CHAPTER 10

Foreign Banks as U.S. Financial Holding Companies[1]

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SYNOPSIS

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§ 10.01 Introduction

This Chapter discusses the expanded powers that a foreign bank or its parent [*herein* foreign banking organization or FBO] may exercise in the United States if it successfully elects to be treated as a U.S. financial holding company [*herein* FHC]. We first describe the restrictions imposed by the Bank Holding Company Act of 1956 [*herein* BHC Act] on an FBO's power to engage in nonbanking activities or make nonbanking investments in the United States if it owns or controls a U.S. bank or otherwise has or acquires a *U.S. commercial banking presence*,[2] but does not qualify for or elect to be treated as a financial holding company. We then summarize the expanded powers that an FBO may exercise if it qualifies and elects to be treated as a financial holding company under the BHC Act. We next set forth the conditions and procedures for becoming an FHC. We then elaborate on an FHC's expanded powers, focusing on securities underwriting and dealing, insurance underwriting, merchant banking, insurance company portfolio investments, commodities, hedge funds and real estate powers. Finally, we discuss the streamlined notice and approval procedures available to FHCs, the consequences of becoming an FHC and the consequences of failing to maintain the FHC conditions.

§ 10.02 Legal Framework

[1] Restrictions on U.S. Nonbanking Powers of FBOs

The BHC Act generally prohibits both a domestic bank holding company and an FBO that controls a U.S. bank or otherwise has a U.S. commercial banking presence from owning or controlling any company other than a U.S. bank or from engaging in, or directly or indirectly owning or controlling any company engaged in, any activities that are not "so closely related to banking as to be a proper incident thereto."[3] These

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[2] We refer to any foreign bank with a branch, agency or commercial lending company in the United States as a foreign bank with a "U.S. commercial banking presence." Such a foreign bank and any company that controls such a foreign bank is subject to the BHC Act as if it were a bank holding company under Section 8(a) of the International Banking Act of 1978, 12 U.S.C. § 3106(a).

[3] *See* 12 U.S.C. § 1843(a), 1843(c)(8). The BHC Act also contains various narrow exemptions from this general prohibition, including exemptions that allow a bank holding company (i) to make noncontrolling investments for its own account or an investment fund controlled by it in up to 4.9 percent of any class of voting securities and up to 24.9 percent of the total equity (including voting, nonvoting

restrictions on the nonbanking activities and investments of an FBO reflect the traditional U.S. policy of maintaining an appropriate separation between banking and commerce.[4] They are implemented by the Board of Governors of the Federal Reserve System [*herein* the Board], principally through its Regulation Y.[5]

[2] QFBO Exemptions

The potential extraterritorial impact of these activities restrictions, however, is limited in part by exemptions for "qualifying foreign banking organizations" [*herein* QFBOs], which are permitted to engage in any activity outside the United States and in certain activities in the United States, which, although more limited than is customary in many countries, are more varied than those permitted to domestic bank holding companies.[6] These exemptions [*herein* the QFBO exemptions] fall into four

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securities and subordinated debt) of any non-banking company; (ii) to invest in a subsidiary that does not have any office or direct or indirect subsidiary or otherwise engage in any activities directly or indirectly in the United States, other than those that are incidental to its foreign or international business; (iii) to hold investments as a fiduciary; or (iv) to furnish services to its subsidiaries. 12 U.S.C. §§ 1843(c)(1)(C), (c)(4), (c)(6), (c)(7), (c)(13).

[4] This traditional policy is justified mainly on the grounds that the mixing of banking and commerce would lead to (i) conflicts of interest in the allocation of credit, (ii) potential increased risks to insured depository institutions and expansion of the federal deposit insurance safety net, (iii) undue concentration of economic power and therefore anti-competitive behavior, and (iv) the creation of conglomerates that would be too complex to manage or supervise because it is not possible to have the skills necessary to manage or supervise both financial and commercial businesses in the same group. *See, e.g.*, Leach, The Mixing of Commerce and Banking, in PROCEEDINGS OF THE 43RD ANNUAL CONFERENCE ON BANKING STRUCTURE AND COMPETITION, FEDERAL RESERVE BANK OF CHICAGO, 13 (May 2007) [*herein* PROCEEDINGS]; Fine, U.S. Households and the Mixing of Banking and Commerce, in PROCEEDINGS, 28; Tenhundfeld, Banking and Commerce: 1 + 1 = 0, in PROCEEDINGS, 33; Evanoff, Preface, in PROCEEDINGS. Perhaps the most ardent preservationist of this traditional policy is former Congressman James A. Leach, after whom the Gramm-Leach-Bliley Act of 1999 was named, who has described the mixing of commerce and banking in almost apocalyptic terms. Leach, The Mixing of Commerce and Banking, in PROCEEDINGS, 13, at 13. ("[T]here are few broad principles that could hurriedly be legislated, which could in shorter order change the fabric of American democracy as well as the economy, than adoption of a new radical approach to this issue [*i.e.*, mixing commerce and banking].") Critics argue that (i) relaxing this traditional policy would (A) foster competition; (B) level the playing field between banks and other financial institutions like securities firms, insurance companies and hedge funds that are not prevented from engaging in commerce or having commercial affiliates; and (C) reduce risk by allowing banking organizations to have greater diversification of assets and income flows; and (ii) (A) the highly competitive nature of the credit markets would prevent any potential adverse effects from any conflicts of interest in the allocation of credit and (B) provisions such as Sections 23A and 23B of the Federal Reserve Act are sufficient to insulate insured depository institutions and the federal safety net from the risks of commercial affiliates. *See, e.g.*, Wallison, *Thinking Ahead: Treasury Prepares to Lay Down a Marker for the Future (Part 1)*, FINANCIAL SERVICES OUTLOOK (American Enterprise Institute for Public Policy Research, Oct. 2007); Muckenfuss & Eager, The Separation of Banking and Commerce Revisited, in PROCEEDINGS, 39; Wall, Reichert & Liang, The Last Frontier: The Integration of Banking and Commerce in the U.S., in PROCEEDINGS, 67; Evanoff, Preface, in PROCEEDINGS.

[5] 12 C.F.R. pt. 225.

[6] The qualifying foreign banking organization concept is found in Subpart B of the Board's Regulation K, 12 C.F.R. pt. 211, which implements in part the statutory exemptions from the BHC Act's coverage set forth in Sections 2(h)(2) and 4(c)(9) of the BHC Act. An analysis of the several statutory exemptions

general categories: (1) activities, and investments in other companies engaged in activities, conducted wholly outside the United States; (2) activities, and investments in other companies engaged in activities, conducted in the United States that are "incidental" to international or foreign business (such as would be permitted to Edge Act and agreement corporations);[7] (3) minority noncontrolling investments in foreign companies doing a majority of their business outside the United States and not engaged in securities underwriting or dealing; and (4) controlling investments in foreign companies doing a majority of their business outside the United States, with any U.S. activities being limited to those that are nonfinancial in nature and related to nonfinancial businesses conducted abroad.[8]

[3] Expanded Powers of FHCs

The BHC Act was amended by the Gramm-Leach-Blilely Act of 1999 [*herein* the GLB Act] to permit bank holding companies, and FBOs that are otherwise subject to the BHC Act, to exercise certain expanded powers if they qualify for and elect to be treated as financial holding companies.[9] In contrast to ordinary bank holding companies or FBOs, FHCs are not limited to owning and controlling banks and engaging in, or owning or controlling companies engaged in, activities that are "closely related to banking" or, in the case of QFBOs, certain additional activities and investments under the QFBO exemptions. Instead, FHCs may also engage in, or own or control any companies engaged in, any activity that is *financial in nature*, *incidental* to a financial activity or *complementary* to a financial activity.[10] This category of financial and financial-related activities includes everything deemed to be "closely

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available to foreign banks is beyond the scope of this Chapter. *See* Chapter 9 for a more extended discussion. To be a qualifying foreign banking organization, more than half of a foreign institution's worldwide business (*excluding* the portion of such business attributable to U.S. banking operations) must be banking, and more than half of its worldwide banking business must be outside of the United States. 12 C.F.R. § 211.23(b). If, as a result of the acquisition of a very large U.S. subsidiary bank, more than half of a foreign acquirer's worldwide banking business was conducted in the United States, the acquirer would be treated as a domestic (rather than a foreign) bank holding company and could not be a QFBO.

[7] *See* 12 C.F.R. § 211.6.

[8] 12 C.F.R. § 211.23(f). In particular, the Board's regulations permit a foreign-chartered commercial subsidiary of a foreign bank holding company, indirectly through a domestic or foreign subsidiary, to engage in a broad range of commercial activities in the United States that are not permitted for a domestic bank holding company if it meets certain conditions, including that (1) a majority of its consolidated assets and revenues are located and derived from outside of the United States; (2) it does not engage, directly or indirectly, or have more than a 10 percent voting interest in, a company engaged in the business of underwriting, selling, or distributing securities in the United States (except to the extent permitted to domestic bank holding companies); and (3) it does not, without prior Board approval, engage in activities in the United States that directly or through a majority-owned subsidiary consist of banking or financial operations (*e.g.*, insurance underwriting and real estate investment and brokerage activities) or "closely-related-to-banking" activities covered by Section 4(c)(8) of the BHC Act. 12 C.F.R. § 211.23(f)(5).

[9] Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 106th Cong., 1st Sess. (Nov. 12, 1999), 113 Stat. 1338–1481 (1999). The GLB Act continues to reflect the U.S. policy of maintaining an appropriate separation between banking and commerce, but it reduced the degree of that separation.

[10] 12 U.S.C. § 1843(k)(1).

related to banking" and much more.[11] In particular, FHCs are permitted to make controlling and noncontrolling investments in companies engaged exclusively in financial activities or activities that are incidental or complementary to financial activities, including securities underwriting and dealing, insurance underwriting, merchant banking, insurance company portfolio investments and certain commodities trading.[12] They are also permitted to make controlling and non-controlling investments in nonfinancial and mixed financial/nonfinancial companies, including companies engaged in owning and managing real estate, subject to certain conditions, under the merchant banking power.[13]

As of July 31, 2008, nearly 600 U.S. BHCs, 2 foreign holding companies of U.S. banks, and 48 FBOs (approximately 25 percent of those with a U.S. commercial banking presence) had successfully elected to be FHCs.[14]

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[11] 12 U.S.C. § 1843(k)(4), especially (k)(4)(F).

[12] 12 U.S.C. §§ 1843(k)(4)(B) (insurance underwriting), (k)(4)(E) (securities underwriting and dealing), (k)(4)(H) (merchant banking), (k)(4)(I) (insurance company portfolio investments). *See, e.g.*, The Royal Bank of Scotland, 94 FED. RES. BULL. C60 (2008) (certain energy commodities trading as a complement to energy derivatives trading).

[13] 12 U.S.C. § 1843(k)(4)(H) (merchant banking).

[14] *See* Federal Reserve Board, Financial Holding Companies as of July 31, 2008, *available at* www.federalreserve.gov/generalinfo/fhc (last visited Sept. 2, 2008), listing only the top-tier company in each organization:

Americas: Banco Bradesco, S.A. (Brazil); Banco Itaú S.A. (Brazil); Bank of Montreal (Canada); The Bank of Nova Scotia (Canada); Canadian Imperial Bank of Commerce (Canada); National Bank of Canada (Canada); Royal Bank of Canada (Canada); The Toronto-Dominion Bank (Canada); and Banco Mercantil del Norte, S.A. (Mexico).

Asia: Mizuho Financial Group (Japan); The Norinchukin Bank (Japan); ShinHan Financial Group (South Korea); Chinatrust Financial Holding Company, Ltd. (Taiwan); and SinoPac Financial Holdings Company Limited (Taiwan).

Australia: Australia and New Zealand Banking Group Limited; National Australia Bank Limited.

Europe: Dexia S.A. (Belgium); Fortis Bank S.A./N.V. (Belgium); KBC Bank NV (Belgium); Barclays PLC (England); HSBC Holdings PLC (England); BNP Paribas (France); Crédit Agricole S.A. (France); Natixis (France); Société Générale (France); Allianz SE (Germany); Bayerische Hypo- und Vereinsbank Aktiengesellschaft (Germany); Commerzbank AG (Germany); Deutsche Bank AG (Germany); DZ Bank AG (Germany); Eurohypo Aktiengesellschaft (Germany); Hypo Real Estate Holding AG (Germany); Landesbank Baden-Württemberg (Germany); DEPFA Bank PLC (Ireland); The Governor and Company of The Bank of Ireland (Ireland); Unicredito Italiano S.p.A. (Italy); ABN AMRO Holding, N.V. (The Netherlands); Rabobank Nederland (The Netherlands); DnB NOR ASA (Norway); Banco Santander Central Hispano, S.A. (Spain); Caixa de Aforros de Vigo, Ourense e Pontevedra (Spain); Caja de Ahorros y Monte de Piedad de Madrid (Spain); HBOS plc (Scotland); The Royal Bank of Scotland Group PLC (Scotland); Skandinaviska Enskilda Banken AB (Sweden); and Credit Suisse Group (Switzerland); UBS AG (Switzerland).

Middle East: Bank Hapoalim (Israel).

Foreign holding companies of U.S. banks: Delta Investment Company (Cayman Islands); SNBNY Holdings Limited (Gibraltar).

The 48 FBOs that are FHCs represent approximately 25 percent of the approximately 200 FBOs that as of March 31, 2008, maintained, directly or indirectly, a branch, agency or commercial lending company

The BHC Act includes a grandfathering provision that would exempt certain FBOs that become FHCs before November 11, 2009 from any of the activities restrictions contained in the BHC Act with respect to activities engaged in as of November 12, 1999 until November 11, 2009 or, with the Board's prior approval, for up to five additional years, if certain conditions are satisfied.[15] It also includes a separate grandfathering provision that would exempt certain FBOs that become FHCs after November 12, 1999 from any restrictions on commodity trading activities, if certain conditions are satisfied.[16]

[4] Overlapping Sources of Authority

The expanded powers of an FHC, and the powers of a QFBO under the QFBO exemptions, include a number of overlapping sources of authority to engage in the same or similar powers. A QFBO that elects to be treated as an FHC is permitted to rely on whichever of these overlapping sources of authority gives it the broadest powers, and is generally permitted to switch sources of authority if it is in its advantage to do so as its circumstances or business objectives change.[17]

For example, Section 4(k)(4)(E) of the BHC Act permits an FHC to engage in securities underwriting, dealing and market making without any geographic or other limitation.[18] In contrast, Section 4(k)(4)(F) and (G) of the BHC Act, which incorporate by reference the power to engage in any activity that was determined as of a certain date to be closely related to banking or usual in connection with banking abroad, only permit securities underwriting and dealing subject to certain revenue, geographical, or other limitations.[19] A QFBO that is an FHC is permitted to rely on the broadest source of authority for securities underwriting, dealing and market making, without regard to the geographic or other limitations in the overlapping, alternative sources of such authority.

Similarly, an FHC is permitted to make controlling and noncontrolling investments

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in the United States. *See* Federal Reserve Board, Structure and Call Report Data for U.S. Offices of Foreign Entities by Country as of March 31, 2008, *available at* www.federalreserve.gov/releases/iba/200803/bycntry.htm (last visited Sept. 2, 2008).

[15] 12 U.S.C. § 1843(n).

[16] 12 U.S.C. § 1843(o).

[17] *See* 66 Fed. Reg. 400, 406 (Jan. 3, 2001).

[18] 12 U.S.C. § 1843(k)(4)(E).

[19] *See* 12 U.S.C. §§ 1843(k)(4)(F) and 1843(k)(4)(G); 12 C.F.R. §§ 211.10(a)(13)–(14) (geographic limitations), 225.28(b)(8)(i) (limited to government securities); J.P. Morgan & Co., Incorporated, et al., 75 FED. RES. BULL. 192, 195–197 (1989), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 900 F.2d 360 (D.C. Cir. 1990); Citicorp, *et al.*, 73 FED. RES. BULL. 473 (1987), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988) *as modified by* Modifications to Section 20 Orders, 75 FED. RES. BULL. 751 (1989), and 10 Percent Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 48,953 (Sept. 17, 1996), and Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (Dec. 30, 1996) (revenue limits).

in nonfinancial companies or mixed financial/nonfinancial companies under Section 4(k)(4)(H) of the BHC Act, subject to certain conditions, including a maximum holding period, restrictions on involvement in the routine management or operation of portfolio companies and compliance with certain reporting requirements.[20] In contrast, the QFBO exemptions permit a QFBO to make controlling and noncontrolling investments in foreign nonfinancial companies, subject to a different set of conditions including that the foreign portfolio companies do a majority of their business outside the United States, are not engaged in securities underwriting or dealing and, if controlled by the QFBO, have U.S. activities that are limited to those that are nonfinancial in nature and are related to nonfinancial businesses conducted by the QFBO or its affiliates abroad.[21] A QFBO that has elected to be treated as an FHC may find it preferable to rely on Section 4(k)(4)(H) of the BHC Act for most of its private equity investments in U.S. or foreign nonfinancial companies or mixed financial/nonfinancial companies because the reporting requirements are less burdensome[22] or because of the greater leeway to invest in mixed financial/nonfinancial companies. In contrast, it may find the QFBO exemptions to be preferable for certain investments in foreign nonfinancial companies if it wishes to be involved in their routine management or operation or to hold them for more than the maximum holding period permitted by Section 4(k)(4)(H) and its implementing regulations. A QFBO that is an FHC is free to choose the best source of authority for its particular circumstances and business objectives, or generally to switch sources of authority as circumstances or business objectives change.

§ 10.03 Conditions and Procedures for Becoming an FHC

[1] Conditions

To qualify as an FHC, a foreign banking organization must satisfy the following conditions:

- the FBO, if it is a foreign bank with a U.S. commercial banking presence, all U.S. insured and uninsured depository institutions[23] controlled by the FBO,

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[20] *See* 12 U.S.C. § 1843(k)(4)(H); 12 C.F.R. pt. 225, Subpart J.

[21] *See* 12 C.F.R. § 211.23(f)(5).

[22] *Compare* 12 C.F.R. § 225.87(b)(4) and Report of Changes in Organizational Structure, Form FR Y-10 (one-time post-transaction notice for large merchant banking investments only, showing name of portfolio company and size of investment) *with* 12 C.F.R. § 211.23(h) and Annual Report of Foreign Banking Organizations, Form FR Y-7 (annual reporting for all investments, showing name of portfolio, percentage of portfolio company's assets and revenues attributable to activities outside the United States and, in the case of controlling investments, the types of activities engaged in the United States).

[23] The term "depository institution" is defined as "any bank or savings association," *see* 12 U.S.C. §§ 1841(n), 1813(c)(1), and includes both *insured* and *uninsured* depository institutions. As a result, any FBO that seeks to become an FHC must satisfy the well-capitalized requirements with respect to all of its U.S. depository institution subsidiaries, whether insured or not and whether or not they would be treated as "banks" for purposes of the BHC Act. This would include any U.S. thrift subsidiaries and any Utah industrial bank subsidiaries. *See, e.g.*, MetLife, Inc., 87 FED. RES. BULL. 268, at 269 n.6 & 270 n.15 (2001) (stating that although a certain limited-purpose trust company subsidiary of the applicant MetLife

and all foreign banks with a U.S. commercial banking presence that are controlled by the FBO must be and remain well capitalized,[24] and well managed,[25] and, as a general matter, be subject to comprehensive consolidated supervision [*herein* CCS] by its home-country supervisor;[26]

- it must have filed with the Board a declaration of election to be an FHC and a certification that it meets the well capitalized and well managed conditions;[27] and
- all of its U.S. *insured* depository institution subsidiaries[28] must have achieved a rating of at least "satisfactory" under the Community Reinvestment Act of 1977[29] [*herein* the CRA] in the most recent examination of such institutions.[30]

The BHC Act's broad definition of *control*[31] can lead to surprising results in the application of the well-capitalized and well-managed requirements to minority-owned

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was not a bank for purposes of the BHCA, it was nevertheless a "depository institution" under Section 3(c)(1) of the Federal Deposit Insurance Act, 12 U.S.C. § 1813(c)(1), and, therefore, MetLife in its election to be an FHC must certify that the trust company is well capitalized and well managed).

[24] 12 U.S.C.§ 1843(*l*)(1)(A); 12 C.F.R.§§ 225.81(b)(1), 225.90(a)(1).

[25] 12 U.S.C. § 1843(*l*)(1)(B); 12 C.F.R. §§ 225.81(b)(2), 225.90(a)(1).

