

The Gramm-Leach-Bliley Act (the GLB Act) became effective on March 11, 2000. The GLB Act authorized affiliations among banks, securities firms, insurance firms, and other financial companies. To further this goal, the GLB Act amended section 4 of the BHC Act to allow a bank holding company (BHC) or foreign bank that qualifies as a financial holding company (FHC) to engage in a broad range of activities that (1) the GLB Act defines as financial in nature or incidental to a financial activity, or (2) the Board, in consultation with the Secretary of the Treasury, determines to be financial in nature or incidental to a financial activity. Furthermore, section 4 of the BHC Act authorizes an FHC to engage in designated financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities.

The GLB Act includes conditions that must be met for a BHC or a foreign bank to be deemed a “financial holding company” and engage in expanded activities. The GLB Act also allows an FHC to seek Board approval to engage in any activity that the Board determines (1) is complementary to a financial activity and (2) does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. BHCs that do not qualify as FHCs are limited to engaging in those nonbanking activities that were permissible under section 4(c)(8) of the BHC Act before enactment of the GLB Act.

The GLB Act provides that, in most cases, an FHC may engage in or acquire the shares of a company that is engaged in financial activities without obtaining prior approval from the Board. An FHC is instead required to provide a *post-commencement* notice to the Board within 30 days after commencing a financial activity or acquiring a company. See section 4(k) of the BHC Act. Prior approval from the Board is required to acquire or engage in the activities of a savings association.

3900.0.1 FHC SUPERVISORY OVERSIGHT AUTHORITY

Under the GLB Act, the Federal Reserve has supervisory oversight authority and responsibility for BHCs, including BHCs that operate as FHCs. The GLB Act sets forth parameters for operating relationships between the Federal Reserve and other regulators. The statute differ-

entiates between the Federal Reserve’s relations with (1) depository institution regulators and (2) functional regulators, which include insurance, securities, and commodities regulators. There should be minimal, if any, noticeable change in the well-established relationships between the Federal Reserve as BHC (including FHC) supervisor and the bank and thrift supervisors (federal and state). The Federal Reserve’s relationships with functional regulators will, in practice, depend on the extent to which an FHC is engaged in functionally regulated activities; those relationships will also be influenced by existing working arrangements.

The Federal Reserve’s supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not an extension of more traditional bank-like supervision throughout an FHC. The FHC framework is consistent with and incorporates principles that are well established for BHCs. The FHC supervisory policy focuses on addressing supervisory practice for and relationships with FHCs, particularly those that are engaged in securities or insurance activities. See SR-00-13.

3900.0.2 ROLES OF SUPERVISORS

The Federal Reserve is responsible for the consolidated supervision of FHCs. In this regard, the Federal Reserve will assess the holding company on a consolidated or group-wide basis with the objective of ensuring that the holding company does not threaten the viability of its depository institution subsidiaries. The manner in which the Federal Reserve fulfills this role will likely evolve along with the activities and structure of FHCs, and it may differ depending on the mix of banking, securities, and insurance activities of an FHC.

Depository institution subsidiaries of FHCs are supervised by their appropriate primary bank or thrift supervisor (federal and state). The GLB Act did not alter the role of the Federal Reserve, as holding company supervisor, vis-a-vis the primary supervisors of FHC-associated bank and thrift subsidiaries. Traditionally, the Federal Reserve has relied to the fullest extent possible on those supervisors.

Nonbank (or nonthrift) subsidiaries engaged in securities, commodities, or insurance activi-

ties are supervised by their appropriate functional regulators. Such functionally regulated subsidiaries include a broker, dealer, investment adviser, and investment company registered with and regulated by the Securities and Exchange Commission (SEC) (or, in the case of an investment adviser, registered with any state); an insurance company or insurance agent subject to supervision by a state insurance regulator; and a nonbank subsidiary engaged in activities regulated by the Commodity Futures Trading Commission (CFTC).

3900.0.3 FHC SUPERVISION OBJECTIVES

The Federal Reserve, as umbrella supervisor, will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with those activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company to assess how these risks might affect the safety and soundness of depository institution subsidiaries.

Accordingly, the Federal Reserve will focus on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy. The Federal Reserve will review and assess the internal policies, reports, and procedures and the effectiveness of the FHC consolidated risk-management process. The appropriate bank, thrift, or functional regulator will continue to have primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entities that it supervises.

FHC supervision is not intended to impose bank-like supervision on FHCs, nor is it intended to duplicate or replace supervision by the primary bank, thrift, or functional regulators of FHC subsidiaries. Rather, FHC supervision seeks to protect the depository institution subsidiaries of increasingly complex organizations with significant interrelated activities and risks, while not imposing an unduly duplicative or onerous burden on the subsidiaries of the organization.

Effective financial holding company supervision requires—

1. strong, cooperative relationships between the Federal Reserve and primary bank, thrift, and functional regulators and foreign supervisors (these relationships respect the individual statutory authorities and responsibilities of the respective supervisors, but also allow for enhanced information flows and coordination so that individual responsibilities can be carried out effectively without creating duplication or excessive burden);
2. substantial reliance by the Federal Reserve on reports filed with or prepared by bank, thrift, and functional regulators, as well as on publicly available information for both regulated and nonregulated subsidiaries; and
3. continued reliance on the risk-focused supervision and examination process and on market discipline.

3900.0.4 FHC SUPERVISION IN PRACTICE

The supervisory activities of the Federal Reserve fall into three broad categories: (1) information gathering, assessments, and supervisory cooperation; (2) ongoing supervision; and (3) promotion of sound practices and improved disclosure.

3900.0.4.1 Information Gathering, Assessments, and Supervisory Cooperation

To fulfill its GLB Act responsibilities, the Federal Reserve needs to interact closely and exchange information with the primary bank, thrift, and functional regulators. The Federal Reserve will foster strong relationships with senior management and the boards of directors of FHCs, and have access to timely information from FHCs. These relationships will need to include heads of significant business lines and key internal-audit, control, and risk-management officials in order to understand how risk-management and internal-control policies and procedures established at the consolidated level are being implemented and assessed. To achieve these objectives, Federal Reserve supervisory staff will take the following actions:

1. *Regularly assess an FHC's centralized risk-management and control processes.* Such assessments are necessary to understand an organization's overall risk profile, identify

- material contributions to core risks, and determine how such risks are being managed and controlled on a consolidated basis.
2. *Perform limited, targeted transaction testing.* The purpose of this transaction testing is to verify that the risk-management systems of the FHC are adequately and appropriately measuring and managing areas of risk for the organization, and to confirm that laws and regulations applicable to the FHC and within the jurisdiction of the Federal Reserve are being observed.
 3. *Have periodic discussions with FHC senior management and boards of directors.* Such discussions will enable the Federal Reserve to build relationships with key personnel and to understand changing activities and the evolving risk profile of the consolidated organization. Periodic discussions also will provide a forum for supervisory staff to present any findings or concerns related to the activities of the group as a whole or to business lines that cut across legal entities.
 4. *Have periodic discussions with key personnel.* Discussions will be held with the personnel responsible for corporate management and control functions, such as heads of business lines, risk management, internal audit, and internal control.

When performing the above tasks, Federal Reserve supervisory staff, to the extent possible, will coordinate their actions with those of the primary bank, thrift, and functional regulators of the FHC's subsidiaries. For example, to understand the risks and risk-management systems of an FHC at the consolidated level, the Federal Reserve will need information concerning assets or liabilities booked in significant bank, thrift, and functionally regulated subsidiaries within the FHC group. The primary bank, thrift, and functional regulators of such subsidiaries also may need information from the FHC to perform their respective statutory mandates. To assist in sharing needed information, Federal Reserve supervisory staff should do the following:

1. *Have periodic meetings with the primary bank, thrift, and functional regulators of an FHC's subsidiaries.* The purpose of these meetings is to develop an understanding of the risk profiles of the individual regulated legal entities and their relation to the FHC's overall risk profile. These meetings also should be used, when appropriate, to share information regarding supervisory plans and to coordinate supervisory activities and follow-up, as needed.
2. *Review the examination findings of primary bank, thrift, and functional regulators (and their self-regulatory organizations) together with other relevant information.* The purpose of this review is to develop a consolidated picture of the FHC's financial condition and risk profile, the effectiveness of risk-management and internal-control policies, and the implications for the affiliated depository institutions.
3. *Make available to primary bank, thrift, and functional regulators, to the extent permissible, pertinent information regarding the FHC.* Included is information on the financial condition, risk-management policies, and operations of an FHC that may have a material impact on individual regulated subsidiaries, as well as information concerning transactions or relationships between the regulated subsidiaries and other subsidiaries within the FHC group. This process will assist supervisors in performing their statutory and supervisory responsibilities over regulated subsidiaries.
4. *Participate in the sharing of information among international supervisors, consistent with applicable law.* The purpose of this exchange is to ensure that an FHC's global activities are supervised on a consolidated basis and to minimize material gaps in supervision.
5. *Review internal-audit and management reports and publicly available information (including market information on equity and debt prices of the consolidated organization), as well as reports and statistics collected by other regulators, including regulators of depository institution subsidiaries.* To limit regulatory burden, this information should be obtained, to the fullest extent possible, from (1) the parent organization; (2) primary bank, thrift, and functional regulators of the FHC's regulated subsidiaries; and (3) publicly available sources, such as externally audited financial statements.

3900.0.4.2 Ongoing Supervision

3900.0.4.2.1 FHC Structure, Management, and the Applications Process

The Federal Reserve is responsible for understanding the consolidated organization's legal,

organizational, and risk-management structure; major business activities; and risk exposures and risk-management systems. The Federal Reserve needs to understand the nature and degree of involvement of the board of directors in overseeing their organization's risk-management and control process at the consolidated group level. The Federal Reserve, when considering any formal application, declaration, or notification at the FHC level, will coordinate, as appropriate, with primary bank, thrift, and functional regulators.

3900.0.4.2.2 Reporting and Examination

The Federal Reserve will rely, to the fullest extent possible, on reports that an FHC or its subsidiaries are required to file with federal or state authorities (or self-regulatory organizations) or on reports that are prepared by the federal or state authorities. The Federal Reserve will rely on routinely prepared management reports, publicly reported information, and externally audited financial statements. The Federal Reserve also will rely to the fullest extent possible on the examination of an FHC's bank and nonbank subsidiaries by their appropriate primary bank, thrift, and functional regulators (and their self-regulatory organizations).

If supervisory staff requires a specialized report from a functionally regulated subsidiary of an FHC, staff will first request it from the subsidiary's appropriate functional regulator. In the event that the report is not made available to the Federal Reserve, supervisory staff may obtain the report directly from the functionally regulated subsidiary if it is necessary to assess—

1. a material risk to the FHC or any of its depository institution subsidiaries;
2. compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the FHC or a subsidiary; or
3. the FHC's systems for monitoring and controlling financial and operational risks that may pose a safety-and-soundness threat to a depository institution subsidiary.

The Federal Reserve may examine a functionally regulated subsidiary under certain circumstances. Before examining a functionally regulated subsidiary, supervisory staff should first seek to obtain the necessary information from the appropriate functional regulator. If an examination is determined to be necessary, the Federal

Reserve should coordinate its actions with the appropriate functional regulator. An examination may be conducted when the Federal Reserve has reasonable cause to believe (or reasonably determines) that—

1. the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution,
2. the examination is necessary to be adequately informed about the FHC's systems for monitoring and controlling the financial and operational risks that may pose a safety-and-soundness risk to a depository institution subsidiary; or
3. the subsidiary is not in compliance with any federal law that the Board has specific jurisdiction to enforce (and the Board cannot determine compliance by examining the FHC or its affiliated depository institutions).

The Federal Reserve, consistent with its current practice, will continue relying to the fullest extent possible on the work performed by bank, thrift, and functional regulators to validate that material risks are measured and managed adequately at the regulated subsidiary level. Where necessary and appropriate, and consistent with (1) through (3) immediately above, the Federal Reserve may conduct or participate in reviews at banks, thrifts, or functionally regulated subsidiaries to validate that risk-management and internal-control policies established at the consolidated level are being implemented effectively.

For an FHC subsidiary that is not supervised by a bank, thrift, or functional regulator, the Federal Reserve will obtain information from the subsidiary, as appropriate and necessary, to assess the financial condition of the FHC as a whole. In addition, the Federal Reserve will conduct examinations of such subsidiaries, if necessary, to be informed about (1) the nature of the subsidiary's operations and financial condition, (2) the subsidiary's financial and operational risks that may pose a threat to the safety and soundness of any depository institution subsidiary of the FHC, and (3) the systems for monitoring and controlling such risks. Under the GLB Act, the Federal Reserve may not examine any subsidiary of an FHC that is an investment company registered with the SEC and that is not itself a BHC.

3900.0.4.2.3 Capital Adequacy

The Federal Reserve is responsible for assessing

consolidated capital adequacy for FHCs, with the ultimate objective of protecting the insured depository subsidiaries from the effects of disruptions in the nonbank portions of the organization. Capital adequacy will be assessed in relation to the risk profile of the consolidated organization. The Federal Reserve will review the FHC's internal risk assessment and related capital-analysis process for determining the adequacy of its overall capital position. Such a review will include consideration of current and future economic conditions, business-development plans for the future, possible stress scenarios, and internal risk-control and audit procedures. As BHCs, FHCs are subject to the Federal Reserve's holding company capital guidelines, which set forth minimum capital ratios that serve as tripwires for additional supervisory scrutiny and corrective action. The Federal Reserve will review these requirements as they apply to FHCs and may, if warranted, adapt the manner in which they apply to FHCs that engage in a broad range of financial activities.

Although the Federal Reserve is responsible for assessing the consolidated capital adequacy of FHCs, the primary bank, thrift, or functional regulators of FHC subsidiaries will continue to set and enforce applicable capital requirements for the regulated entities within their jurisdiction. Under the GLB Act, the Federal Reserve may not establish separate capital adequacy requirements for an FHC subsidiary that is in compliance with the capital requirements of its functional regulator.

Consistent with current practice, the Federal Reserve will continue to place significant reliance on the primary bank, thrift, or functional regulator's analysis of the capital adequacy of a regulated subsidiary. That analysis will be a significant input in the Federal Reserve's assessment of an FHC's consolidated capital adequacy, especially when a securities broker-dealer or insurance company is a predominant part of an FHC.

Several issues become particularly important when assessing the consolidated capital adequacy of FHCs with functionally regulated subsidiaries. The capital adequacy requirements that have been established for banking, securities, and insurance entities by their respective regulators reflect varying definitions of the elements of capital and varying approaches to asset and liability valuations. Yet techniques for assessing capital adequacy must be able to identify situations such as double or multiple leverage or double-gearing. In such cases, the actual capital protection may be overstated.

3900.0.4.2.4 Intra-Group Exposures and Concentrations

Intra-group exposures, including servicing arrangements and risk concentrations, have the potential to threaten the condition of regulated entities. Intra-group exposures may be significant at large, complex FHCs, especially those that operate their businesses on global lines that cut across legal entities within the firm. The Federal Reserve's focus in this area is the potential impact of intra-group exposures and concentrations on insured depository institution subsidiaries of an FHC.

Risk concentrations can take many forms, including exposures to one or more counterparties or related entities, industry sectors, and geographic regions. For risk concentrations, the holding company supervisor is uniquely positioned to understand the combinations of exposures within an organization across all legal entities. This understanding is critical at the group level—risk concentrations that are prudent on a legal-entity basis may aggregate to an unsafe level for the consolidated organization. The Federal Reserve will monitor intra-group exposures and risk concentrations as follows:

1. The appropriate primary bank and thrift regulators will continue to monitor and enforce section 23A and 23B restrictions at the bank or thrift level. The Federal Reserve will focus on assessing whether the FHC monitors and ensures compliance with these statutory requirements. The Federal Reserve plans to begin collecting data from each depository institution subsidiary of BHCs, including FHCs, on their covered transactions with affiliates that are subject to sections 23A and 23B and will share that data with primary bank and thrift regulators.
2. Functional regulators will continue to monitor and enforce any intra-group exposure restrictions that may apply to the regulated entities under their jurisdictions.
3. The Federal Reserve will focus on understanding and monitoring related-party exposures at the group level (including areas such as servicing agreements, derivatives exposures, and payments-system exposures). An important emphasis will be the extent to which risk management in a group's subsidiary depository institutions depends on transactions with affiliates.
4. The Federal Reserve will focus on manage-

ment's effectiveness in monitoring and controlling intra-group exposures and risk concentrations. The Federal Reserve will consider how an organization's risk-management processes measure and manage group-wide risk concentrations.

3900.0.4.2.5 *Enforcement Powers*

The Federal Reserve is authorized generally to take enforcement action against FHCs and their nonbank subsidiaries. The primary bank and thrift supervisors have the authority to take enforcement action against the banks and thrifts under their respective jurisdictions. Under the GLB Act, the Federal Reserve may take enforcement action against a functionally regulated subsidiary of an FHC, but only when such action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty that poses a material risk either to (1) the financial safety, soundness, or stability of the affiliated depository institution or (2) the domestic or international payments system. In such circumstances, the Federal Reserve may only take the action if it is not reasonably possible to protect effectively against the material risk through an action directed at or against an affiliated depository institution.

Under any circumstances, the Board may take enforcement action against a functionally regulated subsidiary to enforce compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the subsidiary. If the Federal Reserve believes that an enforcement action against a functionally regulated entity is necessary, the Federal Reserve will notify the entity's appropriate functional regulator and, whenever practical, will coordinate such an action with any action taken by the functional regulator. It is expected that the Federal Reserve will not take an enforcement action against a functionally regulated subsidiary (or a person associated with the subsidiary) if the problem involves factors and statutes that are the primary responsibility of the functional regulator.

Under the existing bank holding company framework, the Federal Reserve coordinates enforcement actions with the primary bank and thrift regulators, possibly with some adaptation of the action for the holding company context (such as limitations on parent company debt or dividends). The Federal Reserve will continue to coordinate enforcement actions with these

regulators. Similarly, the Federal Reserve will coordinate with functional regulators when formulating and issuing enforcement actions that involve or may have an impact on functionally regulated subsidiaries.

3900.0.4.3 *Promotion of Sound Practices and Improved Disclosure*

The Federal Reserve can promote sound practices in a number of ways, such as by monitoring trends in risk exposures and risk-management practices across the FHC population through a combination of efforts, including—

1. regular discussions, centered on specific issues and emerging risks, with FHC management;
2. regular meetings with primary bank, thrift, and functional regulators to explore and discuss issues of mutual interest or concern;
3. interagency working groups or specialty teams to gain early insight into risks that cut across the various entities of a conglomerate or groups of conglomerates; and
4. industry conferences on relevant topics of interest.

These initiatives will contribute to the development of sound practices that the Federal Reserve and the primary bank, thrift, and functional regulators can communicate to the senior management and boards of directors of the FHCs, as well as to the senior management of their bank and nonbank subsidiaries.

Improved transparency and public disclosure can meaningfully supplement the efforts of supervisors to monitor the increasingly complex and global activities of diversified banking organizations. Consistent with sound accounting principles, practices, and depository institution safety-and-soundness practices, the Federal Reserve will participate in efforts to enhance disclosures that will illuminate group-wide activities, risk exposures, risk management, controls, and intra-group exposures.

3900.0.4.4 *Supervisory Response to Challenges Posed by FHCs*

The Federal Reserve's response to the supervisory challenges of FHCs has been in the context of the consolidated supervision of BHCs.¹

1. The Federal Reserve's framework for supervising large complex banking organizations (LCBOs) is described in SR-99-15. See section 2124.04.

Examples include greater reliance on risk-focused supervision; strengthening relationships with senior management; improving coordination with other federal, state, and international regulatory and supervisory authorities; greater reliance on specialty teams, sound-practices papers, and public disclosures; and simplification of the applications process.

The more diversified FHCs present new supervisory challenges. To address these challenges, the Federal Reserve will continue to strengthen—

1. cooperative arrangements with bank and thrift regulators, the SEC, the CFTC, state insurance and securities regulators, and foreign supervisors;
2. relationships with the FHC management and personnel responsible for significant risk-management functions and, when necessary, the management of the organization's non-bank subsidiaries;
3. information flows that provide supervisors with relevant, up-to-date information without imposing an unwarranted burden on financial organizations;
4. techniques for evaluating capital adequacy for FHCs engaged in an expanded range of nonbank financial activities;
5. public disclosures and market discipline;
6. techniques for assessing the overall risk profile of FHCs and the implications for affiliated depository institutions; and
7. incentives for FHCs to continually review and improve their risk-management processes, internal controls, and audit practices.

The Federal Reserve is committed to working constructively and cooperatively with all regulators involved in overseeing the activities of FHCs and their bank and nonbank subsidiaries.

U.S. Bank Holding Companies Operating as Financial Holding Companies (Section 4(k) of the BHC Act) Section 3901.0

To become a financial holding company (FHC), a domestic bank holding company (BHC) must file a written declaration with the appropriate Federal Reserve Bank. This declaration should contain the following information:

1. A statement that the BHC elects to be an FHC.
2. The name and head-office address of the company and each depository institution controlled by the company. For purposes of the election process for both domestic BHCs and foreign banks, the term "depository institution" here means any national bank, state-chartered bank, federal branch of a foreign bank, insured branch of a foreign bank, savings association, savings bank, and industrial bank. It also includes any trust company that engages in the business of receiving deposits other than trust funds. (See 12 U.S.C. 1813.) A depository institution does not have to have FDIC insurance.
3. A certification that all depository institutions controlled by the company are well capitalized as of the date the company files its declaration.
4. The capital ratios for all relevant capital measures (as defined in section 38 of the Federal Deposit Insurance Act), as of the close of the previous quarter, for each depository institution controlled by the company on the date the company files its declaration.
5. A certification that all depository institutions controlled by the company are well managed as of the date the company files its declaration. (See SR-00-1.)

A depository institution is well managed if, at the most recent inspection or examination or subsequent review by its appropriate federal banking agency, the institution received (1) at least a satisfactory composite rating and (2) at least a satisfactory rating for management, if such a rating is given. In the case of a depository institution that has not received an inspection or examination rating, a depository institution is well managed if the Board has determined, after a review of the depository institution's managerial and other resources and after consulting with the depository institution's appropriate federal and state banking agency, that the institution is well managed. In addition, a depository institution that results from the merger of two or more depository institutions that are well managed will be considered to be well managed unless the Board determines otherwise after

consulting with the appropriate federal banking agency for each depository institution involved in the merger.

A depository institution that results from the merger of a depository institution that is well managed with one or more depository institutions that are not well managed or that have not been examined will be considered to be well managed, if the Board determines that the resulting institution is well managed. The Board makes this determination after a review of the managerial and other resources of the resulting institution and after consulting with the appropriate federal and state banking agencies for the institutions involved in the merger, as applicable.

The Gramm-Leach-Bliley Act (the GLB Act) also requires that all the insured depository institutions controlled by the FHC at the time of the declaration must be rated satisfactory or better under the Community Reinvestment Act (CRA). When determining whether the insured depository institutions controlled by a BHC meet the CRA requirement, the Federal Reserve excludes an institution that was acquired during the 12 months preceding the date the company filed its declaration. To qualify for this exception, (1) the company must have submitted the depository institution's affirmative correction plan to the appropriate federal banking agency, and (2) the agency must have accepted the plan.

A BHC must file its declaration to become an FHC with the appropriate responsible Reserve Bank. A BHC's election to become an FHC is effective on the thirty-first day after the date that a complete declaration was received, unless the Board notifies the company before that time that the election is ineffective. The Board or the appropriate Federal Reserve Bank also may notify a BHC in writing that its election to become an FHC is effective before the thirty-first day after the date that a complete declaration was filed.

When an FHC's declaration becomes effective, it may engage in the expanded financial activities available to such companies. If, however, the Board has timely notified a BHC that its declaration is ineffective, the BHC will not be considered an FHC and may not begin to engage in any expanded activities.

A company that is not a BHC may simultaneously submit an application under section 3(a)(1) of the Bank Holding Company Act (BHC

Act) to become a BHC and to request to become an FHC on consummation of that transaction. The company must (1) state that it seeks to become an FHC on consummation of its section 3 proposal to become a BHC and (2) certify that each depository institution that would be controlled by the company on consummation of the section 3 proposal will be both well capitalized and well managed on the date of consummation. To coordinate action on these two requests, the acceptance of the declaration as complete does not occur until the date the company lawfully consummates its section 3 proposal and becomes a BHC. A simultaneous declaration will not be effective if the Board notifies the company at any time before consummation that (1) any depository institution that would be controlled by the company on consummation will not be well capitalized and well managed or (2) any insured depository institution that would be controlled by the company on consummation has not achieved at least a satisfactory rating at its most recent CRA examination. An insured depository institution that is controlled or would be controlled by a company filing a simultaneous declaration and section 3(a)(1) application to become a BHC may not be excluded for the purposes of evaluating the CRA performance record under this provision or the general FHC certification requirements of section 225.82(d) of Regulation Y.

In most cases, an FHC may, without providing prior notice to or obtaining prior approval from the Board, conduct an activity that is financial in nature or incidental to a financial activity (a financial activity). (See section 225.85(a)(1) of Regulation Y.) An FHC may conduct a financial activity by engaging directly in the activity or by acquiring and retaining the shares of any company that is engaged exclusively in one or more financial activities. An FHC may conduct a financial activity at any location inside or outside of the United States, subject to the laws of the jurisdiction in which the activity is conducted. A company acquired or to be acquired by an FHC also may engage in other activities that are permissible for an FHC, in accordance with any applicable notice, approval, or other requirements.

An FHC may acquire more than 5 percent of the voting shares or control of a company that is not engaged exclusively in activities that are financial in nature, incidental to financial activities, or otherwise permissible for the acquiring FHC. (See section 225.85(a)(3) of Regulation

Y.) To do so, the acquisition must meet three requirements:

1. The company to be acquired must be substantially engaged in activities that are financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4(c) of the BHC Act. A company is considered to be substantially engaged in permissible activities if at least 85 percent of the company's consolidated total annual gross revenues is derived from 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 for an FHC under section 4(c) of the BHC Act. An FHC's management should consult with Board staff if they are uncertain whether a proposed acquisition meets this standard.
2. The FHC must comply with the notice requirements of section 225.87 of Regulation Y. The acquired company must conform, terminate, or divest, within two years of the date the FHC acquires shares or control of the company, all activities that are not financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4(c) of the BHC Act. Although an FHC may acquire any percentage of shares or control of a company engaged in limited impermissible activities, the FHC needs only to provide a post-transaction notice if such an acquisition results in control of the company.
3. After being acquired by an FHC, the company engaged in impermissible activities may not engage in or acquire a company engaged in any activity that is not permissible for the FHC.

Section 225.85(c) of Regulation Y identifies two circumstances in which Board approval is still required to engage in financial activities. First, prior approval in accordance with section 4(j) of the BHC Act and section 225.24 of Regulation Y is required to acquire more than 5 percent of the voting shares or control of a savings association or any company that owns, operates, or controls a savings association. Second, the Board may, in the exercise of its supervisory authority, require an FHC to provide it with prior notice or obtain prior Board approval if circumstances warrant. The GLB Act did not change in any way the requirement that a company receive prior Board approval under section 3 of the BHC Act before acquiring shares or control of a bank.

Section 225.87(a) of Regulation Y requires an FHC that commences an activity, or that acquires control or shares of a company engaged in an activity under section 225.86 of Regulation Y, to provide written notice to the appropriate Reserve Bank within 30 calendar days after commencing the activities or consummating the acquisition. The notice must be provided on the FR Y-10 form, obtained from the Board or any Reserve Bank. This requirement also applies to an activity that the FHC may engage in under section 4(c)(8) of the BHC Act that is incorporated under section 4(k) of the act.

There are two circumstances in which notice to the Board is not required to engage in an activity: (1) when an FHC acquires shares of a company without acquiring control of the company, or (2) when an FHC is engaged in securities underwriting, dealing, or market-making activities described in section 4(k)(4)(E), merchant banking investment activities conducted pursuant to section 4(k)(4)(H), or insurance company investment activities conducted pursuant to section 4(k)(4)(I) of the BHC Act, and has provided the System with the appropriate notice regarding the relevant activity. (See section 225.87(b) of Regulation Y.) Under these circumstances, the FHC must provide written notice to the Board within 30 days after acquiring, as part of a merchant banking activity under section 4(k)(4)(H) or an insurance company investment activity under section 4(k)(4)(I) of the BHC Act, more than 5 percent of any company at a cost that exceeds 5 percent of the FHC's tier 1 capital or \$200 million, whichever is less.

3901.0.1 SUPERVISORY CONCERNS

In some instances, a U.S. BHC or a foreign bank may meet the statutory requirements to be an FHC, but its capital strength and managerial resources are less than satisfactory on a consolidated basis. In this situation, the Federal Reserve may have supervisory concerns about the consolidated entity although it technically qualifies as an FHC. The Federal Reserve may, in the exercise of its supervisory authority, restrict or limit the conduct of new activities or future acquisitions of an FHC, or take other appropriate action, if it finds that the FHC does not have the financial or managerial resources to conduct the activity or make the acquisition. This supervisory action could be based, for example, on a determination that the company does not have adequate capital or risk-management systems to conduct a specific activity in a safe and sound

manner and may involve the issuance of cease-and-desist orders, the execution of written agreements, or other appropriate supervisory action.

3901.0.2 HOLDING COMPANY FAILS TO CONTINUE MEETING FHC CAPITAL AND MANAGEMENT REQUIREMENTS

If a domestic bank holding company has made an effective election to be an FHC, and the Board finds that any depository institution subsidiary owned or controlled by the company ceases to be well capitalized or well managed, the company must execute an agreement acceptable to the Federal Reserve Board to comply with all applicable capital and management requirements. This agreement should be executed within 45 days after the Board notifies the company that it is not in compliance with the applicable requirements for an FHC. (See section 225.83 of Regulation Y.)

At the request of the bank holding company, the Federal Reserve Board may extend the 45-day period. The request should state why an extension is necessary. The agreement must explain the specific actions that the bank holding company will take to correct all areas of noncompliance, provide a schedule for all such actions, and provide any other information the Board may require, and be acceptable to the Board.

During the period of noncompliance, the Federal Reserve Board may impose limitations or conditions on the activities of the company. In addition, the company must obtain the Board's approval before conducting any of the activities that are newly authorized for FHCs by the GLB Act. Section 225.83 of Regulation Y also sets forth the consequences of failing to correct the noncompliance within a period of 180 days. Such consequences may include divestiture of ownership or control of any depository institution the company owns or controls, or the cessation of the expanded activities permitted for FHCs.

3901.0.3 DEPOSITORY INSTITUTION SUBSIDIARY FAILS TO MAINTAIN A SATISFACTORY OR BETTER CRA RATING

The Federal Reserve Board prohibits an FHC

from engaging in any additional activity¹ or acquiring control of a company engaged in any activity under section 4(k) and 4(n) of the BHC Act if any insured depository institution con-

trolled by the FHC fails to maintain a satisfactory or better CRA rating.

1. With respect to engaging in any additional activities, see section 225.84 of Regulation Y for the exceptions.

3901.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws¹</i>	<i>Regulations²</i>	<i>Interpretations³</i>	<i>Orders</i>
BHCs and foreign banks that qualify as FHCs can engage in financial activities and those incidental thereto	1843			
Definition of an FHC		225.81	4-056	
Election to become an FHC		225.82	4-056.1	
Failure to meet applicable capital and management requirements		225.83	4-056.2	
Consequences of the failure to maintain at least a satisfactory CRA rating		225.84	4-056.3	
Notices or approvals for FHCs to engage in financial activities		225.85	4-056.4	
Activities permissible for FHCs		228.86	4-056.5	
Post-commencement notice for FHC to engage in a financial activity		225.87	4-056.6	
Board determination that an FHC activity is financial in nature or incidental thereto		225.88	4-056.7	
Board approval for an FHC to engage in an activity that is complementary to a financial activity		225.89	4-056.8	

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. *Federal Reserve Regulatory Service* reference.

3903.0.1 FINANCIAL HOLDING COMPANY QUALIFICATION REQUIREMENTS FOR FOREIGN BANKS

A foreign bank that owns or controls a U.S. bank (and any company that controls the foreign bank) must comply with the same requirements as a domestic bank holding company (BHC) that elects to be treated as a financial holding company (FHC). Either entity is thus able to engage in authorized financial activities under the Gramm-Leach-Bliley Act (GLB Act). If a foreign bank does not own a subsidiary bank in the United States, but instead operates through a branch, agency, or commercial lending company located in the United States, the foreign bank (and any company that controls the foreign bank) is subject to the Bank Holding Company Act (BHC Act) as if the foreign bank or company were a BHC. Such foreign banks may, like U.S. BHCs, also elect to be treated as FHCs. Foreign banks electing to be treated as FHCs must meet “well-capitalized” and “well-managed” standards comparable to those that are applicable to U.S. depository institutions. Further, any U.S. branches of the foreign bank that are FDIC-insured must be rated satisfactory or better under the Community Reinvestment Act (CRA).¹ (See section 225.90 of Regulation Y.)

To be treated as an FHC, a foreign bank (or a company that owns or controls a foreign bank) that operates in the United States only through U.S. branches, agencies, or commercial lending subsidiaries must file a written declaration with the appropriate Reserve Bank. This declaration must contain items 1 through 6 below. Foreign banks or companies that operate in the United States through U.S. branches, agencies, or commercial lending companies and through a U.S. subsidiary bank are not required to provide item 1, but they must provide the items domestic BHCs are to provide.

1. a statement that the foreign bank or company elects to be treated as an FHC
2. the risk-based capital ratios and the amounts of tier 1 capital and total assets of the foreign bank as of the close of the most recent quar-

1. Under the GLB Act, the capital and management standards the Board must apply to foreign banking organizations that elect to become FHCs should be comparable to the standards applied to domestic institutions, giving due regard to the principle of national treatment and equality of competitive opportunity.

