.

## **VARIOUS LIMITATIONS AND REQUIREMENTS**

### **Quantitative Limitations**

A bank may not engage in a new covered transaction with an affiliate if the aggregate amount of covered transactions between the bank and the affiliate would be in excess of 10% of the bank's capital stock and surplus after consummation of the new transaction. Aggregate covered transactions between the bank and all affiliates are limited to 20% of the bank's capital stock and surplus.

Consistent with GLBA, transactions between a bank and a financial subsidiary of the bank are not subject to the 10% limitation. This exemption from the 10% limit applies to investments by the bank in its own financial subsidiaries. Investments by the bank in the financial subsidiaries of affiliated depository institutions are subject to the 10% limitation. Aggregate covered transactions with all financial subsidiaries and other affiliates of the bank are subject to the 20% limitation.

Consistent with existing interpretations of Section 23A, Regulation W does not require the unwinding of transactions if a bank's capital declines such that the 10% or 20% quantitative limitation is exceeded. However, new transactions would be forbidden until the quantitative limits could be met.

### **Collateral Requirements**

Any credit transaction between a bank and its affiliate must be secured with the statutorily required amount of collateral.

Under Section 223.14 of Regulation W:

- A credit transaction must be secured by collateral having a market value equal to at least:
  - 100% of the amount of the transaction if the collateral is:
    - Obligations of the United States or its agencies
    - Obligations fully guaranteed by the United States or its agencies as to principal and interest
    - Notes, drafts, bills of exchange, or bankers' acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank –or–
    - A segregated, earmarked deposit account with the bank that exists for the sole purpose of securing credit transactions between the bank and its affiliates and is identified as such
  - 110% of the amount of the transaction if the collateral is obligations of any state or political subdivision thereof
  - 120% of the amount of the transaction if the collateral is other debt instruments, including loans or other receivables
  - 130% of the amount of the transaction if the collateral is stock, leases, or other real or personal property
- The following types of collateral are ineligible collateral under Regulation W:
  - Low-quality assets
  - Securities issued by any affiliate
  - Equity securities issued by the bank and debt securities issued by the bank that represent regulatory capital of the bank

- Intangible assets, unless specifically approved by the Federal Reserve
- Guarantees, letters of credit, and similar instruments

In addition, a bank must maintain a perfected security interest in collateral securing credit transactions. The security interest must be enforceable under applicable law, including in the event of bankruptcy or similar default.

If the bank does not have a first priority security interest in the collateral, it must deduct from the value of the collateral the lesser of:

- The amount of any security interest in the collateral that is senior to the bank's interest –or–
- The amount of credit secured by the collateral that is senior to the bank's position (any retired or amortized collateral must be replaced with additional eligible collateral over the life of the credit transaction)

Note that some transactions are exempt from the collateralization requirements. These include:

- An acceptance that is already fully secured either by attached document, or other property with an ascertainable market value that is involved in the transaction
- The unused portion of an extension of credit to an affiliate if the bank does not have any legal obligation to advance additional funds until required collateral is posted –and–
- Purchases of affiliate debt securities by the bank from a nonaffiliate in a bona fide secondary market transaction

### **APPLICABILITY TO U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS**

Section 223.61 of Regulation W applies Sections 23A and 23B only to transactions between a U.S. branch or agency of a foreign bank and affiliates of the branch or agency engaged directly in the United States in the following activities: full-scope securities underwriting and dealing, non-credit-related insurance underwriting, merchant banking, and insurance company investments. Regulation W also applies Sections 23A and 23B to transactions between a U.S. branch or agency of a foreign bank and any portfolio company controlled by the foreign bank under GLBA's merchant banking or insurance company investment authorities. Regulation W does not apply to transactions between a U.S. branch or agency of a foreign bank and other affiliates or to transactions between the foreign bank's non-U.S. offices and its U.S. affiliates.