[26] 12 U.S.C. § 1843(*l*)(3); 12 C.F.R. § 225.92(e). If a foreign bank is not subject to CCS, the Board will not consider the foreign bank to be well capitalized and well managed for purposes of the BHC Act, unless the Board finds that the home country has made "significant progress" in establishing arrangements for CCS and the "foreign bank is in strong financial condition as demonstrated, for example, by capital levels that significantly exceed the minimum levels that are required for a well capitalized determination and strong asset quality." 12 C.F.R. § 225.92(e)(2).

[27] 12 U.S.C. § 1843(*l*)(1)(C); 12 C.F.R. §§ 225.81(b)(3), 225.90(a)(2). The regulations require the FBO to make "an effective election" to be treated as an FHC.

[28] An insured depository institution is a depository institution the deposits of which are insured by the Federal Deposit Insurance Corporation [*herein* FDIC]. It includes a foreign bank with an FDIC-insured U.S. branch that is, or is controlled by, an FBO. 12 U.S.C. §§ 1813(c)(2) and (h); 12 C.F.R. § 225.2(g).

[29] The CRA requires banks to help meet the credit needs of the low and moderate income neighborhoods of the local communities in which such banks are chartered. A bank's record of meeting community credit needs must be rated annually by the appropriate federal financial supervisory agency. *See* 12 U.S.C. §§ 2901–2908.

[30] 12 U.S.C. § 2903(c)(1); 12 C.F.R. §§ 225.82(c)(1), 225.92(c)(2).

[31] The BHC Act deems an investment to be controlling if the investor (i) acquires or controls 25 percent or more of any class of voting securities of another company, (ii) has the power to elect a majority of the board of directors or similar governing body of the company or (iii) exercises a controlling influence over the management or policies of the company. 12 U.S.C. § 1841(a)(2). The Board treats the first two alternatives as essentially conclusive, with almost no exceptions. The last alternative is very flexible and highly indeterminate, and its interpretation and application is dependent on all the facts and circumstances. The Board staff will often deem an investor to have a controlling influence over another company whenever it has what most people would consider to be only a significant influence over the company. The Board staff generally will not treat an investment in a company as "controlling" unless the investor acquires control of at least 10 percent of any class of voting securities, or 25 percent or more of the total equity including voting securities, of the target. The Board staff generally treats total equity as including voting securities, nonvoting securities and subordinated debt. For a more detailed discussion on the Board staff's application of the controlling influence test, see § 3.03[5].

banks. For instance, it is possible for a foreign bank to be deemed to control another foreign bank for purposes of the BHC Act based on a stake in as low as 10 percent of the voting equity of the target bank, yet have no actual control over the foreign bank. In its release accompanying its final FHC rules, the Board stated that in limited situations involving strategic minority investments some relief from the well-capitalized and well-managed requirements may be justified, but only "in limited circumstances where the foreign bank can clearly demonstrate that it has no ability to control the other foreign bank."[32]

[2] Election Procedures

The procedures for a foreign bank or any company controlling a foreign bank to make an FHC election are contained in Sections 225.90–225.92 of Regulation Y.[33] If a foreign bank or its parent controls a U.S. bank or bank holding company or is controlled by a bank holding company, it must also comply with the procedures set forth in Sections 225.81-225.82 of Regulation Y.[34]

The procedures for electing to be treated as an FHC are relatively simple. The company electing to be treated as an FHC must file a written declaration with the appropriate Federal Reserve Bank[35] stating the election, certifying that all the entities that must meet the well-capitalized and well-managed requirements satisfy those requirements (including whether any foreign bank is subject to CCS), providing certain capital information and, in the case of an FBO that is a bank holding company or that has or controls a foreign bank with an FDIC-insured branch, information about the CRA compliance record of the applicant's U.S. insured depository institution subsidiaries and insured branches.[36] An election to be an FHC is automatically effective on the 31st calendar day after the date that a complete declaration was filed with the appropriate Federal Reserve Bank, unless the Board notifies the applicant prior to that time that the election is ineffective or that the election is effective prior to such 31st day.[37] In the case of an election by a foreign bank, or a company owning or controlling a foreign bank, the 30-day period may be extended by the Board with

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[32] *See* 66 Fed. Reg. 400, 411 (Jan. 3, 2001). To date, the Board's statement has not resulted in any such relief being granted. The Board staff has not conceded that there is any room between its traditional interpretation of the "controlling influence" test in the BHC Act and the type of control that must be "clearly demonstrated" to be absent as a condition to obtaining the limited relief. As long as the traditional controlling influence test, rather than some sort of actual control test, is used for determining when limited relief is justified, the promise of limited relief is likely to remain unfulfilled. *See* Guynn, Developments in Minority Investments, ANNUAL REGULATORY EXAMINATION, RISK MANAGEMENT AND COMPLIANCE SEMINAR, INSTITUTE OF INTERNATIONAL BANKERS (Nov. 2, 2005).

[33] 12 C.F.R. §§ 225.90–225.92.

[34] 12 C.F.R. § 225.81(c).

[35] The appropriate Federal Reserve Bank is determined pursuant to 12 C.F.R. § 225.3(b).

[36] 12 C.F.R. §§ 225.91(a) and 225.91(b) and, in the case of an FBO that is or is controlled by a bank holding company, 12 C.F.R. §§ 225.82(a)–225.82(d).

[37] 12 C.F.R. §§ 225.92(a)(1) and 225.92(b) and, in the case of an FBO that is or is controlled by a bank holding company, 12 C.F.R. § 225.82(e).

the consent of such foreign bank or such company.[38]

The Board will find an election ineffective if any of the entities that must meet the well-capitalized and well-managed requirements does not meet such requirements.[39] The Board will also find an election ineffective if any U.S. insured depository institution controlled by the FBO or any U.S. insured branch of any foreign bank that is or is controlled by the FBO did not receive a rating of at least "satisfactory" under the CRA at its most recent examination.[40] Finally, the Board may find the election ineffective if the Board does not have sufficient information to determine whether the FBO or any of its foreign bank subsidiaries making an election meets the election requirements.[41]

Because of the difficult issues relating to the well-capitalized and well-managed requirements that a foreign bank's election to be an FHC may raise, a foreign bank or its controlling company, before filing an election to be treated as an FHC, may file a request for a pre-clearance review of its qualifications to be treated as an FHC.[42] Regulation Y specifies two cases in which a pre-clearance process must be initiated.

- A foreign bank whose home country has not adopted risk-based capital standards consistent with the Basel Capital Accord [*herein* Basel I][43] *must* obtain a determination from the Board in the pre-clearance process that the foreign bank's capital is comparable to the capital that would be required of a U.S. bank owned by an FHC.[44]
- A foreign bank that has not been found, and that is chartered in a country where no bank from that country has been found, by the Board to be subject to CCS by its home country supervisor *must* use the pre-clearance process for a determination of its comprehensive supervision on a consolidated basis.[45] In addition, a foreign bank or a company controlling a foreign bank may on its own initiate the pre-clearance process to have the Board review the qualifi-

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[38] 12 C.F.R. § 225.92(a)(2).

[39] 12 C.F.R. §§ 225.92(c)(1), 225.92(c)(3) and, in the case of an FBO that is or is controlled by a bank holding company, 12 C.F.R. § 225.82(c)(2).

[40] 12 C.F.R. §§ 225.82(c)(1), 225.92(c)(2). Special rules apply to the consideration of the CRA performance of recently acquired U.S. insured depository institutions.12 C.F.R. §§ 225.82(d), 225.92(d).

[41] 12 C.F.R. § 225.92(c)(4).

[42] 12 C.F.R. § 225.91(c).

[43] Basel Committee on Banking Supervision [*herein* Basel Committee], International Convergence of Capital Measurement and Capital Standards (July 1988). In June 1999, the Basel Committee announced a proposal for a new, more sophisticated capital accord. That proposal ultimately led to the adoption of a new capital accord in June 2006. Basel Committee, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version June 2006) [*herein* Basel II]. It is not clear whether the Board will require an applicant to use the pre-clearance process to obtain a capital comparability determination if the foreign bank's home country has replaced its risk-based capital standards under Basel I with risk-based capital standards under Basel II.

[44] 12 C.F.R. §§ 225.90(b)(1), 225.90(b)(2).

[45] 12 C.F.R. § 225.91(c).

cations that it has to meet for an effective election to be an FHC.

- A foreign bank whose home country has adopted risk-based capital standards consistent with Basel I but that does not meet the capital standards that would be required of a U.S. bank owned by an FHC (either because it falls short of the required capital adequacy ratios under Basel I or because there is a question about the comparability of the foreign bank's capital to the capital that would be required of a U.S. bank owned by an FHC) *may* obtain a determination from the Board in the pre-clearance process that the foreign bank's capital is otherwise comparable to the capital that would be required of a U.S. bank owned by an FHC.[46]
- The pre-clearance process *may* be used by a foreign bank or company controlling a foreign bank to request the Board to review any other of the qualifications that must be met to make an effective election of the FHC status.[47] In particular, the question of whether the foreign bank is well managed could be subject of the pre-clearance process. For instance, the pre-clearance process *may* be used by a foreign bank that wishes to obtain FHC status but has not been assigned a combined U.S. banking assessment as part of the regular examination cycle and, thus, cannot determine whether it is well managed.[48]

The pre-clearance process helps the Board to comply with the rule that FHC elections become effective on the 31st day after receipt of the election and avoids the need to extend the period with the consent of the electing foreign bank or the company controlling the foreign bank.[49] The pre-clearance process may be advantageous for a foreign bank because the Board does not make a public announcement of the filing of a request for a pre-clearance review, and the records of the Board relating to the pre-clearance process may be accorded confidential treatment.[50]

[3] Capital

For both the Board and bank regulators around the world, capital adequacy is a significant aspect of determining the overall safety and soundness of financial institutions. Basel I,[51] which became fully operative in the United States in 1992,

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[46] 12 C.F.R. §§ 225.90(b)(1)(ii), 225.90(b)(1)(iii), 225.90(b)(2).

[47] 12 C.F.R. § 225.91(c).

[48] *See* 66 Fed. Reg. 400, 409 (Jan. 3, 2001).

[49] *See* 12 C.F.R. § 225.92(a)(2).

[50] The Board's staff takes the position that information relating to a pre-clearance process is a matter contained in or related to examination, operating or condition reports prepared by or for the use of an agency responsible for the regulation or supervision of financial institutions and that therefore such information need not be made available to the public under the Freedom of Information Act, 5 U.S.C. § 552; 12 C.F.R. § 261.14(a)(8). It may still be advisable for an FBO to request confidential treatment of its submissions in connection with a pre-clearance process pursuant to 12 C.F.R. § 261.15.

[51] Basel I is a risk-based capital framework that applies a standard system of assessment and measurement of capital to internationally active banks from countries that are members of the Basel

represented the first step in the standardization of capital standards among countries subscribing to it.[52] Even in countries not subscribing to Basel I, risk-based capital standards have become the accepted international standard for the measurement of capital adequacy.

In June 1999, the Basel Committee announced a proposal for a new, more sophisticated capital accord. That proposal ultimately led to the adoption of a new capital accord in June 2006 [*herein* Basel II].[53]

Basel II has already been implemented in Europe by means of the European Capital Requirements Directive [*herein* European CRD].[54] Under the European CRD as

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Committee, which meets regularly in Basel under the auspices of the Bank for International Settlements. The Accord establishes an analytical framework that relates regulatory capital requirements to differences in risk profiles among banks, including off-balance sheet exposures, and minimizes disincentives for banks to hold liquid, low-risk assets. The risk-based capital standard established by the Accord is composed of four basic elements: (1) an agreed definition of tier 1 (or core) capital, consisting primarily of common stockholders' equity and certain categories of perpetual preferred stock; (2) a "menu" of internationally agreed items constituting tier 2 capital, which supplements tier 1 capital; (3) a general framework for assigning assets and certain off-balance sheet exposures to broad risk categories, as well as procedures for calculating a risk-based capital ratio; and (4) a minimum ratio of total capital to risk-weighted assets of 8 percent (of which at least 4 percent should be in the form of tier 1 capital). In addition, the Accord requires that the risk weight assigned to a bank or bank holding company's trading account, foreign exchange and commodity positions reflect the market risk to which such assets are exposed. *See* Basel Committee, Amendment to the Capital Accord to Incorporate Market Risks (Jan. 1996). Each of the federal bank and thrift regulators follows this practice in its risk-based capital regulations. *See* 12 C.F.R. pt. 225 Apps. A, E (Board); 12 C.F.R. pt. 3 Apps. A, B (OCC); 12 C.F.R. pt. 325 Apps. A, C C (FDIC); 12 C.F.R. pt. 567 (OTS).

[52] The Basel Committee consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version June 2006) at 1, n.1. Countries that voluntarily subscribe to Basel I, but are not members of the Basel Committee include Australia, Austria, Finland, Hong Kong, Ireland, Israel, Korea, Mexico, and Taiwan. *See* Board of Governors of the Federal Reserve System & Secretary of the Department of the Treasury, *Capital Equivalency Report*, 13 n.6 (June 19, 1992) [*herein* Capital Equivalency Report].

[53] International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version June 2006). Basel II consists of three pillars: (1) minimum capital requirements; (2) supervisory review; and (3) market discipline through effective disclosure of banking risks. The fundamental purpose of Basel II is to "develop a framework that would further strengthen the soundness and stability of the international banking system" by introducing "more risk-sensitive capital requirements." Basel II, Introduction at 2 (paras. 4 and 5). The focus of the first pillar is on developing a more sensitive system of measuring credit risk, operational risk and market risk than Basel I. Basel II has three approaches for measuring credit risk: (i) the standardized approach, (ii) the internal ratings-based approach and (iii) the securitization framework . *See* Basel II, Part 2.II–IV. It has three ways to measure operational risk: (i) the basic indicator approach, (ii) the standardized approach and (iii) the advanced measurement approaches. *See* Basel II, Part 2.V. And it has two methods of measuring market risk: (i) the standardized approach and (ii) the internal models approach. *See* Basel II, Part 2.VI.

[54] Capital Requirements Directive, Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 Relating to the Taking Up and Pursuit of the Business of Credit Institutions (recast) *and* Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the

implemented by member state law, European banks were required to start a "parallel run" in the first quarter of 2007, during which they continued to comply with Basel I but also calculated their capital under Basel II. The European implementation of Basel II does not contain any floors limiting the benefits from Basel II in terms of any reduced capital requirements.

Basel II has also been adopted in the United States, but it only became effective on April 1, 2008 [*herein* U.S. Basel II].[55] Under the U.S. Basel II, approximately 11 of the largest bank holding companies and insured depository institutions [*herein* core banks] will initially be required to calculate and report their capital ratios under the Basel II advanced approaches.[56] All other bank holding companies and insured depository institutions will have the option to calculate their capital ratios under the Basel I or Basel II advanced approaches.[57] A core bank is required to adopt an implementation plan within six months after the later of the effective date of the new rule and the date on which it becomes a core bank [*herein* the trigger date]. The plan must include a start date for a "parallel run" within two years after the trigger date and for the first "transitional floor period" within three years after the trigger date. During each of three transitional floor periods of at least one year, the core banks will be subject to floors equal to 95 percent, 90 percent, and 85 percent of what their capital would have been under Basel I. Subject to approval from their primary federal regulator, they will be permitted to rely on the Basel II advanced approaches for their risk-based capital requirements without being subject to any floors after the last transitional floor period. However, the tier 1 leverage capital ratio, which is not based on Basel I or Basel II will continue to apply, as well.

As noted above, an FBO will satisfy the well-capitalized requirement to become an FHC only if the FBO, if it is a foreign bank with a U.S. commercial banking presence, all of its U.S. insured and uninsured depository institution subsidiaries, and all foreign banks with a U.S. commercial banking presence that are controlled by it, are well capitalized.

A U.S. insured and uninsured depository institution will be deemed to be well capitalized if it has a total risk-based capital ratio of at least 10 percent, a tier 1 risk-based capital ratio of at least 6 percent, and a tier 1 leverage ratio of at least 5 percent, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by its primary federal banking regulator to meet or maintain a specific capital level for any capital measure.[58]

Capital Adequacy of Investment Firms and Credit Institutions (recast).

[55] Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 72 Fed. Reg. 69,288 (Dec. 7, 2007).

[56] Office of the Comptroller of the Currency, Regulatory Impact Analysis for Risk-Based Capital Standards: Revised Capital Adequacy Guidelines (Basel II: Advanced Approach) 25 tbl. 1 (2007).

[57] The U.S. bank regulators have also proposed a rule that would permit banks and bank holding companies that are not "core banks" to calculate their capital ratios under the Basel II standardized framework. *See* 77 Fed. Reg. 43,982 (July 29, 2008).

[58] 12 C.F.R. §§ 225.2(r)(2) (insured and uninsured depository institutions), 6.4(b)(1) (Office of the

Section 4(*l*)(3) of the BHC Act authorizes the Board to develop capital standards for foreign banks with a U.S. commercial banking presence that are "comparable" to U.S. standards.[59] In exercising its authority under this provision with respect to foreign banks with a U.S. commercial banking presence, the Board has determined that the well-capitalized requirement should be measured on the basis of the foreign bank's capital as a whole, and not by the separate capital of any U.S. branch, agency or commercial lending company.[60]

Regulation Y provides two methods for determining whether a foreign bank will be considered "well capitalized" for purposes of electing to be treated as an FHC.[61]

The first method relies on Basel I. If the home country of the foreign bank has adopted risk-based capital standards that are consistent with Basel I, the foreign bank must maintain a tier 1 risk-based capital ratio of at least 6 percent and a total risk-based capital ratio of at least 10 percent, as calculated on the basis of home-country standards.[62] Although the Board does not require a foreign bank to satisfy any specific tier 1 leverage ratio, the Board is required to determine that the foreign bank's capital is comparable to the capital required for a U.S. bank that is owned by an FHC and it will consider an FBO's leverage ratio as part of this determination.[63] Indeed, Regulation Y authorizes the Board to consider a variety of factors in determining whether a foreign bank is well capitalized in accordance with comparable capital standards, including:

- the foreign bank's composition of capital;
- its tier 1 leverage ratio;
- applicable accounting standards;
- its long-term debt ratings;
- its anti-money laundering procedures; and
- whether it is subject to CCS.

The Board's rules also prevent it from considering a foreign bank to be well capitalized unless the foreign bank is either subject to CCS or the Board has

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Comptroller of the Currency—national banks), 208.43(b)(1) (Board—state-chartered banks that are members of the Federal Reserve System), 325.103(b)(1) (Federal Deposit Insurance Corporation—state-chartered banks that are not members of the Federal Reserve System), 565.4(b)(1) (Office of Thrift Supervision—federal and insured state-chartered savings associations).

[59] 12 U.S.C. § 1843(*l*)(3). *Comparable* does not mean *identical* but means adjusted to the special circumstances of the foreign bank.

[60] *See* 12 C.F.R. § 225.2(r)(3)(ii).

[61] 12 C.F.R. §§ 225.2(r)(3)(i), 225.90(b).

[62] 12 C.F.R. §§ 225.2(r)(3)(i)(A), 225.90(b)(1)(i) and 225.90(b)(1)(ii).

[63] 12 C.F.R. § 225.90(b)(1)(iii). *See also* 12 U.S.C. § 1843(*l*)(3). The release accompanying the final FHC rules states that the financial information necessary for the Board's staff to compute a foreign bank's leverage ratio will be required as part of the certification process and ongoing reporting required of foreign FHCs. 66 Fed. Reg. 400, 408 n.18 (Jan. 3, 2001).

determined that its home country has made "significant progress" in establishing arrangements for CCS and the foreign bank is in strong financial condition as demonstrated, for example, by capital levels that significantly exceed the minimum levels that are required for a well-capitalized determination and strong asset quality.[64]

It is not clear how the Board's analysis of a foreign bank's capital will be affected if the bank's risk-based capital ratios are calculated under its home country's implementation of Basel II instead of Basel I. Although the Board should be willing to rely on capital ratios calculated under home-country Basel II the way it has relied on those calculated under home-country Basel I, the Board could require foreign bank's to provide risk-based capital ratios calculated under home-country Basel I or subject to floors analogous to those required by the U.S. Basel II in order to compare the foreign bank's capital to that of U.S. banks and bank holding companies to assess whether it is comparable.

The second method permits (1) a foreign bank whose home country has not adopted risk-based capital standards consistent with Basel I (or Basel II) and (2) a foreign bank whose home country has adopted capital standards based on Basel I but which does not meet the 6 percent tier 1 or 10 percent total risk-based capital ratios under the first method[65] to obtain from the Board a determination that their capital is "otherwise comparable" to the capital that would be required of a U.S. bank owned by an FHC.[66] This Board determination is made in a pre-clearance process.[67] Before filing an election to be treated as an FHC, a foreign bank whose home country has not adopted risk-based capital standards consistent with Basel I or a company owning or controlling such foreign bank must file a request for a determination in the pre-clearance process that the foreign bank's capital is comparable to the capital that would be required of a U.S. bank owned by an FHC.[68] If the home country of the foreign bank has adopted standards based on Basel I, the foreign bank may request a review of its capital qualification in the pre-clearance process.