- ter, and as of the close of the most recent audited reporting period
3. a certification that the foreign bank meets the standards to be well capitalized that are set out in section 225.90(b)(1)(i) and (ii) or section 225.90(b)(2) of Regulation Y, as of the date the foreign bank or company files its election
4. a certification that the foreign bank is well managed, as defined in section 225.90(c)(1) of Regulation Y, as of the date the foreign bank or company files its election
5. a certification that all U.S. depository institutions controlled by the foreign bank or company (including thrifts and nonbank trust companies) are well capitalized and well managed as of the date the foreign bank or company files its election
6. the capital ratios and all relevant capital measures (as defined in section 38 of the Federal Deposit Insurance Act) for all U.S. depository institution subsidiaries of the foreign bank or company as of the end of the previous quarter

The well-capitalized and well-managed tests in items 2, 3, and 4 above apply to each foreign bank that has U.S. operations in the form of a branch, agency, or commercial lending company subsidiary that is part of a foreign banking organization seeking certification as an FHC.

For those foreign banks whose home-country supervisors have adopted risk-based capital standards consistent with the Basel Accord, their tier 1 and total risk-based capital ratios, as calculated under the home-country standard, must be at least 6 percent and 10 percent, respectively. The Board will determine the comparability of the foreign bank’s capital under the listed comparability factors in section 225.92(e) of Regulation Y. Among these factors are the composition of the foreign bank’s capital, accounting standards, long-term debt ratings, the ratio of tier 1 capital to total assets, reliance on government support to meet capital requirements, the foreign bank’s anti-money laundering procedures, whether the foreign bank is subject to comprehensive consolidated supervision, and other factors that may affect the analysis of capital and management.² For those foreign banks whose

2. The Board may consider whether the overall level of the foreign bank’s capital and other factors indicate that addi-

home-country supervisors have not adopted the Basel Accord and for any other foreign banking organizations that otherwise do not meet the capital standards noted above, the foreign bank may be considered well capitalized by obtaining from the Board a prior determination that its capital is otherwise comparable to the capital that would be required of a U.S. banking organization to become an FHC. The pre-clearance process provided by section 225.91(c) of Regulation Y can be used to obtain this determination.

A foreign bank will be considered well managed if—

1. the branches, agencies, and commercial lending subsidiaries of the foreign bank have received at least a satisfactory composite rating at their most recent examination;³
2. the home-country supervisor of the foreign bank consents to the foreign bank expanding its activities in the United States to include FHC activities;⁴ and
3. the Board determines that the management of the foreign bank meets standards comparable to those required of a U.S. bank owned by an FHC.

tional analysis should be undertaken to assess comparability. The Board will not impose a specific standard for the foreign bank's ratio of tier 1 capital to total assets (the leverage ratio), but a foreign bank's leverage ratio may be among the factors taken into account in the comparability review.

3. The Federal Reserve's foreign bank examination process includes the assignment of a combined assessment (the combined ROCA rating) of a foreign banking organization's (FBO's) U.S. branch, agency, and commercial lending operations through the regular examination cycle. (See SR-00-14.) The combined ROCA rating will be factored into the FBO's overall combined U.S. operations rating, which will continue to be a single composite rating that reflects the U.S. supervisors' collective assessment of all operations (that is, banking and nonbanking) of the FBO in the United States. If a foreign bank wishes to obtain FHC status, but does not have the assignment of a combined U.S. banking assessment as part of the regular examination cycle, the foreign bank can contact its responsible Federal Reserve Bank or engage in the pre-clearance process. If a foreign banking group contains more than one foreign bank with U.S. banking offices, each such foreign bank in the group must have a satisfactory composite U.S. banking assessment in order for the foreign banking group or any of its subsidiaries to obtain FHC status.

4. The home-country supervisor should consider the FBO's consolidated capital and management before providing its consent to the expansion. If the home country has no formal consent process, the Board will consult with the supervisor to assure itself that the supervisor considers the capital and management of the bank to satisfy its home-country standards and that the supervisor has no objections to the expansion.

The Board believes that, as a general rule, the top tier foreign bank in a foreign banking group that requests an FHC determination should be subject to comprehensive consolidated supervision by the home-country supervisor.

As a general matter, a foreign bank will *not* be determined to be well capitalized and well managed when it is not subject to comprehensive consolidated supervision. When a foreign bank has not been determined by the Board to be subject to comprehensive consolidated supervision, and the Board has not deemed any other bank from the country where the foreign bank is chartered to be subject to comprehensive consolidated supervision, the foreign bank must use the pre-clearance process provided by section 225.91(c) of Regulation Y—even if it otherwise meets the objective screening criteria. The Board may review a foreign bank's home-country supervision through the pre-clearance process and make a comprehensive consolidated supervision determination in that context. The Board will try to make a determination on pre-clearance requests within 30 days of receipt.⁵

There may be limited situations when an exceptionally strong bank from a country that has not yet fully implemented comprehensive consolidated supervision should be considered for FHC status. Such a foreign bank can qualify for FHC status if (1) the home-country supervisor has made significant progress in adopting and implementing arrangements for the consolidated supervision of its banks, and (2) the foreign bank demonstrates significant financial strength, such as through high levels of capital or exceptional asset quality. The Board anticipates, however, that a foreign bank that is not subject to comprehensive consolidated supervision will be granted FHC status only in rare instances.

As in the case of domestic BHCs, each U.S. depository institution subsidiary of a foreign bank is required to meet all the well-capitalized and well-managed standards in order for the foreign bank or company to obtain FHC status in the same manner as required for U.S. BHCs. In addition, all the U.S. insured depository institutions controlled by the foreign bank or company must be rated satisfactory or better under the CRA. If the foreign bank operates a U.S. branch that is FDIC-insured, the branch must be rated satisfactory or better under the CRA.

5. If the Board makes an affirmative comprehensive consolidated supervision determination through the FHC pre-clearance process, the determination will be relied on for the foreign bank to establish additional branches and agencies under the Foreign Bank Supervision Enhancement Act.

An election by a foreign bank or company to be treated as an FHC will become effective on the thirty-first day after the date that an election was received by the appropriate Reserve Bank, unless the Board notifies the foreign bank or company before that time that the election is ineffective or unless the period for the Board's determination is extended with the consent of the foreign bank or company making the election. The date the Federal Reserve Bank receives the declaration should be considered the first day of the 30-day review period. The Board or the Reserve Bank also may notify a foreign bank or company in writing that its election to become an FHC is effective before the thirty-first day after the election was filed. A foreign bank or company should file the declaration (or pre-clearance request) with the responsible Reserve Bank.

If the election is determined to be effective, the foreign bank or company may engage in the financial activities available to FHCs. The GLB Act requires that an FHC that engages in an activity, or that acquires control or shares of a company engaged in an activity, under section 4(k) of the BHC Act provide written notice to the appropriate Reserve Bank within 30 calendar days after commencing the activities or acquisition. The notice should describe the activity commenced or identify the name of the company acquired and describe its activities.

3903.0.2 FOREIGN BANK FAILS TO CONTINUE MEETING FHC CAPITAL AND MANAGEMENT REQUIREMENTS

If a foreign bank or company has made an effective election, and the Board finds that the foreign bank; any foreign bank that is controlled by the foreign bank and maintains a U.S. branch, agency, or commercial lending company; or any U.S. depository institution owned or controlled by the foreign bank or company ceases to be well capitalized or well managed, the foreign bank or company must execute an agreement acceptable to the Federal Reserve Board to com-

ply with all applicable capital and management requirements. This agreement should be executed within 45 days after the Board notifies the foreign bank or company that it is not in compliance with the applicable requirements for an FHC. (See section 225.93 of Regulation Y.) At the request of the foreign bank or company, the Board may extend the 45-day period. (The request should state why an extension is necessary.) The agreement must explain the specific actions that the foreign bank or company will take to correct all areas of noncompliance, provide a schedule for all such actions, provide any other information the Board may require, and be acceptable to the Board. During the period of noncompliance, the Board also may impose limitations or conditions on the U.S. activities of the foreign bank or company. Section 225.93 of Regulation Y also sets forth the consequences of failing to correct the noncompliance within a period of 180 days. Such consequences may include termination of the foreign bank's U.S. branches and agencies and divestiture of its commercial lending company subsidiaries, or cessation of the expanded activities permitted for FHCs. The foreign bank may also choose to cease engaging in activities not permitted for a foreign bank under sections 2(h) and 4(c) of the BHC Act.

3903.0.3 INSURED BRANCH FAILS TO MAINTAIN A SATISFACTORY OR BETTER CRA RATING

When an insured branch of a foreign bank, or an insured depository institution controlled by a foreign bank, fails to maintain a satisfactory or better CRA rating, section 225.94 of Regulation Y applies the provisions of section 225.84 to the foreign bank and to any company that owns or controls the foreign bank. For these purposes, the insured branch is treated as an "insured depository institution." An FHC is thus prohibited by the Board from engaging in any additional activity or acquiring control of a company engaged in activities under section 4(k) or 4(n) of the BHC Act. (See section 225.84 of Regulation Y.)

3903.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws¹</i>	<i>Regulations²</i>	<i>Interpretations³</i>	<i>Orders</i>
BHCs and foreign banks that qualify as FHCs can engage in financial activities and those incidental thereto	1841(h) 1843(c)			
Election of a foreign bank to become an FHC		225.91	4-057.2	
How elections by foreign banks to be an FHC become effective		225.92	4-057.3	
Foreign bank fails to satisfy capital and management requirements		225.93	4-057.4	
Foreign branch fails to retain a satisfactory CRA rating		225.94 225.84	4-057.7 4-056.5	

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. *Federal Reserve Regulatory Service* reference.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, this section was revised to include the Board's September 7, 2007, determination, by order, at the FDIC's request, that disease management and mail-order pharmacy activities complement the financial activity of underwriting and selling health insurance; permissible for an FHC under section 4 (k) of the BHC Act, as amended by the Gramm-Leach-Bliley (GLB) Act (see 2007 FRB C133). (An applicant had filed an application with the FDIC for deposit insurance for a proposed de novo industrial loan company.) The Board determined the activities to be financial in nature under section 4(k) of the BHC Act and complementary to a financial activity. The Board's determination is conditioned and based on the limitations it placed on the activities in the aggregate (that is, the specified percentages of the applicants' consolidated total assets, consolidated total annual revenues, and total capital).

The section is also amended for the Board's approvals of FHC notices, under section 4 of the BHC Act, to provide energy management services under energy management agreements and also, energy tolling. On December 4, 2007, the Board determined, by order, that an FHC's provision of energy management services is complementary to the financial activities of engaging as principal in physical commodity derivatives and the providing of financial and investment advisory services for derivative transactions. (See 2008 FRB C20.) On March 27, 2008, the Board also determined, by order, that an FHC's providing energy tolling is complementary to the financial activity of engaging in commodity derivatives activities (see 2008 FRB 60).

The section has been revised to also delete a reference to an interim Board rule that is final. See 225.4(g) of Regulation Y (12 C.F.R. 225.4(g)). This rule pertains to nonbank activities involving the underwriting and dealing in, or making a market in, bank-ineligible securities under section 4(k)(4)(E) of the BHC Act.

3905.0.1 NONBANK ACTIVITY AUTHORIZATIONS FOR FHCS

The Gramm-Leach-Bliley Act (the GLB Act) amended the Bank Holding Company Act (the BHC Act) to allow a BHC or foreign bank that qualifies as a financial holding company (FHC)

to engage in a broad range of activities that the GLB Act defines as "financial in nature." Section 4(k)(4)(A)–(E) of the BHC Act defines the following activities as financial in nature:

1. lending, exchanging, transferring, investing for others, or safeguarding money or securities
2. 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, in any state
3. providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940)
4. issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly
5. underwriting, dealing in, or making a market in securities

The Board had previously determined that some of these activities were impermissible for BHCs, such as acting as principal, agent, or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, and issuing annuity products. Permissible insurance activities as principal include reinsuring insurance products.

An FHC acting under section 4(k)(4)(B) of the BHC Act may conduct insurance activities without regard to the restrictions on the insurance activities imposed on BHCs under section 4(c)(8).

Providing claims-administration and risk-management services. Legal counsel representing an FHC sought an opinion as to whether an insurance agency owned by an FHC may engage in certain insurance claims activities, as described below, under section 4(k)(4)(B) of the BHC Act. In particular, it was asked whether such an insurance agency may engage in the following claims-administration activities in connection with its insurance sales activities: (1) collecting insurance premiums; (2) holding insurance premiums in trust; (3) establishing an insurance claims-paying account; (4) adjusting insurance claims (which would include obtaining facts about claims, investigating the veracity of claims, and estimating losses relating to claims);

(5) negotiating with insureds and their representatives concerning insurance claims; and (6) paying and settling insurance claims. A representation was made that insurance agents typically perform these claims-administration services for an insurance underwriter in connection with insurance policies sold by the agents on behalf of an insurance underwriter.

With respect to the insurance risk-management activities provided in connection with insurance sales activities, a legal opinion was requested as to whether an insurance agency or broker owned by an FHC could engage in the following activities: (1) assessing the risks of a client seeking insurance and identifying the client's exposures to loss; (2) designing programs, policies, and systems (such as workplace safety programs) to reduce the client's risks; (3) advising clients about risk-management alternatives to insurance (such as self-insurance, securitization, or derivatives); and (4) negotiating insurance coverages, deductibles, and premiums for an insurance client. It was represented that insurance agents and brokers provide these risk-management services to their customers in connection with the sale of insurance products, including, in particular, commercial property and casualty insurance, and other insurance activities. It also was understood that the proposed risk-management services would (1) be related to managing insurable risks, (2) be advisory in nature, and (3) not allow the risk manager to control or perform operations of its clients.

Board staff noted that most states require a person performing one or more of the insurance claims-administration services listed above to be licensed by, or registered with, the appropriate insurance authority of the state as an insurance company, an insurance agent, or a third-party administrator (TPA).¹ The legislative history of the GLB Act also suggests that the Congress

believed that insurance-related claims-administration services are a necessary part of the insurance sales and underwriting activities authorized by section 4(k)(4)(B).²

State insurance laws generally do not require companies that provide insurance risk-management services to obtain a special insurance license. However, states generally do require a license of any person who negotiates insurance coverages, deductibles, and premiums for another.³

In a legal opinion dated July 10, 2002, Board staff opined that the specific insurance claims-administration services listed above are encompassed within the insurance activities authorized by section 4(k)(4)(B) of the BHC Act and that the services may be conducted by an FHC when they are provided by an insurance agent or broker in connection with its other insurance sales activities. In addition, Board staff believes that the specific insurance risk-management services listed above are encompassed within section 4(k)(4)(B) insurance activities and that the services may be conducted by an FHC if they (1) are provided by an insurance agent or broker in connection with its other insurance sales activities, (2) involve managing insurable risks, (3) are advisory in nature, and (4) do not allow the FHC to control, or perform operations of, the person to whom the services are provided.⁴

Acting as a third-party administrator. Other legal counsel representing a BHC that had elected to become an FHC requested an opinion on whether acting as a TPA on behalf of an insurance company is an activity that is permissible for an FHC under the BHC Act. The BHC proposed to invest in a company that acts as a TPA for licensed insurance companies that underwrite and sell credit life insurance. A TPA provides one or more insurance companies with administrative and related services that support and assist the sale of insurance products by the

1. For example, the Model Third Party Administrator Statute adopted by the National Association of Insurance Commissioners (NAIC) requires a person who collects premiums or adjusts or settles claims for an insurer in connection with the sale of life or health insurance policies or annuities to register with the relevant state insurance authority as a TPA if the person is not already registered with the state as an insurance company, agent, or broker. See the NAIC Model Third Party Administrator Statute, sections 1.A and 11 (1996).

The NAIC's Model Managing General Agents Act also requires a person to register with the relevant state insurance authority if the person adjusts or pays claims for an insurer and engages in certain other activities on behalf of an insurer. See NAIC Model Managing General Agents Act, sections 2.C and 3 (1993).

2. See H.R. Rep. No. 106-74, part I, p. 122 (1999) ("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)(B)].").

3. See NAIC Producer Licensing Model Act, sections 2.K and 3 (2000).

4. A BHC or an FHC may provide advice to customers concerning financial matters, including insurance, self-insurance, securitizations, and derivatives, under 12 C.F.R. 225.28(b)(6), and may provide management consulting advice to customers regarding nonfinancial equity matters, such as workplace safety, subject to Regulation Y's limits and restrictions. See 12 C.F.R. 225.28(b)(9) (management consulting activities permissible for all bank holding companies) and 225.86(b)(1) (management consulting activities permissible for all FHCs).

insurance company. A TPA may provide some or all of the following services to an insurance company: (1) assisting the insurance company in designing its insurance programs (which would include policy and certificate development and issuance); (2) determining whether a prospective insured meets the insurance company's established underwriting guidelines; (3) collecting and processing insurance premiums; (4) processing, adjudicating, and paying claims on behalf of the insurance company; (5) investing excess cash and maintaining bank accounts for the insurance company; (6) establishing risk reserves for the insurance company; (7) advising on, and arranging for, reinsurance or stop-loss insurance for the insurance company; (8) preparing and filing tax returns and regulatory reports for the insurance company and providing other related services designed to ensure that the insurance company remains properly licensed and in compliance with applicable government regulations; (9) providing accounting and recordkeeping services to the insurance company in connection with its insurance activities; and (10) providing insurance-product sales training to employees of the insurance company. It was represented that the BHC may engage in some, but not all, of the activities in its capacity as a TPA.

The Board's staff noted that the activities listed above are directly related to the provision and sale of insurance by a third-party insurance company and constitute an integral part of the regulated insurance activities of the third-party insurance company. Consequently, most states require a person performing one or more of these services for an insurance company to be licensed by, or registered with, the appropriate insurance authority of the state either as an insurance company or agent or as a TPA. In addition to the previously stated requirements, the Model Third Party Administrator Statute (Model TPA Statute) requires a person to register as a TPA if the person accepts insurance contracts for an insurer that meet the insurer's underwriting guidelines, assists an insurer in the overall planning and coordination of its insurance program, or collects premiums or adjusts claims for an insurer.⁵

5. See the NAIC Model TPA Statute, sections 1.A and 11 (1996). A person generally does not have to register as a TPA if the person is currently registered with the state as an insurer or as an insurance agent or broker. See Model TPA Statute, section 1.A.(3) and (4).

Similarly, the NAIC's Model Managing General Agents Act requires a person to register with the relevant state insurance authority if the person manages all or part of the business of an insurer or, subject to certain conditions, accepts or

In a legal opinion dated July 10, 2002, the Board staff opined that the above-listed services are encompassed within the insurance activities authorized by section 4(k)(4)(B) of the BHC Act when provided to, or on behalf of, an insurance company in connection with the sale or underwriting of insurance. Staff concluded that an FHC could, under section 4(k)(4)(B) of the BHC Act, provide these services to a third-party insurance company.

Section 4(k)(4)(F) of the BHC Act also defines as "financial in nature" any activity that the Board determined to be closely related to banking under section 4(c)(8) of the BHC Act by a regulation or order that was in effect on November 12, 1999. Section 225.86(a)(1) of Regulation Y cross-references the long-standing "laundry list" of nonbanking activities (at section 225.28(b)) permissible by regulation for BHCs. Section 225.86(a)(2) lists nonbanking activities approved for BHCs by Board order as of November 12, 1999.⁶ All activities an FHC may engage in pursuant to section 225.86(a) must be conducted subject to the terms and conditions in Regulation Y and the Board orders authorizing those activities.

Section 4(k)(4)(G) of the BHC Act also defines "financial in nature" as any activity (1) in which a BHC may engage outside the United States and (2) that the Board has determined, by regulation or interpretations issued under section (4)(c)(13) of the BHC Act that were in effect on November 11, 1999, to be usual in conducting banking or other financial services abroad.⁷ Section 225.86(b) lists three activities that the Board has found to be usual in connection with the transaction of banking or other financial operations abroad. These activities are—

1. providing management consulting services, including services to any person with respect to nonfinancial matters, as long as the services are advisory and do not allow the FHC to control the person to whom the services are provided (these services go beyond the

rejects policies for the insurer and either adjusts or pays claims for the insurer or negotiates reinsurance for the insurer. See the NAIC Model Managing General Agents Act, sections 2.C and 3 (1993).

6. Section 20 company activities are not included in this list. Section 4(k)(4)(E) of the BHC Act authorizes FHCs to engage in securities underwriting, dealing, and market-making activities in a broader form than was previously authorized by Board order.

7. See sections 211.8 and 211.10 of Regulation K (12 C.F.R. 211.8 and 211.10).

- management consulting services that are allowed under section 225.28(b)(9) of Regulation Y and are incorporated by reference at section 225.86(a)(1));
2. operating a travel agency in connection with financial services offered by the FHC or others; and
 3. organizing, sponsoring, and managing a mutual fund, as long as the fund does not exercise managerial control over the companies in which it invests and the FHC reduces its ownership, if any, of the fund to less than 25 percent of the equity of the fund within one year (or such longer time as the Board permits) after sponsoring the fund.

The activities that a BHC is authorized to engage in outside the United States under sections 211.8 and 211.10 of Regulation K have been either (1) authorized for FHCs in a broader form by the GLB Act (for example, underwriting, distributing, and dealing in securities and underwriting various types of insurance) or (2) authorized in the same or a broader form in Regulation Y (for example, data processing activities; real and personal property leasing; and acting as agent, broker, or adviser in leasing property).⁸ The remaining activities authorized by section 4(k)(4) of the BHC Act are defined to be “financial in nature” under section 4(k)(4)(H) and (I). These are merchant banking activities conducted under section 4(k)(4)(H) through a securities affiliate or an affiliate thereof, or through an affiliate of an insurance company (as defined in section 4(k)(4)(I)(ii) when the affiliate is registered under the Investment Advisers Act of 1940 and provides investment advice to an insurance company or is an affiliate of such a registered company. Under section 4(k)(4)(I), these merchant banking activities may be conducted by an insurance company. These activities must be conducted in accordance with the restrictions and limitations under subpart J of Regulation Y, sections 225.170 through 225.177.

Section 4(k)(1)(A) of the BHC Act also allows FHCs to engage in activities that the Board, in coordination with the Secretary of the Treasury, determines to be financial in nature or incidental to such financial activity (section 4(k)(2)(A)).

8. The Board also has approved, under section 4(c)(13) of the BHC Act, activities in individual orders. Section 4(k)(4)(G) of the BHC Act does not authorize an FHC to engage in activities that the Board has authorized a BHC to provide in individual orders.

Section 225.86(d) of Regulation Y lists only one activity, acting as a finder, that has been authorized under this provision. (See section 3910.0 of this manual.)

The Board, in consultation with the Secretary of the Treasury, authorizes an FHC to engage in activities by Board order that are determined and approved to be financial in nature or incidental to a financial activity (section 225.86(e)). Only one activity has been approved by Board order under 225.86(e) in consultation with the Secretary of the Treasury: the acquisition, management, and operation in the United Kingdom of certain defined-benefit pension plans that are established by nonaffiliated third parties. This order was approved by the Board on October 12, 2007. (See section 3912.0 of this manual.)

Section 4(k)(1)(B) of the BHC Act allows FHCs to seek Board approval to engage in any activity that the Board determines to be complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. Also with regard to section 4(k)(1)(B) of the BHC Act that an activity is complementary to a financial activity, the Board determined on September 7, 2007, by order, at the FDIC’s request, that disease management and mail-order pharmacy activities complement the financial activity of underwriting and selling health insurance. (See 2007 FRB C133.) An applicant had filed an application with the FDIC for deposit insurance for a proposed *de novo* industrial loan company. The Board determined the disease management and mail-order pharmacy activities to be financial in nature under section 4(k) of the BHC Act and activities that are complementary to a financial activity. The Board conditioned its determination based on the limitations it placed on the activities in the aggregate (that is, the specified percentages of the applicants’ consolidated total assets, consolidated total annual revenues, and total capital).

Also with regard to other activities that are deemed to be complementary to a financial activity, the Board approved, on December 4, 2007, an FHC’s request to provide energy management services to owners of power generation facilities under energy management agreements. This is an activity that is complementary to the financial activities of engaging as principal in commodity derivatives and providing financial and investment advisory services for derivatives transactions. (See 2008 FRB C20.) In addition, the Board, on March 27, 2008, determined that providing energy tolling services is complementary to the financial activity of engaging in

commodity derivatives activities. (See 2008 FRB C60).

Previously, the Board had approved physical commodity trading in commodities that were CFTC-approved for trading on a U.S. futures exchange (unless specifically excluded by the Board) or that were specifically approved by the Board. With the Board's approval of its March 27, 2008, order (2008 FRB C60), the Board specifically approved physical commodity trading in commodities not CFTC-approved for trading on a U.S. futures exchange. The Board recognized that a market-maker may not seek CFTC approval for a particular commodity if there is already an established foreign trading market, which may deter a U.S. exchange from listing a product. A derivatives contract that is based on a commodity that trades on a non-U.S. exchange may be subject to a regulatory structure comparable to the one administered by the CFTC (trading on a non-U.S. exchange that may be sufficient to demonstrate that a market for the commodity in financially settled contracts exists, that the commodity is fungible, and that it has a reasonably liquid market). Within this order, the Board approved the FHC's request to take and make physical delivery of nickel, a metal that is traded on the London Metal Exchange. Within the same Board order, the Board recognized that many commodities for which derivatives contracts have not been approved for trading by the CFTC or that are not traded on a non-U.S. exchange but that trade on established alternative trading platforms may also be commodities that have viable markets with financially settled contracts on the commodities and that satisfy fungibility and liquidity concerns. Standards were established to receive Board approval to engage in physical commodity trading in non-CFTC-approved commodities traded on alternative trading platforms in the U.S. or on certain non-U.S. exchanges. The standards are consistent with the Board's existing limited physical commodity trading authority. (See section 3920.0 for more information on Board orders approving limited physical-commodity-trading activities that are complementary to a financial activity.)

Other permissible activities under section 4(k)(4)(E) of the BHC Act are underwriting and dealing in or making a market in securities without any limitation on revenues that can be derived from bank-ineligible securities. These activities must be conducted in accordance with applicable restrictions and limitations found in the BHC Act and any regulations or supervisory guidance adopted by the Board. The Board

adopted a rule pertaining to these activities.⁹ It imposed two restrictions on FHCs engaged in securities underwriting, dealing, or market-making activities. All intraday extensions of credit by a bank, thrift, or U.S. branch or agency of a foreign bank to an affiliated company engaged in these activities under section 4(k)(4)(E) must be on market terms consistent with section 23B of the Federal Reserve Act (FRA). In addition, a foreign bank that is an FHC must ensure that its U.S. branch or agency making a loan to, or purchasing securities as a principal or fiduciary from, such an affiliated company complies with sections 23A and 23B of the FRA as if the branch or agency were a member bank.

Section 4(k)(5) of the BHC Act requires the Board and the Secretary of the Treasury to define three categories of activities as financial in nature, as well as the extent to which these activities are financial in nature or incidental to a financial activity. These three categories encompass a wide range of activities:

1. lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities
2. providing any device or other instrumentality for transferring money or other financial assets
3. arranging, effecting, or facilitating financial transactions for the account of third parties

The above categories include activities in which FHCs and national banks and their financial subsidiaries are already permitted to engage. For example, the categories include safe deposit services, electronic funds transfer activities, credit and stored-value card activities, securities brokerage, and finder activities. The categories are intended to allow FHCs and financial subsidiaries to engage in activities that were not otherwise permitted for these companies. The procedure below allows an FHC or financial subsidiary to obtain a determination from the Board and the Secretary of the Treasury that an activity is financial in nature or incidental to a financial activity pursuant to section 4(k)(5).

An FHC's request for the Board to determine whether an activity falls within one of the three categories listed above must be in writing. The request must—

1. identify and define the activity for which the

9. See section 225.4(g) of Regulation Y.

determination is sought, specifically describing what the activity would be and how the activity would be conducted, and

2. provide information that supports the requested determination, including information on how the proposed activity falls into one of the three categories, as well as any other information the Board requires concerning the proposed activity.

In making its determination, the Board will take into account the same factors that it must consider when determining whether an activity is financial in nature or incidental to a financial activity. These factors include, among other

things, changes in the marketplaces in which FHCs and banks compete, changes in technology for delivering financial services, and whether the activity is necessary or appropriate to allow FHCs and their affiliates, or banks and their subsidiaries, to compete effectively with any company seeking to provide financial services in the United States.

If an activity is listed in more than one provision of section 4 of the BHC Act, the FHC may choose to conduct the activity under any applicable provision. The FHC is subject only to the procedures and limitations that the chosen source of authority imposes on the activity.

3905.0.2 ACTIVITIES THAT ARE PERMISSIBLE FOR FHCs UNDER SECTION 225.86(a) OF REGULATION Y

<i>Activities That Are Financial in Nature or That Are Incidental to a Financial Activity</i>	<i>Manual Section 3600.</i>
1. Nonbanking activities listed in section 225.28(b) of Regulation Y that have been determined to be so closely related to banking as to be a proper incident thereto (see section 3000.0.2).	
2. Any nonbanking activity that the Board has determined by order (those in effect on November 12, 1999) to be so closely related to banking as to be a proper incident thereto. The activities are—	
a. providing administrative and other services to mutual funds;	27
b. owning shares of a securities exchange;	6
c. acting as a certification authority for digital signatures, and authenticating the identity of persons conducting financial and nonfinancial transactions (includes transactions abroad);	7
d. providing employment histories to third parties for use in making credit decisions and to depository institutions and their affiliates for use in the ordinary course of business;	29
e. check-cashing and wire-transmission services; ¹	
f. in connection with offering banking services, providing notary public services, selling postage stamps and postage-paid envelopes, providing vehicle-registration services, and selling public-transportation tickets and tokens; and	25
g. real estate title abstracting.	30

1. See 1990 FRB 860 and 1995 FRB 1130.

An FHC or other interested party may request that the Board, in consultation with the Secretary of the Treasury, determine that an additional activity is financial in nature or incidental to a financial activity. The written request should (1) identify and define the activity, specifically describing what the activity would involve and

how the activity would be conducted; (2) explain in detail why the activity should be considered financial in nature or incidental to a financial activity; and (3) provide information supporting the request and any other information the Board requests concerning the proposed activity. (See section 225.88(b) of Regulation Y.)

An FHC may request an advisory opinion from the Board on whether a proposed specific activity falls within the scope of an activity already determined to be a financial activity and listed in section 225.86 of Regulation Y. The request must be in writing and provide (1) a detailed description of the activity, product, or service about which the company proposes to engage in or provide; (2) an explanation supporting an interpretation on the scope of the permissible financial activity; and (3) any other information the Board requests. (See section 225.88(e) of Regulation Y.)

An FHC may request approval to engage in an activity that is complementary to a financial activity. The written request must (1) identify the proposed complementary activity, specifically describing what the activity would involve and how it would be conducted; (2) identify the financial activity for which the proposed activity would be complementary and provide information to support a finding that the proposed activity should be considered complementary to the identified financial activity; (3) describe the scope and relative size of the proposed activity, as a percentage of projected FHC revenues and on the basis of assets associated with conducting the activity; (4) discuss the risks that conducting the proposed activity pose to the subsidiary depository institutions of the FHC and the financial system in general; (5) describe the potential adverse effects of conducting the activity and explain the proposed measures the FHC would take to address these potential effects; and (6) provide any other information the Board requests. (See section 225.89(a) of Regulation Y.)

3905.0.3 SECURITIES UNDERWRITING, DEALING, AND MARKET-MAKING ACTIVITIES

The GLB Act also authorizes securities underwriting, dealing, and market making without

regard to whether such securities may be sold by a bank. This activity includes underwriting or distributing shares of open-end investment companies commonly referred to as mutual funds.

Securities underwriting activities conducted under section 4(k)(4)(E) of the BHC Act may be conducted without regard to the 25 percent revenue limitation that is applicable to section 20 nonbank subsidiaries of BHCs engaged in securities underwriting and dealing, as authorized by Board order under section 4(c)(8). In addition, dealing may be done without regard to the 5 percent limitation on ownership of voting securities.

The operating standards applicable to section 20 companies do not apply to FHCs that engage in securities underwriting, dealing, and market making under section 4(k)(4)(E) of the BHC Act, with two exceptions. First, intraday extensions of credit to a securities firm from an affiliated bank or thrift or U.S. branch or agency of a foreign bank must be on market terms consistent with section 23B of the FRA. Second, foreign banks that are FHCs or that are treated as FHCs are required to comply with the restrictions of sections 23A and 23B of the FRA with respect to lending and securities-purchase transactions between the U.S. branch or agency of a foreign bank and a U.S. securities affiliate. The operating standards and revenue limit continue to apply to BHCs that are not FHCs and to FHCs that continue to conduct securities activities pursuant to section 4(c)(8) of the BHC Act.

3905.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws¹</i>	<i>Regulations²</i>	<i>Interpretations³</i>	<i>Orders</i>
BHCs and foreign banks that qualify as FHCs can engage in financial activities and those incidental thereto	1843			
Activities permissible for an FHC		225.86	4-056.5	
Notice requirement for FHCs engaging in a financial activity		225.87	4-056.6	
Requests for Board to determine whether an activity is financial in nature or incidental to a financial activity		225.88	4-056.7	
Request to engage in an activity that is complementary to the financial activity of engaging as principal in BHC-permissible commodity derivatives		225.89	4-056.8	2003 FRB 508 2004 FRB 215 2004 FRB 511
Physical commodity trading in energy-related commodities (natural gas, crude oil, electricity, and emissions allowances) as a complement to a financial activity	1843(k)(1)(B)			2006 FRB C54 2006 FRB C57 2006 FRB C113
Disease management and mail-order pharmacy activities are complementary to the financial activity of underwriting and selling health insurance	1843(k)(1)(B)			2007 FRB C133
Providing energy management services is complementary to the financial activities of engaging as principal in commodity derivatives and providing derivatives investment advisory services	1843(k)(1)(B)			2008 FRB C20

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. *Federal Reserve Regulatory Service* reference.

<i>Subject</i>	<i>Laws¹</i>	<i>Regulations²</i>	<i>Interpretations³</i>	<i>Orders</i>
Providing energy tolling services as a complement to the financial activity of engaging in commodity derivatives activities	1843(k)(1)(B)			2008 FRB C60
Trading in commodities not approved by the CFTC for trading on a U.S. futures exchange (e.g., nickel on London Metal Exchange) or on certain non-U.S. exchanges				2008 FRB C60

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. *Federal Reserve Regulatory Service* reference.