### **SPECIAL RULES AND EXEMPTIONS UNDER REGULATION W**

#### **Special Rules for Derivatives Transactions**

Under Section 223.33 of Regulation W, a bank must establish policies and procedures reasonably designed to manage the credit exposure arising from its derivatives transactions with each affiliate and all affiliates in the aggregate. Specifically, the policies and procedures must at a minimum provide for:

- Monitoring and controlling the credit exposure arising at any one time from the bank's derivatives transactions with each affiliate and all affiliates in the aggregate
- Ensuring that the bank's derivatives transactions comply with the Market Terms Requirement of Section 23B

In particular, a bank must:

- Have in place credit limits on its derivatives exposures to affiliates that are at least as strict as those imposed on unaffiliated companies engaged in similar businesses and substantially equivalent in size and credit quality

- Monitor its derivatives exposure to affiliates in a manner at least as rigorous as used to monitor exposure to comparable unaffiliated companies –and–
- Price, and require collateralization of, affiliate derivatives transactions in a way that is at least as favorable to the bank as pricing and collateralization of unaffiliated transactions

Monitoring and controlling the credit exposure from derivatives transactions includes, at a minimum, imposing appropriate credit limits, mark-to-market requirements, and collateral requirements. The limits and requirements imposed by a bank should reflect the nature, volume, and complexity of its derivatives transactions, and should be approved by the board of directors of the bank or an appropriate board committee.

Under Section 223.33(c) of Regulation W, a credit derivative between a bank and a nonaffiliate in which the bank provides credit protection to the nonaffiliate with respect to an obligation of an affiliate of the bank is considered a “guarantee” by a bank on behalf of an affiliate and, as such, would be a covered transaction. Such derivatives include:

- An agreement under which the bank, in exchange for a fee, agrees to compensate the nonaffiliate for any default of the underlying obligation of the affiliate; and
- An agreement under which the bank, in exchange for payments based on the total return of the underlying obligation of the affiliate, agrees to pay the nonaffiliate a spread over funding costs plus any depreciation in the value of the underlying obligation of the affiliate

### **Special Rules for Financial Subsidiaries**

Regulation W treats financial subsidiaries of a bank as affiliates of the bank, in contrast to the general treatment of subsidiaries of a bank as nonaffiliates. A financial subsidiary is any subsidiary of a national or state bank that engages in activities (whether as principal or agent) not permissible for national banks to conduct directly.

Regulation W exempts from the definition of a financial subsidiary a subsidiary of a state bank that engages only in activities permissible for the state bank to conduct directly or activities lawfully conducted prior to December 12, 2002, the date of publication of final Regulation W. However, neither of these exemptions is available for a financial subsidiary of a state bank that engages in principal activities that GLBA requires a national bank to conduct in a financial subsidiary. For example, a subsidiary of a state bank that is underwriting and dealing in bank-ineligible securities would be a financial subsidiary.

A bank’s investment in securities issued by its own financial subsidiary is valued at the greater of:

- The total amount of consideration given by the bank in exchange for the security –and–
- The carrying value of the security as of the date of acquisition (The carrying value of the bank’s investment for purposes of this valuation rule is not adjusted going forward for any earnings retained or losses incurred by the subsidiary after the bank’s investment.)

### **Exemptions from the Attribution Rule**

Regulation W provides certain exemptions (which are described below) from the general rule that treats a transaction with any person as an affiliate transaction to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate. Notwithstanding these exemptions, these transactions are subject to the Safety and Soundness and Market Terms Requirements of Regulation W.

### **Exemption from the Attribution Rule for General Purpose Credit Cards**

Section 223.16(c) of Regulation W exempts from the attribution rule an extension of credit to a nonaffiliate if (1) proceeds are used to purchase goods and services from an affiliate of the bank, and (2) the extension of credit is made pursuant to and consistent with the conditions of a general-purpose credit card. A general-purpose credit card means a credit card issued by the bank that is widely accepted by merchants that are not affiliates of the bank if less than 25% of the total value of products and services purchased with the card are purchases of products and services from an affiliate of the bank. This is under the stated rationale of the Federal Reserve that the funding benefit received by the bank's affiliate from the use of general purpose credit cards by unaffiliated borrowers is likely to be minimal, and a bank's decision to issue a general-purpose credit card and extend credit pursuant to the card likely would be based on independent credit standards unrelated to possible affiliate transactions.

A bank has several methods for demonstrating that its credit card meets the 25% test. The computation of monthly compliance with the 25% test is based on cardholder purchases over a rolling average of the preceding 12 months. Banks that fall out of compliance with the 25% test generally have a three-month grace period to return to compliance before they become subject to Section 23A. Moreover, banks that become subject to Section 23A are eligible to retest and regain the exemption the following month.

### **Exemption from the Attribution Rule for Agency Transactions**

Under Section 223.16(b) of Regulation W, an extension of credit by a bank to a nonaffiliate is not attributed to an affiliate of the bank if the proceeds are used to purchase an asset through an affiliate that is acting exclusively as an agent or broker in the transaction, and the asset is not issued, underwritten, or sold as principal by any affiliate of the bank. However, the receipt of a fee, commission, or other compensation by the affiliate agent or broker is subject to the Market Terms Requirement.