The Board has had a longstanding practice of generally requiring the top-tier intermediate U.S. bank holding companies controlled by FBOs to calculate, report and

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[64] 12 C.F.R. § 225.92(e). Despite the promise of this alternative standard, the Board has not previously approved an FHC election based on a foreign bank's home country supervisor making "significant progress" toward CCS. In contrast, the Board has approved several applications by foreign banks to establish branches in the U.S. based on home country supervisors "actively working toward" CCS. *See, e.g.,* ICICI Bank, 94 FED. RES. BULL. C26 (2008); Guynn, Emerging Trends and Key Developments in the Regulation and Supervision of Branches and Agencies of International Banks and in the Regulation of International Banks Themselves as Bank Holding Companies and Financial Holding Companies, ANNUAL REGULATORY EXAMINATION, RISK MANAGEMENT AND COMPLIANCE SEMINAR, INSTITUTE OF INTERNATIONAL BANKERS (Oct. 30, 2007).

[65] 12 C.F.R. § 225.90(b) gives the foreign bank a choice between relying on the Basel I capital standards of its home country or using the pre-clearance process.

[66] 12 C.F.R. § 225.90(b)(2). Presumably the factors to determine comparability of capital set forth in 12 C.F.R. § 225.92(e)apply to this determination.

[67] 12 C.F.R. §§ 225.90(b)(2), 225.91(c).

[68] 12 C.F.R. §§ 225.90(b)(2), 225.91(c).

satisfy minimum capital requirements under U.S. capital rules for bank holding companies.[69] The Board has modified this practice for such intermediate U.S. bank holding companies that are controlled by foreign banks that are well capitalized and well managed.[70] In such cases, the Board assumes that the foreign bank has sufficient financial strength and resources to support its banking activities in the United States. Thus, as a general matter, an intermediate U.S. bank holding company that is controlled by a foreign bank FHC will not be required to maintain any minimum capital ratios, but it will be required to calculate and report its capital under U.S. capital rules for bank holding companies.[71]

[4] Management

As noted above, an FBO will satisfy the well-managed requirement to become an FHC only if the FBO, if it is a foreign bank with a U.S. commercial banking presence, all of its U.S. insured and uninsured depository institution subsidiaries, and all foreign banks with a U.S. commercial banking presence that are controlled by it, are well managed.

A U.S. insured and uninsured depository institution will be deemed to be well managed if it received a composite rating of at least "satisfactory," and if such rating is given, a rating for management of at least "satisfactory," at its most recent state or federal examination.[72]

A foreign bank with a U.S. commercial banking presence will be deemed to be well managed if (i) its U.S. branches, agencies and commercial lending company subsidiaries received a combined, composite assessment of at least "satisfactory" at their most recent examination; (ii) its home country supervisor consents to the foreign bank expanding its activities in the United States to include activities permissible for an FHC; and (iii) its management otherwise meets standards comparable to those required of a U.S. bank owned by an FHC.[73] The consent of the home country

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[69] Application of the Board's Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations, SR Letter 01-1 (SUP) (Jan. 5, 2001).

[70] Application of the Board's Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations, SR Letter 01-1 (SUP) (Jan. 5, 2001).

[71] Application of the Board's Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations, SR Letter 01-1 (SUP) (Jan. 5, 2001). The supervisory letter, however, qualified its policy by stating that "[r]elying on the capital strength of the consolidated banking organization, as well as requiring all subsidiary banks to meet appropriate capital and management standards, is consistent with the [Board's] supervisory assessment process for domestic [BHCs]. The [Board,] retains its supervisory authority to require any [BHC,] including a U.S. BHC owned and controlled by a foreign bank that meets the FHC standards, to maintain higher capital levels where such levels are appropriate to ensure that its U.S. activities are operated in a safe and sound manner. This authority may be exercised as part of ongoing supervision or through the application process."

[72] 12 C.F.R. § 225.2(s)(1). *See, e.g.*, Commercial Bank Examinations Manual, § A.5020.1, Board of Governors of the Federal Reserve System (May 1997).

[73] 12 C.F.R. § 225.90(c). *See, e.g.*, Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations, SR Letter 00-14 (SUP) (Oct. 23, 2000).

supervisor may be provided in writing or by arranging for the Board to consult with the home country supervisor.[74]

In case of new depository institutions that have not received an examination rating, the term *well managed* means that "the Board has determined, after a review of the managerial and other resources of the depository institution. . .that the. . .institution is well managed."[75] Although this provision does not expressly apply to new U.S. branches, agencies or commercial lending company subsidiaries of foreign banks that have not received an examination assessment, the Board has the discretion to employ the same flexible standard in determining whether the well-managed standard is satisfied.[76]

[5] Comprehensive Consolidated Supervision

As noted above, the Board's own regulations prevent it from considering a foreign bank to be well capitalized and well managed unless the foreign bank is subject to "comprehensive supervision or regulation on a consolidated basis" in its home country or the Board determines that the foreign bank's home country supervisor has made "significant progress" toward CCS and the foreign bank is in strong financial condition.[77] A foreign bank may be considered to be subject to CCS if the Board determines that the bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the foreign bank, including the relationship of the bank to its affiliates, to assess the foreign bank's overall financial condition and compliance with law and regulation.[78]

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[74] *See* 66 Fed. Reg. 400, 409 (Jan. 3, 2001). The purpose of the consultation is that the Board can assure itself that the home country supervisor considers the consolidated capital and management of the bank to satisfy its home country standards and that the supervisor has no objections to the expansion.

[75] 12 C.F.R. § 225.2(s)(1)(ii). *See also* Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations, SR Letter No. 00-14 (SUP) (Oct. 23, 2000).

[76] If a foreign bank that wishes to obtain FHC status has not been assigned a combined U.S. banking assessment as part of the regular examination cycle, the foreign bank should contact its responsible Federal Reserve Bank or utilize the pre-clearance process. 12 C.F.R. § 225.91(c). A combined U.S. banking assessment may be assigned to a foreign bank as part of the FHC pre-clearance process. *See* 66 Fed. Reg. 400, 409 (Jan. 3, 2001).

[77] 12 C.F.R. § 225.92(e). Despite the promise of this alternative standard, the Board has not previously approved an FHC election based on a foreign bank's home country supervisor making "significant progress" toward CCS. In contrast, the Board has approved several applications by foreign banks to establish branches in the U.S. based on home country supervisors "actively working toward" CCS. *See, e.g.,* ICICI Bank, 94 FED. RES. BULL. C26 (2008); China Merchants Bank, 94 Fed. Res. Bull. C24 (2008); Industrial and Commercial Bank of China, Order Approving Establishment of a Branch (Aug. 5, 2008). *See* Guynn, Emerging Trends and Key Developments in the Regulation and Supervision of Branches and Agencies of International Banks and in the Regulation of International Banks Themselves as Bank Holding Companies and Financial Holding Companies, ANNUAL REGULATORY EXAMINATION, RISK MANAGEMENT AND COMPLIANCE SEMINAR, INSTITUTE OF INTERNATIONAL BANKERS (Oct. 30, 2007).

[78] The Board considers, among other factors, the extent to which the home supervisor:

- Ensures that the foreign bank has adequate procedures for monitoring and controlling its activities worldwide;
- Obtains information on the condition of the foreign bank and its subsidiaries and offices outside

The terms "comprehensive regulation" and "consolidated basis" are sufficiently broad to leave the Board substantial latitude in determining whether to disapprove an FHC election as ineffective on the basis of insufficient home-country regulation.

In theory, the CCS requirement must be fulfilled on a bank-by-bank basis, not on a country-by-country basis. According to one staff member, however, "applicants chartered in the same country may rely on information previously submitted and considered by the Board on consolidated supervision in that country. Subsequent applicants need only describe the extent to which the supervision system already evaluated applies to them and how, if at all, that system has changed since the Board last considered it."[79] As a result, it is normally less difficult for the second bank from a particular country to work through the CCS requirement with the Board.

A foreign bank that has not been previously determined by the Board to be subject to CCS and that is chartered in a country where no other bank from that country has been determined by the Board to be subject to CCS is *required* (not merely encouraged) to use the pre-clearance process, even if it otherwise meets the objective FHC criteria.[80]

There may be limited situations in which an exceptionally strong bank from a country that has not yet fully implemented CCS should be able to be considered for FHC status. The Board may grant FHC status to a foreign bank that is not yet fully subject to CCS if the home country supervisor has made "significant progress" in adopting and implementing arrangements for the comprehensive and consolidated supervision of its banks, and if the foreign bank demonstrates significant financial strength, such as through levels of capital that significantly exceed the minimum levels required for a well-capitalized determination or through exceptional asset quality.[81] A foreign bank that is not subject to CCS may use the pre-clearance process to explain to the Board why it should be granted FHC status. The Board anticipates granting FHC status to foreign banks that are not subject to CCS only in rare instances.[82]

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the home country through regular reports of examination, audit reports, or otherwise;

- Obtains information on the dealings and relationship between the foreign bank and its affiliates, both foreign and domestic;
- Receives from the foreign bank financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the foreign bank's financial condition on a worldwide, consolidated basis; and
- Evaluates prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis

12 C.F.R. §§ 211.24(c)(ii)(A)–211.24(c)(ii)(E).

[79] Ann E. Misback, *The Foreign Bank Supervision Enhancement Act of 1991*, 79 FED. RES. BULL. 1, 9 (1993); *see also, e.g.*, Bank Sinopac, 83 FED. RES. BULL. 669, 669 (1997).

[80] 12 C.F.R. § 225.91(c).

[81] 12 C.F.R. § 225.92(e)(2).

[82] *See* 66 Fed. Reg. 400, 411 (Jan. 3, 2001). To date, the Board has not approved FHC status for any FBO that has not met the CCS standard based on the "significant progress" standard. *See* Guynn, Emerging Trends and Key Developments in the Regulation and Supervision of Branches and Agencies of International Banks and in the Regulation of International Banks Themselves as Bank Holding

[6] Community Reinvestment Act

As noted above, if an FBO is a bank holding company, or has or controls a foreign bank with any insured branches, all of its FDIC-insured depository institution subsidiaries and insured branches must have achieved a rating of at least "satisfactory" under the CRA in the most recent examination of such institutions. Although the CRA requirement is not expressly part of the certification requirement, the Board is prohibited from treating an FHC election as effective if the CRA requirement is not satisfied.[83] The Board must use the 30-day period beginning on the date the declaration of election to be an FHC is deemed to be complete to determine whether the CRA rating requirement is met.[84]

§ 10.04 Expanded Powers of an FHC

As noted above, the BHC Act permits both bank holding companies and FBOs that are otherwise subject to the BHC Act to exercise certain expanded powers if they qualify for and elect to be treated as financial holding companies. In contrast to ordinary bank holding companies or FBOs, FHCs are not limited to owning and controlling banks and engaging in, or owning or controlling companies engaged in, activities that are "closely related to banking" or, in the case of QFBOs, certain additional activities and investments under the QFBO exemptions. Instead, FHCs may also engage in, or own or control any companies engaged in, any activity that is *financial in nature*, *incidental* to a financial activity or *complementary* to a financial activity.[85] The authority to engage in these expanded activities is not limited to activities in the United States, but rather extends to anywhere in the world, subject to the laws of the jurisdiction in which the activity is conducted.[86] Of course, electing FHC status does not prevent a QFBO from relying on the QFBO exemptions to engage in certain activities or make certain investments outside the United States that are not generally permissible even for FHCs.[87]

[1] Financial Activities

The BHC Act defines financial activities as any activity that the Board determines, by regulation or order in accordance with certain procedures described below, to be

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Companies and Financial Holding Companies, ANNUAL REGULATORY EXAMINATION, RISK MANAGEMENT AND COMPLIANCE SEMINAR, INSTITUTE OF INTERNATIONAL BANKERS (Oct. 30, 2007).

[83] 12 U.S.C. § 2906(b)(2)(B).

[84] 12 U.S.C. § 2903(c)(1)(B).

[85] 12 U.S.C. § 1843(k)(1).

[86] 12 C.F.R. § 225.85(b). The territorial limitations of 12 C.F.R. §§ 211.8 and 211.10 relating to investments by BHCs outside the United States do not apply to FHCs, whether the activity is conducted in or out of the United States. *See* 66 Fed. Reg. 400, 406 n.14 (Jan. 3, 2001).

[87] *See* § 10.02[2]. For example, QFBOs are permitted to hold controlling interests in foreign commercial companies with only limited activities in the United States, without complying with the conditions applicable to merchant banking or insurance company portfolio investments. *See* 12 C.F.R. § 211.23(f). For a more extended discussion of the QFBO exemptions, see Chapter 9.

financial in nature.[88] It also lists certain activities that "shall be considered to be financial in nature" without any Board action,[89] as well as certain activities that will be considered financial in nature only to the extent the Board specifies by regulation or order.[90] In essence, this statutory scheme creates a "laundry list" of activities that are automatically deemed to be financial in nature and a process by which the Board may add to that list by regulation or order. The Board's Regulation Y lists all of the activities considered to be financial in nature by this statutory scheme, as well as all of the activities that the Board has thus far determined by regulation or order to be financial in nature or incidental to a financial activity.[91]

[a] Laundry List

The following activities are considered to be "financial in nature" without further Board action:

- *Money and Securities*. Lending, exchanging, transferring, investing for others or safeguarding money or securities (but not other assets, except as described below).[92]
- *Insurance*. Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing.[93]

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[88] 12 U.S.C. § 1843(k)(1).

[89] 12 U.S.C. § 1843(k)(4).

[90] 12 U.S.C. § 1843(k)(5).

[91] 12 C.F.R. § 225.86.

[92] 12 U.S.C. § 1843(k)(4)(A).

[93] 12 U.S.C. § 1843(k)(4)(B). *See* Conference Report on S. 900 at 154 stating that the reference to "insuring, guaranteeing, or indemnifying against . . . illness" is meant to include activities commonly thought of as health insurance; and that the reference is not meant to include the activity of directly providing health care on a basis other than to the extent that it may be incidental to the business of insurance. *Insurance* includes reinsurance. *See* 12 Fed. Reg. 400, 405 (Jan. 3, 2001).

The Board has determined that the insurance activities permitted by § 4(k)(4)(B) of the BHC Act include insurance claims administration (*i.e.*, collecting and holding in trust insurance premiums, establishing an insurance claims paying account, adjusting insurance claims, negotiating with insureds concerning insurance claims, and paying and settling insurance claims) and risk management services in connection with insurance sales activities (*i.e.*, assessing the risks of a client and identifying the client's exposure to loss, designing programs, policies and systems to reduce the client's risks, advising clients about risk management alternatives to insurance, and negotiating insurance coverage, deductibles and premiums for an insurance client). Letter from J. Virgil Mattingly, General Counsel to the Board, to Karol K. Sparks (July 10, 2002), 2002 Fed. Res. Interp. LEXIS 5, FED. BANKING L. REP. (CCH) ¶ 80-304 (Curr. Vol. 2002). Permitted insurance activities also include acting as a third-party administrator for an insurance company. *See* H.R. Rep. 106-74 pt. 1, 106th Cong. 1st Sess., at 122 (1999), 1999 WL 176905 (Leg. Hist.) at 116 ("Activities such as administering, marketing, advising or assisting with. . .claim administration or similar programs shall be deemed to be incidental to insurance activities as described in [section 4(k)(4) of the BHC Act]."); Letter from J. Virgil Mattingly, General Counsel to the Board, to Craig N. Landrum (July 10, 2002), 2002 Fed. Res. Interp. Ltr. LEXIS 4, FED. BANKING L. REP. (CCH) ¶ 80-303 (Curr. Vol. 2002) (listing the services that are included in third-party administration).

- *Advisory Services*. Providing financial, investment or economic advisory services, including advising an investment company (as defined by the U.S. Investment Company Act of 1940).[94]
- *Securitization of Bank-Eligible Assets*. Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly.[95]
- *Securities Activities*. Underwriting, dealing in, or making a market in securities.[96]
- *Merchant Banking*. Acquiring controlling or noncontrolling interests in any company that is engaged in "any activity" other than an activity that is financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act, provided that the FHC has a securities affiliate or both an insurance affiliate and an investment adviser affiliate and subject to certain conditions described more fully below.[97]
- *Insurance Company Portfolio Investments*. Acquiring controlling or noncontrolling interests in any company that is engaged in "any activity" other than an activity that is financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of

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Before the adoption of the GLB Act, a BHC could, and after the adoption of the GLBA it may continue to, (i) underwrite or sell as agent, life, disability and unemployment insurance, that is related to credit extended by the BHC or its subsidiaries, 12 C.F.R. § 225.28(b)(11)(i) (Regulation Y), (ii) sell as agent property insurance that is related to small credits issued by the BHC's finance company subsidiary, 12 C.F.R. § 225.28(b)(11)(ii) (Regulation Y), and (iii) perform insurance agency activities from a place with a population of 5,000 or less (or which has otherwise inadequate insurance facilities, as determined by the Board) if the BHC or any of its subsidiaries has a lending office in such small town (insurance can be sold to customers nationwide from such location, regardless of the customer's location), 12 C.F.R. § 225.28(b)(11)(iii) (Regulation Y). *See* 12 U.S.C. § 92.

[94] 12 U.S.C. § 1843(k)(4)(C).

[95] 12 U.S.C. § 1843(k)(4)(D).

[96] 12 U.S.C. § 1843(k)(4)(E). Unlike the securities underwriting and dealing powers that are deemed to be closely related to banking or usual in connection with banking abroad, these securities powers are not subject to revenue limits or firewalls other than Sections 23A and 23B of the Federal Reserve Act (including that intra-day extensions of credit by banking entities to securities affiliates be on market terms), 12 C.F.R. § 225.4(g), or to any condition that they be exercised only outside the United States. *See, e.g*., J.P. Morgan & Co., Inc., *et al.*, 75 FED. RES. BULL. 192 (1989), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 900 F.2d 360 (D.C. Cir. 1990); Citicorp, et al., 73 FED. RES. BULL. 473 (1987), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988) *as modified by* Modifications to Section 20 Orders, 75 FED. RES. BULL. 751 (1989), and 10 Percent Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 48,953 (1996), and Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (1996) (revenue limits); 12 C.F.R. §§ 211.10(a)(14), (15) (territorial conditions), 225.200 (firewalls).

[97] 12 U.S.C. § 1843(k)(4)(H).

the BHC Act, provided that the interests are acquired and held by an insurance company affiliate and subject to certain other conditions described more fully below.[98]

- *Closely Related to Banking*. Any activity that the Board had determined by order or regulation in effect on November 12, 1999 to be so closely related to banking or managing or controlling banks as to be a proper incident thereto (subject to the same terms and conditions contained in such order or regulation, unless modified by the Board), including the activities that are listed in Sections 225.28 and 225.86(a)(2) of Regulation Y.[99] The activities listed in Section 225.28 of Regulation Y include:
  - *Derivative Contracts*. Engaging as principal in forward contracts, options, futures, options on futures, swaps and similar contracts, whether exchange-traded or over-the-counter, based on any rate, price, financial asset, nonfinancial asset or group of assets, subject to certain conditions.[100]
- *Usual in Connection with Banking Abroad*. Any activity that the Board has determined by regulation or interpretation to be usual in connection with the transaction of banking or other financial operations abroad, including the activities listed in Section 211.10(a) of Regulation K, without regard to any condition that otherwise requires any of these activities be conducted outside the United States.[101] These activities include:
  - *Mutual Funds*. Organizing, sponsoring and managing a mutual fund, so

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[98] 12 U.S.C. § 1843(k)(4)(I).

[99] 12 U.S.C. § 1843(k)(4)(F), 12 C.F.R. §§ 225.28, 225.86(a)(2). For a discussion of the list of activities that are considered to be "closely related to banking," see Chapter 9. Because Section 4(k)(4)(F) is limited to activities that the Board had determined by order or regulation in effect on November 12, 1999 to be closely related to banking, the list is effectively frozen as of that date, *i.e.*, any activities subsequently added to the closely related to banking list will only be considered financial in nature if the Board follows the procedures in Section 4(k).