In 2007, the Federal Deposit Insurance Corporation (FDIC) requested the Board to determine whether the disease management and mail-order pharmacy activities are permissible for a financial holding company (FHC) under the Bank Holding Company Act (BHC Act), as amended by the Gramm-Leach-Bliley Act (GLB Act). WP had filed an application with the FDIC to obtain deposit insurance for AFB, a proposed U.S.-based de novo industrial loan company (ILC).¹

Section 4(k) (see 12 U.S.C. 1843(k)(4)) of the BHC Act permits a bank holding company (BHC) that qualifies to be an FHC to engage in a broad range of activities that are defined by statute to be financial in nature. The FDIC requested that the Board determine the permissibility of WP's disease management and mail-order pharmacy activities under the BHC Act, as amended by the GLB Act, in connection with the FDIC's moratorium then in place on actions on ILC applications by companies engaged in any nonbanking activity *not* permissible for an FHC.

WP is principally engaged in underwriting and selling health insurance and related activities. Underwriting and selling health insurance as principal, agent, or broker are activities deemed by Congress in the GLB Act to be financial in nature.² WP, through its regulated insurance company subsidiaries, provides health insurance. WP's insurance offerings include preferred provider, health maintenance, point of service, Medicare and Medicaid health plans; vision, dental, pharmacy benefit, life, disability, and long-term care insurance products; and consumer-directed, high-deductible, and limited-service health insurance products. WP also engages in a variety of related activities, including claims processing.

WP also provides disease management and mail-order pharmacy services through subsidiaries to persons who obtain health insurance from WP or another insurance company. Through its disease management services, WP provides insurance plan members with access to a variety of tools and resources designed to help them maintain healthy lifestyles and properly manage

their medical conditions. These disease management services typically are provided by, or under the direction of, licensed health-care professionals (including doctors and nurses) employed by WP. WP's subsidiaries engage in providing mail-order pharmacy services, fill prescriptions for customers who have pharmacy benefit insurance coverage from WP or another insurance company, provide drug-related information to customers, and track potential issues with customer prescriptions, such as drug interactions. WP's mail-order pharmacy subsidiaries are state-licensed and employ state-licensed pharmacists.

WP's disease management and mail-order pharmacy activities are not within the scope of activities that the Board previously determined to be financial in nature, incidental to a financial activity, or complementary to a financial activity under the provisions of the BHC Act. The activities do not themselves involve providing insurance, are not regulated as insurance by state insurance authorities, and are not provided by an affiliate that is licensed as an insurance company or as an insurance agent or broker. Both activities involve the provision of health-care services that, while related to insurance underwriting activities, are themselves non-financial activities. The Board concluded, however, for the reasons set forth below, that there is a reasonable basis for construing these activities as complementary to a financial activity within the meaning of the GLB Act.

WP's disease management and mail-order pharmacy services help employers that obtain health insurance from an insurance company to manage and reduce the risks and costs of providing health insurance to employees. In its submissions to the Board, WP provided data demonstrating that many of the largest health insurers in the U.S. provide these services to their own customers and those of other health insurance companies and that employer-customers of health insurance companies often demand such services.

Based on the foregoing, the information provided by WP, and other facts of record, the Board concluded that disease management and mail-order pharmacy activities complement the financial activity of underwriting and selling health insurance. Section 4(k)(1)(B) of the BHC Act requires that the Board determine that any proposed complementary activity does not pose a substantial risk to the safety or soundness of depository institutions or the financial system

1. Under section 4(c)(2)(H) of the BHC Act, an exemption is provided from the definition of "bank" for ILCs. A BHC may own, control, or operate an ILC, provided that it is not a bank. Under section 225.28(b)(4) of the Board's Regulation Y, a BHC may acquire or retain an industrial bank to the extent authorized by state law.

2. See section 4(k)(4)(B) of the BHC Act (12 U.S.C. 1843(k)(4)(B)).

generally.³ Moreover, the Board previously has stated that complementary activities should be limited in size and scope relative to the financial activities that they complement.⁴ As a condition of its determination that the proposed activities are complementary to a financial activity, the Board required that these activities in the aggregate not account for more than 2 percent of WP's consolidated total assets or 5 percent of its consolidated total annual revenues. In addition, the total assets of WP's subsidiaries engaged in disease management or mail-order pharmacy activities in the aggregate could not exceed 5 percent of the total capital (calculated in accordance with applicable statutory accounting principles) of all regulated insurance company subsidiaries and health plans of WP. The Board

also considered how WP managed and addressed the risks posed by the activities through insurance training and other measures. The Board also stated that any future extensions of credit by AFB to, or other covered transactions by AFB with, these or other affiliates, including any covered transaction with an unaffiliated person the proceeds of which are transferred to or used for the benefit of an affiliate, must comply with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.⁵ For these reasons, the Board concluded that the proposed activities would not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The Board approved the order on September 7, 2007 (The previous discussion is only a summary. See the full text of the Board order at 2007 FRB C133).

3. See section 4(k)(1)(B) of the BHC Act (12 U.S.C. 1843(k)(1)(B)).

4. See 68 Federal Register 68493, 68497 (December 9, 2003).

5. See the Federal Reserve Act, sections 371c and 371c-1 (12 U.S.C. 371c, 371c-1) and 12 C.F.R. Part 223.

3907.0.1 MERCHANT BANKING INVESTMENT AUTHORITY

The Gramm-Leach-Bliley Act (GLB Act) and the Board's Regulation Y permit financial holding companies (FHCs) (but not bank holding companies (BHCs) generally) to make investments as part of a bona fide securities underwriting or merchant or investment banking activity.¹ These investments may be made in any type of ownership interest in any type of nonfinancial entity (portfolio company), and they may include any amount up to all of the ownership interests in the company. The investments that may be made are substantially broader in scope than the investment activities that are otherwise permissible for BHCs.

The authority section 4(k)(4)(H) of the Bank Holding Company Act (BHC Act) grants to FHCs to make merchant banking investments (MBIs) is an alternative to any other authority that the FHC may have to make investments in nonfinancial companies under other provisions of the BHC Act, except as specifically noted in the rule. For example, the rule's provisions do not apply to investments acquired as part of securities underwriting, dealing, or market-making activities conducted under section 4(k)(4)(E) of the BHC Act; investments made by insurance underwriting subsidiaries of an FHC in accordance with section 4(k)(4)(I) of the BHC Act; investments made under section 4(c)(6) or (7) of the BHC Act; or investments made overseas under the Board's Regulation K (12 C.F.R. 211).² As described below, the BHC Act allows an FHC to make MBIs if it controls a securities affiliate or controls both an insurance underwriter and a registered investment adviser. The GLB Act does contain certain limitations on MBIs made by FHCs, and it provides a framework for MBIs that is designed to help maintain the separation between banking and commerce to ensure the safety and soundness of depository institutions. All MBIs made by an

1. Unless stated otherwise in this section, the "merchant banking statutory provisions" refer to section 4(k)(4)(H) of the Bank Holding Company Act, and references to the "rule" or "regulatory provisions" pertain to Regulation Y and are found in sections 225.170 through 225.177.

2. Although the rule does not apply to investments held under section 4(c)(6) or (7) of the BHC Act or the Board's Regulation K, those authorities are only available if the FHC's aggregate investment in the relevant company under a combination of authorities, including any investment made under the merchant banking authority, is within the applicable investment limitations and restrictions set forth in section 4(c)(6) or (7) or Regulation K.

FHC under section 4(k)(4)(H) must comply with the Board's rule.

3907.0.2 PERMITTED INVESTMENTS

Under section 4(k)(4)(H) of the BHC Act and the Board's rule, an FHC may acquire or control *any* amount of shares, assets, or a full range of ownership interests in a company or other entity that is engaged in an activity that is *not* financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4 of the BHC Act. The interests an FHC may acquire include securities, warrants, partnership interests, trust certificates, other instruments representing an ownership interest in a company, and instruments convertible into a security or other ownership interest whether the interest is voting or nonvoting. An FHC can acquire *any amount* of ownership interests in the company or other entity, whether or not that amount results in control for purposes of the BHC Act. An FHC must file a notice with the Board under section 4(k)(6) of the BHC Act and section 225.87 of Regulation Y (12 C.F.R. 225.87) within 30 days after commencing MBI activities or acquiring any company that makes MBIs.³

An FHC also can acquire and control "assets" other than debt or equity securities or other ownership interests of a company. For example, assets acquired as an MBI may include real estate or the assets of a division of an operating company. To be permissible, the assets must be acquired through or promptly transferred to a portfolio company that has and maintains a separate corporate existence, management, and operations to the extent required by the rule. (See section 225.170(e)(3) of Regulation Y.)

3907.0.2.1 Securities Affiliate

A BHC may make MBIs only if it becomes an FHC.⁴ The FHC must either (1) control or be a "securities affiliate" or (2) control both an insurance underwriter affiliate and an invest-

3. See section 4(k)(6)(A) of the BHC Act (12 U.S.C. 1843(k)(6)(A)) and section 225.87(a) of Regulation Y (12 C.F.R. 225.87(a)).

4. The Board's Regulation Y sets forth the procedures and qualification criteria applicable to BHCs that seek to elect to become an FHC. See section 225.81 et seq. of Regulation Y (12 C.F.R. 225.81 et seq.).

ment adviser affiliate registered under the Investment Advisers Act of 1940 that provides investment advice to an insurance company. The GLB Act and the rule, however, do *not* require that the FHC make its MBIs *through* such a securities, insurance underwriting, or investment adviser affiliate. Instead, an FHC may make MBIs directly or through any affiliate other than a depository institution or a subsidiary of a depository institution.

The rule defines a “securities affiliate” to include any broker or dealer registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). The definition also includes an SEC-registered municipal securities dealer, including a separately identifiable division or department of a bank that is registered as a municipal securities dealer under the Exchange Act. An FHC may make MBIs if the holding company is itself a registered securities broker or dealer.

3907.0.2.2 Investments in Companies Engaged in Nonfinancial Activities

An FHC is authorized under section 4(k)(4)(H) of the BHC Act to acquire or control a company or entity “engaged in any activity not authorized pursuant to [section 4 of the BHC Act].” An FHC may not make MBIs in financial companies under section 4(k)(4)(H) or the rule. FHCs have separate authority under other provisions of the BHC Act to make investments in companies engaged in financial activities. However, a company held as an MBI may be engaged in both nonfinancial and financial activities, and an FHC may retain an MBI in a nonfinancial company even if the company subsequently commences a financial activity. An FHC also is not prohibited from using a combination of authorities to invest, through the same subsidiary or fund, in ownership interests of both nonfinancial and financial companies.

Investments in financial companies are not authorized in section 4(k)(4)(H) of the BHC Act. The rule’s restrictions, such as those for holding periods and cross-marketing, therefore do not apply to FHC investments in financial companies that are made under other provisions of the BHC Act and the Board’s Regulation Y—even if such investments are made for strategic reasons or for reselling the investment. An FHC may not, however, use the merchant bank-

ing authority to evade restrictions, such as consent or approval requirements or restrictions that address conflicts of interest or that govern the acquisition of financial companies.⁵ In addition, nothing in section 4(k)(4)(H) or the rule overrides the prior-approval requirements of section 3 of the BHC Act, which governs the acquisition of shares of a bank or BHC, or the provisions of section 4(k)(6) and (j) of the BHC Act, which governs the acquisition of shares of a savings association or a company that controls a savings association.

3907.0.2.3 Bona Fide Underwriting or Merchant Banking or Investment Activity

An FHC may only make MBIs as part of a bona fide underwriting or merchant banking or investment banking activity.⁶ An FHC is not authorized to make an investment in a nonfinancial company for the purpose of engaging in the activities of the nonfinancial company, such as real estate investment or development or other activities that have not been found to be financial in nature. This “bona fide” requirement thus preserves the financial nature of MBI activities and the separation of banking from commerce.

The bona fide requirement does not prohibit an FHC from specializing in making MBIs in particular industries or from making its first MBI in a company engaged in real estate investment or development. However, such investments should be made only for investment as part of an ongoing underwriting or investment or merchant banking activity, and they should be held in accordance with the Board’s rules.⁷

3907.0.2.3.1 Investments Made Directly or Through Funds

An FHC may acquire or control MBIs directly or through any subsidiary *other than* a depository institution or subsidiary of a depository institution. An FHC also may *not* acquire or control MBIs on behalf of a depository institution or subsidiary of a depository institution. A

5. See section 4(l)(2) of the BHC Act (12 U.S.C. 1843(l)(2)) and section 225.84 of Regulation Y (12 C.F.R. 225.84).

6. See section 4(k)(4)(H) of the BHC Act (12 U.S.C. 1843(k)(4)(H)).

7. Concentration in particular industries or in individual investments may present supervisory concerns. The Board expects all FHCs that engage in MBI activities to establish policies governing portfolio diversification and to maintain capital that is adequate, considering the FHC’s investment portfolio. See section 3900.0 of this manual and SR-00-9.

U.S. branch or agency of a foreign bank is considered a “depository institution” for purposes of the merchant banking rule and its related restrictions. Accordingly, a U.S. branch or agency of a foreign bank may not acquire or control MBIs, and MBIs may *not* be acquired or controlled on behalf of a U.S. branch or agency of a foreign bank.

An FHC is allowed to make MBIs through a private equity fund or other investment fund that, in turn, invests in nonfinancial companies. When an FHC makes such an investment, the holding company’s investment in the fund is considered an MBI that must comply with the rule. Certain benefits for investments in or held through a qualifying private equity fund are provided, including an extended holding period and certain relief from the rule’s cross-marketing restrictions. Investments in funds that do not qualify as private equity funds are treated as any other type of MBI.

3907.0.2.3.2 Definition of Portfolio Company and Financial Holding Company

Some of the rule’s requirements—such as the restrictions on routine management and operation—apply only to portfolio companies. A “portfolio company” means any company or entity that is directly or indirectly held, owned, or controlled by an FHC that is using the merchant banking authority, and the company or entity is engaged in an activity that is not authorized for the FHC under section 4 of the BHC Act. (See section 225.177 of Regulation Y.)

The term “financial holding company,” as used in the rule, refers to the FHC and any direct or indirect subsidiary of the holding company (including a private equity fund or other fund controlled by the FHC). The term does not include—

1. a portfolio company that is controlled by the FHC or
2. any depository institution controlled by the FHC or any subsidiary of such a depository institution, unless otherwise provided in the rule.

3907.0.3 LIMITS ON MANAGING OR OPERATING A PORTFOLIO COMPANY HELD AS A MERCHANT BANKING INVESTMENT

The GLB Act prohibits an FHC from routinely

managing or operating a portfolio company, except as may be necessary or required to obtain a reasonable return on the resale or disposition of the investment. (See section 225.171 of Regulation Y.)

3907.0.3.1 Relationships That Involve Routine Management or Operation

An FHC routinely manages or operates a portfolio company if any director, officer, or employee of the FHC serves as or has the responsibilities of an executive officer of the portfolio company. The term “executive officer” has the same meaning as used in the Board’s Regulation O. This definition includes any person who participates or has the authority to participate (other than in the capacity of a director) in major policymaking functions of the portfolio 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.⁸ (See section 225.177(d) of Regulation Y and 12 C.F.R. 215.2(e)(1).) An FHC is also considered to routinely manage or operate a portfolio company if an executive officer of the parent FHC or certain of its major subsidiaries serves as (or has the responsibilities of) an officer or employee of the portfolio company. For the purposes of these restrictions, an FHC’s major subsidiaries include any subsidiary that is (1) a depository institution, (2) an SEC-registered broker-dealer, (3) engaged in MBI activities or insurance company investment activities under section 4(k)(4)(H) or (I) of the BHC Act, (4) a small business investment company, or (5) engaged in significant equity investment activities that are subject to a special capital charge under the Board’s capital guidelines (for example, a company engaged in investment activities under section 4(c)(6) or (7) of the BHC Act). An FHC also is considered to routinely manage or operate a portfolio company if

8. An executive officer does not include a person who may exercise a certain measure of discretion in the performance of his or her duties, including the discretion to make decisions in the ordinary course of business, but who does not participate in the determination of major policies of the company and whose decisions are limited by policy standards fixed by senior management. In addition, the term does not include any person who is excluded from participating (other than in the capacity of a director) in major policymaking functions of the company by resolution of the board of directors or by the bylaws of the company, provided the person does not in fact participate in such policymaking functions.

it restricts, by covenants, agreements, or otherwise, the portfolio company's ability to make routine business decisions. Covenants or agreements that involve routine business decisions include covenants that restrict the portfolio company's ability to enter into transactions in the ordinary course of business or to hire nonexecutive officers or employees. As described below, an FHC may have covenants and agreements that restrict actions that are outside the ordinary course of business.

In addition, an FHC is presumed to be involved in the day-to-day management or operations of a portfolio company if a director, officer, or employee of the FHC serves as a nonexecutive officer or employee of the portfolio company or if an officer or employee of the portfolio company is supervised by or reports to an officer or employee of the FHC. An FHC may rebut this presumption by presenting specific facts demonstrating that the junior-officer or employee interlock with the portfolio company would not involve the investing FHC in the routine management and operating of the company.⁹ Any request to rebut a presumption must be made to the Board and should fully describe all the facts and circumstances related to the FHC's investment in and relationships with the portfolio company.

3907.0.3.2 Relationships That Do Not Constitute Routine Management or Operation

The rule identifies several relationships that an FHC may have with a portfolio company that would *not* involve the FHC in routinely managing or operating the portfolio company.¹⁰ The following relationships allow the FHC to monitor and provide strategic and financial advice to a portfolio company without becoming involved in the day-to-day management or operations of the company:

1. *Director interlocks.* An FHC may have one or more representatives on the board of directors of a portfolio company. The Board considers the selection of the partners (including the general partner) of a partnership to be the equivalent of selecting the directors of a

company. An FHC representative who serves as a director of a portfolio company may participate fully in those matters that are typically presented to directors of a company, whether the director participates in these matters at a meeting of the board, at meetings of committees of the board, through written votes, through meetings with officers or employees of the portfolio company, or in other ways. The FHC's director representatives, however, may not participate in the day-to-day operations of the portfolio company or in management decisions that are made in the ordinary course of business and that are not customarily presented to the directors of a company. The portfolio company also must have officers and employees that routinely manage and operate the company, and the FHC must not have other arrangements or relationships with the portfolio company that would involve the FHC in the routine management or operation of the portfolio company.

2. *Covenants concerning actions outside the ordinary course of business.* An FHC may restrict, by covenant or otherwise, the ability of a portfolio company to take actions that are outside the ordinary course of business. Some examples of actions that are outside the ordinary course of business and that may be subject to these types of covenants or agreements are—

- a. the acquisition of significant assets or control of another company by the portfolio company or any of its subsidiaries;
- b. the removal or selection of the portfolio company's independent accountant or investment banker;
- c. significant changes to the portfolio company's business plan or accounting methods or policies;
- d. the removal or replacement of any or all of the executive officers of the portfolio company;
- e. the redemption, authorization, or issuance of any equity or debt securities of the portfolio company;
- f. any borrowing by the portfolio company that is outside the ordinary course of business;
- g. the amendment of the portfolio company's articles of incorporation, bylaws, or similar governing documents; and
- h. the sale, merger, consolidation, spin-off, recapitalization, liquidation, dissolution, or sale of substantially all of the assets of the portfolio company or any of its significant subsidiaries.

9. See section 225.171(c) of Regulation Y (12 C.F.R. 225.171(c)).

10. See section 225.171(d) of Regulation Y (12 C.F.R. 225.171(d)).

3. *Providing advisory and underwriting services to and consulting with a portfolio company.* An FHC also may provide financial, investment, or management consulting advisory services to the portfolio company in accordance with applicable limitations under Regulation Y.¹¹ Any management consulting services provided to a portfolio company must remain solely advisory, and the FHC may not assume responsibility for decision making or for the day-to-day management or operations of the portfolio company.¹² An FHC may also underwrite or act as placement agent for the securities of a portfolio company and provide assistance to the portfolio company in connection with the underwriting or placement of its securities without being considered to be involved in routinely managing or operating the company. An FHC also may have regular or periodic meetings with the officers or employees of a portfolio company to monitor and provide advice regarding the portfolio company's performance or activities, so long as the FHC, through such meetings or otherwise, does not routinely manage or operate the portfolio company.

3907.0.3.2.1 Other Permissible Covenants Not Involving the FHC in Routinely Managing and Operating a Portfolio Company

Listed below are some additional examples of covenants that an FHC may have with a portfolio company without routinely managing or operating the portfolio company.^{12a} In particular, an FHC may, consistent with the GLB Act and section 225.171(d) of Regulation Y, have covenants with a portfolio company that restrict the ability of the portfolio company to—

1. alter its capital structure through the issuance, redemption, authorization, or sale of any equity or debt securities of the portfolio company;^{12b}
2. establish the general purpose for funds sought

11. See sections 225.28(b)(6) and 225.86(b)(1) of Regulation Y (12 C.F.R. 225.28(b)(6) and 12 C.F.R. 225.86(b)(1)).

12. See sections 225.28(b)(9) and 225.86(b)(1) of Regulation Y (12 C.F.R. 225.28(b)(9) and 12 C.F.R. 225.86(b)(1)).

12a. See letter from Virgil Mattingly, the Federal Reserve Board's general counsel, to Peter T. Grauer, Credit Suisse First Boston, dated December 21, 2001.

12b. For these purposes, the phrase "equity and debt securities" includes options, warrants, obligations, or other instruments that give the holder the right to acquire securities of the portfolio company.

- to be raised through the issuance or sale of any equity or debt securities of the portfolio company (for example, retirement of existing debt, acquisition of another company, or general corporate use);
3. amend the terms of any equity or debt securities issued by the company;
4. declare a dividend on any class of securities of the portfolio company or change the dividend-payment rate on any class of securities of the portfolio company;
5. engage in a public offering of securities of the portfolio company;
6. register a class of securities of the portfolio company under federal or state securities laws;
7. list (or de-list) any securities of the portfolio company on a securities exchange;
8. create, incur, assume, guarantee, refinance, or prepay any indebtedness outside the ordinary course of business of the portfolio company;
9. voluntarily file for bankruptcy, or consent to the appointment of a receiver, liquidator, assignee, custodian, or trustee of the portfolio company for purposes of winding up its affairs;
10. significantly alter the regulatory, tax, or liability status of the portfolio company (examples of actions that would significantly alter the regulatory, tax, or liability status of the portfolio company include the registration of the portfolio company as an investment company under the Investment Company Act of 1940, or the conversion of the portfolio company from a corporation to a partnership or limited-liability company);
11. make, or commit to make, any capital expenditure that is outside the ordinary course of business of the portfolio company, such as the purchase or lease of a significant manufacturing facility, an office building, an asset, or another company;
12. engage in, or commit to engage in, any purchase, sale, lease, transfer, or other transaction outside the ordinary course of business of the portfolio company, which may include for example—
 - a. entering into a contractual arrangement (including a property lease or consulting agreement) that imposes significant financial obligations on the portfolio company;
 - b. the sale of a significant asset of the portfolio company (for example, a signifi-

- cant patent, manufacturing facility, or parcel of real estate);
- c. the establishment of a significant new subsidiary by the portfolio company;
 - d. the transfer by the portfolio company of significant assets to a subsidiary or to a person affiliated with the portfolio company; or
 - e. the establishment by the portfolio company of a significant new joint venture with a third party;
13. hire, remove, or replace any or all of the executive officers of the portfolio company;^{12c}
 14. establish, accept, or modify the terms of an employment agreement with an executive officer of the portfolio company, including the terms setting forth the executive officer's salary, compensation, and severance;
 15. adopt or significantly modify the portfolio company's policies or budget concerning the salary, compensation, or employment of the officers or employees of the portfolio company generally;
 16. adopt or significantly modify any benefit plan covering officers or employees of the portfolio company, including defined benefit and defined contribution retirement plans, stock option plans, profit sharing, employee stock ownership plans, or stock appreciation rights plans;
 17. alter significantly the business strategy or operations of the portfolio company, for example, by entering or discontinuing a significant line of business or by altering significantly the tax, cash-management, dividend, or hedging policies of the portfolio company; or
 18. establish, dissolve, or materially alter the duties of a committee of the board of directors of the portfolio company.

Some of the above actions by their very nature are outside the ordinary course of business of a portfolio company and, thus, may be subject to a covenant with the portfolio company. For example, covenants restricting the ability of a portfolio company to issue or redeem its equity or debt securities or hire or fire its executive officers are unusual actions that typically are taken only by or in consultation with the company's board of directors.

^{12c}. The term "executive officer" is defined in section 225.171 of Regulation Y.

Covenants concerning other types of actions may, or may not, involve the FHC in routine business decisions of the portfolio company, depending on the specific scope of actions covered by the covenant and the size and characteristics of the portfolio company. To provide FHCs maximum flexibility in structuring their relationships with portfolio companies to the extent permitted by the GLB Act, several of the examples included above permit an FHC to restrict the ability of a portfolio company to take certain actions whenever the actions are significant.

The measure of "significant" in this context would depend on the size, capital, condition, business, and other characteristics of the portfolio company. In determining what is significant for a particular portfolio company, one rule of thumb is that any action that would, under ordinary business practices, be presented to the board of directors of the portfolio company for approval or consideration may also be subject to a covenant that requires review and approval of the action by the financial holding company investor. In this way, the rule permits a financial holding company investor to exercise the same type of review and approval rights through a covenant that the FHC could exercise directly through representation on the board of directors of the portfolio company. As with a director representative, however, an FHC may not use a covenant as a means to become involved in routine business decisions made in the ordinary course of the portfolio company's day-to-day business activities.

There also may be situations in which a covenant is permissible even though the actions involved are ones that, under ordinary business practices, would not be considered by the board of directors of the portfolio company. It is expected that these situations would be unusual and the permissibility of such a covenant would likely depend on the particular facts and circumstances involved in the case.

3907.0.3.2.2 FHC May Routinely Manage or Operate a Portfolio Company in Special Circumstances

An FHC may routinely manage or operate a portfolio company only when such action is "necessary or required to obtain a reasonable return on [the] investment upon resale or disposition." Examples of situations in which intervention may be needed would be when the portfolio company experiences a significant operating loss or when there is a loss of senior

management. Once the FHC has taken appropriate action to obtain a reasonable return on the resale or disposition of the investment, the GLB Act requires the FHC to cease routinely managing or operating the portfolio company. The FHC may routinely manage or operate a portfolio company only for the period of time that may be necessary to address the cause of the holding company's involvement in the routine management or operations of the portfolio company, to obtain suitable management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return on the resale or disposition of the investment. The determination of whether and how long FHC intervention is necessary or required will depend on the facts and circumstances of the particular investment.

Two requirements in the rule assist the Federal Reserve in monitoring the interventions of FHCs in the routine management or operations of portfolio companies. These requirements ensure that such actions are consistent with the GLB Act's limitations. First, FHCs are required to maintain and make available to the Board on request a written record describing the company's involvement in routinely managing or operating any portfolio company.¹³ Second, an FHC is required to provide the Board with written notice if the company routinely manages or operates a portfolio company for more than nine months.¹⁴ The notice may be in the form of a letter and should identify the portfolio company, the date on which the FHC first became involved in the routine management or operations of the portfolio company, the reasons for the involvement, and the actions that the FHC has taken to address the circumstances giving rise to the intervention, as well as provide an estimate of when the FHC anticipates it will cease routinely managing or operating the portfolio company.

3907.0.3.3 Depository Institutions Prohibited from Managing or Operating Portfolio Companies

A depository institution or a subsidiary of a depository institution may not routinely manage or operate a portfolio company held by an FHC. As noted above, U.S. branches and agencies of foreign banks are considered depository institutions for purposes of the rule. A director, officer, or employee of a depository institution or its

subsidiary, as well as a U.S. branch or agency, however, is not prohibited from serving as a director of a portfolio company to the same extent as would be permitted for a director, officer, or employee of an FHC. Such director, officer, or employee is also not prohibited from taking other actions that the rule does not define to be routine management or operation. In addition, a depository institution is not prevented from having covenants or from taking actions pursuant to covenants that are typically found in credit agreements to ensure repayment of extensions of credit in the ordinary course of business, provided the covenant or action is not an attempt to evade the rule's restrictions.

The rule also does not apply the prohibition on a depository institution routinely managing or operating a portfolio company to a financial subsidiary of a bank that is held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the Federal Deposit Insurance Act (FDI Act). The prohibition also does not apply to a small business investment company subsidiary of a bank held in accordance with the Small Business Investment Act of 1958. These subsidiaries may, however, exercise routine management or operation only in accordance with the limitations that apply to FHCs.

3907.0.4 HOLDING PERIODS FOR MERCHANT BANKING INVESTMENTS

The GLB Act requires that any shares, assets, and ownership interests acquired as an MBI be held only for a period of time that enables the sale or disposition of the interest on a reasonable basis, consistent with the financial viability of the FHC's merchant banking activity. The rule permits an FHC to hold any MBI for a period of up to 10 years. In addition, the rule allows an FHC to own or control an MBI in or through a private equity fund (as defined below) for the life of the fund, up to 15 years.¹⁵

An FHC may hold an MBI beyond the rule's specified time periods only with the Board's prior approval. A request by an FHC for an extension of the applicable holding period must be filed at least 90 days before the expiration of the holding period. An extension request must provide the reasons for the request (including

13. See section 225.171(e)(4) of Regulation Y (12 C.F.R. 225.171(e)(4)).

14. See section 225.171(e)(3) of Regulation Y (12 C.F.R. 225.171(e)(3)).

15. See section 225.172 of Regulation Y (12 C.F.R. 225.172).

the factors listed below), explain the FHC's plan for divesting the investment, and discuss the factors that the Board may consider in reviewing the request. Factors to be included in the extension request are the cost to the FHC of disposing of the investment within the applicable time period, the total exposure of the FHC to the portfolio company and the risks that disposing of the investment without an extension may pose to the FHC, market conditions, the nature of the portfolio company's business, the extent and history of the FHC's involvement in the management and operations of the portfolio company, and the average holding period of the FHC's MBIs. The Board may also consider any other relevant information related to the investment.

If an FHC receives permission to hold an MBI beyond the applicable holding period, a special capital charge applies to the investment. The Board must set this charge at a rate that is above the highest marginal tier 1 capital charge applicable under the Board's capital guidelines for MBIs held by that FHC, but the rate may not be below 25 percent of the adjusted carrying value of the investment as reflected on the FHC's balance sheet. The Board may also impose other restrictions it determines to be appropriate in connection with granting the extension request.

the firm's capital with capital provided by third-party investors, such as investment companies, pension funds, endowments, financial institutions or corporations, and sophisticated individual investors who have a high net worth. Frequently, these pooled investment vehicles have characteristics (such as limited terms, manager-compensation arrangements, and the presence of third-party investors that monitor investments) that encourage the fund to dispose of its investments in a relatively short period of time. Considering such characteristics, and to

3907.0.4.1 Holding-Period Tacking Provisions

The rule includes special "tacking" provisions to prevent an FHC from circumventing the holding periods on MBIs by transferring an MBI from one company or fund to another.¹⁶ The rule also provides that, for purposes of calculating compliance with the merchant banking holding periods, an investment the FHC acquires under another authority that imposes a restriction on the amount of time that the FHC may hold the investment is considered to have been acquired on the original acquisition date.

3907.0.5 PRIVATE EQUITY FUNDS

As noted above, the rule permits an FHC to make MBIs directly or through funds that pool

16. See section 225.172(b)(2) and (3) of Regulation Y (12 C.F.R. 225.172(b)(2) and (3)).

accommodate industry practice on investment funds, the rule includes several special provisions for MBI activities conducted through a qualifying “private equity fund.” The provisions include a longer holding period for private equity fund investments, a higher aggregate investment threshold for review of an organization that makes investments in or through private equity funds, and streamlined reporting and recordkeeping provisions for investments in or held through private equity funds.

3907.0.5.1 Definition of Private Equity Fund

To qualify as a “private equity fund” under the rule, the fund must have a fixed duration of not more than 15 years including all potential extensions, and the FHC (including its officers, directors, employees, and principal shareholders) may not own more than 25 percent of the total equity of the fund. There are no limits on advisory fees or on the various types of incentive compensation that the FHC may receive for services rendered to the fund, provided such fees do not increase the FHC’s equity stake in the fund above the 25 percent threshold.

A private equity fund also may not be an operating company and must be engaged exclusively in the business of investing in financial and nonfinancial companies for resale or other disposition. In addition, the fund may not be established or operated for the purpose of making investments that are inconsistent with section 4(k)(4)(H) of the BHC Act or evading the limitations of the GLB Act or the rule.

A private equity fund can be organized in any form, including a partnership, corporation, or limited-liability company. In addition, the fund may, but need not be, registered as an investment company under the federal securities laws.

3907.0.5.2 Permissible Holding Period for Private Equity Fund Investments

As noted above, an FHC, without Board approval, may own or control an investment in a private equity fund that makes MBIs for the duration of the fund, which may be up to 15 years. A qualifying private equity fund may therefore hold investments in portfolio companies for up to 15 years, and it is not required to dispose of its investments within the 10-year period applicable to other types of MBIs. In special circumstances, an FHC may seek the Board’s approval

to retain an investment in a qualifying private equity fund or to extend the duration of a private equity fund for a period longer than 15 years.¹⁷ (See section 3907.0.5 of this manual for a discussion of how an FHC may request an extension of this holding period.)

3907.0.5.3 Routine Management and Operation Restrictions for Private Equity Funds

The GLB Act and the rule generally prohibit an FHC from routinely managing or operating any portfolio company—that is, any company engaged in nonfinancial activities.¹⁸ These restrictions apply regardless of whether the FHC owns or controls its interest in the portfolio company directly or through a private equity fund. Accordingly, an FHC may not routinely manage or operate a portfolio company that is owned or controlled by a private equity fund in which the FHC owns or controls any ownership interest, except in the limited circumstances permitted by the rule.¹⁹ In addition, if an FHC controls a private equity fund, the private equity fund is a subsidiary of the FHC and the *private equity fund* must abide by the rule’s limits on routine management and operation of portfolio companies. An FHC, however, is not prohibited from routinely managing or operating the private equity fund itself.

An FHC is considered to control a private equity fund for the purpose of the rule if the FHC or any director, officer, employee or principal shareholder of the company (1) serves as a general partner, managing member, or trustee of the private equity fund; (2) owns or controls in the aggregate 25 percent or more of any class of voting shares or similar interests in the fund; (3) selects, controls, or constitutes a majority of the directors, trustees, or management of the fund; or (4) owns or controls more than 5 percent of any class of voting shares or similar ownership interests in the fund and serves as the fund’s investment adviser.