### **Exemption from the Attribution Rule for Riskless Principal Transactions**

Under Section 223.16(c) of Regulation W, an extension of credit by a bank to a nonaffiliate is not attributed to an affiliate of the bank if the following are true:

- The proceeds of the extension of credit are used to purchase a security through an SEC-registered broker-dealer affiliate of the bank, and the affiliate is acting exclusively as a riskless principal in the transaction.
- The security purchased is not issued, underwritten, or sold as principal (other than as riskless principal) by an affiliate of the bank.
- Any markup or other compensation received by the affiliate is substantially the same as, or lower than, those prevailing at the time for comparable transactions with or involving nonaffiliates.

A company is acting as a riskless principal if, after receiving an order to buy (or sell) a security from a customer, the company purchases (or sells) the security in the secondary market for its own account to offset a contemporaneous sale to (or purchase from) the customer.

### **Exemption from the Attribution Rule for Preexisting Lines of Credit**

Section 223.16(c)(3) of Regulation W provides that an extension of credit by a bank to a nonaffiliate is not attributed to an affiliate of the bank from which the nonaffiliate purchases securities, provided that the extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit that was not established in contemplation of the purchase of securities from or through an affiliate of the bank.

### **Exemptions from the Quantitative Limits and Collateral Requirements**

Certain transactions are exempt from the quantitative limits and collateral requirements of Regulation W. These transactions are subject, however, to the Safety and Soundness Requirement and the prohibition on the purchase of a low-quality asset from an affiliate.

#### **Sister Bank Transactions**

Transactions between a bank and an insured depository institution, 80% or more of the voting securities of which are controlled by the holding company that also controls 80% or more of the voting securities of the bank, are exempt from the quantitative limits and collateral requirements of Regulation W. In addition, transactions between a bank and an insured depository institution where the bank controls 80% or more of the voting securities of the depository institution, or the depository institution controls 80% or more of the voting securities of the bank, are exempt from the quantitative limits and collateral requirements.

#### **Exemption for Purchases of Marketable Securities**

Purchases of marketable securities from a securities affiliate that is not a principal underwriter of the issue are exempt from the quantitative limitations and collateral requirements of Regulation W, if:

- The securities affiliate is an SEC-registered broker-dealer.
- The security has a ready market.
- The security is eligible for a state member bank to purchase directly and the bank records the transaction as a purchase of a security for Call Report purposes.
- The security is not a low-quality asset or issued by an affiliate of the bank.
- The bank does not purchase the security during or within 30 days of an underwriting, unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies.
- The price of the security is quoted routinely on an unaffiliated electronic, real-time service, the price paid by the bank is at or below the current quotation, and the size of the transaction does not cast material doubt on the appropriateness of relying on the quotation.
- The bank maintains, for two years, appropriate documentation in support of reliance on the exemption.

Again, any such transaction must comply with the Market Terms Requirement.

#### **Exemption for Internal Corporate Reorganizations**

Section 223.41(d) of Regulation W provides an exemption from the rule's quantitative limits and collateral requirements for certain internal corporate reorganizations. Under this exemption, a bank is permitted to purchase assets (other than low-quality assets) from an affiliate if the following conditions are met:

- The asset purchase is part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate.
- The bank holding company provides the Federal Reserve with contemporaneous notice of the transaction and commits to the Federal Reserve to make the bank whole, for a two-year period, for any transferred assets that become low-quality assets.

- A majority of the bank's directors reviews and approves the transaction prior to consummation.
- The Section 23A value of the covered transaction is less than 10% of the bank's capital stock and surplus (or up to 25% with the approval of the appropriate federal banking agency).
- The bank's holding company and each of its subsidiary depository institutions are well capitalized and well managed and remain well capitalized upon consummation of the transaction.

Any such transaction must comply with the Market Terms Requirement.

### **Exemption for Nonrecourse Loan Purchases**

Section 223.41(c) of Regulation W provides an exemption from the rule's quantitative limits and collateral requirements for purchases of loans by a bank from an affiliated insured depository institution on a nonrecourse basis.

### **Exemptions from the Quantitative Limitations, Collateral Requirements, and Low-Quality Asset Purchase Prohibition**

Several other transactions are exempt from the quantitative limitations, collateral requirements, and prohibition on the purchase of a low-quality asset contained in Regulation W. Each of these transactions must comply with the Safety and Soundness Requirement.