While Section 4(k)(4)(F) of the BHC Act may have frozen the *categories* of closely related to banking activities that will be considered to be financial in nature, Section 4(k)(4)(F) permits the Board to relax any conditions applicable to any previously permitted category of activity even if relaxing the limitation has the effect of expanding the range of permissible activities within the overall category. Thus, the Board has effectively expanded the range of principal activities with respect to commodity contracts that are considered to be closely related to banking by amending Section 225.28(b)(8)(ii)(B) of Regulation Y to eliminate the previous prohibitions on (i) taking or making delivery of title to commodities underlying commodity derivative contract, to the extent they are done on an instantaneous pass-through basis and (ii) entering into commodity derivative contracts that do not require cash settlement or specifically provide for assignment, termination or offset prior to delivery. *See* 68 Fed. Reg. 39,807 (July 3, 2003). The Board has also effectively expanded the range of permissible data processing activities by amending Section 225.28(b)(14) of Regulation Y to relax certain previously applicable limitations on data processing. *See* 68 Fed. Reg. 68,493 (Dec. 9, 2003).

[100] 12 C.F.R. § 225.28(b)(8)(ii).

[101] 12 U.S.C. § 1843(k)(4)(G); 12 C.F.R. §§ 211.5(d), 225.86(b).

long as the fund does not exercise managerial control over the entities in which the fund invests and the FHC reduces its ownership in the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund or such additional period as the Board permits.[102]

- *Management Consulting*. Providing management consulting services, including with respect to nonfinancial matters, so long as the management consulting services are advisory and do not allow the FHC to control the person to which the services are provided.[103]
- *Travel Agency*. Operating a travel agency in connection with financial services offered by the FHC or others.[104]

The following activities are considered "financial in nature" solely to the extent, and subject to the conditions, that the Board specifies by regulation:

- *Financial Assets other than Money or Securities*. Lending, exchanging, transferring, investing for others or safeguarding financial assets other than money or securities.
- *Asset Transfer Devices*. Providing any device or other instrumentality for transferring money or other financial assets.
- *Agency Activities*. Arranging, effecting or facilitating financial transactions for the account of third parties, but only to the extent the Board specifies by regulation or order that such activities are financial in nature.[105]

The Board has specified by regulation that these activities are financial in nature only when conducted pursuant to a specific determination by the Board for a particular FHC.[106]

An FHC or other interested party may request an advisory opinion from the Board about whether a proposed activity falls within the scope of an activity listed in Section 225.86 of Regulation Y as an activity that is financial in nature or incidental to a financial activity.[107]

The authority to engage in the financial activities of (i) merchant banking, (ii) insurance company portfolio investments and (iii) securities underwriting, dealing and market making differ from the other financial activities in that they permit FHCs to control portfolio companies that are engaged exclusively in nonfinancial activities or a mixture of financial and nonfinancial activities, subject to certain conditions, including maximum holding periods and restrictions in being routinely involved in the management or operation of such portfolio companies, as more fully described below.

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[102] 12 C.F.R. §§ 225.86(b)(3), 211.10(a)(11).

[103] 12 C.F.R. §§ 225.86(b)(1), 211.10(a)(12).

[104] 12 C.F.R. §§ 225.86(b)(2), 211.10(a)(16).

[105] 12 U.S.C. § 1843(k)(5); 12 C.F.R. § 225.86(e).

[106] 12 C.F.R. §§ 225.86(e)(1), 225.86(e)(2).

[107] 12 C.F.R. § 225.88(e).

[b] Additional Financial Activities

In addition to the "laundry list" of financial activities, the Board has the authority to permit FHCs to engage in, or own or control companies engaged in, any other activity that the Board determines by regulation or order to be financial in nature.

An FHC or other interested party[108] may request a determination from the Board that an activity not listed in the BHC Act, or previously determined by the Board to be a financial activity, is "financial in nature."[109] The Board or the Secretary of the Treasury may also propose that an activity be considered financial in nature on its own initiative.[110]

Before declaring a new activity to be financial in nature, the Board must notify and consult with the Secretary of the Treasury.[111] The Board is prohibited from declaring any activity to be financial in nature if the Secretary of the Treasury objects.[112] The Board must implement its approval of any proposal by the Secretary of the Treasury by amending its regulations subject to the ordinary public notice and comment requirements.[113] On any proposal from any other person, the Board is permitted, but not required, to request public comment on the proposal.[114]

In determining whether an activity is financial in nature, the Board is required to take into account the following factors:

- the purposes of the BHC Act and the GLB Act;
- changes or reasonably expected changes in the marketplace in which FHCs compete;
- changes or reasonably expected changes in the technology for delivering financial services; and
- whether the proposed activity is necessary or appropriate to allow an FHC and its affiliates to compete effectively with any company seeking to provide financial services in the U.S., efficiently deliver information and services that are financial in nature through the use of technological means; and offer customers any available or emerging technological means for using financial

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[108] 12 C.F.R. § 225.88(a). A BHC that has not yet elected FHC status may file a request if its decision whether or not to seek FHC status depends on certain activities being considered to be financial in nature or incidental to a financial activity.

[109] 12 C.F.R. § 225.88(a).

[110] 12 U.S.C. §§ 1843(k)(2)(A)(i), 1843(k)(2)(B)(i); 66 Fed. Reg. 400, 407 (Jan. 3, 2001).

[111] 12 U.S.C. § 1843(k)(2)(A)(i); 12 C.F.R. § 225.88(c).

[112] 12 U.S.C. § 1843(k)(2)(A)(ii). The Secretary of the Treasury must respond to a notice within 30 days, and the Board will endeavor to make a decision on the request within 60 calendar days following the completion of the consultative process with the Secretary of the Treasury and any public comment period. 12 C.F.R. § 225.88(d).

[113] 12 U.S.C. § 1843(k)(2)(B)(ii).

[114] *See* 66 Fed. Reg. 400, 407 (Jan. 3, 2001).

services or for the document imaging of data.[115]

To date, neither the Board nor the Secretary of the Treasury has proposed to add any activity to the list of activities considered financial in nature.

[2] Incidental Activities

Similar to the definition of financial activities, the BHC Act defines activities that are incidental to a financial activity as any activity that the Board determines, by regulation or order in accordance with certain procedures described more fully below, to be incidental to a financial activity.[116] As noted above, an FHC or other interested party may request an advisory opinion from the Board about whether a proposed activity falls within the scope of an activity listed in Section 225.86 of Regulation Y as an activity that is financial in nature or incidental to a financial activity.[117] The procedures for finding a new activity to be incidental to a financial activity are identical to the procedures for finding a new activity to be financial in nature. As a result, the Board has tended to treat both categories as a single category for purposes of Regulation Y.[118]

The Board has determined that acting as a "finder" is incidental to financial activities.[119] A finder is an intermediary that brings together one or more buyers and sellers of any product or service for transactions that the parties negotiate and consummate themselves.[120] Among the sorts of activities that fall within this category are hosting electronic markets on internet websites that bring buyers and sellers together to effect transactions that they negotiate and consummate themselves.[121]

On January 3, 2001, the Board and the Secretary of the Treasury jointly proposed that real estate brokerage and real estate management be treated as incidental to a financial activity.[122] Although the agencies have not formally withdrawn their joint proposal, they have effectively abandoned it in the face of substantial public opposition to the proposal, mainly from a host of independent real estate brokers.

Although real estate investment, brokerage and management have not been determined to be financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act, an FHC

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[115] 12 U.S.C. § 1843(k)(3)(D).

[116] 12 U.S.C. § 1843(k)(1).

[117] 12 C.F.R. § 225.88(e).

[118] *See* 12 C.F.R. § 225.86.

[119] 65 Fed. Reg. 80,735 (Dec. 22, 2000).

[120] 12 C.F.R. § 225.86(d)(1). *See* 65 Fed. Reg. 47,696 (Aug. 3, 2000) (proposed rule on finders); 65 Fed. Reg. 80,735 (Dec. 22, 2000) (final rule on finders); 66 Fed. Reg. 19,081 (Apr. 13, 2001) (technical amendments restoring finders rule that had been inadvertently dropped from Section 225.86 of Regulation Y). *See* Julie L. Williams & James F.E. Gillespie, Jr., *The Impact of Technology on Banking: The Effect and Implications of "Deconstruction" of Banking Functions*, 5 N.C. BANKING INST. 135, 150–156 (2001), for a discussion of the activity of banks acting as finders.

[121] 12 C.F.R. § 225.86(d)(ii).

[122] 66 Fed. Reg. 307 (Jan. 3, 2001).

may underwrite, deal and make markets in securities of *companies* engaged in such activities, and make controlling and noncontrolling investments in them pursuant to, and subject to the conditions and limitations of, the merchant banking and insurance company portfolio investment powers, as discussed more fully below.

[3] Complementary Activities

Similar to the definitions of financial and incidental activities, the BHC Act defines activities that are complementary to a financial activity as any activity that the Board determines, by regulation or order, to be both (i) complementary to a financial activity and (ii) not a substantial risk to the safety or soundness of depository institutions or the financial system generally.[123] Unlike the procedures for adding activities to the list of financial or incidental activities, the Board is not required to notify or consult with the Secretary of the Treasury about whether a particular activity is complementary to a financial activity.

An FHC that seeks to engage in, or acquire more than 5 percent of the outstanding shares of any class of voting securities of a company engaged in, an activity that the FHC believes to be complementary to a financial activity must obtain prior approval from the Board by filing a notice in accordance with Section 4(j) of the BHC Act.[124] In deciding whether to approve such a notice, the Board will consider whether the proposed activity (i) is complementary to a financial activity, (ii) would pose a substantial risk to the safety and soundness of any depository institutions or the financial system generally, and (iii) would produce public benefits that outweigh its potential adverse effects.[125] The Board has observed that its power to designate certain activities as complementary to an FHC's financial activities "was intended to permit the Board to authorize an FHC to engage, to a limited extent, in activities that appear to be commercial if a meaningful connection exists between the proposed commercial activity and the FHC's financial activities and the proposed commercial activity would not pose undue risks to the safety and soundness of the FHC's affiliated depository institutions or the financial system."[126]

The Board has exercised its authority to find two types of activities to be complementary to financial activities. In a series of orders, the Board has found that certain commodities trading activities, energy management services and energy tolling arrangements are complementary to the financial activity of trading in commodities futures, forwards and other contracts.[127] The Board has also found that certain disease management and mail-order pharmacy services are complementary to the financial

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[123] 12 U.S.C. § 1843(k)(1).

[124] 12 C.F.R. § 225.89(a).

[125] 12 C.F.R. § 225.89.

[126] 68 Fed. Reg. 68,493, 68,493 (Dec. 9, 2003).

[127] *See, e.g.*, Citigroup, 89 FED. RES. BULL. 508 (2003) (commodities trading); Fortis S.A./N.V., 94 FED. RES. BULL. C20 (2008) (energy management); The Royal Bank of Scotland Group plc, 94 FED. RES. BULL. C60 (2008) (energy tolling).

activity of underwriting and selling health insurance.[128] In approving these applications, the Board has imposed a number of conditions designed to limit the potential safety and soundness risks of the complementary activities, and to ensure that the proposed activities would produce public benefits that outweighed any potential adverse effects. These conditions have typically included limits on the market value of assets acquired as part of the complementary activities, requirements that the assets be reasonably liquid and conditions designed to preserve the separation of banking and commerce.

[4] Exclusivity Requirement

In general, an FHC is not permitted to acquire or retain the shares of any company in reliance on Section 4(k)(1) of the BHC Act unless the company is *exclusively* engaged in activities that are financial in nature or incidental to a financial activity.[129] If an FHC acquires shares of any company that is engaged exclusively in nonfinancial activities or a mixture of financial and nonfinancial activities, the FHC must obtain a determination that the nonfinancial activities are complementary to a financial activity or rely on the merchant banking power, the insurance company portfolio investments authority, the securities underwriting or dealing power, the QFBO exemptions, Sections 4(c)(6) or 4(c)(7) of the BHC Act or some other source of authority that specifically permits FHCs to acquire shares of companies engaged in nonfinancial or a mixture of financial and nonfinancial activities, subject to the conditions of such other source of authority.

There is one exception to this general rule. An FHC may acquire and retain the shares of any company engaged in mixed financial and nonfinancial activities if the following conditions are satisfied:

- it is "substantially engaged" in financial activities, meaning at least 85 percent of the company's consolidated total annual gross revenues is derived from,

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[128] Wellpoint, Inc., 93 FED. RES. BULL. C133 (2007). The Wellpoint order was issued in the context of an application by Wellpoint to the Federal Deposit Insurance Corporation to obtain deposit insurance for a newly chartered Utah industrial bank. Although Wellpoint was not a bank holding company or otherwise subject to the BHC Act at the time of the Board's determination, and would not become a bank holding company by virtue of acquiring the Utah industrial bank, *see* 12 U.S.C. § 1841(c)(2)(H) (industrial banks excluded from the term "bank" for purposes of the BHC Act), Wellpoint requested the determination because it had filed its application with the FDIC during an FDIC-imposed moratorium that prohibited approval of any such applications, except by applicants engaged exclusively in activities that were permissible for an FHC. *See* Moratorium on Certain Industrial Bank Applications and Notices, 72 Fed. Reg. 5,290 (Feb. 5, 2007).

[129] *See* 12 C.F.R. § 225.85(a); 66 Fed. Reg. 400, 404 (Jan. 3, 2001). The regulation and release distinguish complementary activities from other permissible activities, but this is because they are referring to them in the context of post-transaction notice requirements, which do not apply to complementary activities, which must be pre-approved. *See*, *e.g.*, 66 Fed. Reg. at 404, n. 9. *See* 12 C.F.R. § 225.85(a)(2), which makes it clear that companies otherwise required to engage exclusively in activities that are financial in nature, incidental to a financial activity or otherwise permissible under Section 4(c) of the BHC Act are nevertheless permitted to engage in complementary activities despite the general exclusivity requirement.

and at least 85 percent of the company's consolidated total assets is attributable to, the conduct of activities that are financial in nature, incidental to a financial activity or otherwise permissible under Section 4(c) of the BHC Act;

- the FHC complies with the post-transaction notice requirements applicable to such transactions; and
- the FHC causes the company to conform, terminate or divest any nonconforming activities within 2 years of the company's acquisition by the FHC.[130]

[5] Securities Underwriting and Dealing

As noted above, securities underwriting, dealing and market making is a listed financial activity.[131] As a result, an FBO that is an FHC may engage in, or own or control a subsidiary exclusively engaged in, such securities activities, as well as any other activities that are financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permissible under Section 4 of the BHC Act. Because any company engaged in securities underwriting, dealing and market making in the United States must also be registered as a broker-dealer with, and will be subject to the supervision and regulation of, the Securities and Exchange Commission,[132] an FBO will virtually always engage in those securities activities in the United States through a separately incorporated subsidiary.

The power to engage in securities underwriting, dealing and market making pursuant to Section 4(k)(4)(E) of the BHC Act extends to all types of securities, including debt and equity securities, by all types of issuers, including banks, companies engaged in financial activities and companies engaged in nonfinancial activities. Unlike the more limited underwriting and dealing powers that are permissible under Sections 4(c)(8) and 4(c)(13) of the BHC Act,[133] the power granted by

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[130] 12 C.F.R. § 225.85(a)(3).

[131] 12 U.S.C. § 1843(k)(4)(E).

[132] 15 U.S.C. § 78o; *see also* 12 C.F.R. § 218 (Federal Reserve rules jointly issued with the Securities and Exchange Commission implementing exceptions for banks from the definition of "broker" under Section 3(a)(4) of the Securities and Exchange Act); Exemptions for Banks under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules, Release No. 34-56502 (Sept. 24, 2007) (rules implemented by the Securities and Exchange Commission only, regarding the bank exemptions from the definition of "dealer"). State and federal broker-dealer registration and change-in-control requirements, as well as state and federal regulation and supervision of broker-dealers is beyond the scope of this Chapter.

[133] 12 U.S.C. §§ 1843(c)(8), 1843(c)(13); J.P. Morgan & Co., Incorporated, et al., 75 FED. RES. BULL. 192 (1989), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 900 F.2d 360 (D.C. Cir. 1990); Citicorp, *et al.*, 73 FED. RES. BULL. 473 (1987), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988) *as modified by* Modifications to Section 20 Orders, 75 FED. RES. BULL. 751 (1989), and 10 Percent Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 48,953 (1996), and Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (1996) (revenue limits); 12 C.F.R. §§ 211.10(a)(14) and (15) (geographical limits).

Section 4(k)(4)(E) of the BHC Act is not subject to revenue, geographical or other limitations.[134]

Although there is nothing in the statute or regulations expressly imposing any maximum holding period on securities acquired by an FHC as a securities underwriter, dealer or market maker pursuant to Section 4(k)(4)(E) of the BHC Act, implicit in the notion of underwriting securities is that the securities are acquired with a bona fide intent to resell them as promptly as possible rather than to hold them for investment purposes. Similarly, dealing and market making in securities is generally understood to be the practice of holding oneself out to the public as willing to buy or sell securities in specified volumes at specified prices, and therefore typically results in the securities being turned over on regular basis rather than being held for investment. In general, the Board would likely expect securities acquired pursuant to this power to be disposed of or turned over within a relatively short period of time, typically within 30-60 days.[135] If an FHC or its securities affiliate decides to hold securities for investment purposes, instead of for bona fide underwriting, dealing or market making purposes, or finds itself with securities it cannot resell on a reasonable basis for more than 90-180 days despite bona fide efforts to do so, the FHC would likely need to find another source of authority to continue holding such securities, such as the merchant banking power.

[6] Insurance Underwriting

Underwriting life, health, property and casualty and other types of insurance is also a listed financial activity.[136] As a result, an FBO that is an FHC may engage in, or own or control a subsidiary exclusively engaged in, such insurance underwriting activities, as well as any other activities that are financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permissible under Section 4 of the BHC Act. In addition, the Board has determined that certain disease management and mail-order pharmacy services are complementary to the financial activity of underwriting and selling health insurance, subject to certain conditions.[137]

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[134] *See* 66 Fed. Reg. 400, 406 (Jan. 3, 2001).

[135] *See, e.g.,* 12 C.F.R. § 211.10(a)(15)(iv)(C) (treating securities acquired pursuant to an underwriting commitment as an investment if held for more than 90 days); 12 U.S.C. § 1841(a)(5)(B) (exempting acquisitions of bank and bank holding company securities from the prior approval requirements of Section 3 of the BHC Act if acquired in connection with an underwriting of such securities, but only if the shares are held "for such period of time as will permit the sale thereof on a reasonable basis"). J.P. Morgan & Co., Incorporated, *et al.*, 75 FED. RES. BULL. 192 (1989), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 900 F.2d 360 (D.C. Cir. 1990); Citicorp, *et al.*, 73 FED. RES. BULL. 473 (1987), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988) *as modified by* Modifications to Section 20 Orders, 75 FED. RES. BULL. 751 (1989), and 10 Percent Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 48,953 (1996), and Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (1996) (revenue limits).

[136] 12 U.S.C. § 1843(k)(4)(B).

[137] Wellpoint, Inc., 93 FED. RES. BULL. C133 (2007).

Because complementary activities are only permissible if specifically permitted for a specific FHC, any other FHC would be required to obtain its own approval from the Board before commencing to engage in those activities.

The Board will not necessarily treat all of the activities of an insurance affiliate as permissible insurance or other financial activities despite the broad wording of Section 4(k)(4)(B) of the BHC Act. Insurance companies are not generally subject to the same activities and investment restrictions as FHCs. As a result, they are free to engage in certain activities that may not fall within any of the activities listed as financial in nature or incidental to a financial activity or otherwise permissible under Section 4 of the BHC Act. Unless the Board determines that any such nonfinancial activities are complementary to a financial activity, an FBO may be precluded from acquiring or maintaining more than 5 percent of the voting shares of an insurance company unless the nonfinancial activities are terminated or transferred to a separate company that can be held under, and subject to the conditions of, the merchant banking power or the insurance company portfolio investments authority.

Although the regulation of insurance companies is almost exclusively a matter of state law in the United States,[138] federal law preempts state anti-affiliation laws that would otherwise prevent or restrict affiliations between depository institutions (including foreign banks with a U.S. commercial banking presence) and insurance companies, other than prior approval, information collection, capital maintenance or restoration, or similar requirements that do not discriminate against depository institutions (including foreign banks with a U.S. commercial banking presence).[139] Federal law also preempts state laws that would otherwise regulate the insurance activities of a depository institution (including a foreign bank with a U.S. commercial banking presence) or its affiliates that are otherwise permitted by federal law in a manner that discriminates against the depository institution or its affiliates.[140] Finally, federal law preempts state law that would otherwise interfere with the ability of an insurer or its affiliates to acquire a depository institution (including a foreign bank with a U.S. commercial banking presence) or to elect to become an FHC[141] or limit the amount of an insurer's assets that may be invested in the voting securities of a depository institution or any company which controls such an institution.[142] The state of an insurer's domicile may, however, limit the amount of an insurer's assets that may be invested in the voting securities of a depository institution or a company controlling such an institution to an amount that is not less than 5 percent of the insurer's admitted assets.[143]

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[138] State insurance licensing and change-in-control requirements, as well as state regulation and supervision of insurance companies is beyond the scope of this Chapter.