17. The holding-period tacking rules in section 225.172(b)(2) and (3) of Regulation Y must be applied when a private equity fund investment has been held longer than the permitted time.

18. See sections 225.177(c) and 225.171(a) of Regulation Y (12 C.F.R. 225.177(c) and 225.171(a)).

19. See section 225.171(e) of Regulation Y (12 C.F.R. 225.171(e)).

3907.0.5.4 Other Matters Related to Private Equity Funds

When an FHC has a passive (that is, noncontrolling) investment in a private equity fund that is advised and controlled by an unaffiliated entity, any shares owned by the fund generally are not considered to be owned or controlled by the passive FHC investor.²⁰ Therefore, the rule's cross-marketing restrictions on the products or services of a portfolio company, the limitations of sections 23A and 23B of the FRA, and the rule's reporting and recordkeeping requirements *do not apply* to investments in portfolio companies that are held by a private equity fund and that are not controlled by the FHC. These restrictions and requirements (other than the cross-marketing restrictions) would, however, apply to the FHC's investment in the private equity fund and would govern the relationship of the FHC with the private equity fund.

3907.0.5.4.1 Funds That Are Not Qualifying Private Equity Funds

An FHC is permitted to invest in and control a fund that does not meet the private equity fund definition. If the FHC controls the nonqualifying fund, then the provisions of the rule, including the holding-period provisions for portfolio companies, the routine-management restrictions, the risk-management and recordkeeping requirements, the cross-marketing provisions, and the section 23A provisions, apply to investments made by the nonqualifying fund in the same manner as those provisions would apply if the investment in the portfolio company were held directly by the FHC. If the FHC owns a noncontrolling interest in the fund, then the fund is itself considered to be a portfolio company.

An FHC may thus own more than 25 percent of the equity of a fund that has an unlimited life (and, consequently, is not a qualifying private equity fund), so long as the fund does not hold investments in portfolio companies for more than 10 years, and the FHC and the fund comply with the routine management and other restrictions of the rule. Similarly, an FHC may invest in a fund that, in addition to making MBIs,

engages in other businesses (and, consequently, is not a qualifying private equity fund), so long as the FHC does not control the fund, divests its interest in the fund within 10 years, and complies with the other provisions of the rule that apply to investments in a portfolio company.

3907.0.6 TEMPORARY AGGREGATE INVESTMENT THRESHOLDS FOR MBIs

To allow the Federal Reserve to review the risk-management policies, procedures, and systems of an FHC that seeks to devote a significant portion of its capital to MBIs, temporary investment thresholds on MBIs are included in the rule. An FHC may not, without the Board's prior approval, make additional MBIs if the aggregate carrying value of its existing MBIs exceeds either of the two thresholds. The first threshold prevents an FHC from making additional MBIs (including making additional capital contributions to a company held under the rule) if the aggregate carrying value of the FHC's MBIs exceeds 30 percent of the FHC's tier 1 capital. A second threshold applies if the aggregate carrying value of the FHC's MBIs, *excluding* investments in private equity funds, exceeds 20 percent of the FHC's tier 1 capital. An FHC may exceed either threshold with the prior approval of the Board.

The investment thresholds were adopted as sunset provisions until the Board adopts a final rule specifically addressing the regulatory capital treatment for MBIs and that rule becomes effective. In February 2001, the Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation jointly requested comment on proposed rules that would establish special capital requirements for MBIs and similar equity investments held by BHCs and banks. (See 66 *Federal Register* 10, 212 (February 14, 2001).)

The investment thresholds discussed above apply only to MBIs made by FHCs under section 4(k)(4)(H) of the BHC Act and under the rule. They do not apply to or restrict investments made by BHCs or FHCs under other authorities, such as investments made through small business investment companies (SBICs), investments made in less than 5 percent of the voting shares of a company under section 4(c)(6) or (7) of the BHC Act, or investments made overseas under Regulation K.

²⁰ See section 2(g)(1) of the BHC Act (12 U.S.C. 1841(g)(1)) and section 225.2(e)(2)(i) of Regulation Y (12 C.F.R. 225.2(e)(2)(i)).

3907.0.7 RISK-MANAGEMENT, REPORTING, AND RECORDKEEPING POLICIES

3907.0.7.1 Policies, Procedures, Systems, and Reports

An FHC must maintain policies, procedures, and systems that are reasonably designed to manage the risks associated with making MBIs and to monitor compliance with the statutory and regulatory provisions governing such investments. The rule identifies the major areas that must be addressed by the internal policies and controls of an FHC engaged in making MBIs. In particular, an FHC engaged in merchant banking activities must have policies, procedures, records, and systems that are reasonably designed to—

1. monitor and assess the carrying value, market value, and performance of MBIs and of the company's aggregate MBI portfolio;
2. identify and manage the market, credit, concentration, and other risks associated with MBIs;
3. identify, monitor, and assess the terms, amounts, and risks arising from transactions and relationships (including contingent fees or contingent interests) with each company in which the FHC has an MBI;
4. ensure the maintenance of corporate separateness between the FHC and each company in which the FHC holds an interest under the rule, and protect the FHC and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of any such company; and
5. ensure compliance with the rule, including the rule's holding-period, routine management and operation, and cross-marketing restrictions, as well as with any other applicable provisions of law governing transactions and relationships with companies in which the FHC holds an interest under the rule, such as fiduciary principles and sections 23A and 23B of the FRA.

This list of policies, procedures, records, and systems identifies only some of the most important elements of a sound approach to monitoring MBI activities. The Board has issued supervisory guidance (see SR-00-9) that provides additional detail concerning the internal controls, policies, and systems that any BHC engaged in equity investment activities is expected to have and maintain to engage in such activities in a

safe and sound manner. (See section 3900.0 of this manual for more detail on this guidance.)

If the FHC controls a private equity fund or other fund that makes MBIs, the FHC must ensure that the fund has the types of policies, procedures, and systems for making and monitoring MBIs that are required for FHCs. The FHC may satisfy these requirements by ensuring that the private equity fund or other fund is subject to the FHC's merchant banking policies, procedures, and systems. If an FHC does not control the fund, then the fund is not subject to the recordkeeping and risk-management provisions of the rule. Nevertheless, an FHC must apply its merchant banking policies, procedures, and systems to any investment made by the company in any fund that is controlled by an unaffiliated entity.

It is anticipated that FHCs will be able to satisfy the rule's recordkeeping requirements by using the internal reports and records it prepares in the ordinary course of making an MBI or controlling a private equity fund. Similarly, if an FHC makes a noncontrolling investment in a private equity fund, the FHC should be able to use information provided by the fund's adviser or sponsor to satisfy the rule's recordkeeping requirements.

3907.0.7.2 Notice of Commencement of Merchant Banking Activities

An FHC must notify the Board within 30 days of commencing merchant banking activities under section 4(k)(4)(H) of the BHC Act. (See section 225.87(a) of Regulation Y.) For a domestic FHC, this notice should be provided on the Federal Reserve's reporting form, the FR Y-6A (which is expected to be replaced by the FR Y-10). For qualifying foreign banking organizations, the notice should be provided on the FR Y-7 (which is expected to be replaced by the FR Y-10F).

The appropriate Reserve Bank, in coordination with Board staff, should schedule a review of the investment and risk-management policies, procedures, and systems of an FHC that files a notification indicating that it has commenced merchant banking activities. The review may be conducted either off- or on-site, depending on the expected level and complexity of the FHC's MBIs and the company's previous experience in making equity investments under other legal authorities. This review may be deferred

until the next regularly scheduled inspection or examination, if the FHC has significant experience in making equity investments under pre-existing authorities and if the Federal Reserve has recently reviewed the company's policies, procedures, and systems for managing and controlling the risks associated with equity investment activities.

3907.0.7.3 Quarterly and Annual Reporting Requirements

The Federal Reserve has instituted two periodic reporting requirements relating to MBIs. The first is a quarterly report (FR Y-12) that seeks aggregate information on the cost and carrying values of an FHC's MBIs. This report also collects information on nonfinancial equity investments made by BHCs and their subsidiaries under other legal authorities, including investments made through SBICs and investments made in less than 5 percent of the voting shares of a company under section 4(c)(6) or (7) of the BHC Act. This quarterly report assists the Federal Reserve in monitoring the exposure of BHCs to MBIs and similar types of equity investments. The second report is an annual report, the FR Y-12A, that will collect basic information on MBIs held by an FHC for an extended time period. The FR Y-12A annual report collects information on MBIs that are approaching the end of their applicable holding period.

3907.0.7.4 Notice of Large Merchant Banking Acquisitions

After an FHC has provided notice to the Federal Reserve that it has commenced merchant banking activities, the FHC generally is *not* required to file a notice after acquiring the shares of a company under its merchant banking investment authority. However, an FHC must file a post-transaction notice with the Federal Reserve within 30 days after making an MBI in a company if (1) the investment represents more than 5 percent of the voting shares, assets, or ownership interests of the company, and (2) the total cost of the investment to the FHC exceeds the lesser of 5 percent of the tier 1 capital of the FHC or \$200 million. This notice must be provided on the forms discussed above.

3907.0.8 CROSS-MARKETING RESTRICTIONS

The GLB Act prohibits a depository institution subsidiary of an FHC from marketing or offering any product or service of a company in which the FHC has an MBI. Similarly, the GLB Act prohibits a company held by an FHC as an MBI from marketing or offering any product or service of a depository institution subsidiary of the FHC. U.S. branches and agencies of a foreign bank that conduct BHC activities in the United States or through a U.S. company are considered depository institutions under the rule. Thus, a U.S. branch or agency of a foreign bank may not cross-market the products or services of a company that is owned or controlled by the foreign bank or an affiliate of the foreign bank under section 4(k)(4)(H) of the BHC Act. In addition, the cross-marketing restrictions generally apply to any *subsidiary* of a depository institution controlled by an FHC.

The cross-marketing restrictions, however, do not apply to certain subsidiaries of a depository institution that Congress has expressly authorized the parent institution to own or control. In particular, the cross-marketing restrictions do *not* apply to (1) a financial subsidiary of a depository institution held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the FDI Act, (2) any company held by an Edge Act or agreement subsidiary of the depository institution that is controlled pursuant to section 25 or 25A of the FRA, or (3) any company held by an SBIC subsidiary of the depository institution that is controlled in accordance with the Small Business Investment Act.

The cross-marketing restrictions of the GLB Act and the rule also do *not* apply to nondepository affiliates of FHCs. Accordingly, a nondepository holding company affiliate of an FHC may engage in cross-marketing activities with a portfolio company held by the FHC under section 4(k)(4)(H) of the BHC Act. In addition, these restrictions do not apply to (1) portfolio companies in which the FHC, either directly or indirectly, owns less than 5 percent of the voting shares or ownership interests; (2) portfolio companies that are held by a private equity fund the FHC does not control; and (3) interests in a private equity fund (whether or not the FHC controls the fund). Accordingly, a depository institution subsidiary of an FHC may engage in cross-marketing activities with such a company, or it may market the shares of a private equity fund.

3907.0.8.1 Marketing Products or Services Involving a Portfolio Company

As noted above, the GLB Act prohibits any depository institution controlled by an FHC from (1) marketing or offering any product or service of a portfolio company held by the FHC under section 4(k)(4)(H) of the BHC Act or (2) allowing any product or service of the depository institution to be offered or marketed by or through any portfolio company held by the FHC under that section. A depository institution or subsidiary of a depository institution is *not* prohibited from marketing its own products or services—such as deposit, lending, and advisory products or services—to a portfolio company so long as the portfolio company does not then market those products or services to its customers or others. A depository institution subsidiary of an FHC also may purchase the products or services of a portfolio company—such as data processing hardware, software, or services to support the depository institution’s own operations—provided that the institution does not, directly, indirectly, or through any arrangement, market the portfolio company’s products or services to the institution’s customers or others. Likewise, the cross-marketing restrictions would not prohibit a depository institution controlled by an FHC from engaging in cross-marketing activities with a company that is a co-investor with the FHC in a portfolio company, so long as those activities do not involve products or services of the portfolio company.

3907.0.9 PRESUMPTION OF CONTROL UNDER SECTIONS 23A AND 23B OF THE FRA

Sections 23A and 23B of the FRA impose specific quantitative, qualitative, and collateral requirements on certain types of transactions between an insured depository institution and its affiliates, that is, companies that are under common control with the insured depository institution. Typically, a company owned by an FHC is considered to be an affiliate of the FHC’s subsidiary insured depository institution for the purposes of sections 23A and 23B, if the FHC owns or controls 25 percent or more of any class of the company’s voting securities. The GLB Act, however, includes a presumption that an FHC controls a company for purposes of sections 23A and 23B if the FHC directly or indirectly, or acting through one or more other persons, owns or controls 15 percent or more of

the equity capital of the company under the merchant banking authority of section 4(k)(4)(H) of the BHC Act.²¹ Thus, a company is presumed to be a section 23A affiliate of a subsidiary insured depository institution of an FHC if the FHC owns or controls more than 15 percent of the total equity of the company under section 4(k)(4)(H).

An FHC can rebut the presumption by providing information to the Board demonstrating that the FHC does not control the company.²² In the three situations identified below, the presumption of control under the GLB Act will be considered rebutted. In each situation, the FHC is assumed to own more than 15 percent of the total equity of the portfolio company under section 4(k)(4)(H) of the BHC Act (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the portfolio company (thereby not meeting the statutory definition of control). In particular, absent evidence to the contrary, an FHC will *not* be presumed to control a portfolio company if—

1. no officer, director, or employee of the FHC serves as a director, trustee, or general partner (or as an individual exercising similar functions) of the portfolio company;
2. 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 the FHC, and no more than one officer or employee of the holding company serves as a director or trustee (or as an individual exercising similar functions) of the portfolio company; or
3. a person that is not affiliated or associated with the FHC 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 of individuals exercising similar functions) of the portfolio company.

21. Equity capital includes voting and nonvoting shares, warrants, options, and other instruments convertible into equity capital.

22. The presumption applies only when an FHC owns or controls 15 percent or more of the total equity of a portfolio company under section 4(k)(4)(H) of the BHC Act and the rule. Under existing Board precedents, an FHC may not own any shares of a company in reliance on section 4(c)(6) or (7) of the BHC Act when the company owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company.

These safe harbors do not require Board review or approval under the provisions allowing rebuttal of the presumptions. An FHC also may request the Board's approval to rebut a presumption of control under other circumstances.

The rule's presumption of control is independent from the general definition of control in section 23A of the FRA.²³ A portfolio company, under the statute, is per se a section 23A affiliate of any insured depository institution subsidiary of an FHC if the FHC owns 25 percent or more of a class of voting securities of the portfolio company, even if the FHC owns or controls less than 15 percent of the portfolio company's *total equity* or is within one of the rule's safe harbors.

For the purpose of applying the presumption of control, an FHC that has an investment in a private equity fund will not be considered to indirectly own the equity capital of a portfolio company held by the fund *unless* the FHC controls the private equity fund. For example, if an FHC has a noncontrolling investment in a private equity fund that, in turn, owns 20 percent of the total equity of a portfolio company, the portfolio company is not presumed to be an affiliate of the insured depository institution subsidiaries of the FHC. On the other hand, if an FHC acts as general partner of a private equity fund and thus controls the fund, and if the private equity fund owns or controls more than

15 percent of the total equity of any portfolio company, the portfolio company is presumed to be an affiliate of the insured depository institution subsidiaries of the FHC.

To ensure competitive equity, the Board's rule applies sections 23A and 23B of the FRA to covered transactions between a U.S. branch or agency of a foreign bank and (1) any portfolio company controlled by the foreign bank or an affiliate of the foreign bank under the merchant banking authority of section 4(k)(4)(H) of the BHC Act, and (2) any company controlled by the foreign bank or an affiliate if the company is engaged in making MBIs under section 4(k)(4)(H) and the proceeds of the covered transaction are used for the purpose of funding the company's merchant banking activities. In determining if a portfolio company is controlled by a foreign bank or an affiliate of a foreign bank for these purposes, the rebuttable presumption of control and the three safe harbors discussed above apply to the foreign bank and affiliate in the same manner that the presumption and safe harbors apply to domestic FHCs. The rule does not restrict lending by a foreign bank's U.S. branches and agencies to parent companies or other affiliated companies unless the proceeds of such lending would be used by these companies to make or fund the making of MBIs.

23. See 12 U.S.C. 371c(3)(A).

3907.0.10 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws¹</i>	<i>Regulations²</i>	<i>Interpretations³</i>	<i>Orders</i>
Merchant banking investment activities	1843(k)(7)(A)			
Permitted investments		225.170	4-058	
Limitations on managing or operating a portfolio company held as an MBI		225.171	4-058.2	
MBI holding periods		225.172	4-058.3	
Investments in private equity fund		225.173	4-058.4	
Aggregate limits on MBIs		225.174	4-058.5	
Risk-management, reporting, and recordkeeping policies for MBIs		225.175	4-058.6	
Cross-marketing and FRA section 23A and 23B limitations for MBIs		225.176	4-058.7	
Definitions		225.177	4-058.8	

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. *Federal Reserve Regulatory Service* reference.

Supervisory Guidance on Equity Investment and Merchant Banking Activities (Section 4(k) of the BHC Act) Section 3909.0

Investments in the equity of nonfinancial companies¹ as well as lending to private-equity-financed companies have emerged as important sources for earnings and business relationships at a number of banking organizations (BOs).² These equity investments in nonfinancial companies, however, can entail significant market, liquidity, and other risks. Equity investments can also give rise to increased volatility of both earnings and capital. Accordingly, sound investment and risk-management practices and strong capital positions are critical when conducting these activities.

In June 2000, the Board issued supervisory guidance on various sound practices related to the equity investment activities of BOs; this guidance merits the attention of management, examiners, and other supervisory staff. The guidance applies to the equity investment activities of financial holding companies (FHCs), bank holding companies (BHCs), state member banks, and their affiliates, regardless of the authority under which the investments are made. The major elements of this guidance, equity investments and the provision of traditional credit-based services to equity-funded companies, are highlighted below. For a more complete discussion, see SR-00-9.

3909.0.1 LEGAL AND REGULATORY AUTHORITY FOR EQUITY INVESTMENTS

FHCs, BHCs, and depository institutions are able to make equity investments under several statutory and regulatory authorities. Under section 4(c)(6) and (7) of the Bank Holding Company Act (BHC Act), BHCs may make passive

investments in up to 5 percent of the outstanding voting shares of any company and up to 25 percent of the total equity of the company. Under this authority, there is no aggregate limit on the total dollar amount of equity investments that a BHC may hold.

BOs can make equity investments through a small business investment corporation (SBIC), which can be a subsidiary of a bank or BHC. Investments made by SBIC subsidiaries are allowed up to a total of 50 percent of a portfolio company's outstanding shares, but can only be made in companies defined as a small business, according to SBIC rules. A bank's aggregate investment in the stock of SBICs is limited to 5 percent of the bank's capital and surplus. In the case of BHCs, the aggregate investment is limited to 5 percent of the BHC's proportionate interest in the capital and surplus of its subsidiary banks.

Under Regulation K, which implements sections 25 and 25A of the Federal Reserve Act (FRA) and section 4(c)(13) of the BHC Act, BOs may, with Board approval, make portfolio investments in foreign companies that in the aggregate do not exceed 25 percent of the tier 1 capital of the BHC. In addition, individual investments must be less than 20 percent of a portfolio company's voting shares and must not exceed 40 percent of the portfolio company's total equity.³

FHCs are also permitted to acquire any amount of the shares, assets, or ownership interests of a nonfinancial company under the merchant banking investment authority of section 4(k)(4)(H) of the BHC Act, as amended by the Gramm-Leach-Bliley Act (GLB Act). The GLB Act places certain limits on the holding period of merchant banking investments and on the ability of an FHC to routinely manage or operate a portfolio company held as a merchant banking investment. Subpart J of the Board's Regulation Y (12 C.F.R. 225.170–225.177) implements these and other restrictions applicable to merchant banking investments.

Equity investments made under any of the authorities described above may be in publicly

1. Unless otherwise noted, references to equity investments in this guidance are references to equity investments in nonfinancial companies. Nonfinancial companies include companies that engage in activities other than financial activities that a financial holding company may conduct pursuant to section 4 of the Bank Holding Company Act (12 U.S.C. 1843), as amended by the Gramm-Leach-Bliley Act, and the regulations and interpretations thereunder. Equity investments include merchant banking investments made by financial holding companies under the regulations adopted by the Board of Governors (12 C.F.R. 225, subpart J, sections 225.170 through 225.177) and the Treasury Department (12 C.F.R., chapter XV, part 1500, sections 1500.1 through 1500.8) that became effective on February 15, 2001.

2. The term "private equity," as used in this guidance, refers to shared-risk investments outside of publicly quoted securities and also activities such as venture capital, leveraged buyouts, mezzanine financing, and holdings of publicly quoted securities obtained through these activities.

3. Also included in calculating a BO's investment are shares of the corporation held in trading or dealing accounts or under any other authority. The 25 percent of tier 1 capital limitation increases to 100 percent of tier 1 capital for certain non-BHC investors. See Regulation K for more detailed information.

traded securities or privately held equity interests. The investment may be made as a direct investment in a specific portfolio company, or it may be made indirectly through a pooled investment vehicle, such as a private equity fund. In general, private equity funds are investment companies, typically organized as limited partnerships, that pool capital from third-party investors to invest in shares, assets, and ownership interests in companies for resale or other disposition.⁴ Private equity fund investments may provide seed or early-stage investment funds to start-up companies, or they may finance changes in ownership, middle-market business expansions, and mergers and acquisitions.

The supervisory guidance applies to all equity investments a BHC or FHC holds in nonfinancial companies, public or private, regardless of the authority under which such investments are made. FHCs and BHCs are expected to control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries and affiliates. Also, the basic principles set forth in this guidance should be incorporated into the U.S. operations of foreign BOs, with appropriate adaptations to reflect the fact that (1) those operations are an integral part of a foreign bank, which should be managing its risks on a consolidated basis, and (2) the foreign bank is subject to overall supervision by its home authorities.

3909.0.2 SOUND PRACTICES FOR EQUITY INVESTMENTS

High returns in both equity investments and lending to private-equity-financed companies can spur an increased flow of funds into this market segment. As in other rapidly expanding and highly profitable business lines, business and competitive pressures can lead to compromises in due diligence, the use of overly optimistic assumptions, and breakdowns in internal controls. Sound investment and risk-management practices are crucial to the success of equity investment activities. As with any financial activity, sound management practices for these activities involve—

1. active involvement and oversight by the board of directors and senior management;

4. For a detailed definition of “private equity funds,” see the merchant banking rule (12 C.F.R. 225.170 et seq.).

2. appropriate policies, limits, procedures, and management information systems that govern all elements of the investment decision-making and management process; and
3. adequate internal controls.

As with all financial activities, institutions should ensure that they have sufficient capital for conducting equity investment activities. BOs that are conducting material equity investment activities are expected to have an internal capital-allocation system that meaningfully links the identification, monitoring, and evaluation of the risks of the institution’s equity investment activities to the determination of its needs for economic capital. (See SR-99-18.) A review of these systems should be an important part of the investment-management process, as well as an integral element of ongoing supervisory review and monitoring of this business line. The federal banking agencies have recognized that equity investment activities entail greater risks than traditional banking activities, and they have requested comment on proposed amendments to their regulatory capital guidelines that would establish special capital requirements for equity investments.⁵

Supervisory approach. Examiners and other supervisors (and a BO’s management) should review each of the three areas listed above to identify any deficiencies in the management of FHCs and BHCs. The supervisory efforts should be targeted appropriately in accordance with Federal Reserve policies on risk-focused supervision, taking into account both (1) the findings of internal audit and other independent reviews and (2) the materiality of equity investment activities to the banking organization. Consistent with the Federal Reserve’s role as umbrella supervisor, reviews of the merchant banking activities of FHCs and the equity investment activities of BHCs should focus on the potential exposure these activities may pose to insured depository affiliates and should, where appropriate and available, use the findings of primary bank supervisors and functional regulators of holding company affiliates. At the same time, supervisory and examination staff should ensure that they continue to conduct sufficient and targeted transaction testing across legal-entity lines if necessary to fully assess the adequacy of business-line risk management. Transaction testing should be consistent with the risk profile of the institution and the materiality of the activity to the institution’s financial condition.

5. See 66 *Federal Register* 10, 212 (Feb. 14, 2001).

3909.0.2.1 Oversight by the Board of Directors and Senior Management

Equity investment activities require the active oversight of the board of directors and senior management of the institution that is conducting the activities. The board should approve portfolio objectives, overall investment strategies, and general investment policies that are consistent with the institution's financial condition, risk profile, and risk tolerance. Portfolio objectives should address the types of investments, expected business returns, desired holding periods, diversification parameters, and other elements of sound investment-management oversight. Board-approved objectives, strategies, policies, and procedures should be documented and clearly communicated to all the personnel involved in their implementation. The board should actively monitor the performance and risk profile of equity investment business lines in light of the established objectives, strategies, and policies.

The board of directors should also 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. The board should approve policies that specify lines of authority and responsibility for both acquisitions and sales of investments. The board should also approve limits on aggregate investment and exposure amounts, the types of investments (for example, direct and indirect, mezzanine financing, start-ups, or seed financing) and appropriate diversification-related aspects of equity investments such as industry, sector, and geographic concentrations.

For its part, senior management must ensure that adequate policies, procedures, and management information systems are in place for managing equity investment activities on a day-to-day and longer-term basis. Management should set clear lines of authority and responsibility for making and monitoring investments and for managing risk. Management should ensure that competent staff conduct the institution's equity investment activities. The staff's technical knowledge and experience should be consistent with the scope of the institution's activities.

3909.0.2.2 Management of the Investment Process

Institutions engaging in equity investment activities should have a sound process for

executing all elements of investment management, including initial due diligence, periodic reviews of holdings, investment valuation, and realization of returns. This process requires appropriate policies, procedures, and management information systems, the formality of which should be commensurate with the scope, complexity, and nature of an institution's equity investment activities. A sound investment process should be applied to all equity investment activities, regardless of the legal entity in which investments are booked.

Supervisory approach. Any supervisory reviews of equity investment activities should be risk-focused. The review should take into account the institution's stated tolerance for risk, the ability of senior management to govern these activities effectively, the materiality of activities in light of the institution's risk profile, and its capital position.

3909.0.2.2.1 Equity Investment Policies and Limits

Institutions engaging in equity investment activities require effective policies that—

1. govern the types and amounts of investments that may be made,
2. provide guidelines on appropriate holding periods for different types of investments, and
3. establish parameters for portfolio diversification.

Investment strategies and permissible types of investments should be clearly identified. Portfolio-diversification policies should identify factors pertinent to the risk profile of the investments being made, such as industry, sector, geographic, and market factors. Policies establishing expected holding periods should specify the general criteria for liquidation of investments, as well as guidelines for the divestiture of underperforming investments. Decisions to liquidate underperforming investments are necessarily made on a case-by-case basis, considering all relevant factors. However, policies and procedures that stipulate more frequent review and analysis are generally used to address investments that are performing poorly or that have been in portfolio for a considerable length of time.

Policies should identify the aggregate exposure that the institution is willing to accept by the type and nature of investment (for example, direct or indirect, industry sectors). When adhering to those limits, institutions should consider unfunded and funded commitments. Where hedging activities are conducted, formal and clearly articulated hedging policies and strategies should identify limits on hedged exposures and permissible hedging instruments.

Management and staff compensation play a critical role in providing incentives and controlling risks within a private equity business line. Clear policies should govern compensation arrangements, including co-investment structures and sales of portfolio company interests by employees of the BO.

3909.0.2.2.2 Equity Investment Procedures

As they do with investment policies, many institutions have different procedures for assessing, approving, and reviewing investments based on their size, nature, and risk profile. Often, procedures used for direct investments are different than those used for indirect investments made through private equity funds. For example, different levels of due diligence and senior management approvals may be required. The management infrastructures that have been constructed for conducting these activities should ensure that operating procedures and internal controls appropriately reflect the diversity of investments.

Supervisory approach. Supervisors should recognize the potential diversity of practice when conducting reviews of the equity investment process. They should focus on the appropriateness of the process employed relative to the risk of the investments made and the materiality of this business line to the overall soundness of the BO and the potential impact on affiliated depository institutions.

3909.0.2.2.2.1 Investment Analysis and Approvals

Well-founded analytical assessments of investment opportunities and formal processes for approving investments are critical in conducting equity investment activities. While analyses and

approval processes may differ by individual investments and across institutions, the methods and types of analyses conducted should be appropriately structured to adequately assess the specific risk profile, industry dynamics, management, and specific terms and conditions of the investment opportunity, as well as other relevant factors. All elements of the analytical and approval processes, from initial review through the formal investment decision, should be documented and clearly understood by the staff who are conducting these activities. An institution's evaluation of potential investments in private equity funds, as well as its reviews of existing fund investments, should assess the adequacy of a fund's structure, with due consideration given to the following:

1. management fees
2. carried interest⁶ and its computation on an aggregate portfolio basis
3. the sufficiency of the general partners' capital commitments in providing management incentives
4. contingent liabilities of the general partner
5. distribution policies and wind-down provisions
6. performance benchmarks and return-calculation methodologies

3909.0.2.2.2.2 Investment-Risk Ratings

It is a sound practice to establish a system of internal risk-ratings for equity investments. The system should assign each investment a rating based on factors such as the nature of the company, strength of management, industry dynamics, financial condition, operating results, expected exit strategies, market conditions, and other pertinent factors. Different rating factors may be appropriate for indirect investments and direct investments. For example, rating factors for investments in private equity funds could include an assessment of the fund's diversification, management experience, liquidity, and actual and expected performance. Rating systems should be used for assessments of both new investment opportunities and existing portfolio investments.

3909.0.2.2.2.3 Periodic Reviews

Management should ensure the periodic and timely review of the institution's equity investments. Reviews should be conducted at both

6. The carried interest is the share of a partnership's return that is received by general partners or investment advisers.

individual investment and portfolio levels. Depending on the size, complexity, and risk profile of the investment, reviews should, where appropriate, include factors such as—

1. the history of the investment, including the total funds approved;
2. commitment amounts, principal-cash-investment amounts, cost basis, carrying value, major-investment cash flows, and supporting information, including valuation rationales and methodologies;
3. the current actual percentage of ownership in the portfolio company on both a diluted and undiluted basis;
4. a summary of recent events and current outlook;
5. the recent financial performance of portfolio companies, including summary compilations of performance and forecasts, historical financial results, current and future plans, key performance metrics, and other relevant items;
6. internal investment-risk ratings and rating-change triggers;
7. exit strategies, both primary and contingent, and expected internal rates of return on exit; and
8. other pertinent information for assessing the appropriateness, performance, and expected returns of investments.

Portfolio reviews should include an aggregation of individual investment-risk and performance ratings; an analysis of appropriate industry, sector, geographic, and other pertinent concentrations, and total portfolio valuations. Portfolio reports containing the cost basis, carrying values, estimated fair values, valuation discounts, and other factors summarizing the status of individual investments are integral tools for conducting effective portfolio reviews. Reports containing the results of all reviews should be available to supervisors for their inspection.

Given the inherent uncertainties in equity investment activities, institutions should include in their periodic review consideration of best case, worst case, and probable case assessments of investment performance. The reviews should evaluate changes in market conditions and alternative assumptions used to value investments—including expected and contingent exit strategies. Major assumptions used in valuing investments and forecasting performance should be identified. The assessments need not be confined to quantitative analyses of potential losses, but may also include qualitative analyses. The formality and sophistication of investment reviews should be appropriate for the overall

level of risk the BO incurs from this business line.

3909.0.2.2.2.4 Valuation and Accounting

Valuation and accounting policies and procedures can have a significant impact on the earnings of institutions engaged in equity investment activities. Many equity investments are made in privately held companies, for which independent price quotations are either unavailable or not available in sufficient volume to provide meaningful liquidity or a market valuation. Valuations of some equity investments may involve a high degree of judgment on the part of management or require the skillful use of peer comparisons. Similar circumstances may exist for publicly traded securities that are thinly traded or subject to resale and holding-period restrictions, or when the institution holds a significant block of a company's shares. Accordingly, clearly articulated policies and procedures on the accounting and valuation methodologies used for equity investments are of paramount importance.

Several methods are used in accounting for equity investments. Under generally accepted accounting principles (GAAP), equity investments held by investment companies, held by broker-dealers, or maintained in the trading account⁷ are reported at fair value, with any unrealized appreciation or depreciation included in earnings and flowing to tier 1 capital. For some holdings, fair value may reflect adjustments for liquidity and other factors.

Equity investments not held in investment companies, by broker-dealers, or in the trading account and that have a readily determinable fair value (quoted market price) are generally reported as available-for-sale (AFS). They are marked to market with unrealized appreciation or depreciation recognized in GAAP-defined "comprehensive income," but not earnings. Appreciation or depreciation flows to equity but, for regulatory capital purposes only, depreciation is included in tier 1 capital.⁸ Equity investments without readily determinable fair

7. Equity investments in nonfinancial companies held under the authorities discussed previously would not normally be held in the trading account, as they are not intended to be traded actively.

8. Under regulatory capital rules, tier 2 capital may include up to 45 percent of the unrealized appreciation of AFS equity investments with readily determinable fair values.

values generally are held at cost, subject to write-downs due to impairments in the value of the asset. As is the case with all assets, impairments in value should be promptly addressed. Institutions should ensure that they have taken write-downs in a timely manner and in an appropriate amount.

In determining fair value, the valuation methodology is critical. Clearly articulated methods for valuing investments are critical to the effective management of equity investments. Formal valuation and accounting policies should be established for investments in public companies; direct private investments; indirect fund investments; and, where appropriate, other types of investments with special characteristics. In establishing valuation policies, institutions should consider market conditions, taking account of lockout provisions, the restrictions of Securities and Exchange Commission Rule 144, liquidity features, the dilutive effects of warrants and options, and industry characteristics and dynamics.