### **Exemption for Intraday Credit to Affiliates**

Section 223.42(l) of Regulation W provides that intraday extensions of credit to an affiliate by a bank are exempt from the quantitative limits and collateral requirements contained in the rule, provided that:

- The bank establishes and maintains policies and procedures reasonably designed to manage in a safe and sound manner the credit exposure arising from the bank's intraday extensions of credit to affiliates, including policies and procedures that address monitoring and controlling the credit exposure to affiliates from intraday credit and ensure compliance with the Market Terms Requirement.
- The bank has no reason to believe that the affiliate will be unable to repay the extension of credit in accordance with its terms.

Monitoring and controlling the credit exposure from intraday extensions of credit include, at a minimum, imposing appropriate credit limits (on a per-affiliate and aggregate basis) and collateral requirements. The limits and requirements imposed by a bank should reflect the volume of intraday credit transactions and the reasons for those transactions. Limits and requirements on intraday credit transactions should be approved by the board of directors of the bank or an appropriate board committee.

Regulation W also defines an intraday credit extension by a bank to an affiliate as an extension of credit by a bank to an affiliate that the bank expects to be repaid, sold, or terminated, or to qualify for a complete exemption under the rule, by the end of the day. Regulation W extends the Section 23A intraday exemption to all intraday extensions of credit to affiliates and does not limit the exemption to credit extensions relating to clearing and settlement.

### **Exemption for Riskless Principal Transactions**

Section 223.42(m) of Regulation W exempts from the quantitative limits, collateral requirements, and prohibition on the purchase of a low-quality asset the purchase of securities by a bank from its securities affiliate if the bank

or the affiliate is acting exclusively in a riskless principal capacity and the security is not issued, underwritten, or sold as principal (other than as riskless principal) by any affiliate of the bank. All such transactions are subject to the Safety and Soundness and Market Terms Requirements of Regulation W.

### **Exemption for Purchases of Municipal Securities from a Securities Affiliate**

Purchases of municipal securities from a securities affiliate are exempt from the quantitative limitations, collateral requirements and prohibition on the purchase of a low-quality asset of Regulation W, if:

- The securities affiliate is an SEC-registered broker-dealer.
- The security is rated by a nationally recognized statistical rating organization or is part of an issue of securities that does not exceed \$25 million.
- The security is eligible for purchase by a state member bank and the bank records the transaction as a purchase of a security for Call Report purposes.
- One of the following applies:
  - The security price is quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks, the price paid by the bank is at or below the current market quotation, and the size of the transaction does not cast doubt on the appropriateness of relying on the quotation.
  - The price paid can be verified by reference to two or more actual, current price quotes from unaffiliated broker-dealers on the same or a similar security, based on a similarly sized transaction, and the bank does not pay a price that exceeds the average of the price quotes.
  - The price paid can be verified by reference to the written summary of aggregate prices and par values provided to syndicate members by the syndicate manager, and the bank purchases the security during the underwriting period at a price at or below that indicated in the summary and retains a copy of the summary in its books and records for a period of three years.

Any such transaction must comply with the Market Terms Requirement.

### **Exemption for Nonrecourse Loan Purchases**

Nonrecourse purchases by a bank from an affiliate of extensions of credit made by the affiliate are exempt from the quantitative limitations, collateral requirements, and prohibition on the purchase of a low-quality asset contained in Regulation W if:

- The extension of credit was originated by the affiliate.
- The bank made an independent evaluation of the creditworthiness of the borrower and committed to purchase the extension of credit before the affiliate made or committed to make the extension of credit.
- The bank does not make blanket advance commitments to purchase loans from the affiliate.
- The dollar amount of all purchases over the preceding 12 months by the bank and its insured depository institution affiliates does not represent more than 50% of the dollar amount of all extensions of credit by the affiliate during such period. The appropriate federal banking agency may impose a lower percentage threshold in its discretion.