[139] 15 U.S.C. §§ 6701(c) and 6701(g)(3).

[140] 15 U.S.C. § 6701(e).

[141] 15 U.S.C. § 6715(1).

[142] 15 U.S.C. § 6715(2).

[143] 15 U.S.C. § 6715(2). *See, e.g.*, N.Y. Ins. Law § 1301 (McKinney) for definitions of admitted assets.

[7] Merchant Banking

Section 4(k)(4)(H) of the BHC Act permits an FHC to make controlling and noncontrolling investments in the shares, assets or other ownership interests of a company or other entity that is engaged in "any activity" that is not financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act,[144] subject to the following conditions:

- the investment is not made or held by a U.S. depository institution (including any FDIC-insured U.S. branch of a foreign bank), or by a subsidiary of a U.S. depository institution;[145]
- the investment is made as part of a bona fide underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment;[146]
- the FHC has (i) a registered securities affiliate or (ii) both (A) an insurance company affiliate that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities and (B) a registered investment adviser affiliate that provides advice to an insurance company;[147]
- the investment is held only for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the merchant banking investment activities;[148] and
- the FHC does not routinely manage or operate the company in which the investment is made except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.[149]

The merchant banking power overlaps with several other sources of authority for investments in nonfinancial companies, including the securities underwriting, dealing and market making power contained in Section 4(k)(4)(E) of the BHC Act, the insurance company portfolio investment power contained in Section 4(k)(4)(I), investments made under Sections 4(c)(6) and 4(c)(7) and investments made under Section 4(c)(13), the QFBO exemptions and Regulation K. To the extent any of these provisions overlap, they are alternative sources of authority for the same investments, but with different conditions and limitations. An FHC is free to choose whichever

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[144] 12 U.S.C. § 1843(k)(4)(H); 12 C.F.R. § 225.177(c).

[145] 12 U.S.C. § 1843(k)(4)(H)(i); 12 C.F.R. § 225.170(d).

[146] 12 U.S.C. § 1843(k)(4)(H)(ii); 12 C.F.R. § 225.170(b).

[147] 12 U.S.C. § 1843(k)(4)(H)(ii); 12 C.F.R. § 225.170(f). It suffices if a bank has a separate and identifiable department or division that is registered as a municipal securities dealer.12 C.F.R. § 225.170(f)(1)(ii).

[148] 12 U.S.C. § 1843(k)(4)(H)(iii); 12 C.F.R. § 225.172(a).

[149] 12 U.S.C. § 1843(k)(4)(H)(iv); 12 C.F.R. § 225.171(a).

source of authority gives it the most flexibility with the least burden under any particular circumstances.[150]

[a] Nonfinancial or Mixed Financial/Nonfinancial

The merchant banking authority permits an FHC to make investments in any company or other entity that is engaged in *any activity* that is not financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act. This includes companies that are engaged exclusively in nonfinancial activities, as well as companies that are engaged in mixed financial and nonfinancial activities. Neither the statute nor the implementing regulations impose any minimum percentage or other threshold on the amount of nonfinancial activities in which a company or other entity must engage in order to be an eligible merchant banking investment. Thus, unless a company or other entity is engaged *exclusively* in activities that are financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act, it is an eligible merchant banking investment, subject to the conditions and limitations of such investments.

If a company or other entity is engaged exclusively in activities that are permissible by Section 4 of the BHC Act, the investment is permissible under Section 4(k)(1) of the BHC Act, but it is not an eligible merchant banking investment.[151] If a company is engaged in a mixture of financial and nonfinancial activities, but is substantially engaged in financial activities (meaning that its financial activities, activities that are incidental to a financial activity and activities permissible under Section 4(c) of the BHC Act account for at least 85 percent of the company's assets and revenues), the FHC has a choice in making any investment in the company. The FHC is permitted to make the investment under the merchant banking power, subject to the conditions and limitations of that power, or it may make the investment under Section 4(k)(1), subject to the requirement that it terminate any nonconforming activities, or obtain a determination from the Board that the nonconforming activities are complementary to a financial activity, within two years of making the investment.[152] An FHC might choose the second authority if it wanted to be involved in the routine management or operation of the company or hold the investment for more than the maximum holding period for a merchant banking investment.

[b] Bona Fide Investment Banking Activity

The BHC Act requires merchant banking investments to be made as part of a bona fide underwriting or merchant or investment banking activity.[153] The Board has stated that "this requirement was intended to distinguish between merchant banking investments that . . . are made for purposes of resale or other disposition, and

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[150] 66 Fed. Reg. 8,466, 8,469 (Jan. 31, 2001).

[151] 66 Fed. Reg. 8,466, 8,468–8,469 (Jan. 31, 2001).

[152] *See* 12 C.F.R. § 225.85(a)(3).

[153] 12 U.S.C. § 1843(k)(4)(H)(ii); 12 C.F.R. § 225.170(b).

investments that are made for purposes of allowing the [FHC] to engage in the nonfinancial activities conducted by the portfolio company."[154] It "preserves the financial nature of merchant banking investment activities and helps further the . . . purpose of maintaining the separation of banking and commerce."[155] The Board has said that it will monitor compliance with the bona fide requirement through the supervisory process to make sure the merchant banking power is not used by an FHC to become "impermissibly involved in nonfinancial activities, such as real estate investment or development."[156] Although the bona fide requirement does not prohibit an FHC from making investments in real estate investment or management companies or from concentrating its investments in any other particular sector, the Board might scrutinize an FHC's compliance with the bona fide requirement if it makes merchant banking investments only in real estate investment or development companies.[157]

[c] Portfolio Company Requirement

Although the statute does not make any distinction between investments in the shares or assets of a company, the Board's implementing regulations prohibit an FHC from making investments in assets unless the following conditions are satisfied:

- The assets are held by or promptly transferred to a portfolio company;
- The portfolio company maintains policies, books and records, accounts, and other indicia of corporate, partnership or limited liability organization and operation that are separate from the FHC and limit the legal liability of the FHC for obligations of the portfolio company; and
- The portfolio company has management that is separate from the FHC to the extent required by the restriction on routine management or operation of the portfolio company.[158]

[d] No Routine Management or Operation

The statute provides that an FHC may not "routinely manage or operate" any company acquired under the merchant banking power "except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition."[159] This restriction does not prevent an FHC from controlling up to 100 percent of the board of directors or similar governing body of a portfolio company, as long as the portfolio company employs officers and employees responsible for routinely managing and operating the company and the board does not participate in routine management

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[154] 66 Fed. Reg. 8,466, 8,469 (Jan. 31, 2001).

[155] *Id.*

[156] *Id.*

[157] *See id.* Real estate investment and development are not financial activities. *See* 66 Fed. Reg. 8,466 8,469 (Jan. 31, 2001); 65 Fed. Reg. 16,460, 16,463 (Mar. 28, 2000) (interim rule).

[158] 12 C.F.R. § 225.170(e).

[159] 12 U.S.C. § 1843(k)(4)(H)(iv); *see also* 12 C.F.R. § 225.171(a).

or operation of the company even if the board has the authority to do so under applicable corporate law.[160]

An FHC is deemed to be engaged in the routine management or operation of a portfolio company if any of the following exist:

- Any director, officer or employee of the FHC or any of its securities, depository institution, merchant banking, small business investment corporation or certain other equity investing subsidiaries serves as, or has the responsibilities of, an executive officer of the portfolio company;[161]
- Any executive officer of the FHC or any of its securities, depository institution, merchant banking, small business investment corporation or certain other equity-investment subsidiaries serves as, or has the responsibilities of, an officer or employee of the portfolio company; or
- Negative covenants restricting the portfolio company's ability to make routine business decisions, such as entering into transactions in the ordinary course of business.[162]

An FHC is presumed, subject to rebuttal, to be engaged in the routine management or operation of a portfolio company if any of the following exist:

- Any director, officer or employee of the FHC serves as, or has the responsibilities of, a non-executive officer or employee of the portfolio company; or
- Any officer or employee of the portfolio company is supervised by any director, officer or employee of the FHC (other than in that individual's capacity as a director of the portfolio company).[163]

The following arrangements are not considered routine management or operation of a portfolio company:

- Negative covenants limited to restricting the portfolio company's ability to take actions on matters that are not in the ordinary course of business—that is, actions that customarily require board or shareholder action;[164]
- Providing financial, investment and management consulting advice in a manner consistent with and subject to any restrictions on routine management or operations;[165]

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[160] 12 C.F.R. § 225.171(d)(1).

[161] The term "executive officer" is defined by12 C.F.R. § 225.177(d) as "any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of the company, whether or not the officer has an official title, the title designates the officer as an assistant, or the officer serves without salary or other compensation."

[162] 12 C.F.R. § 225.171(b)(1).

[163] 12 C.F.R. § 225.171(b)(2).

[164] 12 C.F.R. § 225.171(d)(2) *See also* Letter from J. Virgil Mattingly, General Counsel of the Board, to Peter T. Grauer, Credit Suisse First Boston (Dec. 21, 2001).

[165] 12 C.F.R. § 225.171(d)(3)(i).

- Providing underwriting and private placement services to a portfolio company in connection with the portfolio company's securities;[166] or
- Meeting with officers or employees of the portfolio company to monitor or provide advice in connection with the portfolio company's performance or activities.[167]

Notwithstanding the general prohibition on routine management or operation of portfolio companies, an FHC (other than any U.S. depository institution subsidiary or the U.S. branch or agency of a foreign bank) is permitted to engage in the routine management or operations of a portfolio company on a temporary basis if necessary or required to obtain a reasonable return on the investment in the portfolio company upon resale or other disposition.[168] An FHC may routinely manage or operate a portfolio company only for the period of time as may be necessary to address the cause of the FHC's involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or otherwise to obtain a reasonable return upon the resale or other disposition of the investment.[169] However, an FHC may not routinely manage or operate a portfolio company for a period greater than 9 months without prior written notice to the Board.[170] An FHC must maintain and make available to the Board upon request a written record describing its involvement in routinely managing or operating a portfolio company.[171]

[e] Minority Investments and Veto Rights

The restriction on routine management or operation of a portfolio company applies to both majority and minority investments. Its chief impact on minority investments is to limit the negative covenants, or "veto" rights, that an FHC may have over certain corporate actions. Such negative covenants must be limited to matters that are not in the ordinary course of business—that is, matters that customarily require board or shareholder action. The negative covenants may not extend to matters that constitute routine management or operations. The Board has issued an interpretive letter with a list of examples of matters over which negative covenants are permissible, consistent with the restriction on routine management or operations.[172]

[f] Limited Holding Period

The Board has interpreted the requirement that a merchant banking investment be

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[166] 12 C.F.R. § 225.171(d)(3)(ii).

[167] 12 C.F.R. § 225.171(d)(3)(iii).

[168] 12 U.S.C. § 1843(k)(4)(H)(iii); 12 C.F.R. § 225.171(e).

[169] 12 C.F.R. § 225.171(e)(2).

[170] 12 C.F.R. § 225.171(e)(3).

[171] 12 C.F.R. § 225.171(e)(4).

[172] Letter from J. Virgil Mattingly, General Counsel of the Board, to Peter T. Grauer, Credit Suisse First Boston (Dec. 21, 2001), which sets forth examples of negative covenants that an FHC may enter into with a portfolio company without being deemed to be engaged in the routine management or operation of the portfolio company. *See also* 12 C.F.R. § 225.171(d)(2).

limited to "a period of time to enable the sale or disposition thereof on a reasonable basis"[173] as meaning that an FHC generally may hold a merchant banking investment for a maximum of 10 years, except that a merchant banking investment held through a qualified private equity fund may be held for the duration of the fund (which may not exceed 15 years).[174] If an FHC, a controlled qualified private equity fund or any other affiliate of the FHC acquires an investment in a portfolio company from an affiliate that was previously held under the merchant banking rule or any other provision of the Federal banking laws that imposes a limited holding period, the acquiring company must tack onto its holding period the amount of time such affiliate has held such investment for purposes of determining the acquiring company's compliance with the applicable maximum holding period under the merchant banking power.[175] In unusual circumstances, an FHC may seek Board approval to hold an interest in a portfolio company in excess of the applicable maximum holding period.[176] However, an FBO that holds a merchant banking investment in excess of the applicable maximum holding period must abide by any restrictions that the Board may impose in connection with granting approval of the extension of the holding period.[177]

[g] Qualified Private Equity Funds

FHCs are permitted to make merchant banking investments through private equity funds, which are generally structured as limited partnerships or other investment vehicles that pool the FHC's capital with capital provided by third-party investors. These third-party investors typically are institutional investors, such as other investment companies, pension funds, endowments, financial institutions or corporations, and sophisticated individual investors with high net worth. In most instances, the FHC is the sponsor or advisor to the fund and has a general partnership or similar interest in the fund. A private equity fund qualifies for the longer holding period if the fund satisfies the following conditions:

- It was formed for the purpose of and is engaged exclusively in the business of investing in shares, assets and ownership interests of financial and nonfinancial companies for resale or other disposition;
- It is not an operating company;
- The FHC and its directors, officers, employees and principal shareholders do not hold, own or control more than 25 percent of the of the total equity of the fund;
- The fund has a maximum term of not more than 15 years; and
- It is not formed or operated for the purpose of making investments inconsistent

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[173] 12 U.S.C. § 1843(k)(4)(H)(iii).

[174] 12 C.F.R. §§ 225.172(b)(1), 225.173(c)(1).

[175] 12 C.F.R. §§ 225.172(b)(2), 225.172(b)(3), 225.173(c)(3).

[176] 12 C.F.R. §§ 225.172(b)(4), 225.172(b)(5), 225.173(c)(2).

[177] 12 C.F.R. §§ 225.172(b)(6)(ii), 225.173(c)(2).

with the merchant banking power or evading the limitations on merchant banking investments.[178]

An FHC is permitted to make both controlling and noncontrolling investments in qualified private equity funds. Regulation Y defines situations in which an FHC is considered to control a qualified private equity fund.[179] An FHC is deemed to control a qualified private equity fund if the FHC, including any director, officer, employee or principal shareholder of the FHC:

- serves as general partner, managing member or trustee of the private equity fund;
- owns or controls 25 percent or more of any class of voting shares or similar interests in the fund;
- in any manner selects, controls or constitutes a majority of the directors, trustees or management of the fund; or
- owns or controls more than 5 percent of any class of voting shares or similar interests in the private equity fund and is the investment adviser to the fund.[180]

If an FHC is deemed to control a qualified private equity fund, the FHC will be deemed to control the fund's investments in portfolio companies. As a result, the FHC will be responsible for ensuring that the qualified private equity fund complies with the prohibition against routine management or operation of portfolio companies and the maximum holding period. In contrast, if an FHC has a noncontrolling interest in a qualified private equity fund, the investments of the private equity fund are not attributable to the FHC; such a qualified private equity fund may routinely manage or operate its portfolio companies[181] and hold its investments in portfolio companies indefinitely without causing the FHC to be in violation of the BHC Act.

An FHC's controlling or noncontrolling investment in a qualified private equity fund (in contrast to any investments in portfolio companies attributable to the FHC by virtue of controlling a qualified private equity fund) is, by definition, an investment in a company that is engaged exclusively in activities that are financial in nature. As a result, an FHC may routinely manage or operate a qualified private equity fund. In contrast, both the FHC and any qualified private equity fund that is controlled by the FHC must comply with the limits on routine management or operation and on maximum holding periods with respect to any investments by the qualified private equity fund in portfolio companies.

An FHC is also permitted to make controlling investments in private equity funds that do not satisfy the conditions of qualified private equity funds. If the investment is a controlling one in a nonqualified private equity fund (*e.g.*, a fund such as a hedge fund formed as a company with unlimited life) that is otherwise exclusively engaged

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[178] 12 C.F.R. § 227.173(a).

[179] 12 C.F.R. § 225.173(d)(4).

[180] *Id.*

[181] 12 C.F.R. § 227.173(d)(3).

in activities that are financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act, the only consequence is that the FHC must comply with the 10-year maximum holding period and the restrictions on routine management or operation of portfolio companies as if the portfolio investments were made directly by the FHC. If the investment is a controlling or noncontrolling one in a nonqualified private equity fund that engages in any activity not permitted by Section 4 of the BHC Act, then the FHC must treat its investment in the private equity fund itself as a merchant banking investment in a portfolio company, subject to the maximum holding period and restriction on routine management or operation at the level of the private equity fund itself, or under some other source of authority other than Section 4(k)(1) of the BHC Act. Finally, if the investment is a noncontrolling one in a nonqualified private equity fund (*e.g.*, a hedge fund formed as an unlimited life company) that is otherwise exclusively engaged in activities that are financial in nature, incidental to a financial activity, complimentary to a financial activity or otherwise permitted by Section 4 of the BHC Act, the investment will be permissible under Section 4(k)(1) and the merchant banking limitations will not be applicable either at the level of the private equity fund or its portfolio companies.[182]

[h] After-the-Fact Notice Requirements

An FHC is required to provide the Board with notice within 30 days after the closing of any merchant banking investment in which the FHC directly or indirectly acquires more than 5 percent of the shares, assets or other ownership interests of a portfolio company if the aggregate acquisition cost of such investment exceeds the lesser of 5 percent of the FHC's Tier 1 capital and $200 million.[183] It is also required to provide any notice that the Board otherwise deems to be necessary in the exercise of its supervisory authority.[184] Otherwise, an FHC is not required to obtain prior approval for, or otherwise provide before- or after-the-fact notice of, any merchant banking investment. If an after-the-fact notice is required, the notice is provided on Form FR Y-10.

[i] Risk Management, Record Keeping and Reporting

An FHC, including a private equity fund controlled by an FHC, that makes merchant banking investments must establish and maintain policies, procedures, records, and systems reasonably designed to conduct, monitor and manage such investments and the risks associated with such investments in a safe and sound manner.[185] In addition, the Division of Banking Supervision and Regulation of the Board has issued a supervisory letter entitled Supervisory Guidance on Equity

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[182] *See* 66 Fed. Reg. 8,466, 8,477 (Jan. 31, 2001), which is not entirely consistent with the description in the text, which is based on the plain language and purposes of Section 4(k) of the BHC Act.

[183] 12 C.F.R. § 225.87(b)(4)(i).

[184] 12 C.F.R. § 225.87(b)(4)(iii).

[185] 12 C.F.R. § 225.175(a)(1).

Investment and Merchant Banking Activities [*herein* the Guidance Letter].[186] The Guidance Letter describes in detail the internal controls and risk management policies, procedures and systems that the Board expects bank holding companies engaged in equity investment activities to have and to maintain in order to conduct such activities in a safe and sound manner. The Guidance Letter notes that foreign banks should incorporate the basic principles set forth in the Guidance Letter into their U.S. operations with appropriate adaptation to reflect the fact that those operations are an integral part of a foreign bank, which should be managing its risks on a consolidated basis and that the bank is subject to overall supervision by its home country authorities.[187]

The risk management, record keeping and reporting requirements of Regulation Y and the Guidance Letter can be summarized as follows:

Internal Risk Management Requirements

FHCs engaged in merchant banking investment activities are required to establish policies, procedures and systems and maintain records reasonably designed to:

- Monitor and assess the carrying value, market value and performance of each investment and such values of the FHC's aggregate merchant banking investment portfolio;
- Identify and manage the market, credit, concentration and other risks associated with merchant banking investments;
- Identify, monitor and assess the terms, amounts and risks arising from transactions and relationships (including contingent fees or contingent interests) between the FHC and the portfolio companies;
- Ensure the maintenance of corporate separateness between the FHC and the portfolio companies in order to protect the FHC and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of any of the portfolio companies; and
- Ensure compliance with Subpart J (Merchant Banking Investments) of Regulation Y and other provisions of law governing transactions and relationships between the FHC and portfolio companies.[188]

In addition, the Guidance Letter recommends that FHCs implement "sound management practices."[189] These practices include:

- *Oversight* : Active oversight by the FHC's board of directors and senior management. The board should approve portfolio objectives and investment strategies and policies, limits on aggregate investment and exposure amounts, types of investments and diversification-related aspects of equity investments.

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[186] SR Letter No. 00-9 (SPE) (June 22, 2000).

[187] SR Letter No. 00-9 (SPE), Attachment, at 3 (June 22, 2000).

[188] 12 C.F.R. § 225.175(a)(1).