For institutions acting as general partners of private equity funds, “clawback,” or “look-back,” provisions of partnership agreements can pose additional challenges when accounting for and valuing the distributions received from funds managed by the institution. Clawback provisions are promises general partners make to repay limited partners at the end of the term of a fund, if the general partner has received more than its contractually defined compensation or “carried interest” over the life of the fund. Clawback provisions can come into play when the liquidation and associated disposition of both limited-partner and general-partner returns on well-performing investments in a fund occur before the liquidation of poorer-performing investments. Often, escrow accounts are established to hold a portion of the general partners’ carried interest during the life of the fund. When applicable, institutions should appropriately recognize the estimated impact of these provisions in accounting for and valuing general-partner activities, including the earnings derived from those activities.

The accounting and valuation of equity investments should be subject to regular periodic reviews. In all cases, valuation reviews should produce documented audit trails that are available to supervisors and auditors. These reviews should assess the consistency of the methodologies used to estimate fair value.

Accounting and valuation treatments should

be assessed in light of their potential for abuse through the inappropriate management or manipulation of reported earnings on equity investments. For example, high valuations may produce overstatements of earnings through gains and losses on investments reported at “fair value.” On the other hand, inappropriately understated valuations can be vehicles for “smoothing earnings” by recognizing gains on profitable investments when an institution’s earnings are otherwise under stress. While reasonable people may disagree on the valuations given to illiquid private equity investments, institutions should have rigorous valuation procedures that are applied consistently.

Given the uncertainties in valuation methodologies and the relatively high volatility of the equity market, equity investments that are reported at fair value can contribute to earnings volatility in the institutions where they play a major role. Equity investments are increasingly contributing to the earnings of some BOs. Therefore, the potential impact of these investments on the composition, quality, and sustainability of overall earnings should be appropriately recognized and assessed by both management and supervisors.

3909.0.2.2.2.5 Exit Strategies

Returns and reported earnings on equity investments are highly affected by assumed and actual exit strategies. The principal means of exiting an equity investment in a privately held company include initial public stock offerings, sales to other investors, and share repurchases. An institution’s assumptions regarding exit strategies can significantly affect the valuation of the investment. The importance of reasonable and comprehensive primary and contingent take-out strategies for equity investments should be emphasized. Management should periodically review investment exit strategies, particularly focusing on larger or less liquid investments.

3909.0.2.2.2.6 Disposition of Investments

Policies and procedures should be established to govern the sale, exchange, transfer, or other disposition of the institution’s investments. These policies and procedures should state clearly the levels of management or board approval required for the disposition of investments, and, in the case of investments held under the merchant banking provisions of the GLB Act, should take

into account and comply with the time limits for holding merchant banking investments.⁹

3909.0.2.2.2.7 Capital

Given the potential volatility of returns on equity investments, the risks associated with private equity investment and merchant banking business lines can exceed those of many more traditional banking activities. BOs that are conducting material equity investment activities should have internal methods for allocating economic capital based on the risk inherent in those activities.¹⁰ These methods should identify all material risks and their potential impact on the safety and soundness of the institution. The amount and percentage of capital that is dedicated to this business line should be appropriate to the size, complexity, and financial condition of the BO. Organizations substantially engaged in equity investment and merchant banking activities should have strong capital positions supporting their equity investments, and they should allocate economic capital to them that is well in excess of the current regulatory minimums applied to lending activities.

Supervisory approach. Assessments of capital adequacy (by supervisors and the BO's management) should include not only the institution's compliance with regulatory capital requirements and the quality of regulatory capital, but also its methodologies for internally allocating economic capital to this business line.

3909.0.2.3 Internal Controls

An adequate system of internal controls, with appropriate checks and balances and clear audit trails, is critical to conducting equity investment activities effectively. Appropriate internal controls should address all of the elements of the investment-management process, and they should focus on the appropriateness of existing policies and procedures; adherence to policies and procedures; and the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting. Departures from policies and procedures should be documented and reviewed by senior management. This documentation should be available for examiner review.

Assessments of an institution's compliance with both written and implied policies and procedures should be independent of line decision-making functions to the fullest extent possible. Large complex banking institutions with material equity investment activities should have internal auditors or independent outside parties conduct periodic independent reviews of their investment process and valuation methodologies. In smaller, less complex institutions, where limited resources may preclude independent review, alternative checks and balances should be established. These checks and balances may include random internal audits, reviews by senior management who are independent of the function, or the use of outside third parties.

3909.0.2.3.1 Documentation of the Investment Process

Documentation of key elements of the investment process, including initial due diligence, approval reviews, valuations, and dispositions, is an integral part of any private equity investment internal-control system. Accordingly, institutions should appropriately document their policies, procedures, and investment activities, and they should make this documentation accessible to supervisors.

Institutions should be aware that the statutory and regulatory authority under which some equity investment activities are conducted may impose specific documentation and recordkeeping requirements. For example, merchant banking regulations require an FHC to maintain a written record any time it becomes involved in the routine management or operation of a portfolio company and to notify the Board if it routinely manages or operates a portfolio company for more than nine months.

Supervisory approach. Review the documentation of the internal controls over the key elements of the equity investment process. If senior management has authorized and reviewed any departures from policies and procedures, review the documentation for those departures.

3909.0.2.3.2 Legal Compliance

Compliance with all federal laws and regulations that are applicable to the institution's investment activities should be a focus of an

9. See 12 C.F.R. 225.172.

10. The internal methods for allocating economic capital should be consistent with the general guidance in SR-99-18.

institution's system of internal controls. Regulatory compliance requirements, in particular, should be incorporated into internal controls so managers outside of the compliance or legal functions understand the parameters of permissible investment activities.

It is important to recognize that private equity and merchant banking activities are subject to different laws and regulations, depending on the authority under which the activities are conducted. For example, the merchant banking investments an FHC makes are subject to holding-period limits and restrictions on the FHC's involvement in the routine management or operation of the portfolio company. Accordingly, management should have a system in place, consistent with applicable laws and regulations, to ensure that impermissible control is not exercised over portfolio companies held under this authority and that merchant banking investments are disposed of within the time periods required by the rule. Limiting involvement in the portfolio company's day-to-day management and operation is also important to protect the institution from lender-liability claims.

Likewise, certain cross-marketing restrictions apply to subsidiary depository institutions of FHCs and to portfolio companies controlled by the FHC under statutory merchant banking authority. Management should ensure that these limits are observed. When a banking organization owns or controls a significant percentage of a company's voting securities, the company may be an affiliate of the organization's depository institution subsidiaries for the purposes of the affiliate transaction limits of sections 23A and 23B of the FRA. Also, the section 23A and 23B limitations on transactions between a depository institution and its affiliates are presumed by the GLB Act to apply to certain transactions between a depository institution subsidiary of an FHC and any portfolio company in which the FHC owns at least a 15 percent equity interest under the merchant banking authority. This ownership threshold is lower than the ordinary definition of an affiliate for section 23A purposes, which is typically 25 percent.

Moreover, to ensure compliance with federal securities laws, institutions should establish policies, procedures, and other controls addressing insider trading. A restricted list of securities for which the institution has inside information is one widely used mechanism for controlling the risk of insider trading. In addition, the institution should have control procedures in place to

ensure that appropriate reports are filed with functional regulators.

3909.0.2.3.3 Compensation

Often, key employees in the private equity investment units of BOs may co-invest in the direct or fund investments made by the unit. The return on this co-investment, which the FHC may underwrite, may constitute a significant portion of the compensation of these employees. These co-investment arrangements can be an important incentive mechanism and risk-control technique and can help to attract and retain qualified management. However, "cherry picking," or selecting only certain investments for employee participation while excluding others, should be discouraged.

In many cases, the employees' co-investment may be funded through loans from affiliates of the BO, which, in turn, hold a lien against the employees' interests. The administration of the compensation plan should be appropriately governed pursuant to formal agreements, policies, and procedures. Among other matters, policies and procedures should address the terms and conditions of employee loans and sales of participants' interests before the release of the lien.

3909.0.3 DISCLOSURE OF EQUITY INVESTMENT ACTIVITIES

Given the important role that market discipline plays in controlling risk, institutions should ensure that they adequately disclose the information necessary for the markets to assess the institution's risk profiles and performance in the equity investment business line. Indeed, it is in the institution's interest, as well as that of its creditors and shareholders, to disclose publicly information about earnings and risk profiles. Institutions are encouraged to disclose in public filings information on the type and nature of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital. The following topics are relevant for public disclosure, though disclosures of each of these topics may not be appropriate, relevant, or sufficient in every case:

1. the size of the portfolio
2. the types and nature of investments (for example, direct or indirect, domestic or international, public or private, equity or debt with conversion rights)

3. the initial cost, carrying value, and fair value of investments, and, where applicable, comparisons to publicly quoted share values of portfolio companies
4. the accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices
5. the realized gains (or losses) arising from sales and unrealized gains (or losses)
6. insights regarding the potential performance of equity investments under alternative market conditions

Supervisory approach. Supervisors should fully use the disclosures in public filings, as well as the periodic regulatory reports filed by publicly held BOs, as part of the information that they review routinely. Supervisors should encourage BOs to make adequate disclosures or to improve their public disclosures of equity investment and merchant banking activities (these disclosures should include the items listed above).

3909.0.4 INSTITUTIONS LENDING TO OR ENGAGING IN OTHER TRANSACTIONS WITH PORTFOLIO COMPANIES

Additional risk-management issues may arise when a banking institution or an affiliate lends to or has other business relationships with (1) a company in which the banking institution or an affiliate has invested (that is, a portfolio company); (2) the general partner or manager of a private equity fund that has also invested in a portfolio company; or (3) a private-equity-financed company in which the banking institution 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 BO has other investments. Given the potentially higher than normal risk attributes of these lending relationships, institutions should devote special attention to ensuring that the terms and conditions of these relationships are at arm's length and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivatives transactions with or guaranteed by portfolio companies and general partners.

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 FRA. The holding company also should

have systems and policies in place to monitor transactions between the holding company, or a nondepository institution subsidiary of the holding company, and a portfolio company. (These transactions are not typically governed by section 23B.) A holding company should ensure that the risks of these transactions, including exposures of the holding company on a consolidated basis to a single portfolio company, are reasonably limited and that all transactions are on reasonable terms. Special attention should be paid to transactions that are not on market terms.

A BO may lend to a private-equity-financed company in which it has no equity interest. When the borrowing company is a portfolio investment of private equity fund managers or general partners with which the institution may have other private-equity-related relationships, the extension of credit should be conducted on reasonable terms. In some cases, supervisors have found that lenders may wrongly assume that the general partners or another third party implicitly guarantees or stands behind such credits. Reliance on implicit guarantees or comfort letters should not substitute for reliance on a sound borrower that is expected to service its debt with its own resources. As with any type of credit extension, absent a written contractual guarantee, the credit quality of a private equity fund manager, general partner, or other third party should not be used to upgrade the internal credit-risk rating of the borrower company or to prevent the classification or special mention of a loan. Any tendency to relax this requirement when the general partners or sponsors of private-equity-financed companies have significant business dealings with the BO should be strictly avoided.

When an institution lends to a portfolio company in which it has a direct or indirect interest, implications arise under sections 23A and 23B of the FRA, which govern credit-related transactions and asset purchases between a depository institution and its affiliates. Section 23A applies to transactions between a depository institution and any company when the institution's holding company or shareholders own at least 25 percent of the company's voting shares. The GLB Act extends this coverage by establishing a presumption that a portfolio company is an affiliate of a depository institution subsidiary of an FHC if the FHC uses the merchant banking authority of the GLB Act to own or control more than 15 percent of the total equity of the company. Institutions should obtain the assistance of coun-

sel to determine whether such issues exist or would exist if loans were extended to a portfolio company, general partner, or manager.

In addition to limiting and monitoring the exposure to portfolio companies that arises from traditional banking transactions, BHCs should adopt policies and practices that limit their legal liability, and that of their affiliates, for the financial obligations and liabilities of portfolio companies. These policies and practices include, for example, the use of limited-liability corporations or special-purpose vehicles to hold certain types of investments, the insertion of corporations that insulate liability between the BHC and a partnership controlled by the BHC, and contractual limits on liability. BHCs that extend credit to companies in which the BHC has made an equity investment should also be aware of the potential for equitable subordination of the lending arrangements.

Supervisory approach. Supervisors should ensure that the institution has conducted a proper review of section 23A and 23B compliance issues to avoid violations of law or regulations. Ascertain that internal controls limit and monitor the exposures to portfolio companies in which the institution has a direct or indirect interest. Determine if the BHC has adopted policies and practices that limit its legal liability and that of its affiliates for the financial obligations and liabilities of the portfolio companies.

3909.0.5 SUPERVISORY OBJECTIVES

1. To ensure that any risk assessment, supervisory strategies, and on-site and targeted reviews of the banking organization adequately and appropriately consider its equity investment and merchant banking activities.
2. To ascertain that the board of directors and senior management are taking the necessary actions to ensure that the risks associated with private equity investments and merchant banking activities are properly identified and managed, and that these activities do not adversely affect the soundness of the banking organization and its affiliated federally insured depository institutions.
3. To encourage the banking organization's board of directors and management to make the necessary and adequate public disclosures of its equity investment activities.
4. When the banking organization is engaged in

material equity investment and merchant banking activities, to ascertain (1) that the board of directors and management have taken the necessary actions to ensure that the organization has a strong capital position that is adequate to support its activities, and (2) that the banking organization has robust internal methods for allocating capital that fully reflect the inherent risks of those activities.

5. To assess the existence, adequacy, maintenance, and documentation of the institution's system of internal controls over the key elements of the equity investment and merchant banking process.
6. To review compliance with limits on transactions governed by sections 23A and 23B of the FRA.

3909.0.6 SUPERVISORY PROCEDURES

1. Identify the organization's deficiencies and the material risks that are involved in the management of its equity investment and merchant banking activities. Also identify those activities that pose potential risks to the financial condition of state member banks and other federally insured depository institutions affiliated with FHCs and BHCs. Fully use the findings of primary bank supervisors and the functional regulators of holding company affiliates to review and assess the potential risks of the equity investment activities.
2. Assess the ability of senior management to govern equity investment activities effectively, particularly the—
 - a. involvement and oversight by the board of directors and senior management;
 - b. implementation and maintenance of appropriate policies, limits, procedures, and management information systems; and
 - c. system of internal controls.
3. Target supervisory efforts to assess the compliance of the board of directors and management with the Federal Reserve's risk-focused management and supervision policies, considering—
 - a. the BO's stated tolerance for risk,
 - b. the findings of internal audit and other independent reviews, and
 - c. the materiality of the activities, considering the BO's risk profile.

4. Focus and assess the impact of the equity investment activities on insured depository affiliates, considering the potential risks and returns associated with the activities and the potential volatility in some segments of the equity markets.
5. Conduct sufficient, targeted transaction testing across legal-entity lines, if necessary, to fully assess the adequacy of risk management in the equity investment business lines. The transaction testing should be consistent with the institution's risk profile, the materiality of the business line's activity, and the overall soundness of the BO's financial condition.
6. Assess the adequacy and quality of the BO's capital position in relation to the risk that is associated with its equity investment activities and the potential impact on affiliated depository institutions. If the organization is substantially engaged in equity investment activities, determine that it has a strong capital position with capital backing that is well above regulatory minimums for traditional banking activities. Also evaluate the adequacy and quality of the methods used to internally allocate economic capital to the business line (or lines) involving equity investment activities.
7. Recognize, as a supervisor, that many institutions have diverse practices and procedures for assessing, approving, and reviewing investments based on the size, nature, and risk profile of an investment. Focus on and assess the appropriateness, adequacy, and quality of the process employed relative to the—
 - a. risk of the investments made,
 - b. materiality of this business line in relation to the overall soundness of the BO, and
 - c. the potential impact on affiliated depository institutions.
8. Review and determine the adequacy of senior management's documentation of the internal controls over the key elements of the equity investment process, including its documentation for any authorized departures from any of these controls.
9. Use the disclosures the institution has made in public filings and period regulatory reports, and review and assess their adequacy and quality. Encourage the BO to improve any deficient public disclosures involving equity investment and merchant banking activities.
10. Ascertain that—
 - a. the institution maintains and monitors proper internal controls, and that it conducts adequate periodic reviews of the controls to ensure its and its affiliate's compliance with sections 23A and 23B of the FRA;
 - b. the internal controls are designed to limit and monitor the institution's exposure to portfolio companies in which it has a direct or indirect ownership interest; and
 - c. the BHC has adopted policies and practices that limit its legal liability and that of its affiliates for the financial obligations of the portfolio companies.
11. Communicate to the management of the banking organization and other appropriate supervisors any concerns about deficiencies found in reviewing equity investment and merchant banking activities.

A finder brings together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate. National banks and state banks have been permitted to act and have acted as a finder in nonfinancial transactions for many years. Banking organizations have served as a finder by providing enclosures (or “statement stuffers”) and other marketing materials from sellers of various products and services. Banking organizations have also helped to identify service providers as an accommodation to their customers. Financial holding companies (FHCs) have argued that acting as a finder, particularly in an electronic form, offers them increased opportunities to cross-sell financial products and services or to enhance the attractiveness of their electronic web site to customers. BHCs and foreign banks that qualify as FHCs may engage in finder activities (as authorized by section 225.86(d)(1) of Regulation Y) by providing the post-transaction notice stipulated in section 225.87(a) of Regulation Y.

An FHC may act as a finder for financial and nonfinancial products or services.¹ A finder includes providing any or all of the following services:

1. identifying potential parties, making inquiries as to their interest, introducing and referring potential parties to each other, and arranging contacts between and meetings of interested parties
2. conveying between interested parties expressions of interest, bids, offers, orders, and confirmations relating to a transaction
3. transmitting information concerning products and services to potential parties in connection with the activities described in this section

Some examples of finder services that may be provided by a finder, in accordance with section 225.86(d) of the rule, include—

1. hosting an electronic marketplace on the FHC’s Internet web site by providing hyper-text or similar links to the web sites of third-party buyers or sellers;

2. hosting, on the FHC’s servers, the Internet web site of—
 - a buyer (or seller) that provides information concerning the buyer (or seller) and the products or services it seeks to buy (or sell) and allows sellers (or buyers) to submit expressions of interest, bids, offers, orders, and confirmations relating to those products or services; or
 - a government or government agency that provides information concerning its services or benefits, assists persons in completing applications to receive such government or agency services or benefits, and allows persons to transmit their applications for services or benefits to the government or agency;
3. operating an Internet web site that allows multiple buyers and sellers to (1) exchange information concerning the products and services that they are willing to purchase or sell, (2) locate potential counterparties for transactions, (3) aggregate orders for goods or services with those made by other parties, and (4) enter into transactions between themselves; or
4. operating a telephone call center that provides permissible finder services.

An FHC that acts as a finder for a buyer or seller may also provide the buyer or seller with any combination of other services that are permissible under Regulation Y, so long as the finder and other services are provided in accordance with any applicable limitations under the finder provisions of Regulation Y. For example, a finder for a merchant may, in addition to acting as a finder, make, acquire, broker, or service loans or other extensions of credit to or for the merchant or merchant’s customers; provide the merchant with check-verification, check-guaranty, collection agency, and credit bureau services; provide financial investment advice to the merchant or its customers (within the parameters of Regulation Y); act as a certification authority for digital signatures and thereby authenticate the identity of persons conducting business with the merchant over electronic networks; and process and transmit financial, economic, and banking data on behalf of the merchant, such as processing the merchant’s accounts receivable and debit and credit card transactions. The FHC may also provide the merchant

1. An FHC is permitted to act as a finder for financial products and services as part of other permissible financial activities. For example, an FHC may act as a finder (1) in the purchase and sale of securities under authority to act as a securities broker under section 225.86(a) of Regulation Y or (2) in the purchase or sale of insurance products as an insurance agent under section 225.86(c) of Regulation Y.

with bill-payment and billing services, as well as processing order, distribution, accounting, settlement, collection, and payment information for the merchant's transactions.

Furthermore, an FHC may market and provide its own financial products and services in conjunction with acting as a finder for buyers and sellers of nonfinancial products and services. For example, an FHC may use its finder services to promote a company's products and services and, in connection with that activity, may negotiate on its own behalf and bind itself to transactions.

3910.0.1 LIMITATIONS ON AN FHC THAT ACTS AS A FINDER

A finder cannot serve as a principal in the underlying transaction. A finder may act only as an intermediary between a buyer and a seller. A finder may not negotiate for or bind any buyer or seller to the terms of a specific transaction or negotiate the terms of a specific transaction on behalf of a buyer or seller. However, a finder may—

1. arrange for buyers to receive preferred terms from sellers so long as the terms are not negotiated as part of any individual transaction, are provided generally to customers or broad categories of customers, and are made available by the seller (and not by the FHC), and
2. establish rules of general applicability governing the use and operation of the finder service, including rules that—
 - govern the submission of bids and offers by buyers and sellers that use the finder service and the circumstances under which the finder service will match bids and offers submitted by buyers and sellers, and
 - govern the manner in which buyers and sellers may bind themselves to the terms of a specific transaction.

A finder may not (1) take title to or acquire or hold an ownership interest in any product or service offered or sold through the finder service; (2) provide distribution services for physical products or services offered or sold through the finder service; (3) own or operate any real or personal property that is used for the purpose of manufacturing, storing, transporting, or assembling physical products offered or sold by third parties; or (4) own or operate any real or personal property that serves as a physical location for the physical purchase, sale, or distribution of products or services offered or sold by third parties. Further, a finder cannot engage in any activity that would require the company to register or obtain a license as a real estate agent or broker under applicable law.

3910.0.2 REQUIRED DISCLOSURES

A finder is required to distinguish the products and services offered by the FHC from those offered by a third party through the finder service. Because an FHC may act as a finder for third parties through varied technological means and in a wide variety of circumstances, FHCs are not required to provide specific disclosures. The Board expects FHCs to provide disclosures that, given the medium employed and type of buyers and sellers using the service (for example, consumers or corporations), are reasonably designed to ensure that users are not led to believe that the FHC is providing the products or services offered or sold by third parties through the finder service. An FHC could provide such notice by identifying those products or services that are offered or sold by the FHC (with a corresponding notice that all other products or services are provided by third parties), or by identifying those products or services that are offered and sold by third parties and not by the FHC.

To Acquire, Manage, and Operate Defined Benefit Pension Plans in the United Kingdom (Section 4(k) of the BHC Act) Section 3912.0

A financial holding company (FHC), a bank holding company (BHC) that meets the requirements of 4(l)(1) of the Bank Holding Company Act (the BHC Act),¹ proposed to acquire, manage, and operate in the United Kingdom defined benefit pension plans established and maintained by unaffiliated third parties (third-party UK pension plans). The activities would be conducted by or through a nonbank subsidiary of the FHC. The FHC would acquire third-party UK pension plans in standalone transactions and not as part of the acquisition of all or part of the ongoing business operations of the third parties.

Section 4 of the BHC Act generally prohibits a BHC, including an FHC, from directly or indirectly engaging in, or acquiring the shares of a company engaged in, any nonbanking activity unless the activity is otherwise permissible under the act. Section 4(k) of the BHC Act, as amended by the Gramm-Leach-Bliley Act (the GLB Act), permits a BHC that qualifies to be an FHC to engage in, and acquire and retain shares of any company engaged in, a broad range of activities that are defined by statute to be financial in nature.² The BHC Act also permits an FHC to engage in, and acquire and retain shares of any company engaged in, any activity that the Board determines, by order or regulation and in consultation with the Secretary of the Treasury, to be financial in nature or incidental to a financial activity.³

A defined benefit pension plan generally is a plan established by or on behalf of an employer (the plan “sponsor”). The plan provides for the payment of benefits to employees, typically beginning on their retirement or other termination of service, in an amount that is specified in and determinable under the plan, typically through a formula that takes into account the employee’s pay, years of employment, age at retirement, and other factors.⁴ The terms of the plan itself also typically specify (1) the circumstances under which benefits will be paid under the plan to an

employee, a former employee, or a related person (such as a spouse) (collectively, a beneficiary) and (2) the length of time such payments will be made to a beneficiary. The benefits payable under a plan typically take the form of a specified stream of payments that begin on retirement or, at the employee’s option, a lump sum payable at retirement; plan rules may also provide for other ancillary benefits, such as spousal or survivor benefits.⁵ The nonbank subsidiary of the FHC that directly acquires a third-party UK pension plan would assume the responsibilities of the plan’s sponsor under applicable UK law. In the United Kingdom, defined benefit pension plans are regulated by the UK Pensions Regulator under the Pensions Act of 1995, the Pensions Act of 2004, and the general law of trusts. These laws provide that pension plans must be managed and administered by a trustee that is independent of the plan sponsor. Plan sponsors must also provide sufficient assets to a pension plan to pay all benefits under the plan,⁶ consult with the trustees for the pension plan concerning the investment strategy of the plan, and agree with the plan trustees on a statement of funding principles that sets out the plan’s funding target, methods, and assumptions. In addition, trustees and plan sponsors must agree on amendments to any part of the plan.

As proposed, the FHC would acquire a third-party UK pension plan only if no additional beneficiaries may be added to the plan and existing beneficiaries may not accrue additional benefits under the plan (a hard-frozen plan). In addition, the FHC would acquire a third-party UK pension plan only if the plan, at the time of its acquisition, is fully funded by the selling sponsor, based on the plan’s assets and projected liabilities (using appropriate actuarial assumptions).⁷ The FHC indicated that, as part of its due-diligence process for each transaction,

1. 12 U.S.C. 1841 et seq.

2. See 12 U.S.C. 1843(k)(4).

3. 12 U.S.C. 1843(k)(1)(A) and (2). In addition, the BHC Act permits an FHC to engage in any activity that the Board (in its sole discretion) determines, by regulation or order, is “complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally” (12 U.S.C. 1843(k)(1)(B)).

4. A defined contribution plan is a benefit plan under which an individual account is established for each participant and the benefits payable to each participant are based on the amount contributed to the participant’s account, plus or minus income, gains, expenses, and losses allocated to that account.

5. “Defined benefit pension plan” does not include a plan that provides health insurance to employees or that guarantees or indemnifies employees for health care costs.

6. The sponsor may recover assets contributed to or held on behalf of a plan after all of the plan’s obligations to beneficiaries have been satisfied and the plan is closed out.

7. The term “fully funded” means that, at the time of acquisition, the current value of the plan’s assets is at least equal to the present value of the plan’s projected liabilities. The selling sponsor may issue debt to the plan or the FHC to fully fund the plan at acquisition. In some situations, the requirement that a plan be fully funded may require funding

it would employ qualified actuaries to review and analyze the present value of benefits owed to plan beneficiaries to ensure that all pension plans acquired are fully funded by the selling sponsor.

The activity of acquiring, operating, and managing third-party pension plans had not been previously determined to be financial in nature or incidental to a financial activity for purposes of the BHC Act. The activity proposed is broader than the pension plan activities that FHCs are currently permitted to conduct for third parties. For example, as discussed above, a nonbank subsidiary of the FHC would assume the rights and obligations of the sponsor of an acquired third-party UK pension plan and would do so in transactions that do not represent the acquisition of a going concern or ongoing business operations by the FHC. In addition, the assets and liabilities of an acquired third-party UK pension plan (unlike assets held by an FHC as trustee for third parties or assets held by the pension plans maintained for the FHC's own employees) would be fully consolidated with the assets and liabilities of the FHC on its balance sheet.⁸

The Board concluded, for the reasons set forth below, that there is a reasonable basis for determining that the acquisition, management, and operation by the FHC of hard-frozen, fully funded third-party UK pension plans is an activity that is financial in nature within the meaning of the BHC Act. The activity involves, at its core, the types of investment advisory and investment management skills that are routinely exercised by banking organizations and also involves the types of operational and investment risks that banking organizations routinely incur and manage.

FHCs are currently permitted by the BHC Act to engage in activities that are related or operationally and functionally similar to the proposed activity and that involve similar risks. For example, an FHC is already permitted to pro-

in excess of the statutory funding requirements of the relevant jurisdiction.

8. Since the FHC would acquire each third-party UK pension plan in a standalone transaction, and not as part of a business combination involving it and the selling sponsor, the FHC stated that it will fully reflect the assets and liabilities of an acquired plan as assets and liabilities of the FHC on its balance sheet. This treatment differs from the manner in which the assets and liabilities of an internal pension plan of an employer typically are accounted for on the balance sheet of the employer under U.S. generally accepted accounting principles. See Statement of Financial Accounting Standards No. 158 (FAS 158), "Accounting for Defined Benefit Pension and Other Post Retirement Plans."

vide a wide variety of services to third-party pension plans, including acting as trustee, custodian, or investment adviser (with or without investment discretion) for a third-party benefit plan, as well as designing, assisting in the implementation of, providing administrative services to, and developing employee communication programs for third-party benefit plans.⁹ FHCs engaged in these activities have gained substantial expertise with the laws, regulations, and fiduciary obligations associated with providing fiduciary, custodial, and administrative services to pension plans. Moreover, FHCs engaged in these plan-related activities have developed risk-management systems and internal controls to monitor, manage, and address the legal, operational, and reputational risks associated with managing the investments of and administering third-party pension plans.

The proposed activity also bore a strong functional resemblance to the issuance of a group annuity contract. The BHC Act, as amended by the GLB Act, expressly states that providing and issuing annuities is an activity that is financial in nature.¹⁰ A company that issues a fixed annuity becomes obligated to make periodic payments to the annuitant during his or her lifetime and to pay any death or survivor benefits in accordance with the terms of the annuity contract. The company that issues a fixed annuity assumes responsibility for investing and managing the funds received from the annuitant and bears the risk that such funds and the returns earned on the funds will not be sufficient to pay out the full amount of benefits promised under the annuity contract. The company also assumes responsibility for administering the annuity contract both before and during its payout period.

In connection with these activities, the issuer of fixed annuities is exposed to certain types of risks, which are part of the activity determined to be financial in the GLB Act. These risks include the risk that (1) the life expectancy of annuitants, on average, will exceed the actuarial estimates used in establishing the terms of and funding for the annuities; (2) the inflation rate and other assumptions used to determine the expected obligations under the annuity contracts underestimate these obligations; and (3) payments from the annuitant and the return obtained through the investment of such payments will fall short of estimates.

The FHC would perform essentially the same financial functions and assume essentially the same financial obligations and risks through the

9. See 12 C.F.R. 225.28(b)(5), (6), and (9)(ii).

10. 12 See 12 U.S.C. 1843(k)(4)(B).

acquisition of a third-party UK pension plan as an insurance company would perform and assume in connection with the issuance of fixed annuities. The functional similarity between a plan sponsor's obligations under a defined benefit pension plan and an insurance company's obligations under an annuity contract is especially close when the pension plan is both fully funded and hard-frozen, as it is in the FHC's proposed activity. When a pension plan's obligations to plan beneficiaries are hard-frozen and the plan is fully funded, one method commonly used by a plan sponsor to close out a plan is to purchase a terminal funding group annuity contract from an insurance company. Through such an annuity contract, the provider of the annuity becomes obligated to satisfy the responsibility to pay the benefits promised under the plan to the plan's beneficiaries. The FHC's proposed activities would be specifically permitted under the BHC Act if they were provided through an annuity contract or other form of insurance.

When evaluating this proposal, the Board considered that, under UK law, the nonbank subsidiary established by the FHC to acquire a third-party UK pension plan will generally bear sole responsibility for making additional contributions to the plan if the plan assets are not sufficient to meet the plan's expected or actual liabilities. However, UK law also permits the UK Pensions Regulator in certain circumstances to commence proceedings to hold an affiliate of a plan sponsor (including a depository institution affiliate) responsible for the sponsor's obligations to the plan.¹¹

Generally, the Board has taken the position that, when a depository institution is secondarily liable for a financial obligation of an affiliate, even if the depository institution's liability is created by statute or regulatory action, the institution has issued a guarantee on behalf of an affiliate for purposes of section 23A of the Federal Reserve Act and the Board's Regulation W. Section 23A and Regulation W impose quantitative and qualitative limits on covered transactions between a depository institution and its affiliates.¹² The limitations in section 23A and Regulation W provide important protections against a depository institution suffering losses due to covered transactions with its affiliates

and also limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net.

To address the potential section 23A and Regulation W issues presented by its initial proposed transaction, and in accordance with UK law,¹³ the FHC obtained written assurances from the UK Pensions Regulator that it will not seek to hold any of the FHC's depository institution subsidiaries that are subject to section 23A responsible for any shortfalls that may occur in the pension plan proposed to be acquired by the FHC in this initial transaction. As a condition of this order, the FHC must obtain similar written assurances from the UK Pensions Regulator before acquiring any additional third-party UK pension plan.¹⁴

Based on the foregoing and other facts of record, the Board concluded that the acquisition, management, and operation by the FHC of hard-frozen, fully funded third-party UK pension plans, when conducted in accordance with the conditions and limitations set forth in the order, is an activity that is financial in nature within the meaning of section 4(k) of the BHC Act. Any investment made by a third-party UK pension plan acquired by the FHC must otherwise be permissible for an FHC under the BHC Act and the Board's Regulation Y.¹⁵ The authorization and determination granted by the Board's order is limited to the acquisition, management,

13. The Pensions Act of 2004 expressly authorizes the UK Pensions Regulator, on application by a plan or other person, to issue a "clearance statement" that determines that it would be unreasonable to issue a contribution notice or financial support directive to the plan or person under the circumstances described in the application. See Pensions Act of 2004, sections 42 and 46. The FHC received such a clearance statement with respect to its initial proposed acquisition of a third-party pension plan in the United Kingdom.

14. The FHC has indicated that the written assurances provided by the UK Pensions Regulator are subject to review and renewal by the regulator no later than five years after issuance. Before the expiration of any written assurances provided by the UK Pensions Regulator in connection with the acquisition by the FHC of a third-party UK pension plan, the FHC must either ensure that its activities conform with those permitted under section 23A and Regulation W or obtain an exemption from the Board from the limitations of section 23A and Regulation W with respect to the plan. The Board has not determined that section 23A applies to the contingent liabilities that may arise under applicable pension law from the establishment or operation by an affiliate of a depository institution of employee benefit plans in the ordinary course of its other business to provide benefits to the employees or former employees of the affiliate.

15. See, for example, 12 U.S.C. 1843(c)(5), (c)(6), and (k)(4)(H).

11. See the UK Pensions Act of 2004, section 38 (contribution notices) and section 43 (financial support directives). The UK Pensions Regulator may issue a contribution notice or financial support directive to an affiliate of a sponsor only if, among other things, the Pensions Regulator determines that it is reasonable to impose the proposed financial obligations on the affiliate.