### **Additional Transactions Exempt from the Quantitative Limitations, Collateral Requirements, and Low-Quality Asset Purchase Prohibition**

- **Purchases of loans subject to repurchase.** Purchases from an affiliate of extensions of credit originated by the bank and sold to the affiliate subject to a repurchase agreement or with recourse.
- **Purchases of securities of a servicing affiliate.** Purchasing a security issued by any company engaged solely in providing services to a bank or bank holding company under Section 4(c)(1) of the Bank Holding Company Act of 1956 (12 U.S.C. § 1843(c)(1)).
- **Purchases of liquid assets.** Purchasing an asset, other than an affiliate-issued security, having a readily identifiable and publicly available market quotation at a price at or below the current market quotation.
- **Purchases of assets by a newly formed bank.** Purchases of assets by a newly formed bank, as approved in writing by the appropriate federal banking agency.
- **Mergers and acquisitions.** Mergers or acquisitions, or purchase and assumption transactions, between a bank and an affiliated depository institution or U.S. branch or agency of an affiliated foreign bank that has been approved by the responsible federal banking agency under the Bank Merger Act (12 U.S.C. § 1828(c)).
- **Correspondent banking deposits.** Making a deposit in an affiliated depository institution or affiliated foreign bank that represents an ongoing working balance maintained in the ordinary course of correspondent business.
- **Giving credit for uncollected items.** Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.
- **Transactions secured by cash or U.S. government securities.** A credit transaction with an affiliate to the extent that the transaction is and remains secured by obligations of the United States or its agencies, obligations fully guaranteed by the United States or its agencies as to principal and interest, or a segregated, earmarked deposit account with the bank that is for the sole purpose of securing credit transactions between the bank and its affiliates and is identified as such.

### **Exemption from the Prohibition on Purchases of Low-Quality Assets**

The general prohibition on purchases of low-quality assets from affiliates does not apply to certain situations in which a bank seeks to protect its interest in a distressed loan participation. Under Section 223.15(b) of Regulation W, the prohibition does not apply to the renewal of, or extension of additional credit with respect to, a bank's participation in a loan to a nonaffiliate that was originated by an affiliate of the bank, if all of the following are true:

- The loan was not a low-quality asset at the time the bank purchased its participation.
- The renewal or extension of additional credit is approved as necessary to protect the bank's investment by the board of directors of the bank.
- The participating bank's share of the renewal or extension of additional credit does not exceed its proportional share of the original transaction by more than 5%, unless the bank obtains the written approval of its appropriate federal banking agency.
- The bank provides its appropriate federal banking agency with written notice of the renewal or extension of additional credit within 20 days.

### **PENALTIES FOR VIOLATIONS**

Section 29 of the Federal Reserve Act (12 U.S.C. § 504) provides for civil money penalties for any member bank, as well as any institution-affiliated party with respect to such member bank, that violates Section 23A or 23B of

that Act. IAPs are defined broadly to include a director, officer, employee, or agent of a member bank, as well as (under certain circumstances) a consultant or joint venture partner who participates in the conduct of the affairs of the bank, and an independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in such violation.

The term “violate” includes any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation.

- **First tier penalties.** Any member bank which, and any institution-affiliated party with respect to such member bank who, violates any provision of Section 23A or 23B, or Regulation W, shall forfeit and pay a civil penalty of not more than \$5,000 for each day during which such violation continues.
- **Second tier penalties.** Any member bank which, and any institution-affiliated party with respect to such member bank who, in committing such violation:
  - Recklessly engages in an unsafe or unsound practice in conducting the affairs of such member bank –or–
  - Breaches any fiduciary duty; and which violation, practice, or breach:
    - Is part of a pattern of misconduct
    - Causes or is likely to cause more than a minimal loss to such member bank –or–
    - Results in pecuniary gain or other benefit to such party, shall forfeit and pay a civil penalty of not more than \$25,000 for each day during which such violation, practice, or breach continues
- **Third tier penalties.** Any member bank which, and any institution-affiliated party with respect to such member bank who knowingly:
  - Commits any such violation
  - Engages in any unsafe or unsound practice in conducting the affairs of such member bank –or–
  - Breaches any fiduciary duty; and knowingly or recklessly causes a substantial loss to such member bank or a substantial pecuniary gain or other benefit to such party by reason of such violation, practice, or breach, shall forfeit and pay a civil penalty of not more than \$1 million (or 1% of the total assets of such member bank, whichever is lesser) for each day during which such violation, practice, or breach continues

**Eric S. Yoon**

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Eric S. Yoon is a partner at K&L Gates LLP, splitting time evenly between its New York and Seoul offices. Eric focuses his practice in banking and financial services regulation, cross-border M&A, and financings. He has represented major multinational corporations, global financial institutions, and foreign sovereign entities in the regulatory and transactional aspects of their geographic and product-line expansions as well as strategic divestitures.

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