[189] *See* SR Letter No. 00-9 (SPE), Attachment, at 3 (June 22, 2000).

> The board should actively monitor the performance and risk profile of the equity investment business in light of its established objectives, strategies and policies. The board should ensure that there is an effective management structure for conducting the institution's equity activities, including adequate systems for measuring, monitoring, controlling and reporting on the risks of equity investments, and should specify lines of authority and responsibility for acquisition and sales of investments.[190]

Senior management must ensure that there are adequate policies, procedures and management information systems for managing equity investment activities on a day-to-day and longer-term basis and that there is competent staff.[191]

- *Management of the Investment Process* :
  - — *Policies and Limits* : The FHC must have effective policies that: (i) govern the types and amounts of investments that may be made; (ii) provide guidelines on appropriate holding periods for different types of investments; (iii) establish parameters for portfolio diversification;[192] (iv) govern compensation arrangements, including co-investment structures and sales of portfolio company interests by employees of the FHC;[193] (v) govern the terms and conditions of employee loans and sales of participants' interests prior to the release of the lien securing such loans in connection with key employees' co-investments;[194] and (vi) limit the legal liability of the FHC and its affiliates for the financial obligations and liabilities of the portfolio companies.[195]
  - — *Procedures* : The FHC must have procedures for assessing, approving and reviewing investments based upon the size, nature and risk profile of an investment. These include: (i) analytical assessments of investment opportunities and formal approval process; (ii) internal risk rating for equity investments; (iii) periodic and timely review of the FHC's equity investments; (iv) valuation accounting policies and procedures; (v) exit strategies; (vi) policies and procedures to govern the sale, exchange or other disposition of the FHC's investments; (vii) internal methods for allocating economic capital based on the risk inherent in the investment activities; and (viii) terms and conditions of employee loans and sales of participants' interests prior to the release of the liens securing such loans in connection with key employees' co-investments.[196]

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[190] *See id.*, at 4–5.

[191] *See id.*, at 5.

[192] *See id.*, at 5.

[193] *See id.*, at 6.

[194] *See id.*, at 12.

[195] *See id.*, at 14.

[196] *See id.*, at 6–10, 12.

- *Control System* : The FHC must have an adequate system of internal controls, with appropriate checks and balances and clear audit trails, that focuses on all of the elements of the investment management process including: (i) the appropriateness of existing policies and procedures; (ii) the adherence to policies and procedures; (iii) the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting; (iv) departures from policies and procedures; and (v) compliance with all federal laws and regulations applicable to an FHC's investment activities (in particular, compliance with the prohibition on impermissible control over equity investments and compliance with restrictions on cross-marketing between depository institution and portfolio companies of FHCs.)[197]

The policies and procedures described above are expected to be at the top-tier FHC level and applied by it on a consolidated basis to its subsidiaries. Accordingly, any subsidiary of an FHC should be informed of the policies and procedures that it would be expected to follow when engaged in merchant banking investments, including reporting requirements to the parent FHC.

Record-Keeping Requirements

Regulation Y requires FHCs to keep records designed to conduct, monitor and manage the investment activities and the risks associated with such investments in a safe and sound manner.[198]

The Guidance Letter recommends the following record-keeping measures:[199]

- documentation of key elements of the investment process, including initial due diligence, approval reviews, valuation and disposition;
- documentation of board-approved objectives, strategies, policies and procedures;[200]
- records of transactions between an FHC and companies held under the merchant banking investment authority, specifically documentation of transactions that are not on market terms;
- documentation of incentive arrangements in connection with controlling or advising a fund, including the carrying value and market value of the arrangement and amounts that may be payable based on future asset performance; and
- documentation of the legal separation between the FHC and the portfolio company.[201]

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[197] *See id.*, at 10–11.

[198] 12 C.F.R. § 225.175(a)(1).

[199] *See* SR Letter No. 00-9 (SPE), Attachment, at 11 (June 22, 2000).

[200] *See id.*, at 4, 11.

[201] *See id.*, at 11.

Reporting Requirements

Upon request by the Board or the appropriate Federal Reserve Bank, an FHC must make the policies, procedures and records maintained with respect to its merchant banking investments available to the Board or the Federal Reserve Bank.[202] Furthermore, an FHC must provide reports to the appropriate Federal Reserve Bank in such format and at such times as the Board may prescribe.[203]

Disclosure of Merchant Banking Investment Activities

The Guidance Letter recommends that FHCs adequately disclose to the public relevant information that is necessary for the markets to assess the risk profiles and performance of their merchant banking investment activities. FHCs are encouraged to disclose information relating to:

- The size of their merchant banking investment portfolios;
- The types and nature of their merchant banking investments, such as direct/indirect, domestic/international, public/private and equity/debt with conversion rights;
- The initial cost, carrying value, and fair value of investments, and where applicable, comparisons to publicly quoted share values of portfolio companies;
- The accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices;
- The realized gains and losses arising from sales and unrealized gains and losses; and
- Any insights regarding the potential performance of equity investments under alternative market conditions.[204]

Institutions Lending to or Engaging in Other Transactions with Portfolio Companies

Additional risk management issues may arise when a U.S. insured depository institution subsidiary of an FHC or the U.S. branch or agency of a foreign bank lends to or has other business relationships with: (i) a company in which the FHC or an affiliate has invested (*i.e.*, a portfolio company); (ii) the general partner or manager of a private equity fund that has also invested in a portfolio company; or (iii) a private equity-financed company in which the FHC does not hold a direct or indirect ownership interest but which is an investment or portfolio company of a general partner or fund manager with which the FHC has other investments. Given their potentially higher than normal risk attributes, FHCs should devote special attention to ensuring that the terms and conditions of such lending relationships are at arm's length and are consistent with the lending policies and procedures of the institution. Similar

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[202] 12 C.F.R. § 225.175(a)(2).

[203] 12 C.F.R. § 225.175(b).

[204] *See* SR Letter No. 00-9 (SPE), Attachment, at 12–13 (June 22, 2000).

issues may arise in the context of derivatives transactions with or guaranteed by portfolio companies and general partners.[205]

Where a U.S. insured depository institution subsidiary of an FHC, or the U.S. branch or agency of a foreign bank, lends to a private equity-financed company in which the FHC has no equity interest but where the borrowing company is a portfolio investment of private equity fund managers or general partners with which the FHC may have other private-equity related relationships, care must be taken to ensure that the extension of credit is conducted on reasonable terms.[206]

Private Equity and Other Funds

If an FHC controls a private equity fund or other fund that makes merchant banking investments, the FHC must ensure that the fund has established the types of policies, procedures and systems and maintains the types of records described in Regulation Y for making and monitoring the fund's merchant banking investments or, alternatively, the FHC may ensure that the fund is subject to the FHC's merchant banking policies, procedures and systems.[207] These requirements do not apply if the FHC does not control the fund.[208]

Board Review of Risk Management Policies

The Board has announced that it generally will conduct a review of the investment and risk management policies, procedures and systems of an FHC that makes merchant banking investments within a short period after the FHC commences the activity. The review may be conducted off-site or on-site, depending on the expected level and complexity of the FHC's merchant banking investments and the FHC's previous experience in making equity investments under other legal authorities.[209]

[j] Enhanced Capital Requirements

Although domestic FHCs are subject to the Board's enhanced capital requirements for merchant banking investments,[210] these enhanced capital requirements do not apply to FBOs, which are subject to home-country capital requirements, or even to their top-tier U.S. bank holding company subsidiaries, if any, to the extent the top-tier

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[205] *See id.*, at 13. Lending and other business transactions between an insured depository institution and a portfolio company that meets the definition of an affiliate must be negotiated on an arm's-length basis, in accordance with Section 23B of the Federal Reserve Act, 12 U.S.C. § 371c-1. *See* § 10.06[6] below. The FHC should have systems and policies in place to monitor transactions between the FHC, or a nondepository institution subsidiary of the FHC, and a portfolio company. (These transactions are not typically governed by Section 23B.) An FHC should assure that the risks of these transactions, including exposures of the FHC on a consolidated basis to a single portfolio company, are reasonably limited and that all transactions are on reasonable terms, with special attention paid to transactions that are not on market terms. *See* SR Letter No. 00-9 (SPE), Attachment, at 13 (June 22, 2000).

[206] *See* SR Letter No. 00-9 (SPE), Attachment, at 13 (June 22, 2000).

[207] 12 C.F.R. § 225.175(a)(1) applies to private equity funds controlled by an FHC.

[208] *See* 66 Fed. Reg. 8,466, 8479 (Jan. 31, 2001).

[209] *See id.*

[210] 12 C.F.R. pt. 225, Appendix A, § II.B.5.

bank holding companies qualify for relief under the Board's SR Letter No. 01-1.[211] As a result, we will not discuss the Board's enhanced capital requirements for merchant banking investments in this Chapter.

[k] Cross-Marketing Restrictions

The BHC Act imposes cross-marketing restrictions on any U.S. depository institution controlled by an FHC, with respect to the FHC's merchant banking activities.[212] The main purpose of the cross-marketing restrictions is to ensure an appropriate separation between banking and commerce.[213] The Board has extended these restrictions to the U.S. branches and agencies of foreign banks.[214]

As implemented by the Board, these cross-marketing restrictions prohibit any U.S. depository institution controlled by an FHC, any of the depository institution's subsidiaries with certain exceptions,[215] and any U.S. branch or agency of a foreign bank, from:

- offering or marketing, directly or through any arrangement, any product or service of any company if more than 5 percent of the company's voting shares, assets or other ownership interests are owned or controlled by the FHC under Section 4(k)(4)(H) of the BHC Act; or
- allowing any product or service of the depository institution, including any product or service of a subsidiary of the depository institution, to be offered or marketed, directly or through any arrangement, by or through any company if more than 5 percent of the company's voting shares, assets or other ownership interests are owned or controlled by the FHC under Section 4(k)(4)(H) of the BHC Act.[216]

These cross-marketing restrictions apply to both a company engaged in merchant banking activities and the portfolio companies of such a company held under the merchant banking power.[217]

The cross-marketing restrictions generally apply to a private equity fund and its portfolio investments. But they do not apply to the portfolio companies of a private equity fund that is not controlled by the FHC.[218] Nor do they apply to the sale, offer or marketing of any limited partnership or other interest in a private equity fund,

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[211] SR Letter 01-1 (SUP) (Jan. 5, 2001).

[212] 12 U.S.C. § 1843(n)(5)(A).

[213] *See* H.R. Rep. 106-74 pt. 1, 106th Cong. 1st Sess., at 122–23 (1999); 66 Fed. Reg. 8,466, 8,480 (Jan. 31, 2001).

[214] 12 C.F.R. § 225.177(b) (definition of depository institution includes the U.S. branches and agencies of a foreign bank for purposes of the merchant banking power).

[215] 12 C.F.R. §§ 225.176(a)(1) and 225.176(a)(2) (for example, financial subsidiaries of national banks are excluded from the covered subsidiaries).

[216] 12 C.F.R. § 225.176(a)(1).

[217] *See* 12 U.S.C. § 1843(n)(5).

[218] 12 C.F.R. § 225.176(a)(3)(i).

whether or not it is controlled by the FHC.[219]

The cross-marketing restrictions do not apply to the marketing of products and services by a U.S. depository institution, its subsidiaries or the U.S. branch or agency of a foreign bank—such as deposits, loans and advisory services—to a merchant banking affiliate or its portfolio companies, so long as the merchant banking affiliate or its portfolio companies does not market those products or services to their customers or others.[220] Nor do the cross-marketing restrictions apply to the purchasing of products or services—such as data processing—by a U.S. depository institution, its subsidiaries or the U.S. branch or agency of a foreign bank from a merchant banking affiliate or its portfolio companies, provided that the institution does not, directly or indirectly or through arrangements, market the merchant banking company or portfolio company's products or services to the institution's customers or others. Likewise, the cross-marketing restrictions do not prohibit a U.S. depository institution, its subsidiary or the U.S. branch or agency of a foreign bank from engaging in cross-marketing activities with a company that is a co-investor with the FHC in a merchant banking company or portfolio company, so long as those activities do not involve products or services of the merchant banking company or portfolio company.[221]

[8] Insurance Company Portfolio Investments

Section 4(k)(4)(I) of the BHC Act permits an FHC to make controlling and noncontrolling investments in the shares, assets or other ownership interests of a company or other entity that is engaged in "any activity" that is not financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act, subject to the following conditions:

- the investment is not made or held by a U.S. depository institution (including any FDIC-insured U.S. branch of a foreign bank), or by a subsidiary of a U.S. depository institution;
- the shares, assets or other ownership interests are acquired and held by an insurance company affiliate that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities;
- such shares, assets or other ownership interests represent an investment made in the ordinary course of business of such insurance company in accordance with relevant state law governing such investments; and
- the FHC does not routinely manage or operate the company in which the investment is made except as may be necessary or required to obtain a reasonable return on investment.[222]

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[219] 12 C.F.R. § 225.176(a)(3)(ii).

[220] *See* 66 Fed. Reg. 8,466, 8,481 (Dec. 31, 2001).

[221] *See* 66 Fed. Reg. 8,466, 8,481 and n.28.

[222] 12 U.S.C. § 1843(k)(4)(I).

Insurance companies typically make these types of investments to invest the funds received from policyholders. The investment of funds, in particular funds received from policyholders and funds generated by investments, is an essential and inherent part of the insurance business. The Board recognized in the Citicorp/Travelers Order that, as an integral part of their insurance business, insurance underwriting companies invest the insurance premiums they collect in a variety of investments.[223]

The insurance company portfolio investment power is similar to the merchant banking power in several respects described more fully below. Its chief differences are that there is no maximum holding period on portfolio investments made pursuant to the insurance company portfolio investment power and it is not sufficient for the FHC to have insurance company and investment adviser affiliates in order to rely on this power. Instead, investments actually have to be made and held by an insurance company affiliate that is predominantly engaged in certain insurance activities and the investments must be made in the ordinary course of its insurance business in accordance with state or other applicable law.

Like the merchant banking power, the insurance company portfolio investment power overlaps with several other sources of authority for investments in nonfinancial companies, including the securities underwriting, dealing and market making power contained in Section 4(k)(4)(E) of the BHC Act, the merchant banking power contained in Section 4(k)(4)(H), investments made under Sections 4(c)(6) and 4(c)(7) and investments made under Section 4(c)(13), the QFBO exemptions and Regulation K. To the extent any of these provisions overlap, they are alternative sources of authority for the same investments, but with different conditions and limitations. An FHC is free to choose whichever source of authority gives it the most flexibility with the least burden under any particular circumstances.

[a] Nonfinancial or Mixed Financial/Nonfinancial

Like the merchant banking authority, the insurance company portfolio investment power permits an FHC to make investments in any company or other entity that is engaged in *any activity* that is not financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act. This includes companies that are engaged exclusively in nonfinancial companies, as well as companies that are engaged in mixed financial and nonfinancial activities. The BHC Act does not impose any minimum percentage or other threshold on the amount of nonfinancial activities in which a portfolio company or other entity must engage in order to be an eligible insurance company portfolio investment. Thus, unless a company or other entity is engaged *exclusively* in activities that are financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act, it is an eligible insurance company portfolio investment, subject to the conditions and limitations of such investments.

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[223] Travelers Group Inc., Citicorp, 84 FED. RES. BULL. 985, 988 n.18 (1998) ("As an integral part of their insurance business, the Travelers insurance underwriting subsidiaries invest insurance premiums they collect in a variety of investments").

If a company or other entity is engaged exclusively in activities that are permissible under Section 4 of the BHC Act, the investment is permissible under Section 4(k)(1) of the BHC Act, but it is not an eligible insurance company portfolio investment. If a company is engaged in a mixture of financial and nonfinancial activities, but is substantially engaged in financial activities (meaning that its financial activities, activities that are incidental to a financial activity and activities permissible under Section 4(c) of the BHC Act account for at least 85 percent of the company's assets and revenues), the FHC has a choice in making any investment in the company. The FHC is permitted to make the investment under the insurance company portfolio investment power, subject to the conditions and limitations of that power, or it may make the investment under Section 4(k)(1), subject to the requirement that it terminate any nonconforming activities, or obtain a determination from the Board that the nonconforming activities are complementary to a financial activity, within two years of making the investment.[224] An FHC might choose the second authority if it wanted to be involved in the routine management or operation of the company.

[b] Ordinary Course under State Law

The BHC Act requires that any insurance company portfolio investments be made in the ordinary course of business of the insurance company in accordance with state law governing such investments.[225] If the insurance company is organized under foreign law or doing business under foreign law, this requirement is presumably met if the portfolio investments are made in the ordinary course of business of the insurance company in accordance with applicable foreign law. Like the bona fide investment banking requirement under the merchant banking power, this requirement was intended to distinguish between insurance company portfolio investments made for investment purposes, and more strategic investments that are made for purposes of allowing the FHC to engage in the nonfinancial activities conducted by the portfolio company.[226] It preserves the financial nature of insurance company portfolio investment activities and helps further the purpose of maintaining an appropriate separation between banking and commerce.[227] Presumably, the Board will monitor compliance with this requirement through the supervisory process to make sure the insurance company portfolio investment power is not used by an FHC to become impermissibly involved in nonfinancial activities, as it does with merchant banking investments.[228] Although the ordinary-course-under-state (or other applicable) law requirement does not prohibit an FHC from making investments in real estate investment or management companies or from concentrating its investments in any other particular sector, the Board might scrutinize an FHC's compliance with the ordinary-course-under-state (or other applicable law) requirement if it makes insurance company portfolio

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[224] *See* 12 C.F.R. § 225.85(a)(3).

[225] 12 U.S.C. § 1843(k)(4)(I)(iii).

[226] *See* 66 Fed. Reg. 8,466, 8,469 (Jan. 31, 2001).

[227] *See id.*

[228] *See id.*

investments only in real estate investment or development companies.[229]

[c] Portfolio Company Requirement

Although the BHC Act does not make any distinction between investments in the shares or assets of a company, and the Board has not promulgated any regulations for insurance company portfolio investments similar to its merchant banking regulations, the Board would likely interpret Section 4(k)(4)(I) to prohibit an FHC from making investments in assets unless the following conditions are satisfied, as it does for merchant banking investments:

- The assets are held by or promptly transferred to a portfolio company;
- The portfolio company maintains policies, books and records, accounts, and other indicia of corporate, partnership or limited liability organization and operation that are separate from the FHC and limit the legal liability of the FHC for obligations of the portfolio company; and
- The portfolio company has management that is separate from the FHC to the extent required by the restriction on routine management or operation of the portfolio company.[230]

[d] No Routine or Operation Management

The statute provides that an FHC may not "routinely manage or operate" any company acquired under the insurance company portfolio investments authority power except as may be necessary or required to obtain a reasonable return on investment.[231] This restriction does not prevent an FHC from controlling up to 100 percent of the board of directors or similar governing body of a portfolio company, as long as the portfolio company employs officers and employees responsible for routinely managing and operating the company and the board does not participate in routine management or operation of the company even if the board has the authority to do so under applicable corporate law.[232]

Although the Board has not promulgated any rules for insurance company portfolio investments similar to the rules implementing the merchant banking power, the Board is likely to follow the same rules in determining whether an FHC is deemed to be engaged in the routine management or operation of a portfolio company held under the insurance company portfolio investment power and when and to the extent it may be temporarily involved in routinely managing or operating a portfolio company.[233]

[e] Minority Investments and Veto Rights

The restriction on routine management applies to both majority and minority

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[229] *See id.* Real estate investment and development are not financial activities. *See* 66 Fed. Reg. 8,466, 8,469 (Jan. 31, 2001); 65 Fed. Reg. 16,460, 16,463 (Mar. 28, 2000) (interim rule).

[230] *See* 12 C.F.R. § 225.170(e).

[231] 12 U.S.C. § 1843(k)(4)(I)(iv).

[232] *See* 12 C.F.R. § 225.171(d)(1).

[233] *See* § 10.04[7][d] below.

investments. Its chief impact on minority investments is to limit the negative covenants, or "veto" rights, that an FHC may have over certain corporate actions. Such negative covenants must be limited to matters that are not in the ordinary course of business—that is, matters that customarily require board or shareholder action. The negative covenants may not extend to matters that constitute routine management or operations. The Board has issued an interpretive letter with a list of examples of matters over which negative covenants are permissible, consistent with the restriction on routine management and operations.[234] Although this letter was issued in the context of merchant banking investments, the Board is likely to apply the same guidelines to negative covenants obtained in connection with minority investments made pursuant to the insurance company portfolio investment power.

