UNDERSTANDING REGULATION W

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REGULATION W: UNDERSTANDING ITS RELATIONSHIPS AND RULES

As part of the Federal Reserve Act's intention to protect the sanctity of banks, sections 23A and 23B under Regulation W have been in effect since 1933 and have presented multiple layers of complexity since their enactment. Due to regulatory reform coming out of recent financial crisis – specifically Dodd-Frank – banks are being forced to revisit their Reg W compliance programs with a more skeptical lens.

Reg W establishes a unique set of requirements for and limitations on transactions between member banks and their affiliates. The regulation applies to all federally insured depository institutions, from national to state banks and from trust companies to insured savings associations. The complicated web of Reg W is two-fold: starting with awareness of the relationship between banks and their non-bank affiliates as well as determining what comprises a regulation-covered transaction. These complexities lead to a great amount of confusion and consequential noncompliance.

DEFINING THE RELATIONSHIP

To achieve compliance with Reg W, it is critical to understand what it means to be an affiliate – a term that encompasses a wide variety of structures and entities. Within a corporation's legal entity structure there can be various entities whose relationships with banks or other affiliates may trigger affiliate status under the regulation. These include:

- The parent company of any bank,
- Companies under common control—which can be indirect or via a trust,
- Financial subsidiaries and
- Subsidiaries of affiliates.

This final trigger (subsidiaries of affiliates) is a broad category which results in what can be ominously labeled the "zombie effect" as the subsidiary of a subsidiary of an affiliate is an affiliate and so on and so forth. This wide reaching rule can trigger affiliate status for a majority of a banking corporation's structure.

An important item to note is that a company/structure need not be a legal entity to be considered an affiliate under the regulation. Below lists just a few examples of additional affiliate possibilities:

- Advised funds,
- Certain companies sponsored by a bank—such as a real estate investment trust (REIT),
- Certain partnerships associated with a bank and
- Certain companies held under merchant banking.

The process of determining Affiliate status extends to innately complex structures such as Variable Interest Entities (VIEs). While VIE consolidation is governed by ASC 810, the idea of control within these consolidation rules is not consistent with control under Reg W. As a result, each VIE should be evaluated under the lens of Reg W to determine if there is control per the regulation, and if so, who has this control, a bank or an affiliate.

FOLLOWING THE RULES

Another point of concern when complying with Reg W is the identification and evaluation of transactions that may be covered under the regulation. All covered transactions – and there is a significant number of considered transactions to be covered – must be reported to the Federal Reserve on form FR Y-8 each quarter to ensure the bank is in compliance with the rules that have been set forth under Reg W.

The transactional rules to follow are manifold, but let's take a look at "the big picture" of Sections 23A and 23B of the Federal Reserve Act.

Section 23A of Reg W requires that transactions between banks and their affiliates meet certain criteria, such as:

- Explicit and specific collateral requirements when banks extend credit to their affiliates,
- Prohibition of the transfer or sale of "low quality" assets from affiliates to banks, and
- Adherence to the "Quantitative Limits"
  - Transactions between banks and all their affiliates may not exceed 20 percent of the bank's capital and surplus and
  - Transactions between banks and a single affiliate may not exceed 10 percent of the bank's capital and surplus

Section 23B applies to all covered transactions and sets forth further requirements, including:

- Covered transactions must be kept at "arm's length," meaning the transaction must be on terms that are the same or as favorable to the bank as comparable transactions involving non-affiliates, and
- In the absence of comparable transactions, the transaction must be on terms that would be offered to non-affiliates (which requires analysis/due diligence on behalf of the trade initiator),
- Prohibition on certain types of advertisements, fiduciary purchases by banks from affiliates on behalf of a trust (unless allowed under specific provisions), and the purchase of affiliate underwritten securities during the underwriting period (unless allowed through actions of the Bank's board of directors).

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ATTRIBUTION

When it comes to the complicated designation of a covered transaction, one sentence in the lengthy regulation causes friction: *"A member bank must treat any of its transactions with any person as a transaction with an Affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an Affiliate."*

This sentence sets forth what is known under Reg W as the "attribution" rule. This rule treats transactions between banks and third parties as extensions of credit from banks to affiliates to the extent that the third party utilizes the proceeds to benefit an affiliate. The idea of "benefiting" an affiliate includes but is not limited to the purchase of affiliate-issued securities, paying off a debt held with an affiliate, buying assets from or potentially through an affiliate, or placing the proceeds in certain types of investment vehicles held at an affiliate. This rule triggers 23A and 23B requirements just as if the bank was transacting directly with an affiliate. This nuance provides for a lot of interpretation risks on behalf of banks and can create both an accounting and monitoring nightmare. As a result, banks must have a consistent approach across the enterprise and have sufficient controls in place to ensure identification of covered transactions triggered by attribution.

EXEMPTIONS

There are exemptions to consider when a covered transaction is identified. These exemptions have numerous distinct requirements and varying degrees of documentation complexities. "Riskless principal transactions," for example, often involve a "securities affiliate" and are eligible for exemption from certain requirements. Let's say a bank goes through an affiliate SEC-registered broker dealer to buy stock from a third party. That transaction may be exempt from the quantitative limits of 23A; however, this exemption instantly becomes ineligible if the affiliate provided the stock from its own inventory, the affiliate is not an SEC-registered broker dealer or the stock is issued by any affiliate of the bank.

Other common exemptions include liquid assets, municipal securities and intraday extensions of credit. In deciphering what constitutes a covered transaction and if it qualifies for exemptions, organizations may consider seeking input from advisors to help ensure they have considered all elements of adhering, interpreting and documenting all requirement set forth by the regulation.

TRUST IN A SOLUTIONS-DRIVEN ADVISOR

Noncompliance – blind or not – hurts the bottom line of the entities to which Reg W applies. The Federal Reserve has the capacity to levy unfavorably large fines – up to $1 million per day – for non-compliance.

Penalties can be incurred regardless of awareness and or understanding of the Regulation. The Dixon Hughes Goodman team offers an end to end solution which includes an initial assessment of applicability, gap analysis of Reg W compliance, remediation efforts, applicable guidance, client training, and developing and implementation of process improvements.

Dixon Hughes Goodman's gap analyses are beneficial from the perspective of showing a financial institution's current state of Reg W compliance, which provides the organization an inside look of where they can improve. Moreover, the Reg W team provides entities with knowledge to better understand the intricacies of the Reg W and how it affects them.

A NOBLE CAUSE

While the regulation is timeworn and may pose challenges to compliance departments, its goal is noble: to protect the economy, the safety and soundness of banks and ultimately the customer. Thus, do not let Reg W become a costly and troublesome minefield. Trust in a knowledgeable and experienced advisor, such as Dixon Hughes Goodman, to assist in your regulation compliance and overall knowledge so that you may protect your business, the customer and bottom line.

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