12. See 12 U.S.C. 371c(b)(7) and 12 C.F.R. 223.3(h).

and operation by the FHC of third-party pension plans in the United Kingdom.¹⁶

Under the BHC Act, the Board may not determine, by regulation or order, that an activity is financial in nature or incidental to a financial activity if the Secretary of the Treasury (the Secretary) notifies the Board in writing that the Secretary believes the activity is not financial in nature, incidental to a financial activity, or otherwise permissible under section 4 of the BHC Act.¹⁷ The Board provided the Secretary of the Treasury with notice of the FHC's proposal in accordance with the BHC Act, and the Secretary informed the Board in writing that the Secretary

did not intend to prevent the Board from authorizing the FHC to engage in the proposed UK pension activities, subject to the conditions and limitations in the Board's order.

The Board's determination and approval is subject to all the conditions set forth in Regulation Y, including those in section 225.7,¹⁸ and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to ensure compliance with, or to prevent evasion of, the provisions and purposes of the BHC Act and the Board's regulations and orders. The Board's decision is specifically conditioned on compliance with all the commitments made to the Board in connection with the request, including the commitments and conditions discussed in the order. The Board's order was approved and effective on October 12, 2007.¹⁸

16. Other FHCs may seek approval to engage in similar activities by requesting a determination with respect to their own proposed activities under section 4(k)(2)(A) of the BHC Act and section 225.88 of the Board's Regulation Y (12 C.F.R. 225.88).

17. See 12 U.S.C. 1843(k)(2)(A).

18. 12 C.F.R. 225.7.

WHAT'S NEW IN THIS REVISED
SECTION

Effective July 2008, a brief discussion of a Board order in which the Board considered under section 4(k) of the Bank Holding Company (BHC) Act, and approved, a financial holding company (FHC)'s limited trading in certain physical commodities that are not approved by the Commodities Futures and Trading Commission (CFTC) for trading in the U.S. or on non-U.S. futures exchanges. To trade in such commodities, the FHC must be able to demonstrate that the derivative contracts on the commodity satisfy the specified standards that are stated in the order. The section also discusses the Board's approval of the same FHC's request to make and take delivery in nickel, a metal that is traded on the London Metal Exchange (LME)—a CFTC-comparable regulatory entity. Members of the LME can conduct brokerage activities for U.S. customers without being registered with the FTC as a futures commission merchant.

An FHC's Board-approved request to permit the refining, blending, or altering of approved commodities by a third party is reviewed within the section along with the use of recognized alternate trading platforms. The same Board order includes the Board's approval of the FHC's request to engage in limited physically settled energy tolling by entering into tolling agreements with power plant owners. The Board determined that the activity is complementary to the financial activity of engaging as principal in commodity derivatives transactions. The FHC nonbank activity had not been previously approved by the Board. (See 2008 FRB C60.)

For another Board order, the section discusses the Board's approval of an FHC's request to engage in providing Energy Management Services (EMS) to owners of power generation facilities. The EMS are to be provided under energy management agreements as a complement to the financial activities of engaging as principal in commodity derivatives and providing financial and investment advisory services for derivative transactions. (See 2008 FRB C20.)

3920.0.1 ENGAGING IN LIMITED FHC
COMMODITY-TRADING ACTIVITIES
INVOLVING A PARTICULAR
COMMODITY AS A COMPLEMENT
TO THE BHC-PERMISSIBLE
FINANCIAL ACTIVITY OF
ENGAGING REGULARLY IN
COMMODITY DERIVATIVES BASED
ON THAT COMMODITY

An FHC requested the Board's approval under section 4(k) of the Bank Holding Company Act (the BHC Act) to retain all of the shares of a company that engaged in a variety of commodity-related activities in the United States, including trading in physical commodities, an activity not previously approved under the BHC Act.

Regulation Y authorizes bank holding companies (BHCs) to engage as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on a rate, price, financial asset, nonfinancial asset, or group of assets (other than a bank-ineligible security) (commodity derivatives). A BHC may conduct commodity-derivatives activities under Regulation Y subject to certain restrictions that are designed to limit the BHC's activity to trading and investing in financial instruments rather than dealing directly in physical nonfinancial commodities. Under these restrictions, a BHC may take and make delivery of physically settled derivatives involving commodities that a state member bank is permitted to own.¹ For all other types of physically settled derivatives,² a BHC must make reasonable efforts to avoid delivery on such derivatives or must take and make delivery only on an instantaneous, pass-through basis. (See section 3260.0.4.6.) Other than in the limited circumstances described above in connection with commodity derivatives, Regulation Y generally does not permit BHCs to take or make delivery of nonfinancial commodities underlying commodity derivatives. In addition, BHCs are generally not permitted to purchase or sell nonfinancial commodities in the spot market.

1. State member banks may own, for example, investment-grade corporate debt securities, U.S. government and municipal securities, foreign exchange, and certain precious metals.

2. These derivative contracts would include instruments based on, for example, energy-related and agricultural commodities.

The FHC requested that the Board expand the authority of FHCs to purchase and sell commodities in the spot market and to take and make delivery of physical commodities to settle commodity derivatives (commodity-trading activities), by determining that these activities are “incidental” to a financial activity (pursuant to section 4(k) of the BHC Act). Commodity-trading activities typically involve the commercial activities of physically owning and disposing of assets such as oil, natural gas, agricultural products, and other nonfinancial commodities. Moreover, the risks associated with conducting these activities are commercial risks not traditionally incurred or managed to a material extent by banking organizations. Accordingly, the Board did not believe that commodity-trading activities could be construed as incidental to a financial activity within the meaning of the Gramm-Leach-Bliley Act (the GLB Act) or the BHC Act. The Board concluded, however, for the reasons set forth below, that there was a reasonable basis for construing these activities as complementary to a financial activity within the meaning of the GLB Act or the BHC Act.

Section 4(k)(1)(B) of the BHC Act permits FHCs to seek Board approval to engage in any activity the Board determines (1) to be complementary to a financial activity and (2) not to pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. FHCs must submit a written request for the Board’s approval to engage in a complementary activity through the filing of a notice under section 4 of the BHC Act. The Board considers each request on a case-by-case basis. (Subsection 3905.0.1 provides a list of the information that needs to be included with such a request.)

A number of considerations supported a Board determination that commodity trading activities are complementary to a financial activity. (See 2003 FRB 508.) Commodity-trading activities can flow from the existing financial activities of FHCs. In particular, commodity-trading activities provide FHCs with an alternative method of fulfilling their obligations under otherwise BHC-permissible commodity derivatives. For example, if warranted by market conditions, an FHC would be able to use commodity-trading-activity authority to take a commodity derivative to physical settlement rather than terminating, assigning, offsetting, or otherwise cash-settling the contract.

The Board also noted that the applicant con-

tended that the existing restrictions of Regulation Y place FHCs at a significant bargaining disadvantage when operating in physically settled over-the-counter (OTC) derivatives markets. According to the applicant, counterparties to FHCs in these markets are aware of the regulatory impediments that inhibit BHCs and FHCs from taking derivative contracts to physical settlement. As a consequence, BHCs and FHCs that participate in these markets can be forced to terminate or offset their derivative contracts on uneconomic terms. Allowing BHCs and FHCs to engage in commodity-trading activities would permit FHCs to compete in physically settled OTC derivatives markets more economically.

The Board concluded that commodity trading activities involving a particular commodity complement the financial activity of engaging regularly as principal in BHC-permissible commodity derivatives based on that commodity.³ In order to authorize FHCs to engage in commodity-trading activities as a complementary activity under the GLB Act, the Board must also determine that those activities do not pose a substantial risk to the safety or soundness of depository institutions or the U.S. financial system generally.⁴ To limit the potential safety-and-soundness risks of commodity-trading activities, the applicant proposed to engage in only a limited amount of commodity-trading activities. As a condition of the Board’s order, the market value of commodities held by the applicant as a result of commodity-trading activities must not exceed 5 percent of the applicant’s consolidated tier 1 capital.⁵ The applicant also must notify its designated supervising Federal Reserve Bank if the market value of commodities held by the applicant as a result of its commodity-trading activities exceeds 4 percent of its tier 1 capital.

In addition, the Board’s order permitted the applicant to take and make delivery of only physical commodities for which derivative contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission (CFTC) (unless specifically excluded by the Board) or that have been specifically approved by the Board.⁶ This

3. For example, commodity-trading activities involving all types of crude oil would be complementary to engaging regularly as principal in BHC-permissible commodity derivatives based on Brent crude oil.

4. 12 U.S.C. 1843(k)(1)(B).

5. The applicant is required to include in this 5 percent limit the market value of any commodities it holds as a result of a failure of its reasonable efforts to avoid taking delivery under section 225.28(b)(8)(ii)(B) of Regulation Y.

6. The particular commodity-derivative contract that the applicant takes to physical settlement need not be exchange-traded, but (in the absence of specific Board approval) futures

requirement is designed to prevent the applicant from becoming involved in dealing in finished goods and other items, such as real estate, that lack the fungibility and liquidity of exchange-traded commodities.

The Board concluded that permitting the applicant to buy and sell commodities in the spot market or physically settle commodity derivatives would not appear to increase significantly the organization's potential exposure to commodity-price risk.

The Board's order acknowledged that adding commodity-trading activities would expose the applicant to additional risks, including, but not limited to, storage risk, transportation risk, and legal and environmental risks. To minimize these risks, the applicant was not authorized to (1) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities or (2) process, refine, or otherwise alter commodities. In conducting its commodity-trading activities, the applicant was expected to use appropriate storage and transportation facilities owned and operated by third parties.⁷

The applicant indicated that it will mandate that the commodity-storage facilities it uses have all required governmental permits and provide the applicant with a certificate to that effect. The applicant further stated that all commodity-storage facilities will be inspected by or on its behalf before use and that it will physically inspect any commodity in storage every six months.

The applicant also stated that it would adopt additional standards for commodity-trading activities that involve environmentally sensitive products, such as oil or natural gas. For example, the applicant will require that the owner of every vessel that carries oil on its behalf be a member of a protection and indemnity club and carry the maximum insurance for oil pollution available from the club. Every such vessel will

be required to carry substantial amounts of additional oil-pollution insurance from creditworthy insurance companies. The applicant will place age limitations on vessels and will require vessels to be approved by a major international oil company and have appropriate response plans and equipment for oil spills. The applicant will also have a comprehensive backup plan in the event any vessel owner fails to respond adequately to an oil spill and will hire inspectors to monitor the loading and discharging of vessels.

The applicant also represented that it will have in place specific policies and procedures for the storage of oil. In addition, the applicant will require all oil-storage facilities it uses to carry a significant amount of oil-pollution insurance from a creditworthy insurance company and to have appropriate spill-response plans and equipment. The applicant will also follow a comprehensive backup plan in the event the storage facility owner fails to respond adequately to an oil spill.

The Board determined that the applicant had the managerial expertise and internal control framework to manage the risks of taking and making delivery of physical commodities. It also concluded that the applicant had the expertise and internal controls to integrate effectively the risk management of commodity-trading activities into its overall risk-management framework, which includes managing on a consolidated basis the overall exposure arising from the applicant's commodity-related activities.

For these reasons, and based on the applicant's policies and procedures for monitoring and controlling the risks of commodity-trading activities, the Board concluded that consummation of the proposal did not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally and could reasonably be expected to produce benefits to the public that outweighed any potential adverse effects. (See 2003 FRB 508.)

In another Board order (2004 FRB 215), a foreign bank (the FB) that is treated as a financial holding company (FHC) for purposes of the Bank Holding Company Act (the BHC Act), requested the Board's approval under section 4 of the BHC Act (12 U.S.C. 1843) and the Board's Regulation Y (12 C.F.R. 225) to retain all the voting shares of FB Energy, LLC, located in Connecticut (FB Energy) and to continue engaging in physical-commodity trading in the United States. The FB conducts physical-

or options on futures on the commodity underlying the derivative contract must have been approved for exchange trading by the CFTC. The CFTC publishes annually a list of the CFTC-approved commodity contracts. See, for example, *Commodity Futures Trading Commission, FY 2002 Annual Report to Congress 124 and FY 2003 Annual Report to Congress 109.*

With respect to granularity, the Board intends this requirement to permit commodity-trading activities involving all types of a listed commodity. For example, commodity-trading activities involving any type of coal or coal-derivative contract would be permitted, even though the CFTC list specifically approves only Central Appalachian coal.

7. The Board's approval of commodity-trading activities as a complementary activity, subject to the limits and conditions, did not restrict the existing authority of the applicant to deal in foreign exchange, precious metals, or any other bank-eligible commodity.

commodity trading in the United States pursuant to temporary grandfather authority provided by the BHC Act and Regulation Y.⁸

The FB requested that the Board permit it to purchase and sell physical commodities in the spot market and to take and make delivery of physical commodities to settle commodity derivatives (commodity-trading activities). As noted in the 2003 Board order (2003 FRB 508), the Board had previously determined that commodity-trading activities involving a particular commodity complement the financial activity of engaging regularly as principal in BHC-permissible commodity derivatives based on that commodity. The FB regularly engages as principal in BHC-permissible commodities derivatives based on a variety of commodities, including natural gas and electricity. The Board determined that the commodity-trading activities are complementary to the commodity-derivatives activities of the FB.

The FB has established and maintained policies for monitoring, measuring, and controlling the credit, market, settlement, reputational, legal, and operational risks involved in its commodity-trading activities. These policies address key areas such as counterparty credit risk, value-at-risk methodology and internal limits with respect to commodity trading, new-business and new-product approvals, and identification of transactions that require higher levels of internal approval. The policies also describe critical internal control elements, such as reporting lines, and the frequency and scope of internal audit of commodity-trading activities.

The FB is subject to the same commitments and restrictions set forth in the previously discussed Board order (2003 FRB 508). The FB and its commodity-trading activities also remain subject to the general securities, commodities, and energy laws and to the rules and regulations (including the anti-fraud and anti-manipulation rules and regulations) of the Securities and Exchange Commission, the CFTC, and the Federal Energy Regulatory Commission.

The Board concluded that permitting the FB to engage in the limited amount and types of commodity-trading activities described previously, on the terms described in the order, would not appear to pose a substantial risk to the FB, depository institutions, or the U.S. financial

system generally. Because of its existing authority to engage in commodity derivatives, the FB could already incur the price risk associated with commodities. Therefore, permitting the FB to buy and sell commodities in the spot market or to physically settle commodity derivatives did not appear to increase significantly the organization's potential exposure to commodity-price risk.

Based on the reasons stated in the Board's order, and based on the FB's policies and procedures for monitoring and controlling the risks of commodity-trading activities, the Board concluded that consummation of the proposal did not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally and that it could reasonably be expected to produce benefits to the public that outweigh any potential adverse effects.

Based on all the facts of record, including the representations and commitments made by the FB in connection with the notice, and subject to the terms and conditions set forth in the order, the Board approved the notice on January 27, 2004. (See 2004 FRB 215 and the notice approved by the Board at 2004 FRB 511; both FHCs were approved by the Board to engage in limited physical-commodity trading involving such commodities as natural gas and electricity.) Also see the approvals for FHCs to engage in limited commodities trading that included certain energy-related commodities, such as natural gas, crude oil, electricity, and emissions allowances.⁹ These Board orders were approved on November 18, 2005 (2006 FRB C57), December 19, 2005 (2006 FRB C54), and March 15, 2006 (2006 FRB C113). Subsequently, the Board delegated its authority to approve notices by FHCs to engage in physical-commodity trading as a complementary activity to the director of the Division of Banking Supervision and Regulation, with the concurrence of the General Counsel, when the proposal meets the conditions imposed by the Board in approving previous requests and when the specific proposal raises no significant legal, policy, or supervisory issues.

9. An emission allowance is an intangible right to emit certain pollutants during a given year or any year thereafter that is granted by the U.S. Environmental Protection Agency or comparable foreign regulatory authority to an entity—such as a power plant or other industrial concern—affected by environmental regulation aimed at reducing emission of pollutants. An allowance can be bought, sold, or exchanged by individuals, brokers, corporations, or government entities that establish an account at the relevant governmental authority.

Emissions allowances are stored and tracked in the records of the relevant government authority. Accordingly, there is no transportation, environmental, storage, or insurance risk associated with ownership of emissions allowances.

8. The FB's grandfather rights were scheduled to expire on February 8, 2004. The FB conducts its U.S. energy trading business through FB Energy and FB's London branch.

3920.0.2 TRADING IN CERTAIN PHYSICAL COMMODITIES NOT APPROVED BY THE CFTC FOR TRADING ON A FUTURES EXCHANGE

The Board had previously conditioned its notice approvals to engage in physical commodity trading (PCT) based on commitments made by the FHCs to trade only in commodities for which derivative contracts had been approved for trading on a futures exchange by the CFTC, unless the commodity was specifically excluded or approved by the Board (Approved Commodities Commitment). This commitment provided a means to ensure that the PCT remained complementary to the financial activity of commodity derivatives activities (CDAs) because it helped demonstrate that there was a derivatives market for the underlying commodity. This commitment also was intended to prevent FHCs from dealing in finished goods and other items, such as real estate or industrial products that lacked the fungibility and liquidity of exchange-traded commodities.

In another request, a foreign-domiciled FHC, RB, requested the Board's approval under section 4 of the BHC Act, and the Board's Regulation Y, to engage in limited PCT. That request led to the Board's decisions with regard to trading of certain physical commodities, which are *not* CFTC-approved for trading on a futures exchange. The Board determined that, subject to certain requirements, an FHC may take delivery of certain commodities that have *not* been approved by the CFTC, if those commodities are similarly fungible and liquid, and do not expose the FHC to significant additional risk.

3920.0.2.1 Commodities Approved for Trading on Non-U.S. Exchanges.

The Board has previously used CFTC-approval of a commodity for trading on a U.S. futures exchange as a test to determine whether a derivative or the underlying commodity is liquid and fungible. For some liquid and fungible commodities, however, no market-maker had sought CFTC approval because of the presence of an established foreign trading market, which could deter a U.S. exchange from listing a similar product. The absence of CFTC approval, in those cases, generally would *not* indicate that taking and making physical delivery of the commodity would entail substantially greater risks than taking and making delivery of a CFTC-approved commodity. A derivatives contract

that is based on a commodity that trades on a non-U.S. exchange may be subject to a regulatory structure comparable to the one administered by the CFTC. Such a structure generally should be sufficient to demonstrate that (1) there is a market in financially settled contracts on the commodities, (2) the commodity is fungible, and (3) a reasonably liquid market for the commodity exists.

3920.0.2.1.1 *Take and Make Delivery of Nickel*

RB specifically requested the Board's approval to take and make physical delivery of nickel, which is a metal that is widely and actively traded on the London Metal Exchange (LME). The LME offers futures and options contracts for aluminum, copper, nickel, tin, zinc, and certain aluminum alloy contracts. The CFTC has determined that the LME is subject to a regulatory structure comparable to that administered by the CFTC under the Commodity Exchange Act. As a result, members of the LME may conduct brokerage activities for U.S. customers without having to register with the CFTC as a futures commission merchant or otherwise comply with certain of the CFTC's consumer protection rules.¹⁰ Given the nature of the LME trading market and the CFTC's determination that LME members are subject to comparable regulatory oversight, the Board determined that FHCs that receive approval to engage in PCT may take and make delivery of nickel. The Board determined that other FHCs that had already received approval to engage in PCT could also make and take delivery of nickel, consistent with the Approved Commodities Commitment, as a commodity that has been specifically approved by the Board.

3920.0.2.2 Commodities That Are Not Approved for Trading in the U.S. or on Certain Non-U.S. Exchanges

Many commodities for which derivatives con-

10. The CFTC's Rule 30.10 permits a person affected by the requirements contained in Part 30 of the CFTC's rules, which relate to registration as a futures commission merchant, to petition the CFTC for an exemption from the requirements based on the person's substituted compliance with a foreign regulatory structure found comparable to that administered by the CFTC under the Commodity Exchange Act.

tracts have not been approved for trading by the CFTC or that are not traded on a non-U.S. exchange may also be commodities that have viable markets with financially settled contracts on the commodities and that satisfy fungibility and liquidity concerns. In many cases, the existence of an established over-the-counter market obviates the need to seek CFTC approval for listing on a futures exchange. In addition, the particular commodity may be similar to a CFTC-approved commodity, such as a product that is derived from a CFTC-approved commodity. In which case, the separate listing may be excessive because market participants can use derivatives contracts on the CFTC-approved commodity to hedge their positions in the non-CFTC-approved derivative product.

The Board believes that taking and making physical delivery of non-CFTC-approved commodities may be consistent with the PCT authority if an FHC can demonstrate that (1) there is a market in financially settled contracts on those commodities in addition to the physically settled contracts, (2) the particular commodity is fungible, and (3) the market for the commodity is sufficiently liquid. In addition, the FHC must demonstrate that it has established trading limits in place that address both concentration risk and overall exposure to the commodity to ensure that the FHC could physically trade in these commodities without incurring significant additional risk.

RB requested the Board's approval to trade in certain natural gas liquids, oil products, and petrochemicals. The natural gas liquids consisted of butane, ethane, and natural gasoline; the proposed oil products were asphalt, condensate, boiler cutter, residual fuel oil no. 6, kerosene, straight run, marine diesel, and naphtha; and the proposed petrochemicals were ethylene, paraxylene, styrene, propylene, and toluene (collectively, PCs). Contracts on those PCs are not approved by the CFTC for trading on a U.S. futures exchange or on a major non-U.S. exchange. Nonetheless, the following considerations provided the Board support for making a determination that trading in the PCs should be permitted as part of the PCT authority.

3920.0.2.2.1 Market in Financially Settled Contracts

Many commodities trade on established alternative trading platform(s) or ATPs that are used by

a wide variety of market participants, rather than on a futures exchange. If derivatives contracts on a commodity trade on a recognized ATP, that activity could serve as sufficient evidence that a market in financially settled contracts on the particular commodity exists. Financially and physically settled contracts for all the PCs trade on recognized ATPs.

The natural gas liquids are traded on the Intercontinental Exchange ("ICE") and on the New York Mercantile Exchange ("NYMEX") electronic trading platforms; the distillate and residual oil products trade on ICE and NYMEX; and the petrochemicals are traded on the Chemconnect electronic trading platform. These ATPs are major platforms that are widely used by a variety of producers, consumers, and traders of the PCs.

3920.0.2.2.2 Fungibility

To ensure that a commodity is fungible, an FHC must demonstrate that no specification of exact product or lot would be included for contracts on the commodity. The physical asset that may be delivered to satisfy a contract would be, by nature or usage of trade, the equivalent of any other unit of the asset. The PCs, which trade on ICE, NYMEX, and Chemconnect, are fungible because market participants contract for specific quantities of the commodity but cannot specify the particular product they will receive.

3920.0.2.2.3 Liquidity

To ensure that the market for a particular commodity is sufficiently liquid, an FHC must demonstrate that an active trading market in the commodity exists that would allow the institution to limit its position in the commodity relative to the volume that trades in the market generally. The following factors indicate that a reasonably liquid market exists: (1) reliable trading volume in the commodity or production statistics exist that demonstrate the size of the market in the commodity; (2) daily or intraday price data on the commodity are published; and (3) a number of market makers in the commodity stand ready to buy or sell the commodity each day at published bid and offer quotations. Each of the PCs is derived from CFTC-approved commodities (natural gas and oil) and is used, similar to CFTC approved commodities, as fuel or as inputs for finished products. The PCs are traded widely through brokers on the previously discussed ATPs and are physi-

cally traded at various hubs in the U.S. and abroad.¹¹ The ATPs post daily prices for both the buy and sell offers on which the PCs trade.

3920.0.2.2.4 *Trading Limits*

An FHC that proposes to trade in a new commodity must demonstrate that it has established appropriate limits on its trading in the commodity and has a risk-management program in place to monitor compliance with those limits, which must include both concentration limits and overall exposure limits. RB represented that as part of its risk-management program relating to the PCs, it would impose appropriate concentration and overall exposure limits for each of the PCs.

In light of the characteristics of the PCs and based on all the facts of record, the Board has determined that taking physical delivery of the PCs is consistent with the complementary nature of PCT and does not present undue safety and soundness concerns for RB.¹²

3920.0.2.2.5 *Altering Commodities.*

Previously, the Board approved PCT, on a limited basis, subject to a number of commitments, including that the FHC not process, refine, or otherwise alter a commodity. RB intends to engage third parties to refine, blend, or otherwise alter commodities for which it is permitted to take and make physical delivery.

A number of considerations supported the Board's determination that engaging a third party to alter a commodity is consistent with the existing PCT authority. Permitting RB to engage a third party to alter a commodity would not significantly increase the risks to the institution from PCT. Under this authority, an FHC may already engage a third party to store commodities, which exposes an FHC to substantially the same types of risks as engaging a third party to alter a commodity. Also, an FHC could sell a commodity to a refinery and buy back the refined commodity if both the commodity sold to and

bought from the refinery were permissible commodities. Permitting an FHC to engage third parties to alter commodities also would enhance an FHC's ability to meet its customers' needs.

To ensure that the activity remains consistent with the scope of PCT, RB made the following commitments: (1) RB will not alter commodities itself; (2) both the commodity input and the resulting altered commodity will be permissible commodities under the Board's decisions; and (3) RB will not have exclusive rights to use the alteration facility. Requiring that both the commodity input and the altered commodity be permissible commodities under the Board's decisions helps ensure that RB would not assume the risk of taking and making physical delivery of commodities that the Board has not yet evaluated. In addition, preventing RB from having the exclusive right to use an alteration facility should reduce RB's exposure to the potential risks associated with operating commodity-altering facilities.

3920.0.2.2.6 *Risks of Proposed Physical Commodity Trading Activities.*

Permitting RB to engage in the limited amount and types of PCT described above would not appear to pose a substantial risk to RB, depository institutions, or the U.S. financial system generally. RB made commitments relating to its PCT that are designed to address the risks involved in the proposed activities. In addition to the commitments discussed previously, RB provided substantially the same commitments and agreed to the same limitations as those provided by other FHCs in connection with the Board's approvals of their proposals to engage in PCT. With regard to RB and its Board order, see also subsection 3920.0.4.

3920.0.3 ENERGY MANAGEMENT SERVICES AS A COMPLEMENT TO A FINANCIAL ACTIVITY

A foreign-owned FHC, for the purposes of the BHC Act, a directly owned foreign bank, and its other directly owned foreign companies (all collectively referred to as "F"), requested the Board's approval under section 4 of the BHC Act (12 U.S.C. 1843) and the Board's Regulation Y to provide energy management services (EMS) to owners of power generation facilities

11. Natural gas liquids are physically traded in the U.S. at hubs in Texas and Kansas; the distillate and residual oil products are physically traded at various points in the United States as well as the Caribbean, Africa, Europe, and Singapore; and the petrochemicals are physically traded at various points in the U.S., South Korea, and Thailand.

12. Because trading of the proposed commodities might require that an FHC adapt a particular risk-management program beyond what would be required to trade in the commodities that are currently permissible, the Board's order does not grant authority to take and make delivery of the proposed commodities to all FHCS with PCT authority.

under energy management agreements (EMAs); an activity that is complementary to the financial activities of engaging as principal in commodity derivatives and providing financial and investment advisory services for derivatives transactions.¹³ Providing EMS generally involves acting as a financial intermediary for a power plant owner to facilitate transactions relating to the acquisition of fuel and the power plant owner's sale of power. Such services may also consist of providing advice to assist the owner in developing its risk-management plan.

3920.0.3.1 Provision of Energy Management Services

Under its EMAs, EMT, as energy manager, assists power plant owners by providing transactional and advisory services. The transactional services consisted primarily of EMT acting as a financial intermediary, substituting its credit and liquidity for those of the owner to facilitate the owner's purchase of fuel and sale of power. EMT's advisory services include providing market information to assist the owner in developing and refining a risk-management plan for the plant.

When providing EMS, EMT will provide services under an EMA based on a strategic framework that will be established by the owner. The owner, in consultation with EMT, establishes an energy management plan and risk-management policy to govern how the generation facility should be operated. The energy management plan establishes the amount of power the plant should generate and determines how the plant will meet its reliability obligations to the power transmission grid. The plant owner must approve all commodity contracts, including all contracts for the purchase of fuel or the sale of electricity. The authority to enter into power or fuel contracts, in some cases, may be delegated to EMT, if the contracts satisfy specific criteria that are established by the owner; other contracts must be approved by the owner. The owner also maintains the right, subject to EMT's right of first refusal, to market and sell power directly to third parties. The owner ultimately retains all

decision-making authority, including decisions relating to the facility's generation output and, in particular, whether the facility should be shut down for any period of time.

An EMA's compensation structure includes this allocation of responsibilities. When the facility is in operation, EMT is typically compensated on a monthly basis at the greater of a monthly fixed fee or a stated percentage of the spread between delivered fuel prices and the realized power revenues (adjusted to reflect certain fees and costs). When the facility is not in operation, EMT is not responsible for the fixed costs of the facility and is not entitled to revenues or other compensation, apart from the monthly fees.

EMT is not involved in providing day-to-day operational services to the facility. Those tasks are generally performed by the owner or by an operator who is hired directly by the owner and is not affiliated with EMT. The operator manages and maintains the facility on a daily basis, which typically includes providing labor and support services. The operator is to provide EMT with information on the operating status of the facility, maintenance issues that might affect the availability of the facility to generate power, and scheduled outage and maintenance periods.

EMT may buy fuel for the facility from third parties and enter into a mirror transaction for the fuel with the owner. The owner may then sell the power generated by the facility to EMT, and then EMT generally resells the power in the market. EMT would thus be acting as the financial intermediary for the owner, providing credit and liquidity support, including posting any required collateral for transactions. Because EMT is able to substitute its name and credit rating for the owner's, the terms of the transactions may be generally more favorable than what the owner could negotiate on its own.

EMT assumes responsibility for administrative tasks related to the fuel and power transactions so that the owner does not have to maintain an administrative infrastructure to support its transactions with third parties. The services include (1) arranging for third parties to provide fuel transportation or power transmission services, (2) scheduling those services, and resolving any resulting imbalances; (3) ensuring that fuel deliveries and power sales are properly coordinated; (4) negotiating contracts with, and monitoring the credit support and collateral requirements of, the owner's counterparties; (5) assisting in complying with power tariffs; and (6) paying fuel suppliers. EMT also may enter into transactions with third parties as nec-

13. In connection with an acquisition of a marketing and trading entity, F received approval to engage in the U.S. in limited PCT activities, as an activity that is complementary to a financial activity of engaging in CDAs. The marketing and trading entity, now EMT, also served as an energy manager under EMAs with several power generators.

essary to ensure that the owner meets its power generation obligations to the power grid in accordance with the energy-management plan.

Risk-management and hedging services may also be provided by EMT to the owner in connection with both the purchase of fuel and the sale of power. These transactions may be entered into with third parties back to back (with EMT in the middle) or may consist of direct hedging transactions between the owner and EMT. EMT would retain the risk that the owner is hedging. For the first type of transaction, the owner would inform EMT of its intention to hedge the price of fuel or power for a specified term, and EMT would then solicit bids or offers. After reviewing the competing bids or offers, the owner would make a selection and direct EMT to enter into the transaction with that counterparty. EMT and the owner then would enter into a mirror transaction so that EMT would not retain any risk exposure on the overall transaction. For the second type of transaction, EMT would submit the offer for a hedging transaction to the owner, who can accept or reject the offer. If the owner accepts, EMT may enter into the transaction directly with the owner. All these transactions would be governed by the International Swaps and Derivatives Association's master agreements between the owner and EMT. The owner may also enter into hedging transactions directly with a third party without EMT's involvement.

EMT may generally provide two types of market information services to the owner. First, EMT may provide market and risk information to assist the owner in developing its risk-management plan and strategy. As a direct market participant, EMT has access to information that may help the owner refine its risk-management strategies. Second, EMT may provide the owner with day-to-day market information that the owner, in consultation with the operator of the power facility, may use to determine its short-term dispatch guidelines (that is, the amount of power the facility should generate to meet its contractual requirements and reliability obligations).

3920.0.3.2 Energy Management Services is Complementary

The Board concluded that the provision of EMS is complementary, within the meaning of the GLB Act, to the financial activities of providing commodity derivatives activities (CDAs) and Derivatives Advisory Services (DAS). EMS would add to these financial activities a number of agency and administrative services that would

facilitate providing CDAs and DAS on behalf of a plant owner. The combination of services complements and enhances F's CDAs and DAS by allowing F to offer power plant owners an integrated approach to managing the commodity-related aspects of their business. Some non-BHC participants in the energy trading markets, including diversified financial services companies, offer EMS to clients in connection with their commodity derivatives business. Those companies can, and regularly do, provide EMS to owners. The Board's permitting FHCs to provide EMS would enable FHCs to offer the same integrated services that are provided by a number of their competitors. The Board thus concluded that F's EMS complement its CDAs and DAS.

3920.0.3.3 Limitations on Energy Management Services

In order to limit the size, scope, and safety and soundness risks of EMS, F committed that the revenues attributable to EMS would not exceed 5 percent of F's total consolidated operating revenues.¹⁴ In addition, F's authority to provide EMS is subject to several conditions that limit F's responsibilities and potential liabilities it may assume under an EMA. Specifically, F may only act as energy manager if the relevant EMA provides that:

- the owner retains the right to market and sell power directly to third parties, which may be subject to the energy manager's right of first refusal;
- the owner retains the right to determine the level at which the facility will operate (i.e., to dictate the power output of the facility at any given time);
- neither the energy manager nor its affiliates guarantee the financial performance of the facility; and
- neither the energy manager nor its affiliates bear any risk of loss if the facility is not profitable.

The Board determined that permitting F to engage in EMS in the limited amounts and situations described previously would not appear

¹⁴ Total operating revenues are defined as net income and all non-interest revenue, net securities gains and losses but excluding extraordinary income.

to pose a substantial risk to F, depository institutions, or the U.S. financial system generally. F, acting as an energy manager, would enter into the same type of commodity derivatives transactions that other FHCs had been permitted to enter into; only it would enter into these transactions to facilitate the business strategies of a third-party owner.

Based on all the facts of record that were presented, including the representations and commitments made by F within its notice to the Board, and those commitments and conditions contained in the order, the Board approved the notice on December 4, 2007. (The previous discussion is only a summary. See the full text of the Board order at 2008 FRB C20.)