[f] After-the-Fact Notice Requirements

As with merchant banking investments, an FHC is required to provide the Board with notice within 30 days after consummating any insurance company portfolio investment in which the FHC directly or indirectly acquires more than 5 percent of the shares, assets or other ownership interests of a portfolio company if the aggregate acquisition cost of such investment exceeds the lesser of 5 percent of the FHC's Tier 1 capital and $200 million.[235] It is also required to provide any notice that the Board otherwise deems to be necessary in the exercise of its supervisory authority.[236] Otherwise, an FHC is not required to obtain prior approval for, or otherwise provide before- or after-the-fact notice of, any insurance company portfolio investment. If an after-the-fact notice is required, the notice is provided on Federal Reserve Form FR Y-10.

[g] Risk Management, Record Keeping and Reporting

As with FHCs that make merchant banking investments, an FHC that makes insurance company portfolio investments must establish and maintain policies, procedures, records, and systems reasonably designed to conduct, monitor and manage such investments and the risks associated with such investments in a safe and sound manner in accordance with the Supervisory Guidance on Equity Investment and Merchant Banking Activities [*herein* the Guidance Letter].[237] The Guidance Letter describes in detail the internal controls and risk management policies, procedures and systems that the Board expects bank holding companies engaged in equity investment activities to have and to maintain in order to conduct such activities in a safe and sound manner. The Guidance Letter notes that foreign banks should incorporate the basic principles set forth in the Guidance Letter into their U.S. operations with appropriate

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[234] 12 C.F.R. § 225.171(d)(2). *See* Letter from J. Virgil Mattingly, General Counsel of the Board, to Peter T. Grauer, Credit Suisse First Boston (Dec. 21, 2001), which sets forth examples of negative covenants that an FHC may enter into with a portfolio company without being deemed to be engaged in the routine management or operation of the portfolio company.

[235] 12 C.F.R. § 225.87(b)(4)(ii).

[236] 12 C.F.R. § 225.87(b)(4)(iii).

[237] SR Letter No. 00-9 (SPE) (June 22, 2000).

adaptation to reflect the fact that those operations are an integral part of a foreign bank, which should be managing its risks on a consolidated basis and that the bank is subject to overall supervision by its home country authorities.[238]

[h] Enhanced Capital Requirements

Although domestic FHCs are subject to the Board's enhanced capital requirements for insurance company portfolio investments,[239] these enhanced capital requirements do not apply to FBOs, which are subject to home-country capital requirements, or even to their top-tier U.S. bank holding company subsidiaries, if any, to the extent the top-tier bank holding companies qualify for relief under the Board's SR Letter No. 01-1.[240] As a result, we will not discuss the Board's enhanced capital requirements for insurance company portfolio investments in this Chapter.

[i] Cross-Marketing Restrictions

As with merchant banking investments, the BHC Act imposes cross-marketing restrictions on any U.S. depository institution controlled by an FHC with respect to the FHC's insurance company portfolio investments.[241] The Board has extended these restrictions to the U.S. branches and agencies of foreign banks.[242]

As implemented by the Board, these cross-marketing restrictions prohibit any U.S. depository institution controlled by an FHC, any of the depository institution's subsidiaries with certain exceptions,[243] and any U.S. branch or agency of a foreign bank, from:

- offering or marketing, directly or through any arrangement, any product or service of any company if more than 5 percent of the company's voting shares, assets or other ownership interests are owned or controlled by the FHC under Section 4(k)(4)(I) of the BHC Act; or
- allowing any product or service of the depository institution, including any product or service of a subsidiary of the depository institution, to be offered or marketed, directly or through any arrangement, by or through any company if more than 5 percent of the company's voting shares, assets or other ownership interests are owned or controlled by the FHC under Section 4(k)(4)(I) of the BHC Act.[244]

These cross-marketing restrictions apply to both a company engaged in insurance

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[238] SR Letter No. 00-9 (SPE), Attachment, at 3 (June 22, 2000). For a summary of the guidelines contained in the Guidance Letter, see § 10.04[7][i] below.

[239] 12 C.F.R. pt. 225, Appendix A, § II.B.5.

[240] SR Letter 01-1 (SUP) (Jan. 5, 2001).

[241] 12 U.S.C. § 1843(n)(5)(A).

[242] 12 C.F.R. § 225.177(b) (definition of depository institution includes the U.S. branches and agencies of a foreign bank for purposes of the merchant banking power).

[243] 12 C.F.R. §§ 225.176(a)(1) and 225.176(a)(2) (for example, financial subsidiaries of national banks are excluded from the covered subsidiaries).

[244] 12 C.F.R. § 225.176(a)(1).

company portfolio investments and the portfolio companies of such a company held under the Section 4(h)(4)(I).[245]

The cross-marketing restrictions do not apply to any arrangement with a company owned or controlled under insurance company portfolio investment power for the marketing of products or services through statement inserts or Internet websites if the arrangement does not violate the anti-tying rule applicable to banking products and services[246] and the Board determines that the arrangement is in the public interest, does not undermine the separation of banking and commerce and is consistent with the safety and soundness of depository institutions.[247]

The cross-marketing restrictions do not apply to the marketing of products and services by a U.S. depository institution, its subsidiaries or the U.S. branch or agency of a foreign bank—such as deposits, loans and advisory services—to an affiliate or its portfolio companies, so long as the insurance company portfolio investments affiliate or its portfolio companies does not market those products or services to their customers or others.[248] Nor do the cross-marketing restrictions apply to the purchasing of products or services—such as data processing—by a U.S. depository institution, its subsidiaries or the U.S. branch or agency of a foreign bank from an insurance company portfolio investments affiliate or its portfolio companies, provided that the institution does not, directly or indirectly or through arrangements, market the insurance company portfolio investments affiliate's or portfolio company's products or services to the institution's customers or others. Likewise, the cross-marketing restrictions do not prohibit a U.S. depository institution, its subsidiary or the U.S. branch or agency of a foreign bank from engaging in cross-marketing activities with a company that is a co-investor with the FHC in an insurance company portfolio investments affiliate or portfolio company, so long as those activities do not involve products or services of the insurance company portfolio investments affiliate or portfolio company.[249]

[9] Commodities

The BHC Act generally treats the trading in commodity derivatives contracts as a financial activity. It therefore grants FHCs authority to trade in a broad range of forward contracts, options, futures, options on futures, swaps and similar contracts, whether exchange-traded or over-the-counter, based on any rate, price, financial asset, nonfinancial asset or group of assets, subject to certain conditions.[250] Similarly, the Office of the Comptroller of the Currency [*herein* the OCC] generally treats commodity derivatives trading as a permissible banking activity for national banks.[251]

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[245] *See* 12 U.S.C. § 1843(n)(5).

[246] *See* 12 U.S.C. § 1972.

[247] 12 U.S.C. § 1343(n)(5)(B).

[248] *See* 66 Fed. Reg. 8,466, 8,481 (Jan. 31, 2001).

[249] *See* 66 Fed. Reg. 8,466, 8,481 and n.28.

[250] 12 C.F.R. § 225.28(b)(8)(ii).

[251] OCC Interpretive Letter No. 1040 (Sept. 15, 2005); OCC Interpretive Letter No. 1025 (Apr. 6, 2005); OCC Interpretive Letter #962 (Apr. 21, 2003).

This means that FBOs have considerable scope to engage in such commodity derivatives trading as a permissible banking activity through their U.S. branches or agencies (or the U.S. branches or agencies of their subsidiary foreign banks) or as a financial activity through their non-U.S. offices or non-bank affiliates.

Although trading in commodity derivatives is a permissible financial activity for FHCs, trading in the underlying physical commodities or engaging in certain other commodity-related activities is not considered to be financial in nature or incidental to a financial activity. The Board has determined in a series of orders, however, that certain commodity trading activities, energy management services and energy tolling arrangements are complementary to the financial activity of trading in commodity derivatives.

In an order issued to Citigroup in 2003, the Board determined that taking and making physical delivery of, or storing, oil, natural gas, agricultural products and other nonfinancial commodities were complementary to the financial activity of trading in commodity derivatives.[252] The Board gave several reasons why such commodity trading activities were complementary to commodity derivatives trading. First, they flowed from permissible existing financial activities, allowing FHCs to take an otherwise permissible commodity derivatives contract to physical settlement rather than terminating, assigning, offsetting or otherwise cash-settling the contract. Second, they would make FHCs more competitive with non-FHCs, which are not subject to any limitations on taking or making physical delivery of commodity contracts. Third, they would allow FHCs to provide a full range of commodity-related services to their customers more efficiently. Fourth, by enabling FHCs to gain experience in the markets for physical commodities, they would improve the FHCs' understanding of the commodity derivatives market.[253]

In order to limit the potential safety and soundness risks of Citigroup's commodity trading activities, and to ensure that the proposed activities would produce public benefits that outweighed any potential adverse effects, the Board imposed a number of conditions on Citigroup's exercise of commodity trading activities, including the following:[254]

- *Market Value Limit*. The market value of any commodities acquired and held by Citigroup must not exceed 5 percent of its consolidated Tier 1 capital;
- *Reporting Requirement*. Citigroup must notify the Federal Reserve Bank of New York if the market value of commodities held by it as a result of the commodity trading activities were to exceed 4 percent of its Tier 1 capital;
- *Related Contract Approval Requirement*. Citigroup may take and make physical delivery only of physical commodities for which derivative contracts

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[252] Citigroup, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 89 FED. RES. BULL. 508 (2003).

[253] *Id.*

[254] *Id.*

have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission [*herein* the CFTC], unless specifically excluded or approved by the Board;

- *Limits to Control Nonfinancial Risks*. To minimize nonfinancial risks, such as storage risk, transportation risk, and legal and environmental risk, Citigroup would not be authorized to: (i) own, operate, or invest in facilities for the extraction, transportation, storage or distribution of commodities; or (ii) process, refine, or otherwise alter commodities; instead, Citigroup would be expected to use storage and transportation facilities owned and operated by third parties; and
- *Compliance with Laws*. Citigroup would be expected to conduct its commodity trading activities in compliance with the general securities, commodities and energy laws.

The Board has subsequently granted permission to engage in commodity trading activities to other FHCs, including foreign banks, subject to essentially the same conditions set forth above.[255] In the case of a foreign bank, the Board has made it clear that Tier 1 capital means the Tier 1 capital of the entire foreign bank as calculated under home country capital standards.[256]

The Board has subsequently expanded the range of commodities activities that are considered complementary to commodity derivatives transactions to include (i) energy management services for owners of power generation facilities[257] and (ii) physically settled energy tolling arrangements.[258] It has also determined that commodity trading activities includes entering into long-term electricity supply contracts with large industrial and commercial customers.[259]

The Board has also relaxed certain of the conditions imposed on commodity trading activities. In particular, it has relaxed the requirement that trading in commodities be limited to commodities for which derivative contracts have been approved for trading on a U.S. futures exchange by the CFTC. Instead, it has permitted trading in nickel because, although contracts for nickel have not been approved for trading on a U.S. futures exchange by the CFTC, contracts for nickel are widely and actively traded on the London Metal Exchange, a major non-U.S. exchange which the CFTC has

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[255] *See, e.g.*, UBS AG, 90 FED. RES. BULL. 215 (2004); Barclays Bank PLC, 90 FED. RES. BULL. 511 (2004); Deutsche Bank AG, 92 FED. RES. BULL. C54 (2006); JPMorgan Chase & Co., 92 FED. RES. BULL. C57 (2006); Société Générale, 92 FED. RES. BULL. C113 (2006).

[256] *See, e.g.*, UBS AG, 90 FED. RES. BULL. 215, 216 (2004).

[257] *See, e.g.*, Fortis S.A./N.V., 94 FED. RES. BULL. C20 (2008).

[258] The Royal Bank of Scotland Group plc, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 94 FED. RES. BULL. C60, C66 (2008). An energy tolling agreement is an agreement to pay the owner of a power plant a fixed periodic payment that compensates the owner for its fixed and fuel costs in exchange for the right to all or part of the plant's power output. The plant owner retains control over the day-to-day operations of the plant and physical plant assets.

[259] The Royal Bank of Scotland Group plc, 94 FED. RES. BULL. C60, C61-62 (2008).

determined to be subject to a regulatory structure comparable to that administered by the CFTC. The Board has also permitted trading in certain natural gas liquids, oil products and petrochemicals, even though contracts for those commodities have not been approved for trading on a U.S. futures exchange or on a major non-U.S. exchange, because such commodities are (i) fungible and (ii) traded in a sufficiently liquid market through brokers on alternative trading platforms.[260]

The Board has also relaxed the condition that commodities being traded not be physically altered. The Board has permitted an FHC to engage third parties to refine, blend or otherwise alter commodities for which it is permitted to take and make physical delivery, provided that the both the commodity input and the resulting altered commodity are permissible commodities under the Board's decisions and the FHC will not have exclusive rights to use the alteration facility.[261]

[10] Hedge Funds

An FHC is permitted to make controlling and noncontrolling investments in any hedge fund, provided that the hedge fund is exclusively engaged in activities that are financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act. But if an investment in a hedge fund is a controlling investment, the FHC will be deemed to control the portfolio investments of the hedge fund and the FHC will need a separate source of authority to control such portfolio investments. If the hedge fund's portfolio investments are limited to noncontrolling investments in less than 5 percent of any class of voting securities of its portfolio companies, which may be the case with certain traditional hedge funds that limit their investments to long and short positions in small percentages of large publicly traded companies, the FHC may be able to rely on Section 4(c)(6) of the BHC Act as the authority for holding the hedge fund's portfolio investments. In computing its compliance with the 5 percent limit of Section 4(c)(6), the FHC will need to aggregate all of its direct and indirect investments in the voting securities of each portfolio company, including investments held through the controlled hedge fund.

An FHC may also rely on the merchant banking power as a source of authority for holding any portfolio companies of a controlled hedge fund, but if it does so it must assure itself by contractual arrangement or otherwise that the hedge fund will comply with the conditions of the merchant banking power, including the restrictions on routine management or operation of the portfolio companies and the maximum holding period. This may be a serious issue if the FHC is deemed to control the hedge fund under the Board's control rules, but does not have actual control over the management or policies of the hedge fund.[262] If the hedge fund is organized as a corporation with unlimited life, instead of as a partnership or other entity with a maximum life of 15 years, it will not be able to satisfy the conditions for being a

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[260] The Royal Bank of Scotland Group plc, 94 FED. RES. BULL. C60, C62–C63 (2008).

[261] The Royal Bank of Scotland Group plc, 94 FED. RES. BULL. C60, C64 (2008).

[262] For a discussion of the Board's control rules, see Chapter 3, § 3.03[5].

qualified private equity fund, so the maximum holding period for its portfolio investments will be 10 years, rather than 15 years.

If an FHC is unable to assure itself that a hedge fund will comply with the conditions of the merchant banking power, it may still invest in the hedge fund under Section 4(k)(1) if the hedge fund is engaged exclusively in activities permitted by Section 4 of the BHC Act, but it will need to structure the investment as a noncontrolling investment in order to avoid having the hedge fund's portfolio investments attributed to it.

If a hedge fund is not exclusively engaged in activities that are permissible under Section 4 of the BHC Act, an FHC may nevertheless invest in it under, but subject to the conditions of, the merchant banking power or the insurance company portfolio investment power. These conditions include the maximum holding period and the restrictions on routinely managing or operating the hedge fund.

[11] Real Estate

As noted above, in 2001, the Board and the Secretary of the Treasury jointly proposed that real estate brokerage and real estate management be treated as incidental to a financial activity.[263] Although the agencies have not formally withdrawn their joint proposal, they have effectively abandoned it in the face of substantial public opposition to the proposal, mainly from a host of independent real estate brokers.

Although real estate investment, development, brokerage and management have not been determined to be financial in nature, incidental to a financial activity, complementary to a financial activity or otherwise permitted by Section 4 of the BHC Act, a QFBO that is an FHC may (i) underwrite, deal and make markets in securities of *companies* engaged in such activities, (ii) make controlling and noncontrolling investments in them pursuant to, and subject to the conditions and limitations of, the merchant banking and insurance company portfolio investment powers or the QFBO exemptions or (iii) make noncontrolling investments in them pursuant to Sections 4(c)(6) or 4(c)(7) of the BHC Act.

The most important restriction on using the merchant banking or insurance company portfolio investment powers to make such investments is the restriction on using these powers to make investments in real estate assets, as opposed to companies holding such assets. Under the merchant banking regulations, which apply directly to investments made under the merchant banking power and by analogy to investments made under the insurance company portfolio investment power, an FHC may not make investments in real estate assets unless the following conditions are satisfied:

- The assets are held by or promptly transferred to a portfolio company;
- The portfolio company maintains policies, books and records, accounts, and other indicia of corporate, partnership or limited liability organization and operation that are separate from the FHC and limit the legal liability of the FHC for obligations of the portfolio company; and

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[263] *See* 66 Fed. Reg. 307 (Jan. 3, 2001).

- The portfolio company has management that is separate from the FHC to the extent required by the restriction on routine management or operation of the portfolio company.[264]

§ 10.05 Streamlined Procedures

If an FBO becomes an FHC, not only does it become eligible to exercise an expanded range of nonbanking powers, but it also enjoys streamlined procedures for commencing nonbanking activities and making nonbanking investments.

[1] No Prior Application or Notice

In particular, FHCs are not subject to the prior approval requirements in Section 4 of the BHC Act that otherwise apply to the direct or indirect nonbanking activities of FBOs that control a U.S. bank or otherwise have a U.S. commercial banking presence, so long as the nonbanking activities are financial in nature or incidental to a financial activity.[265] Thus, an FHC is not required to file an application for prior approval by the Board or give prior notice to the Board to (i) engage in, or make a controlling or noncontrolling investment in a company that is exclusively or substantially engaged in, financial activities or activities that are incidental to financial activities, or (ii) acquire a controlling or noncontrolling interest in a company pursuant to the FHC's securities underwriting, dealing and market making; merchant banking; or insurance company portfolio investment powers.[266]

There are four exceptions to this general rule that no prior approval or notice is required for an FHC to commence nonbanking activities or make nonbanking investments under Section 4 of the BHC Act:

- An FHC must obtain prior approval from the Board before commencing, or acquiring 5 percent or more of any class of voting securities of any company engaged in, any activities that are complementary to a financial activity,[267] except for any company substantially engaged in financial activities or activities incidental to a financial activity, or pursuant to the FHC's power to engage in securities underwriting, dealing or market making, or to make merchant banking or insurance company portfolio investments;[268]

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[264] *See* 12 C.F.R. § 225.170(e).

[265] *Compare* 12 C.F.R. § 225.24(a) (prior notice and approval requirements generally applicable to nonbanking activities and investments by FBOs that control a U.S. bank or otherwise have a U.S. commercial banking presence, including activities determined to be closely related to banking under Section 4(c)(8) of the BHC Act) *with* 12 C.F.R. §§ 225.85(a)(2) and 225.85(a)(3) (no prior notice or approvals required for an FHC to engage in, or acquire control of any company exclusively or, subject to certain conditions, substantially engaged in, any activity that is financial in nature or incidental to a financial activity, including any activities determined to be closely related to banking under Section 4(c)(8) of the BHC Act).

[266] 12 U.S.C. § 1843(k)(6)(B); 12 C.F.R. § 225.85(a)(1).

[267] *See* 12 C.F.R. § 225.89(a).

[268] 12 U.S.C. §§ 1843(k)(4)(B), 1843(k)(4)(E), 1843(k)(4)(H), 1843(k)(4)(I); 12 C.F.R. §§ 225.85(a)(1), 225.85(a)(3), 225.86(c).

- An FHC must obtain Board approval prior to acquiring control of more than 5 percent of the shares of any class of voting securities of a savings association or a savings and loan holding company;[269]
- The Board, in the exercise of its supervisory authority, may require an FHC to provide notice to or obtain approval from the Board prior to engaging in any activity or acquiring shares or control of any company engaged in a financial or nonfinancial activity;[270] and
- An FHC must give prior notice before engaging in activities on the basis of Section 4(c) of the BHC Act that have not been determined to be financial in nature or incidental to a financial activity, if Section 4(c) of the BHC Act or Regulation Y requires such prior notice.[271]

[2] Post-Transaction Notices

An FHC is generally required to notify the appropriate Federal Reserve Bank in writing within 30 calendar days after (i) commencing any financial activity or an activity that is incidental to a financial activity or (ii) consummating the acquisition of a controlling interest in a company that is engaged in any financial activities or any activities incidental to financial activities.[272] Once an FHC has given notice that it is engaged in a particular activity, it is not required to give any further notice if it commences the same activity *de novo* in any subsidiary.[273]

Similarly, once an FHC has given notice that it has commenced exercising securities underwriting, dealing or market making, merchant banking or insurance company portfolio investment powers, it is not required to give any further notice when it acquires an interest in a company pursuant to the exercise of those powers, with one exception.[274] An FHC is required to give after-the-fact notice within 30 days after consummating any merchant banking or insurance company portfolio investment in which the FHC directly or indirectly acquires more than 5 percent of the shares, assets or other ownership interests of a portfolio company if the aggregate acquisition cost of such investment exceeds the lesser of 5 percent of the FHC's Tier 1 capital and $200

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[269] 12 U.S.C. § 1843(k)(6); 12 C.F.R. § 225.85(c)(1). Board approval must be obtained in accordance with Section 4(j) of the BHC Act, 12 U.S.C. § 1843(j).

[270] 12 C.F.R. § 225.85(c)(2). The Board may impose such a requirement in accordance with its authority pursuant to 12 C.F.R. § 225.82(g) (residual supervisory authority over FHCs) or 12 C.F.R. § 225.83(d) (limitations during period of noncompliance with FHC conditions).

[271] *See*, *e.g.*, 12 U.S.C. §§ 1843(c)(13) and 1843(c)(14); 87 FED. RES. BULL. 683 (2001). In addition, an FBO that controls a U.S. bank or otherwise has a U.S. commercial banking presence, whether or not it is an FHC, must receive prior approval from the Board under Section 3 of the BHC Act before acquiring 5 percent or more of the shares of any class of voting securities of a bank holding company (including an FBO that controls a U.S. bank) or a U.S. bank. 12 U.S.C. § 1842(a)(3); 12 C.F.R. §§ 225.11(c)(1) and 225.11(f).

[272] 12 C.F.R. §§ 225.87(a) and 225.87(b)(1).

[273] 12 C.F.R. § 225.87(b)(2).

[274] 12 C.F.R. § 225.87(b)(3).

million.[275] It is also required to provide notice for any merchant banking or insurance company portfolio investment if the Board otherwise deems it to be necessary in the exercise of its supervisory authority.[276]

If an FHC acquires a controlling interest in, for instance, a broker-dealer, a company engaged in making merchant banking investments, or an insurance company, a post-transaction notice is necessary. Even if the FHC has previously notified the Board that it has commenced securities underwriting, dealing and market making activities, merchant banking activities or insurance activities, the FHC is still required to give a post-transaction notice in connection with a new acquisition (as opposed to *de novo* commencement) of a broker-dealer, a company engaged in merchant banking activities or an insurance company.

[3] Hart-Scott-Rodino Act

If an FHC makes an acquisition of a company engaged in financial activities or makes an acquisition in exercise of its financial activities investment authority (*i.e.*, the merchant banking investment authority or the insurance company portfolio investment authority) of a company engaged in nonfinancial activities, it may be necessary to file a pre-merger notification under the Hart-Scott-Rodino Antitrust Improvement Act of 1976 [*herein* HSR Act].[277]

The HSR Act is a procedural statute, intended to give the U.S. antitrust enforcement authorities advance notice of certain mergers and acquisitions so that the enforcement authorities may detect and prevent transactions that may violate the U.S. antitrust laws before they are consummated. The HSR Act prohibits acquisitions of substantial amounts of voting securities and assets unless (1) a pre-merger notification is filed with both the Federal Trade Commission [*herein* FTC] and the Assistant Attorney General in charge of the Antitrust Division of the Department of Justice [*herein* DOJ], and (2) a waiting period subsequent to those filings has expired.

The HSR Act provides that no pre-merger notification is necessary for any transactions that require approval of the Board under Sections 3 or 4 of the BHC Act.[278] However, a pre-merger notification under the HSR Act would be required in connection with most acquisitions under Section 4(k) of the BHC Act, including any portion of a transaction that is governed by Section 4(k), since those acquisitions (or portions of transactions) would not require prior Board approval, but only post-transaction notice.[279]

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[275] 12 C.F.R. §§ 225.87(b)(4)(i) and 225.87(b)(4)(ii).

[276] 12 C.F.R. § 225.87(b)(4)(iii).

[277] 15 U.S.C. § 18a.

[278] 15 U.S.C. §§ 18a(c)(7) and 18a(c)(8). For example, the acquisition of 5 percent or more of any U.S. bank or thrift, or any bank or thrift holding company, by an FBO that controls a U.S. bank or otherwise has a U.S. commercial banking presence, regardless of whether it is an FHC, would require prior Board approval and therefore be exempt from the pre-merger notification requirement of the HSR Act.

[279] 15 U.S.C. §§ 18a(c)(7) and 18a(c)(8).

For instance, if the acquired company is a U.S. bank or bank holding company engaged, directly or indirectly, in (i) banking, (ii) financial activities under Section 4(k) of the BHC Act, and (iii) complementary activities, the acquiror would be required to file both a notice with the Board (for the portion of the transaction relating to the complementary activities and the acquisition of the bank) and an HSR Act pre-merger notification with the FTC and the DOJ (for the portion of the transaction that involves financial activities subject to Section 4(k) of the BHC Act.)[280] As stated above, financial activities subject to Section 4(k) of the BHC Act do not require prior notice to or approval by the Board and, hence the acquisition of a company engaged in financial activities requires notification under the HSR Act. By contrast, complementary activities are subject to Section 4(k) of the BHC Act but require prior Board approval under Section 4(j) of the BHC Act; therefore, a notification under the HSRA Act is not required.

§ 10.06 Potential Adverse Consequences

The main consequences of becoming an FHC are the advantages of expanded nonbanking powers and streamlined procedures for exercising nonbanking powers. There are no apparent adverse regulatory consequences associated with becoming an FHC (*i.e.*, no change in applicable supervisors, no perceptible change in the level of supervision for any member of the FBO's group, no decrease in powers, no increased procedural burden for banking or nonbanking acquisitions or activities, no increased reporting requirements), except for the following:

[1] Additional Costs

One potential adverse consequence of becoming an FHC is the additional cost of making an FHC election and ensuring that the FBO continues to satisfy the well-capitalized and well-managed conditions of maintaining FHC status.

[2] New Quarterly Report

Another potential adverse consequence is that foreign banks that are FBOs or controlled by FBOs are required to provide consolidated regulatory capital information to the Board on a quarterly basis, instead of only annually, in order to show their continued compliance with the well-capitalized condition. Such information is provided on Form FR Y-7Q.

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[280] *See* 15 U.S.C. §§ 18a(c)(7) and 18a(c)(8). In order to avoid an HSR Act pre-merger notification in connection with the acquisition of a bank holding company that has subsidiaries engaged in financial activities, some practitioners file a prior notice under Section 4(j) of the BHC Act, 12 U.S.C. § 1843(j), for such financial activities that fall within the limitations of § 4(c)(8) of the BHC Act, 12 U.S.C. § 1843(c)(8), 12 C.F.R. § 225.28. The Board accepts this approach. *See* Royal Bank of Canada, Rocky Merger Subsidiary, Inc. (Centura Banks, Inc.), 87 FED. RES. BULL. 467 (2001) (Royal Bank, an FHC, filed an application under Section 3 of the BHC Act, 12 U.S.C. § 1842, to acquire Centura Bank, Inc. and under Sections 4(c)(8) and 4(j) of the BHC Act, 12 U.S.C. §§ 1843(c)(8) and 1843(j), to acquire the nonbanking subsidiaries of Centura and thereby engage in extending credit and servicing loans. The Board considered the competitive effect of the proposed acquisition of the nonbanking subsidiaries of Centura).

[3] New Self-Reporting Obligation

An FBO that becomes an FHC is required to notify the Board promptly if it (in the case of an FBO that is a foreign bank with a U.S. commercial banking presence) or any foreign bank with a U.S. commercial banking presence or any U.S. depository institution controlled by it fails to satisfy the well-capitalized or well-managed conditions. Failure to comply with this new self-reporting obligation can result in an enforcement action or civil or criminal penalties.

[4] Potential Loss of FHC Status

An FBO that becomes an FHC will be exposed to the adverse impact of losing its FHC status, and its ability to exercise the related expanded powers in the U.S., if it ever fails to satisfy the well-capitalized or well-managed conditions and is unable to cure those deficiencies during a specified cure period. As discussed more fully below, an FHC generally has 180 days to cure any deficiencies (subject to extensions for good cause) before its FHC status may be revoked. The cost and reputational harm to the FBO of having to contract its U.S. operations so that they are permissible for a non-FHC after it has invested time and money in exercising any of the expanded powers could be significant.

[5] Limit Certain Options

In addition, the potential loss of the FBO's FHC status may deter it from making certain otherwise attractive investments. For example, suppose an FBO was interested in making a strategic minority investment in a foreign bank with a U.S. commercial banking presence or with a plan to establish a U.S. commercial banking presence. Under such circumstances, the FBO would risk losing its FHC status if the foreign bank were not well capitalized or well managed, unless the FBO could structure the investment as a noncontrolling one for BHC Act purposes or cause the target bank to become well capitalized and well managed. But because of the Board's very low standard for what constitutes control,[281] the FBO might be deemed to control the foreign bank for purposes of the BHC Act without having the actual control to cause the target bank to become well capitalized or well managed. Thus, the FBO might be forced to choose between the otherwise attractive investment and preserving its FHC status.

[6] Sections 23A and 23B of the Federal Reserve Act

Sections 23A and 23B of the Federal Reserve Act insulate U.S. insured depository institutions from the risks of their non-banking affiliates by imposing certain limits on transactions between the insured depository institutions and their non-banking affiliates.[282] In general, Sections 23A and 23B do not apply to the U.S. branches or agencies of foreign banks.

If a foreign bank or any company controlling a foreign bank elects to become an

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[281] *See* Chapter 3, § 3.03[5].

[282] 12 U.S.C. §§ 371c, 371c-1; 12 C.F.R. pt. 223.

FHC, however, Sections 23A and 23B will apply as a matter of "competitive equality" to any "covered transaction" between the U.S. branches, agencies and commercial lending company subsidiaries of the foreign bank, as if they were respectively members of the Federal Reserve System [*herein* member banks], and any of its affiliates that is also:

- engaged in insurance underwriting pursuant to Section 4(k)(4)(B) of the BHC Act;
- engaged in securities underwriting, dealing or market making pursuant to Section 4(k)(4)(E) of the BHC Act;
- engaged in merchant banking activities pursuant to Section 4(k)(4)(H) of the BHC Act (but only to the extent the proceeds of the transaction are used for the purpose of funding the affiliate's merchant banking activities);
- engaged in insurance company portfolio investments pursuant to Section 4(k)(4)(I) of the BHC Act;
- engaged in any other activity designated by the Board;
- a portfolio company controlled by the foreign bank or an affiliate of the foreign bank or a company that would be an affiliate of the U.S. branch, agency or commercial lending company subsidiary of the foreign bank if such branch, agency or commercial lending company subsidiary were a member bank; or
- any subsidiary of any of the foregoing.[283]

Sections 23A and 23B of the Federal Reserve Act impose specific quantitative, qualitative, collateral and arm's-length terms requirements on loans, other extensions of credit and other "covered transactions" that expose a member bank to the credit risks of its affiliates. In general, the term "affiliate" is defined as any company that controls, is controlled by or is under common control with the member bank (or foreign bank, where applicable).[284] A company is deemed to have "control" over another company if the company (i) owns, controls or has the power to vote 25 percent or more of any class of voting securities of the other company, (ii) controls in any manner the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of the other company; or (iii) exercises a controlling influence over the management or policies of the other company.[285]

There is also a rebuttable presumption that an FHC controls a portfolio company held under the merchant banking or insurance company portfolio investment powers for purposes of Sections 23A and 23B of the Federal Reserve Act if the FHC owns or controls, directly or indirectly, 15 percent or more of the equity capital of the portfolio company.[286] Thus, unless the presumption is rebutted, any such portfolio company

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[283] 12 C.F.R. §§ 223.61, 225.176(b)(6).

[284] *See* 12 C.F.R. § 223.2.

[285] *See* Chapter 3, § 3.03[5].

[286] 12 U.S.C. § 371c(b)(11); 12 C.F.R. § 223.2(a)(9).

will be treated as an affiliate of the FHC and any U.S. insured depository institution or U.S. branch, agency or commercial lending company subsidiary of any foreign bank that is, or is controlled by, the FHC for purposes of Sections 23A and 23B of the Federal Reserve Act.

This presumption of control will be deemed rebutted if any of the following is true:

- No director, officer or employee of the FHC serves as a director, trustee or general partner (or individual exercising similar functions) of the portfolio company;
- A person that is not affiliated or associated with the FHC owns or controls a greater percentage of the equity capital of the portfolio company than is owned or controlled by the FHC, and no more than one officer or employee of the FHC serves as a director or trustee (or individual exercising similar functions) of the portfolio company; or
- A person that is not affiliated or associated with the holding company owns or controls more than 50 percent of the voting shares of the portfolio company, and officers and employees of the FHC do not constitute a majority of the directors or trustees (or individuals exercising similar functions) of the portfolio company.[287]

In addition, FHCs may seek to rebut the presumption of control by submitting evidence to the Board.[288]

[7] Loss of Grandfathered Securities Affiliates

If a foreign bank or other foreign company covered by Section 8(a) of the IBA[289] is engaged in grandfathered activities under Section 8(c) of the IBA[290] and those activities are financial activities or complementary activities,[291] it will lose such grandfather rights upon filing an election to be an FHC.[292] For example, a foreign bank with a grandfathered securities underwriting subsidiary that elects to be an FHC is no

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[287] 12 C.F.R. §§ 223.2(a)(9)(iii), 225.176(b)(3). In each of these situations, the FHC is assumed to own more than 15 percent of the total equity of the portfolio company (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the portfolio company (as such, not meeting the statutory definition of control). *See* 66 Fed. Reg. 8,466, 8,481 (Jan. 31, 2001).

[288] 12 U.S.C. § 371c(b)(11) ("unless the company or shareholder provides information acceptable to the Board to rebut this presumption of control"); 12 C.F.R. §§ 223.2(a)(9)(ii), 225.176(b)(2).

[289] 12 U.S.C. § 3106(a).

[290] 12 U.S.C. § 3106(c). A foreign bank that, prior to the enactment of the IBA in 1978, was engaged in activities which were permitted at that time but prohibited after the enactment of the IBA, was under § 8(c) of the IBA, allowed to continue these activities (so-called grandfathered activities).

[291] 12 U.S.C. § 3106(c)(3)(A) refers to "any activity that the Board has determined to be permissible for [FHCs]" under Section 4(k) of the BHC Act, 12 U.S.C. § 1843(k).

[292] 12 U.S.C. § 3106(c)(3)(A). *See* 12 U.S.C. § 1843(*l*)(1)(C) (filing of declaration of election). Although the IBA provides that the foreign bank or other foreign company covered by Section 8(a) of the IBA, 12 U.S.C. § 3106(a), loses its grandfather rights upon filing a declaration to be an FHC, the meaning probably is that there must have been an effective election to be an FHC.

longer permitted to rely on the grandfather authority under Section 8(c) of the IBA but must rely on Section 4(k)(4)(E) of the BHC Act for the securities underwriting activities of its subsidiary.[293]

§ 10.07 Failure to Maintain FHC Conditions

[1] 4(m) Letter

If the Board finds that an FBO that elected to be treated as an FHC fails to satisfy the well-capitalized or well-managed conditions, Section 4(m) of the BHC Act requires the Board to send the FHC a written notice [*herein* a 4(m) letter] to the effect that the FHC is no longer in compliance with one or both of these conditions.[294] Within 45 days after the receipt of a 4(m) letter, the FHC must enter into an agreement with the Board [*herein* a cure agreement] setting forth the specific actions the FHC will take to bring itself back into compliance with the well-capitalized and well-managed conditions and the schedule for achieving that objective.[295] The FHC will have 180 days to bring itself back into compliance, subject to extensions for one or more additional 180-day periods for good cause [*herein* the cure period].[296] The 4(m) letter and cure agreement will be treated by the Board as confidential supervisory information that will not be disclosed to the public unless the FHC believes it is obligated to do so under the securities laws because the receipt of the 4(m) letter and any related restrictions on its U.S. activities and investments is material to investors, under the particular circumstances of the situation.

[2] Restrictions During Cure Period

During the cure period, the FBO and its affiliates may not commence any additional activity in the United States or acquire control or shares of any company under Section 4(k) of the BHC Act without the prior approval of the Board, unless the Board provides otherwise,[297] and will be subject to any other limitations or conditions on the conduct of their U.S. activities as the Board finds appropriate and consistent with the purposes of the BHC Act.[298]

[3] Failure to Correct

If the FBO fails to correct the condition within 180 days after receipt of the 4(m) letter from the Board, or such longer period as the Board may permit, the FHC will have to choose between terminating any activities that are permissible only for an FHC or divesting any U.S. depository institution affiliate and any other U.S. commercial

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[293] 12 U.S.C. § 1843(k)(4)(E).

[294] 12 U.S.C. § 1843(m)(1); 12 C.F.R. § 225.93(a). Section 4(m)(1) of the BHC Act requires such Board notice only with respect to FHCs that are engaged, directly or indirectly, in any activity under Section 4(k), (n) or (o) of the BHC Act, other than activities that are permissible for a bank holding company under Section 4(c)(8) of the BHC Act.

[295] 12 U.S.C. § 1843(m)(2); 12 C.F.R. § 225.93(c).

[296] 12 U.S.C. § 1843(m)(4).

[297] 12 C.F.R. § 225.93(d)(2).

[298] 12 C.F.R. § 225.93(d)(1).

banking presence.[299] To date, the Board has not ordered any FBO to choose between its FHC powers and its U.S. commercial banking presence for failing to comply with the well-capitalized and well-managed requirements.

[4] CRA Maintenance Requirement

Section 4(m) does not apply to a situation in which a U.S. insured depository institution or insured U.S. branch of a foreign bank that is, or is controlled by, an FBO receives a rating of less than "satisfactory" at its most recent CRA examination. Instead, the FHC simply may not (a) commence any new activity under Section 4(k) of the BHC Act or (b) directly or indirectly acquire control of any company engaged in any activity under Section 4(k) of the BHC Act.[300]

However, new investments made in the ordinary course of engaging in the merchant banking authority or in the ordinary course of the insurance company portfolio investment authority are not prohibited, if the FHC, directly or indirectly, was already engaged in such activities prior to the time that an insured depository institution controlled by the FHC or an insured branch received a CRA rating below "satisfactory."[301] Thus, an FHC or an existing merchant banking or insurance subsidiary of an FHC may continue to make investments under the merchant banking authority and the insurance company portfolio investment authority if it was engaged in such financial activities prior to the less-than-satisfactory rating.[302] Similarly, a securities subsidiary of such an FHC may continue to underwrite, deal and make a market in securities.

The prohibition that applies in case of a failure to maintain a satisfactory CRA rating does not prevent an FHC from commencing any additional activity or acquiring control of a company engaged in any activity under Section 4(c) of the BHC Act,[303] if the FHC complies with the applicable notice, approval and other requirements.[304]

§ 10.08 Conclusion

In sum, an FBO may become an FHC if it satisfies the well-capitalized and well-managed conditions and, if it has or controls a U.S. insured depository institution or an insured U.S. branch, the CRA condition. If the FBO makes an effective election to become an FHC, the FBO is permitted to engage in an expanded range of activities, including insurance underwriting, securities underwriting and dealing, merchant banking and making insurance company portfolio investments. The main conse-

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[299] 12 U.S.C. § 1843(m)(4); 12 C.F.R. § 225.93(e).

[300] 12 U.S.C. § 1843(*l*)(2); 12 C.F.R. §§ 225.84(a)(1), 225.94. The Board reads the language to apply only when an insured depository institution receives a less-than-satisfactory CRA rating while it is under the control of the FHC. It does not apply immediately after an FHC has acquired a poorly rated depository institution. If the depository institution does not achieve at least a satisfactory CRA rating at its first CRA examination following the acquisition, the prohibitions apply to the FHC. *See* 66 Fed. Reg. 400, 404 (Jan. 3, 2001).

[301] *See* 12 U.S.C. § 1843(l)(2)(B); 12 C.F.R. §§ 225.84(b), 225.94.

[302] 12 U.S.C. § 1843(*l*)(2)(B).

[303] 12 U.S.C. § 1843(c).

[304] 12 C.F.R. § 225.84(b)(2).

quences of becoming an FHC are the advantages of these expanded powers and certain streamlined procedures for commencing such activities and acquiring new companies engaged in such activities. If an FBO fails to satisfy the well-capitalized and well-managed conditions, and is unable to cure these deficiencies during a cure period of 180 days, plus such additional time as the Board may allow, it can be forced to terminate its expanded activities or its U.S. commercial banking presence. To date, the Board has not required any FBO to make this choice.