3920.0.4 Energy Tolling Services As A Complement To A Financial Activity

A foreign bank, R Bank (RB), a financial holding company (“FHC”) for purposes of the Bank Holding Company Act (“BHC Act”), requested the Board’s approval under section 4 of the BHC Act (12 U.S.C. 1843) and the Board’s Regulation Y (12 C.F.R. 225) to engage in limited PCT and the providing of EMS for owners of power generation facilities under EMAs. RB has requested the Board’s approval to engage in physically settled energy tolling (ET) by entering into tolling agreements (TAs) with power plant owners as an activity that is complementary to the financial activity of engaging as principal in commodity derivatives transactions. The Board previously determined PCT and EMS to be activities that are complementary to the financial activity of engaging as principal in commodity derivative transactions, and in the case of EMS, also complementary to providing financial and investment advisory services for derivative transactions. The Board has not previously considered whether the requested ET is complementary to a financial activity under section 4 of the BHC Act for a FHC. RB intends to engage in such complementary activities through a joint venture company (JV) formed with SE, to be located in the U.S. and to operate as an energy services company. Certain existing TAs would be transferred to the JV.

3920.0.4.1 FHC’S Proposal

RB operates in the U.S. through CFG Corp., a multibank holding company, as well as through U.S. domiciled branches and representative offices.¹⁵ RB also operates U.S. domiciled non-banking companies in the United States, including a broker-dealer subsidiary, RB-GC.

3920.0.4.2 Physical Commodity Trading

RB intends to expand its commodity-related activities by forming a JV with S Corp. (S). A subsidiary of S, TE Corp. (TE), which engages in commodity derivatives transactions and PCT, would be transferred to the JV.¹⁶ TE acts as principal in commodity transactions in and outside the U.S., taking and making physical delivery of commodities in connection with those transactions. TE also acts as an energy manager and enters into TAs with power plant owners. RB plans to engage in PCT, EMS, and ET under the complementary activity authority of section 4 of the BHC Act so that the ET companies transferred to the JV can continue to conduct those activities.¹⁷ RB engages in CDAs in the U.S. and plans to expand those activities and engage in PCT through the JV. The JV’s activities would include taking or making delivery of permissible commodities pursuant to physically settled commodity derivatives; taking inventory positions in natural gas, oil, emissions allowances, and other permissible commodities; and engaging in other spot market trading activities. RB has also indicated that JV might engage in commodity-related financing transactions, including volumetric production payment transactions (VPPs).¹⁸

15. RB holds a 38 interest in RF, an FHC formed by a group of banking organizations, including F and certain of its affiliates.

16. JV plans to purchase TE and its related energy trading subsidiaries and affiliates (“TE Companies”), which would become JV’s subsidiaries.

17. RB committed that within two years of consummation of the transaction, it will conform, including by divestiture if necessary, any activities that are impermissible for an FHC under the BHC Act or that are inconsistent with the activities permitted under this order.

18. RB may engage in VPPs on oil and gas as permissible credit transactions if it agrees to sell the oil or gas it receives under the VPP to third parties before delivery. VPPs are a means of financing oil and gas exploration and production. Under a VPP, the lender or VPP holder provides an up-front payment in exchange for a royalty interest that entitles the VPP holder to receive hydrocarbons on a regular basis during the life of the VPP transaction in quantities that will allow the VPP holder to recover its up-front payment and a specified return. The Board’s General Counsel has determined that VPPs generally are considered extensions of credit permis-

The Board had previously determined that PCT is a permissible activity because it complements the financial activity of engaging in CDAs. Most of the transactions in which RB is to engage as part of PCT would not differ from transactions that the Board has previously approved. RB plans to engage, however, in a wider set of transactions under the PCT authority and therefore requested confirmation that those activities are within the scope of that authority. Specifically, RB plans to enter into long-term power supply contracts with large commercial and industrial (C&I) end-users; to engage in PCT for which derivatives contracts have *not* been approved by the CFTC for trading on a U.S. exchange or specifically approved by the Board; and to enter into contracts with third parties to process, refine, or otherwise alter commodities.

3920.0.4.3 Long-Term Electricity Supply Contracts

RB plans, as part of its energy trading business, to enter into long-term electricity supply contracts with large C & I customers. The current PCT authority permits an FHC to take a position in a commodity and does not limit the duration of, or counterparties to, an FHC's contracts. Most commodities in which an FHC may trade under the PCT authority tend by their nature to be limited to the wholesale market. Electricity, however, has a greater potential to be sold not only to end-users generally but also to small retail customers who are unlikely to be participants in the market for energy related derivatives products.

To ensure that RB's activities remain consistent with the general complementary nature of the activities permitted, RB committed to enter into long-term supply contracts only with large C & I customers. The market risk relating to these long-term contracts would be handled using the same methodologies that are used for other electricity trades. RB represented that in all states where the electricity market has been deregulated, state regulations distinguish among types of end-users, generally relying on the customer's typical electricity consumption level. To ensure that RB contracts only with customers who are sufficiently large and sophisticated, RB committed that it will enter into long-term electricity supply contracts only with C & I customers that consume electricity at a rate of at

least (1) 800 megawatt-hours/year ("MWHrs/year") or (2) the minimum consumption level for large C & I customers under applicable state law, whichever is greater. This restriction should be sufficient to ensure that RB transacts with financially sophisticated purchasers (and not with retail purchasers) and thus RB would remain essentially a wholesale intermediary.

3920.0.4.4 Energy Tolling Agreements

TE, as toller, pays the plant owner a fixed periodic payment that compensates the owner for its fixed costs ("capacity payments"), usually monthly, in exchange for the right to all or part of the plant's power output. The plant owner, however, retains control over the day-to-day operations of the plant and physical plant assets at all times.¹⁹ The toller provides (or pays for) the fuel needed to produce the power that it directs the owner to produce. The fuel and energy transactions that the toller enters into in these circumstances are generally physically settled.²⁰ The agreements also generally provide that the owner will receive a marginal payment for each megawatt hour produced by the plant to cover the owner's variable costs plus a profit margin. The toll is similar to a call option on the power produced by the plant with a strike price linked to fuel and power prices. In general, the toller would direct the operator to run the plant (i.e., the toller would exercise its option) when the price of power exceeds the cost of producing that amount of power. Some TAs may also give the toller the right to a plant's excess capacity, which the toller may sell to the market or use to meet reliability obligations to the power grid.

3920.0.4.5 Risks of Energy Tolling

The primary risk to a toller is that the plant proves to be uneconomical to operate, which can occur when the cost of producing power is greater than the power's market price. In those cases, the toller has no ability to recover its

19. RB has indicated that TE's TAs are all medium term (generally two to five years), although some market participants enter into longer-term agreements. TE has not entered into longer-term contracts because it can be difficult to hedge exposure over a longer period of time.

20. Because an FHC would generally take or make physical delivery of fuel and electricity in connection with a TA, an FHC would need approval to engage in PCT to engage in ET.

capacity payments. To limit the potential safety and soundness risks of ET, RB has committed that it will limit the amount of its ET activities. Currently, all PCT activities are limited to a maximum of 5 percent of the FHC’s tier 1 capital. RB committed to include the present value of its future committed capacity payments under a TA in calculating the value of commodities held by RB under its Physical Commodity Trading authority to determine compliance with the cap of 5 percent of tier 1 capital. As a result, allowing RB to engage in ET activities would not increase the overall position that it may take in physical commodities. This limit would also ensure that ET remains limited in size and scope relative to RB’s financial activities.

3920.0.4.6 Energy Tolling is Complementary

Energy Tolling is an outgrowth of the existing financial activity of a BHC-FHC engaging in CDAs. Energy tolling complements CDAs by

allowing an FHC to hedge its own, or assist its clients to hedge, positions in energy. An FHC engaging in authorized energy tolling would also provide an FHC with additional information on the energy markets that would help the FHC manage its own commodity risks. The Board also notes that financial institution competitors of RB that are not FHCs engage in tolling activities as part of their energy trading operations. Based on the foregoing and all other facts of record, the Board concluded that RB’s ET activities complement its CDAs.

Based on all the facts of record, including RB’s representations and commitments that were made to the Board in connection with its notice, and the terms and conditions set forth in the Board’s order, the Board approved the FHC’s notice. The Board’s determination is also subject to all the conditions set forth in Regulation Y. The Board order was approved on March 27, 2008. (The previous discussion is only a summary. See the full text of the Board order at 2008 FRB C60.)

3920.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws¹</i>	<i>Regulations²</i>	<i>Interpretations³</i>	<i>Orders</i>
Limited commodity-trading activities involving a particular commodity, such as natural gas and electricity, that complement the financial activity of engaging regularly as principal in BHC-permissible commodity derivatives based on that commodity.	1843(k)(1)(B)	225.89	4-056.8	2003 FRB 508 2004 FRB 215 2004 FRB 511
Limited commodity trading in Energy-related commodities (natural gas, crude oil, electricity, and emissions allowances) as a complement to a financial activity	1843(k)(1)(B)			2006 FRB C54 2006 FRB C57 2006 FRB C113

<i>Subject</i>	<i>Laws¹</i>	<i>Regulations²</i>	<i>Interpretations³</i>	<i>Orders</i>
Commodities not approved by the CFTC for trading on a U.S. futures exchange (e.g., nickel on London Metal Exchange) or on certain non-U.S. exchanges				2008 FRB C60
Engaging third parties to alter commodities.				2008 FRB C60
Providing energy management services as a complement to financial activities—providing commodity derivatives activities and derivatives advisory services				2008 FRB C20
Providing energy tolling services as a complement to a financial activity				2008 FRB C60

1. 12 U.S.C., unless specifically stated otherwise.
 2. 12 C.F.R., unless specifically stated otherwise.

3. *Federal Reserve Regulatory Service* reference.

Insurance Sales Activities and Consumer Protection in Sales of Insurance (Sections 4(k) and 4(c)(8) of the BHC Act) Section 3950.0

Banking organizations have long been engaged in the sale of insurance products and annuities, although these activities historically have been subject to several restrictions. For example, until recently, national banks could sell most types of insurance, but only through an agency located in a small town. Bank holding companies were also permitted to engage in only limited insurance agency activities under the Bank Holding Company Act. State-chartered banks, on the other hand, generally have been permitted to engage in insurance sales activities as agent to the extent permitted by state law.

The Gramm-Leach-Bliley Act of 1999 (the GLB Act), however, authorized bank holding companies that make an effective election to become a financial holding company (FHC) to *underwrite* and *sell* any type of insurance nationwide. In addition, the GLB Act authorized national banks and state-chartered member banks to sell all types of insurance products through a financial subsidiary. *The GLB Act generally did not change the powers of banks to sell insurance directly.* As a result of the GLB Act and marketplace developments, many banking organizations are increasing the range and volume of their insurance and annuities sales activities.

To the extent permitted by applicable law, banking organizations may conduct insurance and annuity sales activities through a variety of structures and delivery channels, including ownership of an insurance underwriter or an insurance agency or broker, the employment by a bank of licensed agents, a joint marketing arrangement with a producer,¹ independent agents located at a bank's office, direct mail, telemarketing, and Internet marketing.

A banking organization may also conduct insurance or annuity sales activities through a managing general agent (MGA). An MGA is a wholesaler of insurance products and services to insurance agents. The MGA has a contractual agreement with an insurance carrier to assume

functions for the carrier, which may include marketing, accounting, data processing, policy recordkeeping, and monitoring or processing claims. The MGA may rely on various local agents or agencies to sell the carrier's products. Most states require an MGA to be licensed.

3950.0.1 OVERVIEW AND SCOPE

The following guidance pertains to bank holding companies (BHCs) (including FHCs) and state member banks that are either directly or indirectly engaged in the sale of insurance or annuity products as agents. As noted above, the GLB Act amended the BHC Act to allow a BHC or foreign bank that qualifies as an FHC to engage in a broad range of insurance activities, including underwriting or selling (as agent or broker) any type of insurance and issuing and selling annuities, in any state.

BHCs that are not FHCs may sell or underwrite insurance as a principal, agent, or broker only to the limited extent authorized, before the GLB Act, under section 4(c)(8) of the BHC Act and section 225.28(b)(11) of Regulation Y. For example, a BHC that is not an FHC may underwrite and sell insurance (including home mortgage redemption insurance) that is directly related to an extension of credit by the BHC or any of its subsidiaries and that is limited to ensuring repayment of the outstanding balance due on the extension of credit in the event of the death, disability, or involuntary unemployment of the debtor. A BHC that is not an FHC can also sell any type of insurance as agent in a town if the town has a population of 5,000 or less and the BHC or a subsidiary has a lending office in the small town. (See section 3170.0.)

The GLB Act permits state member banks that are not authorized by applicable state law to sell insurance directly through a financial subsidiary.² A financial subsidiary engaged in insurance sales may be located wherever state law permits the establishment and operation of an insurance agency. Such subsidiaries, however, would be subject to state licensing and other requirements. The examination guidance found in this section is limited to insurance and annu-

1. The term "producer" refers broadly to persons, partnerships, associations, limited liability corporations, etc., that hold a license to sell or solicit contracts of insurance to the public. Insurance agents and agencies are producers who, through a written contractual arrangement known as a direct appointment, represent one or more insurance underwriters. Independent agents and agencies are those producers that sell products underwritten by one or more insurance underwriters. Captive agents and agencies represent a specific underwriter and sell only its products. Brokers are producers that represent the purchaser of insurance and obtain bids from competing underwriters on behalf of their clients. State insurance laws and regulations often distinguish between an insurance agent and a broker; in practice, the terms are often used interchangeably.

2. Rules pertaining to state member bank financial subsidiaries are found in the Board's Regulation H (12 C.F.R. 208.71-77).

ity sales activities. Because this section focuses only on insurance sales activities, it does *not* address insurance underwriting (that is, as principal) activities of FHCs or the limited insurance-underwriting powers of BHCs or state member banks. Examiner guidance on performing appropriate risk assessments for insurance and annuity sales activities of BHCs (including FHCs) and state member banks is included.³

Additionally, guidance is provided for examining a state member bank for compliance with the consumer protection rules relating to insurance and annuities sales activities that are contained in the Board's December 2000 revisions to Regulation H (subpart H) (12 C.F.R. 208.81–86), "Consumer Protection in Sales of Insurance" (CPSI). Subpart H, which became effective October 1, 2001, implements the insurance consumer protection requirements of the GLB Act, which are codified at 12 U.S.C. 1831x. (See 65 *Fed. Reg.* 75841 (December 4, 2000)). The regulation applies not only to the sale of insurance products or annuities by the state member bank but also to activities of any person engaged in insurance product or annuity sales on behalf of the state member bank, as discussed in this guidance. The guidance is generally not applicable to debt-cancellation contracts and debt-suspension agreements, unless these products are considered to be insurance products by the state in which the sales activities are conducted.

The Federal Reserve is responsible for evaluating the consolidated risk profile of a BHC or state member bank, including determining the risks posed to the BHC or state member bank from the insurance sales activities it conducts, directly or indirectly, and determining the effectiveness of its risk-management systems. The GLB Act also established a regulatory framework that is designed to ensure that the Federal Reserve coordinates with, and relies to the extent possible on information from, the state insurance authorities when it is supervising the insurance activities conducted by a BHC or state member bank through a functionally regulated subsidiary.

3. The term "risk assessment" denotes the work product described in SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," and entails an analysis of (1) the level of inherent risk by type of risk (operational, legal, market, liquidity, credit, and reputation risk) for a business line or business function, (2) the adequacy of management controls over that business line or business function, and (3) the direction of the risk (increasing, decreasing, or stable).

Consistent with the Federal Reserve's risk-focused framework for supervising banking organizations, resources allocated to the review of insurance sales activities should be commensurate with the significance of the activities and the risk they pose to the banking organization. The scope of the review depends on the significance of the activity to the BHC or state member bank and on the extent to which the bank is directly involved in the activity. Examiner judgment is required to tailor the reviews, as appropriate, on the basis of the legal, organizational, and risk-management structure of the BHC's or state member bank's insurance sales activities and on other relevant factors.⁴

3950.0.2 SUPERVISORY APPROACH FOR THE REVIEW OF INSURANCE AND ANNUITY SALES ACTIVITIES

3950.0.2.1 Supervisory Objective

The primary objective of the review is to determine the level and direction of risk to a BHC or state member bank from its insurance sales activities, including insurance sales activities conducted directly, by or in conjunction with a subsidiary or affiliate, or through a third-party arrangement. Primary risks that may arise from insurance sales activities include operational, legal, and reputational risk. If the BHC or state member bank does not adequately manage these risks, they could have an adverse impact on a BHC's or state member bank's earnings and capital. The examiner should produce (1) a risk assessment that summarizes the level of inherent risk to the BHC or state member bank by risk category and (2) an assessment of the adequacy of board of directors and management oversight of the activity, including the activity's internal control framework. For those state member banks selling insurance or annuity products, or that enter into arrangements under which another party sells insurance or annuity products at the bank's offices or on behalf of the bank, a second objective of the review is to determine the bank's compliance with the consumer protection provisions of the GLB Act and the CPSI regulation.

4. See SR-02-01, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less," and section 1000.1 of the *Commercial Bank Examination Manual* for a discussion of the Federal Reserve's risk-focused examinations and the risk-focused supervision program for community banking organizations. See also SR-97-24.

3950.0.2.2 State Regulation of Insurance Activities

Historically, insurance activities have primarily been regulated by the states. In 1945, Congress passed the McCarran-Ferguson Act, which granted states the power to regulate most aspects of the insurance business. The McCarran-Ferguson Act states that “no act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, provided the Act shall be applicable to the business of insurance to the extent that such business is not regulated by State law” (15 U.S.C. 1012(b)).

State regulation of insurance producers is centered on the protection of the consumer and consists primarily of licensing and continuing education requirements for producers. A producer generally must obtain a license from each state in which it sells insurance and for each product sold. Each state in which a producer sells insurance has regulatory authority over the producer’s activities in the state.

The GLB Act does include several provisions that are designed to keep states from (1) unfairly regulating a BHC or bank to prevent it from engaging in authorized insurance activities or (2) otherwise discriminating against BHCs and banks engaged in insurance activities. These provisions are complex and beyond the scope of this guidance. It should be noted, however, that the GLB Act generally does not prohibit a state from requiring a BHC or bank, or its employees engaged in insurance sales, solicitation, or cross-marketing activities, to be licensed within the state.

State insurance regulatory authorities do not conduct routine, periodic examinations of an insurance producer. A state examination of an insurance producer is generally conducted only on an ad hoc basis and is primarily based on the volume and severity of consumer complaints. The state examination may also be based in part on the producer’s market share and on previous examination findings. Additionally, a review of a producer would typically not assess its financial condition.

State market conduct examinations of *insurance sales practices* are focused at the insurance-underwriter level.⁵ The insurance underwriter is

generally held accountable for compliance with state insurance laws to protect the consumer from the unfair sales practices of any producer that markets the insurance underwriter’s products. Market conduct examinations of an insurance underwriter may potentially uncover a concern about a particular producer, such as a bank-affiliated producer.⁶ However, in the past, a state insurance regulatory authority has not typically examined a producer unless the insurance underwriter owns the producer.

Generally, market conduct examinations include reviews of insurance underwriters’ complaint handling, producer licensing, policyholder service, and marketing and sales practices. Typically, a state authority will direct a corrective action for insurance sales activity at the underwriter. The states generally have specific guidance for their market conduct examinations of life, health, and property/casualty⁷ lines of business guidance that corresponds to regulations related to advertising, misrepresentations, and disclosures for these different business lines. The reports of examination issued by the state insurance departments are usually available to the public.

Because the underwriter, not the producer, is liable to the insured, the failure of an insurance producer generally would not result in financial loss to consumers or state guarantee funds. Consequently, there are no regulatory capital requirements for insurance producers, nor do states require regulatory reporting of financial statement data on insurance producers. While the underwriter is ultimately liable to the insured, in some instances a producer and its owner may be held liable for misrepresentations, as well as for violations of laws and regulations.

nation findings. In some states, however, market conduct reviews of insurance underwriters are conducted on a periodic, three- to five-year schedule.

6. The terms “insurance underwriter,” “insurer,” “insurance carrier,” and “insurance company” are industry terms that apply similarly to the party to an insurance arrangement who undertakes to indemnify for losses, that is, the party that assumes the principal risk under the contract.

7. Property insurance indemnifies a person who has an interest in a physical property for loss of the property or the loss of its income-producing abilities. Casualty insurance is primarily concerned with the legal liability for losses caused by injury to persons or damage to the property of others. It may also include such diverse forms of insurance as crime insurance, boiler and machinery insurance, and aviation insurance. Many casualty insurers also underwrite surety bonds.

5. Generally, market conduct reviews of *insurance underwriters* are conducted on an ad hoc basis, triggered primarily by the volume and severity of consumer complaints, and are based on the underwriter’s market share or on previous exami-

3950.0.2.3 Functional Regulation

Under the GLB Act, reviews by banking supervisors of insurance or securities activities conducted in a BHC's or bank's functionally regulated subsidiary are not to be extensions of more traditional bank-like supervision. Rather, to the extent possible, bank supervisors are to rely on the functional regulators to appropriately supervise the insurance and securities activities of a functionally regulated subsidiary. A functionally regulated subsidiary includes any subsidiary of a BHC or bank that (1) is engaged in insurance activities and subject to supervision by a state insurance regulator or (2) is registered as a broker-dealer with the Securities and Exchange Commission. The GLB Act does *not* limit the Federal Reserve's supervisory authority with respect to a BHC or state member bank or the insurance activities conducted by either of them. The functional regulators for insurance sales activities, including the activities of insurance producers, consist of the insurance departments in each of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, American Samoa, and Guam.

The GLB Act places certain limits on the ability of the Federal Reserve to examine, obtain reports from, or take enforcement action against a functionally regulated nondepository subsidiary of a BHC or state member bank. For purposes of these limitations, a subsidiary licensed by a state insurance department to conduct insurance sales activities is considered functionally regulated only with respect to its insurance activities and any activities incidental to those activities.⁸

The GLB Act indicates that the Federal Reserve must rely, to the fullest extent possible, on information obtained by the appropriate state insurance authority of a nondepository insurance agency subsidiary of a BHC or state member bank. In addition, the Federal Reserve may examine a functionally regulated subsidiary of a BHC or state member bank only in the following situations:

1. The Federal Reserve has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated depository institution, as determined by

8. For example, if a BHC's nonbank subsidiary engages in mortgage lending and is also licensed as an insurance agency, it would be considered a functionally regulated subsidiary only to the extent of its insurance sales activities.

the responsible Reserve Bank and Board staff.

2. After reviewing relevant information available at the BHC or state member bank level (including information obtained from the appropriate functional regulator), it is determined that an inspection or examination is necessary to adequately understand and assess the banking organization's systems for monitoring and controlling the financial and operational risks that may pose a threat to the safety and soundness of an affiliated depository institution.
3. On the basis of reports and other available information (including information obtained from the appropriate functional regulator), there is reasonable cause to believe that the subsidiary is not in compliance with a federal law that the Federal Reserve has specific jurisdiction to enforce with respect to the subsidiary (including limits relating to transactions with affiliated depository institutions), and the Federal Reserve cannot assess such compliance by examining the BHC or state member bank or other affiliated depository institution.

Other similar restrictions limit the ability of the Federal Reserve to obtain a report directly from, or take enforcement action against, a functionally regulated nonbank subsidiary of a BHC or state member bank. As noted above, these GLB Act limitations do *not* apply to a BHC parent company or state member bank even if the BHC parent company or state member bank is itself licensed by a state insurance regulatory authority to conduct insurance sales activities.

Staff who are conducting reviews of BHC or state member bank insurance or annuity sales activities should be thoroughly familiar with SR-00-13, which provides guidance on reviews of functionally regulated BHC or state member bank subsidiaries. Reserve Bank staff may conduct an examination of a functionally regulated subsidiary, or request a specialized report from a functionally regulated subsidiary, only after obtaining approvals from the appropriate staff of the Board's Division of Banking Supervision and Regulation.

When preparing or updating the risk assessment of a BHC's or state member bank's insurance or annuity sales activities, Federal Reserve staff, when appropriate, should coordinate their activities with the appropriate state insurance authorities. The Federal Reserve's supervision of BHCs or state member banks engaged in insurance sales activities is not intended to replace or duplicate the regulation of insurance

activities by the appropriate state insurance authorities.

3950.0.2.4 Information Sharing with the Functional Regulator

The Federal Reserve and the National Association of Insurance Commissioners (NAIC) approved a model memorandum of understanding (MOU) on the sharing of confidential information between the Federal Reserve and individual state insurance departments.⁹ The Board also approved the delegation of authority to the Board's general counsel to execute agreements with individual states, based on this MOU. Examiners should follow required Board administrative procedures before sharing any confidential information with a state insurance regulator. (These procedures generally require Federal Reserve staff to identify and forward to Board staff for review any confidential information that may be appropriate to share with the applicable state insurance regulator concerning insurance sales activities conducted by BHCs or state member banks.) The Board's Division of Consumer and Community Affairs' CPLEtter 2001-11 outlines the procedures for sharing consumer complaint information with state insurance regulators.

3950.0.3 STATUTORY AND REGULATORY REQUIREMENTS AND POLICY GUIDANCE

3950.0.3.1 Privacy Rule and the Fair Credit Reporting Act

BHCs, state member banks, and the subsidiaries of both (other than subsidiaries that are subject to the privacy rules of another financial regulator such as a broker-dealer or insurance company) that sell insurance to consumers must comply with the privacy provisions under title V of the GLB Act (12 U.S.C. 6801–6809), as implemented by the Board's Regulation P (12 C.F.R. 216) (the privacy rule). Functionally regulated BHC and state member bank nonbank insurance agency subsidiaries are not covered by the Federal Reserve's privacy rule; however, they must comply with the privacy regulations (if any) issued by their relevant state insurance regulator.

The privacy rule regulates a BHC's or state member bank's treatment of nonpublic personal information about a "consumer," that is, an individual that obtains a financial product or service (such as insurance) from the institution for personal, family, or household purposes. The privacy rule generally requires a BHC or bank to provide a notice to each of its customers that describes the privacy policies and practices of the BHC or bank no later than when the BHC or bank establishes a business relationship with the customer. The privacy rule also generally prohibits a BHC or bank from disclosing any nonpublic personal information about a consumer to any nonaffiliated third party, unless the BHC or bank first provides to the consumer a privacy notice and a reasonable opportunity to prevent (or "opt out" of) the disclosure, and the consumer does not opt out. The privacy rule permits a BHC or bank to provide a joint notice with one or more of its affiliates or other financial institutions, as identified in the privacy notice itself, provided that the notice is accurate with respect to the institution and the other institutions.

While the privacy rule applies to the sharing of nonpublic personal information by a BHC or bank with nonaffiliated third parties, the sharing of certain consumer information with affiliates or nonaffiliates may be subject to the Fair Credit Reporting Act (FCRA) as well. For example, under the FCRA, if a BHC or bank wants to share with its insurance subsidiary information from a credit report or from a consumer application for credit (such as the consumer's assets, income, or marital status), the BHC or bank must first notify the consumer about the intended sharing and give the consumer an opportunity to opt out. The same rules would apply to an insurance company that wants to share information from credit reports or from applications for insurance with an affiliate or a third party.

3950.0.3.2 Anti-Tying Prohibitions

Federal law (section 106(b) of the BHC Act Amendments of 1970 (12 U.S.C. 1972(b))) generally prohibits a bank from requiring that a customer purchase a product or service from the bank or an affiliate as a prerequisite to obtaining another product or service (or a discount on the other product or service) from the bank. This prohibition applies whether the customer is retail or institutional, or whether the transaction is on bank premises or off premises. For example, a

9. The NAIC is the organization of insurance regulators from the 50 states, the District of Columbia, and the four U. S. territories. The NAIC provides a forum for the development of uniform policy among the states and territories. The NAIC is not a governmental or regulatory body.

state member bank may not require that a customer purchase insurance from the bank or a subsidiary or an affiliate of the bank in order to obtain a loan from the bank (or a reduced interest rate on the loan).¹⁰ The special anti-tying rules in section 106 do not apply to tying arrangements imposed by a BHC or a nonbank affiliate of a BHC.

3950.0.3.3 Policy Statement on Income from Sale of Credit Life Insurance

This Federal Reserve Board policy statement (see the *Federal Reserve Regulatory Service* at 3-1556) sets forth the principles and standards that apply to a bank's sales of credit life insurance and the limitations that apply to the receipt of income from those sales by certain individuals and entities associated with the bank. (See section 3170.0.4.1 and the inspection procedure related to this policy statement in section 3170.0.6.)

3950.0.4 RISK-MANAGEMENT PROGRAM

3950.0.4.1 Elements of a Sound Insurance or Annuity Sales Program

A BHC or state member bank engaged in insurance or annuity sales activities should—

1. conduct insurance sales programs in a safe and sound manner;
2. have appropriate written policies and procedures in place that are commensurate with the volume and complexity of its insurance sales activities;
3. obtain its board of directors' approval of the scope of the insurance and annuity sales program and of written policies and procedures for the program;
4. effectively oversee the sales program activities, including third-party arrangements;
5. have an effective, independent internal audit and compliance program;
6. appropriately train and supervise the employees conducting insurance and annuity sales activities;
7. take reasonable precautions to ensure that disclosures to customers for insurance and annuity sales and solicitations are complete

- and accurate and are in compliance with applicable laws and regulations;
8. ensure compliance with all applicable federal, state, or other jurisdiction regulations, including compliance with sections 23A and 23B of the Federal Reserve Act as that act applies to affiliate transactions; and
9. have controls in place to ensure accurate and timely financial reporting.

Every banking organization conducting insurance or annuity sales activities should have appropriate, board-approved policies, procedures, and controls in place to monitor and ensure that it complies with both federal and state regulatory requirements. Consistent with the principle of functional regulation, the Federal Reserve will rely primarily on the appropriate state insurance authorities to monitor and enforce compliance with applicable state insurance laws and regulations, including state consumer protection laws and regulations governing insurance sales.

3950.0.4.1.1 Sales Practices and Handling of Customer Complaints

Every component of a banking organization that engages in insurance or annuity sales activities should have board-approved policies and procedures for handling customer complaints related to these sales. The customer complaint process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. A BHC's or state member bank's board of directors and senior management should also review complaints if the complaints involve significant compliance issues that may pose a risk to the organization.

3950.0.4.1.2 Third-Party Arrangements

BHCs and state member banks, to the extent permitted by applicable law, may enter into agreements with third parties, including unaffiliated agents or agencies, to sell insurance or annuities or provide expertise and services that otherwise would have to be developed in-house. Many banks hire third parties to assist in establishing an insurance program or to train their own insurance staff. A bank may also find it advantageous to offer more specialized insurance products through a third-party arrangement.

A BHC's or state member bank's management should conduct a comprehensive review of an unaffiliated third party before entering into

¹⁰. See section 3500.0.

any arrangement to conduct insurance or annuity sales with the third party. The review should include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the BHC or state member bank, which includes compliance with applicable consumer protection laws and regulations.

The BHC's or state member bank's board of directors or its designated committee should approve any agreements with third parties. Agreements should outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the BHC's or state member bank's office space, equipment, and personnel. If an arrangement includes dual employees (for example, bank employees who are also employed by an independent third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable. The agreement should authorize the banking organization to monitor the third party's compliance with its agreement, as well as authorize the banking organization to have access to third-party records considered necessary to evaluate compliance. A BHC or state member bank that contracts with a functionally regulated third party should obtain from and review, as appropriate, any relevant, publicly available regulatory reports of examination of the third party.¹¹ Finally, the agreement should provide for indemnification of the institution by the unaffiliated third party for any losses caused by the conduct of the third party's employees in connection with its sales activities.

A BHC or state member bank is responsible for ensuring that any third party or dual employee selling insurance at or on behalf of the organization is appropriately trained either by the banking organization or the third party with respect to compliance with the minimum disclosures and other requirements of the CPSI regulation and applicable state regulations. The banking organization should obtain and review copies of third-party training and compliance materials

to monitor the third party's performance on its disclosure and training obligations.

3950.0.4.1.3 Designation, Training, and Supervision of Personnel

A banking organization hiring personnel to sell insurance or annuities should investigate the backgrounds of the prospective employees. When a candidate for employment has previous insurance industry experience, the banking organization should have procedures to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators.¹²

The banking organization should require its own insurance or annuity sales personnel or third-party sales personnel selling at or on behalf of the bank to receive appropriate training and licensing. Training should cover appropriate policies and procedures for the organization's sales of insurance and annuity products. Personnel who are referring potential or established customers to a licensed insurance producer should also be trained to ensure that referrals are made in conformance with the CPSI regulation, if applicable. The training should also include procedures and guidance to ensure that an unlicensed or referring individual cannot be deemed to be acting as an insurance agent that is subject to licensing requirements.

When insurance or annuities are sold by a banking organization or by third parties at an office of, or on behalf of, the organization, the institution should have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as for supervising the referral activities of bank employees not authorized to sell these products. A banking organization also should designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as a state member bank's compliance with the CPSI regulation, if applicable.

3950.0.4.1.4 Compliance

Banking organizations should have policies and procedures to ensure that insurance or annuity

11. The reports of examination issued by state insurance regulators are generally public documents. Many states do not conduct periodic examinations of insurance sales activities.

12. Information from the states on the issuance and termination of producer licenses and on producers' compliance with continuing education requirements is available from the NAIC database known as the National Insurance Producer Registry (NIPR).

sales activities are conducted in compliance with applicable laws and regulations (including the CPSI regulation for sales conducted by or on behalf of a state member bank) and the institution's internal policies and procedures. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. For example, sales-compensation programs should be conducted in a manner that would not expose the BHC or state member bank to undue legal or reputation risks. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third-party sales are being conducted in a manner consistent with the governing agreement with the banking organization.

The compliance function should be conducted independently of the insurance and annuity product sales and management activities. Compliance personnel should determine the scope and frequency of their reviews, and findings of compliance reviews should be reported directly to the banking organization's board of directors or to its designated board committee.

3950.0.5 RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

A risk assessment of insurance activities may be accomplished (1) in the course of conducting a regularly scheduled BHC inspection or state member bank examination or (2) as a targeted review. The purpose of preparing the risk assessment is to determine the level and direction of risk to the BHC or bank arising from its insurance and annuity sales activity. The risks to banking organizations engaged in insurance sales programs consist primarily of legal, reputational, and operational risk, all of which may lead to financial loss. After completing the risk assessment, if material concerns remain, the Board's Division of Banking Supervision and Regulation staff should be consulted for further guidance.

Legal and reputational risk may arise from a variety of sources, such as fraud; noncompliance with statutory or regulatory requirements, including those pertaining to the handling of premiums collected on behalf of the underwriter; claims processing; insurance and annuity sales practices; and the handling of "errors and

omissions" claims.¹³ Other sources of legal and reputational risk may arise from failing to safeguard nonpublic customer information; a high volume of customer complaints; or public regulatory sanctions against a producer.

Legal and reputational risks may also arise from an agent's obligation to provide a customer with products that are suited to the customer's particular needs and are priced and sold in accordance with state regulations. Additionally, an agent or agency may be liable for failing to carry out the appropriate paperwork to bind a policy that it has sold to a customer, or for making an error in binding the policy. State insurance departments generally are permitted by law to suspend or revoke a producer's license and assess monetary penalties against a producer if warranted.

Operational risk may arise from errors in processing sales-related information or from lack of appropriate controls over systems or staff responsible for carrying out the insurance or annuity sales activities. Additionally, banking organizations that have recently commenced insurance or annuity sales activities, or that are expanding their insurance sales business, are exposed to risk arising from inadequate strategic and financial planning associated with the activities, which could result in financial loss. Examiners should be attuned to risks that may arise from inadequate controls over insurance activities, a rapid expansion of the insurance or annuity sales programs offered by banking organizations, the introduction of new products or delivery channels, and legal and regulatory developments.

Operational risk may arise from inadequate premium-payment procedures and trust-account-balance administration by an agency. When the insurance agency bills the insured, the agent must comply with requirements for forwarding the payments to the insurer and for safekeeping the funds. Inadequate internal controls over this activity may result in the inappropriate use of these funds by the agent or agency. The banking organization should ensure that appropriate controls are in place to verify that all funds that are owed to the insurer or the insured are identified in the trust account and that the account is in balance.

When conducting a risk assessment, the examiner should first obtain relevant information to determine the existence and scale of

13. Errors and omissions insurance indemnifies the insured against loss sustained because of an error or oversight by the insured. For instance, an insurance agency generally purchases this type of coverage to protect itself against such things as failing to issue a policy.

insurance or annuity sales activity. Such information is available in the BHC's Bank Holding Company Performance Report or the state member bank's Uniform Bank Performance Report (UBPR) and in other System reports on insurance activities. Relevant reports, including applicable balance sheets and income statements for the insurance and annuity sales activities, may also be obtained from the BHC or state member bank. When preparing a risk assessment for an insurance or annuity sales activity that is conducted by a functionally regulated nonbank subsidiary of a BHC or state member bank, examiners should rely, to the fullest extent possible, on information available from the BHC or state member bank and the appropriate state insurance regulator for the subsidiary. If information that is needed to assess the risk cannot be obtained from the BHC or state member bank, or from the applicable functional regulator, the examiner should consult with the appropriate designated Board staff. Requests should not be made directly to a functionally regulated nonbank insurance and annuity sales subsidiary of a BHC or state member bank without first obtaining approval from the appropriate Board staff.

3950.0.6 CONSUMER PROTECTION IN SALES OF INSURANCE RULES

3950.0.6.1 Overview of the CPSI Regulation

The CPSI regulation is only applicable to all insured depository institutions, including state member banks.¹⁴ The regulation, however, generally *does not* apply to nonbank affiliates or subsidiaries of a state member bank unless the company engages in the retail sale of insurance products or annuities at an office of, or on behalf of, an insured depository institution. Interpretations of the regulation, issued by the federal banking agencies, are found in appendix A of this section. Federal Reserve examiners are responsible for reviewing state member banks' compliance with the regulation. A BHC's board of directors and senior management are responsible for overseeing its depository institution subsidiaries' compliance with the CPSI regulation.

The regulation applies to the retail sale of insurance products and annuities by banks or by any other person at an office of a bank, or acting

on behalf of a bank. For purposes of the CPSI regulation, "office" means the premises of the bank where retail deposits are accepted. The regulation applies only to the retail sale of insurance or annuity products—that is, when the insurance is sold or marketed to an individual primarily for personal, family, or household purposes.

3950.0.6.2 Misrepresentations Prohibited

The regulation prohibits a bank or other covered person from engaging in any practice or using any advertisement at any office of, or on behalf of, the bank or a subsidiary of the bank if the practice or advertisement could mislead any person or otherwise cause a reasonable person to erroneously believe—

1. that the insurance product or annuity is backed by the federal government or the bank, or is insured by the Federal Deposit Insurance Corporation (FDIC);
2. that an insurance product or annuity does not have investment risk, including the potential that principal may be lost and the product may decline in value, when in fact the product or annuity does have such risks; or
3. in the case of a bank or subsidiary of the bank at which insurance products or annuities are sold or offered for sale, that (1) the bank may condition approval of an extension of credit to a consumer by the bank or subsidiary on the purchase of an insurance product or annuity from the bank or a subsidiary of the bank and (2) the consumer is not free to purchase the insurance product or annuity from another source.

The regulation also incorporates the anti-typing provisions of section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972). Additionally, banks are prohibited from selling life or health insurance products if the status of the applicant or insured as a victim of domestic violence or as a provider of services to domestic violence victims is considered as a factor in decision making on the product, except as expressly authorized by state law.

3950.0.6.3 Insurance Disclosures

The regulation also requires that a bank or a person selling insurance at an office of, or on

14. The CPSI regulation applies to all federally insured depository institutions, including all federally chartered U.S. branches and state-chartered insured U.S. branches of foreign banking organizations.

behalf of, a bank make the following affirmative disclosures (to the extent accurate), both orally and in writing, before the completion of the initial sale of an insurance product or an annuity to a consumer. However, sales by mail or, if the consumer consents, via electronic media (such as the Internet) do not require oral disclosure.

1. The insurance product or annuity is not a deposit or other obligation of, or guaranteed by, the bank or an affiliate of the bank.
2. The insurance product or annuity is not insured by the FDIC or any other U.S. government agency, the bank, or (if applicable) an affiliate of the bank.
3. The insurance product or annuity, if applicable, has investment risk, including the possible loss of value.

For telephone sales, written disclosures must be mailed within three business days. The above disclosures must be included in advertisements and promotional materials for insurance products and annuities, unless the advertisements or promotional materials are of a general nature and describe or list the nature of services or products offered by the bank. Disclosures must be conspicuous and readily understandable.

3950.0.6.4 Credit Disclosures

When an application for credit is made in connection with the solicitation, offer, or sale of an insurance product or annuity, the consumer must be notified that the bank may not condition the extension of credit on either (1) the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates or (2) the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity. These disclosures must be made both orally and in writing; however, applications taken by mail or, if the consumer consents, via electronic media do not require oral disclosure. For telephone applications, the written disclosure must be mailed within three business days. The disclosures must be conspicuous and readily understandable.

3950.0.6.5 Consumer Acknowledgment

The bank must obtain written or electronic acknowledgments of the consumer's receipt of

the disclosures described above at the time they are made or at the completion of the initial purchase. For telephone sales, the bank must receive an oral acknowledgment and make a reasonable effort to obtain a subsequent written or electronic acknowledgment.

3950.0.6.6 Location

Insurance and annuity sales activities must take place, to the extent practicable, in an area physically segregated from one where retail deposits are routinely accepted from the general public (such as teller windows). The bank must clearly identify and delineate areas where insurance and annuity sales activities occur.

3950.0.6.7 Referrals

Any person who accepts deposits from the public in an area where deposits are routinely accepted may refer a consumer to a qualified person who sells insurance products or annuities only if the person making the referral receives no more than a one-time, nominal fee of a fixed dollar amount for the referral. The amount of the referral fee may not depend on whether a sale results from the referral.

3950.0.6.8 Qualifications

A bank may not permit any person to sell or offer insurance products or annuities at its office or on its behalf, unless that person is at all times properly qualified and licensed under applicable state law for the specific products being sold or recommended.

3950.0.6.9 Relationship of the CPSI Regulation to State Regulation

The GLB Act contains a legal framework for determining the effect of the CPSI regulation on state laws governing the sale of insurance, including state consumer protection standards. In general, if a state has legal requirements that are inconsistent with, or contrary to, the CPSI regulation, initially the federal regulation does not apply in the state. However, the federal banking agencies may, after consulting with the state involved, decide to preempt any inconsistent or contrary state laws if the agencies find that the CPSI regulation provides greater protections than the state laws. It is not expected that there will be significant conflict between state and

federal laws in this area. If the consumer protection laws of a particular state appear to be inconsistent with and less stringent (that is, provide less consumer protection) than the CPSI regulation, examiners should inform the staff of the Board's Division of Banking Supervision and Regulation.

3950.0.6.10 Relationship to Federal Reserve Guidance on the Sale of Nondeposit Investment Products

When a bank sells insurance products or annuities that also are securities (such as variable life insurance annuities), it must conform with the applicable Federal Reserve and interagency guidance pertaining to a bank's retail sales of nondeposit investment products (NDIPs).¹⁵ If the CPSI regulation and the guidance pertaining to NDIPs conflict, the CPSI regulation prevails.

3950.0.6.11 Examining a State Member Bank for Compliance with the CPSI Regulation

Examinations for compliance with the CPSI regulation should be conducted consistent with the risk-focused supervisory approach when a state member bank sells insurance products or annuities directly, or when a third party sells insurance or annuities at or on behalf of a state member bank. To the extent practicable, the examiner should conduct the review at the state member bank. In certain instances, however, the examiner's review at the state member bank may identify potential supervisory concerns about the state member bank's compliance with the CPSI regulation as it pertains to insurance or annuities sales conducted by a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance products or annuities at or on behalf of the state member bank.

If the examiner determines that an on-site review of a functionally regulated nonbank affiliate or subsidiary of the state member bank is appropriate to adequately assess the state member bank's compliance with the CPSI regulation, the examiner should discuss the situation with staff of the Board's Division of Banking Supervision and Regulation. The approval of the Division of Banking Supervision and Regulation's officer that is responsible for the supervisory policy and examination guidance pertain-

ing to insurance and annuity sales activities should be obtained before examining or requesting any information directly from a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance or annuity products at or on behalf of the state member bank.

The state member bank examination procedures described in section 3950.0.10.2 apply to retail sales, solicitations, advertisements, or offers of insurance products and annuities by any state member bank or any other person that is engaged in such activities at an office of the bank, or on behalf of the state member bank. For purposes of the CPSI regulation, activities "on behalf of a state member bank" include activities in which a person, whether at an office of the bank or at another location, sells, solicits, advertises, or offers an insurance product or annuity and in which at least one of the following applies:

1. The person represents to a consumer that the sale, solicitation, advertisement, or offer of any insurance product or annuity is by or on behalf of the bank.
2. The bank refers a consumer to a seller of insurance products or annuities, and the bank has a contractual arrangement to receive commissions or fees derived from the sale of an insurance product or annuity resulting from the bank's referral.
3. Documents evidencing the sale, solicitation, advertising, or offer of an insurance product or annuity identify or refer to the bank.

3950.0.7 APPENDIX A—JOINT INTERPRETATIONS OF THE CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

In response to a banking association's inquiries, the federal banking agencies jointly issued interpretations regarding the Consumer Protection in Sales of Insurance (CPSI) regulation.¹⁶ A joint statement, issued on August 17, 2001, contains responses to a set of questions relating to disclosure and acknowledgment, the scope of applicability of the regulation, and compliance. Additionally, a February 28, 2003, joint statement

16. These letters, issued jointly by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, may be accessed on these agencies' web sites.

15. Interagency Statement on Retail Sales of Nondeposit Investment Products, February 17, 1994. See SR-94-11.

responded to a request to clarify whether the disclosure requirements apply to renewals of pre-existing insurance policies sold before October 1, 2001, the effective date of the regulation. The issues raised and the banking agencies' responses are summarized below.

3950.0.7.1 Disclosures

3950.0.7.1.1 *Credit Disclosures*

A bank or other person who engages in insurance sales activities at an office of, or on behalf of, a bank ("a covered person") must make the credit disclosures set forth in the regulation if a consumer is solicited to purchase insurance while the consumer's loan application is pending. A consumer's application for credit is still "pending" for purposes of the regulation if the depository institution has approved the consumer's loan application but not yet notified the consumer. Until the consumer is notified of the loan approval, the covered person must provide the credit disclosures if the consumer is solicited, offered, or sold insurance.

3950.0.7.1.2 *Disclosures for Sales by Mail and Telephone*

The regulation requires a covered person to provide oral disclosures and to obtain an oral acknowledgment of these disclosures when sales activities are conducted by telephone. This requirement applies regardless of whether the consumer will also receive and acknowledge written disclosures in person, through the mail, or electronically.

3950.0.7.1.3 *Use of Short-Form Insurance Disclosures*

There is no short form for the credit disclosures. A depository institution, however, may use the short-form insurance disclosures set forth below in visual media (such as television broadcasting, ATM screens, billboards, signs, posters, and written advertisements and promotional materials):

- NOT A DEPOSIT
- NOT FDIC-INSURED
- NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY

- NOT GUARANTEED BY THE BANK
- MAY GO DOWN IN VALUE

3950.0.7.2. Acknowledgment of Disclosures

3950.0.7.2.1 *Reasonable Efforts to Obtain Written Acknowledgment*

The banking agencies have not prescribed any steps that must be taken for a depository institution's efforts to obtain a written acknowledgment to be deemed "reasonable" in a transaction conducted by telephone. Examples of reasonable efforts, however, include:

1. providing the consumer with a return-addressed envelope or similar means to facilitate the consumer's return of the written acknowledgment,
2. making a follow-up phone call or contact,
3. sending a second mailing, or
4. similar actions.

The covered person should (1) maintain documentation that the written disclosures and the request for written acknowledgment of those disclosures were mailed to the consumer and (2) record his or her efforts to obtain the signed acknowledgment. The "reasonable efforts" policy exception for telephone sales does not apply to other types of transactions, such as mail solicitations, in which a covered person must obtain from the consumer a written (in electronic or paper form) acknowledgment.

3950.0.7.2.2 *Appropriate Form or Format for Acknowledgment Provided Electronically*

Electronic acknowledgments are not required to be in a specific format but must be consistent with the provisions of the CPSI regulation applicable to acknowledgments. That is, the electronic acknowledgment must establish that the consumer has acknowledged receipt of the credit and insurance disclosures, as applicable.

3950.0.7.2.3 *Retention of Acknowledgments by an Insurance Company*

If an insurance company provides the disclosures and obtains the acknowledgment on behalf of a depository institution, the insurance com-

pany may retain the acknowledgment. The depository institution is responsible for ensuring that sales made “on behalf of” the depository institution are in compliance with the CPSI regulation. An insurance company may maintain documentation showing compliance with the CPSI regulation, but the depository institution should have access to such records and the records should be readily available for review by examiners.

3950.0.7.2.4 Form of Written Acknowledgment

There is no prescribed form for the written acknowledgment. The regulation requires, however, that a covered person obtain the consumer’s acknowledgment of receipt of the complete insurance and credit disclosures.

3950.0.7.2.5 Timing of Acknowledgment Receipt

A covered person must obtain the consumer’s acknowledgment either at the time a consumer receives disclosures *or* at the time of the initial purchase of an insurance product. The CPSI regulation does not prescribe any specific wording for an oral acknowledgment. However, if a covered person has made the insurance and credit disclosures orally, an affirmative response to the question “Do you acknowledge that you received this disclosure?” is acceptable.

3950.0.7.3 Scope of the CPSI Regulation

3950.0.7.3.1 Applicability to Private Mortgage Insurance

Depending on the nature of a depository institution’s involvement in an insurance sales transaction, the CPSI regulation may cover sales of private mortgage insurance. If the depository institution itself purchases the insurance to protect its interest in mortgage loans it has issued and merely passes the costs of the insurance on to the mortgage borrowers, then the transaction is not covered by the regulation. If, however, a consumer has the option of purchasing the private mortgage insurance and (1) the depository institution offers the private mortgage insurance to a consumer or (2) any other person offers the private mortgage insurance to a consumer at an office of a depository institution, or on behalf of a depository institution, the transaction would be covered by the regulation.

3950.0.7.3.2 Applicability to Federal Crop Insurance

The CPSI regulation does not apply to federal crop insurance that is sold for commercial or business purposes. However, if the crop insurance is purchased by an individual primarily for family, personal, or household purposes, it would be covered.

3950.0.7.3.3 Solicitations and Applications Distributed Before, but Returned After, the Effective Date of the CPSI Regulation

Direct-mail solicitations and “take-one” applications that are distributed on or after October 1, 2001, must comply with the CPSI regulation. If a consumer seeks to purchase insurance after the effective date of the regulation in response to a solicitation or advertisement that was distributed *before* that date, the depository institution would be in compliance with the regulation if the institution provides the consumer, before the initial sale, with the disclosures required by the regulation. These disclosures must be both written and oral, except that oral disclosures are not required if the consumer mails in the application.

3950.0.7.4 Renewals of Insurance

Renewals of insurance are not subject to the disclosure requirements (see the 3950.0.7.1 sections above), but are subject to other requirements of the CPSI regulation. A “renewal” of insurance means continuation of coverage involving the same type of insurance for a consumer as issued by the same carrier. A renewal need not be on the same terms and conditions as the original policy, provided that the renewal does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the time of the initial sale. An upgrade in coverage at a time when a policy is not up for renewal would be treated as a renewal, provided that the solicitation and sale of the upgrade do not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the initial sale.

3950.0.7.4.1 *Disclosures Required with Renewals of Insurance Coverage*

The banking agencies' interpretations clarified that the CPSI regulation does not *mandate* disclosures for renewals of policies sold before October 1, 2001. Accordingly, the CPSI regulation does not require the disclosures to be furnished at the time of renewal of a policy, including a pre-existing policy. However, renewals are subject to the other provisions of the CPSI regulation. Moreover, the banking agencies would expect that, consistent with applicable safety-and-soundness requirements, depository institutions would take reasonable steps to avoid customer confusion in connection with renewals of pre-existing policies.

3950.0.7.4.2 *“On-Behalf-of” Test and Use of Corporate Name or Logo*

Under the CPSI regulation, an affiliate of a bank is not considered to be acting “on behalf of” a bank simply because the affiliate’s marketing or other materials use a corporate name or logo that is common to the bank and the affiliate. In general, this exclusion applies even if a bank and its parent holding company have a similar, but not identical, name. For example, if the names of all of the affiliates of a bank holding company share the words “First National,” an affiliate would not be considered to be engaged in an activity “on behalf of” an affiliated bank simply by using the terms “First National” as part of a corporate logo or identity. The affiliate would, however, be considered to be acting “on behalf of” an affiliated bank if the name of the bank (for example, “First National Bank”) appears in a document as the seller, solicitor, advertiser, or offeror of insurance. A transaction also would be covered if it occurs on the premises of a depository institution or if one of the other prongs of the “on-behalf-of” test is met.

3950.0.7.5 Compliance

3950.0.7.5.1 *Appropriate Documentation of an Oral Disclosure or Oral Acknowledgment*

There is no specific documentation requirement for oral disclosures or acknowledgments. However, other applicable regulatory reporting stan-

dards would apply. Appropriate documentation of an oral disclosure would clearly show that the covered person made the credit and insurance disclosures to a consumer. Similarly, appropriate documentation of an oral acknowledgment would clearly show that the consumer acknowledged receiving the credit and insurance disclosures. For example, a tape recording of the conversation (where permitted by applicable laws) in which the covered person made the oral disclosures and received the oral acknowledgment would be acceptable. Another example would be a contemporaneous checklist completed by the covered person to indicate that he or she made the oral disclosures and received the oral acknowledgment. A contemporaneous note to the consumer’s file would also be adequate. The documentation should be maintained in the consumer’s file so that it is accessible to examiners.

3950.0.7.5.2 *Setting for Insurance Sales*

A depository institution must identify the areas where insurance sales occur and must clearly delineate and distinguish those areas from areas where the depository institution’s retail deposit-taking activities occur. Although the banking agencies did not define how depository institutions could “clearly delineate and distinguish” insurance areas, signage or other means may be used.

3950.0.8 APPENDIX B—GLOSSARY

See section 4040.1 of the Commercial Bank Examination Manual for additional definitions of insurance terms.

Accident and health insurance. A type of coverage that pays benefits in case of sickness, accidental injury, or accidental death. This coverage may provide for loss of income when the insured becomes disabled and provides reimbursement for medical expenses when the insured is ill. The insurance can provide for debt payment if it is taken out in conjunction with a loan. (See *Credit life insurance*.)

Actuary. A professional whose function is to calculate statistically various estimates for the field of insurance, including the estimated risk of loss on an insurable interest and the appropriate level for premiums and reserves.

Admitted insurer. An insurance company licensed

by a state insurance department to underwrite insurance products in that state.

Agency contract (or agreement). An agreement that establishes the contractual relationship between an agent and an insurer.

Agent. A licensed insurance company representative under contract to one or more insurance companies. Depending on the line of insurance represented, an agent's power may include soliciting, advertising, and selling insurance; collecting premiums; claims processing; and effecting insurance coverage on behalf of an insurance underwriter. Agents are generally compensated by commissions on policies sold, although some may receive salaries.

1. *Captive or exclusive agent.* An agent who represents a single insurer.
2. *General agents.* An agent who is contractually awarded a specific geographic territory for an individual insurance company. General agents are responsible for building their own agency and usually represent only one insurer. Unlike exclusive agents, who usually receive a salary in addition to commissions, general agents are typically compensated on a commission basis only.
3. *Independent agent.* An agent who is under contractual agreements with at least two different insurers. Typically, all of the independent's agent's compensation originates from commissions.

Aggregate excess-of-loss reinsurance. A form of "excess-of-loss" reinsurance that indemnifies the ceding company against the amount by which all of the ceding company's losses incurred during a specific period (usually 12 months) exceed either (1) a predetermined dollar amount or (2) a percentage of the company's subject premiums. This type of contract is also commonly referred to as stop-loss reinsurance or excess-of-loss ratio reinsurance.

Allied lines. Various insurance coverages for additional types of losses and against losses by additional perils. The coverages are closely associated with and usually sold with fire insurance. Examples include coverage against loss by perils other than fire, coverage for sprinkler-leakage damage, and business-interruption coverage.

Annuity. A contract that provides for a series of payments payable over an individual's life span or other term, on the basis of an initial lump-

sum contribution or series of payments made by the annuitant into the annuity during the accumulation phase of the contract.

1. *Fixed-annuity contracts* provide for payments to annuitants at fixed, guaranteed minimum rates of interests.
2. *Variable-annuity contracts* provide for payments based on the performance of annuity investments. Variable-annuity contracts are usually sold based on a series of payments and offer a range of investment or funding options such as stocks, bonds, and money market fund investments. The annuity principal and the investment return are not guaranteed as they depend on the performance of the underlying funding option.

Annuity payments may commence with the execution of the annuity contract (*immediate annuity*) or may be deferred until some future date (*deferred annuity*).

Assigned risk. A risk that is not usually acceptable to insurers and is therefore assigned to a group of insurers who are required to share in the premium income and losses, in accordance with state requirements, in order for the insurer to sell insurance in the state.

Assignment. The legal transfer of one person's interest in an insurance policy to another person or business.

Bank-owned life insurance (BOLI). Life insurance purchased and owned by a BHC or bank to fund its exposure arising from employee compensation and benefit programs. In a typical BOLI program, a BHC or bank insures a group of employees; pays the life insurance policy premiums; owns the cash values of the policies, which are booked on the BHC's or bank's balance sheet as "other assets"; and is the beneficiary of the policies upon the death of any insured employee or former employee.

Beneficiary. The person or entity named in an insurance policy as the recipient of insurance proceeds upon the policyholder's death or when an endorsement matures. A revocable beneficiary can be changed by the policyholder at any time. An irrevocable beneficiary can be changed by the policyholder only with the written permission of the beneficiary.

Binder. A written or oral agreement, typically

issued by an insurer, agent, or broker for property and casualty insurance, to indicate acceptance of a person's application for insurance and to provide interim coverage pending the insurance company's issuance of a binding policy.

Blanket bond. Coverage for an employer for loss incurred as a result of employee dishonesty.

Boiler and machinery insurance. Insurance against the sudden and accidental breakdown of boilers, machinery, and electrical equipment, including coverage for damage to the equipment and property damage, including the property of others. Coverage can be extended to cover consequential losses, including loss from interruption of business.

Broker. A person who represents the insurance buyer in the purchase of insurance. Brokers do not have the power to bind an insurance company to an insurance contract. Once a contract is accepted, the broker is compensated for the transaction through a commission from the insurance company. An individual may be licensed as both a broker and an agent.

Bulk reinsurance. A transaction sometimes defined by statute as any quota-share, surplus aid, or portfolio reinsurance agreement through which an insurer assumes all or a substantial portion of the liability of the reinsured company.

Captive insurer. An insurance company established by a parent firm to insure or reinsure its own risks or the risks of affiliated companies. A captive may also underwrite insurable risks of unaffiliated companies, typically the risks of its customers or employees. For example, a BHC or bank may form a captive insurance company to underwrite its own directors' and officers' risks or to underwrite credit life or private mortgage insurance (third-party risks) related to its lending activities.

Cash surrender value of life insurance. The amount of cash available to a life insurance policyholder upon the voluntary termination of a life insurance policy before it becomes payable by death or maturity.

Casualty insurance. Coverage for the liability arising from third-party claims against the insured for negligent acts or omissions causing bodily injury or property damage.

Cede. To transfer to a reinsurer all or part of the insurance or reinsurance risk underwritten by an insurance company.

Ceding commission. The fee paid to a reinsurance company for assuming the risk of a primary insurance company.

Ceding company (also cedant, reinsured, reas-sured). The insurer that transfers all or part of the insurance or reinsurance risk it has underwritten to another insurer or reinsurer via a reinsurance agreement.

Cession. The amount of insurance risk transferred to the reinsurer by the ceding company.

Churning. The illegal practice wherein a customer is persuaded to unnecessarily cancel one insurance policy in favor of buying a purportedly superior policy, often using the cash surrender value of the existing policy to pay the early premiums of the new policy. In such a transaction, the salesperson benefits from the additional commission awarded for booking a new policy.

Claim. A request for payment of a loss under the terms of a policy. Claims are payable in the manner suited to the insured risk. Life, property, casualty, health, and liability claims generally are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims are paid periodically during the period of disability or through a discounted lump-sum payment.

Coinsurance. A provision in property and casualty insurance that requires the insured to maintain a specified amount of insurance based on the value of the property insured. Coinsurance clauses are also found in health insurance and require the insured to share a percentage of the loss.

Combination-plan reinsurance. A reinsurance agreement that combines the excess-of-loss and the quota-share forms of coverage within one contract, with the reinsurance premium established as a fixed percentage of the ceding company's subject premium. After deducting the excess recovery on any one loss for one risk, the reinsurer indemnifies the ceding company on the basis of a fixed quota-share percentage. If a loss does not exceed the excess-of-loss retention level, only the quota-share coverage applies.

Commission. The remuneration paid by insurance carriers to insurance agents and brokers for the sale of insurance and annuity products.

Comprehensive personal liability insurance. A type of insurance that reimburses the policyholder if he or she becomes liable to pay money for damage or injury he or she has caused to others. This coverage does not include automobile liability but does include almost every activity of the policyholder, except business operations.

Contractholder. The person, entity, or group to whom an annuity is issued.

Credit for reinsurance. A statutory accounting procedure, set forth under state insurance regulations, that permits a ceding company to treat amounts due from reinsurers as assets, or as offsets to liabilities, on the basis of the reinsurer's status.

Credit life insurance. A term insurance product issued on the life of a debtor that is tied to repayment of a specific loan or indebtedness. Proceeds of a credit life insurance policy are used to extinguish remaining indebtedness at the time of the borrower's death. The term is applied broadly to other forms of credit-related insurance that provide for debt satisfaction in the event of a borrower's disability, accident or illness, and unemployment. Credit life insurance has historically been among the most common BHC and bank insurance products.

Credit score. A number that is based on an analysis of an individual's credit history and that insurers may consider as an indicator of risk for purposes of underwriting insurance. Where not prohibited by state law, insurers may consider a person's credit history when underwriting personal lines.

Debt-cancellation contract/debt-suspension agreement. A loan term or contract between a lender and borrower whereby, for a fee, the lender agrees to cancel or suspend payment on the borrower's loan in the event of the borrower's death, serious injury, unemployment, or other specified events. The Office of the Comptroller of the Currency considers these products to be banking products. State law determines whether these products are bank or insurance products for state-chartered banks and insurance companies.

Deductible. The amount a policyholder agrees to pay toward the total amount of insurance loss. The deductible may apply to each claim for a loss occurrence, such as each automobile acci-

dent, or to all claims made during a specified period, as with health insurance.

Directors' and officers' liability insurance. Liability insurance covering a corporation's obligation to reimburse its directors or officers for claims made against them for alleged wrongful acts. It also provides direct coverage for company directors and officers themselves in instances when corporate indemnification is not available.

Direct premiums written. Premiums received by an underwriter for all policies written during a given time period by the insurer, excluding those received through reinsurance assumed.

Direct writer. An insurance company that deals directly with the insured through a salaried representative, as opposed to those insurers that use agents. This term refers to insurers that operate through exclusive agents. In reinsurance, a direct writer is the company that originally underwrites the insurance policies ceded.

Disability income insurance. An insurance product that provides income payment to the insured when his or her income is interrupted or terminated because of illness or accident.

Endowment insurance. A type of life insurance contract under which the insured receives the face value of the policy if he or she survives the endowment period. Otherwise, the beneficiary receives the face value of the policy upon the death of the insured.

Errors and omissions (E&O) liability insurance. Professional liability insurance that covers negligent acts or omissions resulting in loss. Insurance agents are continually exposed to the claim that inadequate or inappropriate coverage was recommended resulting in a lack of coverage for losses incurred. The agent or the carrier may be responsible for coverage for legitimate claims.

Excess-of-loss reinsurance. A form of reinsurance whereby an insurer pays the amount of each claim for each risk up to a limit determined in advance, and the reinsurer pays the amount of the claim above that limit up to a specific sum. It includes various types of reinsurance, such as catastrophe reinsurance, per-risk reinsurance, per-occurrence reinsurance, and aggregate excess-of-loss reinsurance.

Excess-per-risk reinsurance. A form of excess-of-loss reinsurance that, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention for each risk involved in each occurrence.

Excess and surplus lines. Property/casualty coverage that is unavailable from insurers licensed by the state (admitted insurers) and must be purchased from a nonadmitted underwriter.

Exposure. The aggregate of all policyholder limits of liability arising from policies written.

Face amount. The amount stated on the face of the insurance policy to be paid, depending on the type of coverage, upon death or maturity. It does not include dividend additions or additional amounts payable under accidental death or other special provisions.

Facultative reinsurance. Reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the faculty to accept or reject each risk offered by the ceding company.

Financial guarantee insurance. Financial guarantee insurance is provided for a wide array of financial risks. Typically, coverage is provided for the fulfillment of a specific financial obligation originated in a business transaction. The insurer, in effect, is lending the debtor its own credit rating to enhance the debtor's creditworthiness.

Financial strength rating. Opinion as to an insurance company's ability to meet its senior policyholder obligations and claims. For many years, the principal rating agency for property and casualty insurers and life insurers has been A.M. Best. Other rating agencies, such as Fitch, Moody's, Standard and Poor's, and Weiss, also rate insurers.

Fixed annuity. See annuity.

Flood insurance. A special insurance policy to protect against the risk of loss or damage to property caused by flooding. Regular homeowners' policies do not pay for damages caused by flooding.

General liability insurance. A broad commercial policy that covers all business liability exposures, such as product liability, completed

operations, premises and operations, independent contractors, and other exposures that are not specifically excluded.

Gross premiums written. Total premiums for insurance written during a given period, before deduction for reinsurance ceded.

Group insurance. Insurance coverage typically issued to an employer under a master policy for the benefit of employees. The insurer usually does not condition coverage of the people that make up the group upon satisfactory medical examinations or other requirements. The individual members of the group hold certificates as evidence of their insurance.

Health insurance. An insurance product that provides benefits for medical expenses incurred as a result of sickness or accident. This product may be in the form of traditional indemnity insurance or managed-care plans and may be underwritten on an individual or group basis.

Incurred but not reported (IBNR). The loss-reserve value established by insurance and reinsurance companies in recognition of their liability for future payments on losses that have occurred but have not yet been reported to them. This definition is often erroneously expanded to include adverse loss development on reported claims. The term incurred but not enough reported (IBNER) is being increasingly used to reflect more accurately the adverse development on inadequately reserved reported claims.

Inland marine insurance. A broad field of insurance that covers cargo being shipped by air, truck, or rail. It includes coverage for most property involved in transporting cargo as well as for bridges, tunnels, and communications systems.

Key person life insurance. Life insurance designed to cover the key employees of an employer. It may be written on a group- or an individual-policy basis.

Lapse. The termination or discontinuance of a policy resulting from the insured's failure to pay the premium due.

Liability insurance. Protects policyholders from financial loss due to liability resulting from injuries to other persons or damage to their property.

Lines. A term used in insurance to denote insurance business lines, as in "commercial lines" and "personal lines."

Long-term care insurance. Health insurance designed to supplement the cost of nursing home care or other care facilities in the event of a long-term illness or permanent disability or incapacity.

Managing general agent. A managing general agent (MGA) is a wholesaler of insurance products and services to insurance agents. An MGA receives contractual authority from an insurer to assume many of the insurance company's functions. The MGA may provide insurance products to the public through local insurance agents as well as provide services to an insurance company, including marketing, accounting, data processing, policy maintenance, and claims-monitoring and -processing services. Many insurance companies prefer the MGA distribution and management system for their insurance products because it avoids the high cost of establishing branch offices. Most states require that an MGA be licensed.

Manuscript policy. A policy written to include specific coverage or conditions not provided in a standard policy.

Morbidity. The incidence and severity of illness and disease in a defined class of insured persons.

Mortality. The rate at which members of a group die in a specified period of time or die from a specific illness.

Mortgage guarantee insurance. A product that insures lenders against nonpayment by borrowers. The policies are issued for a specified time period. Lenders who finance more than 80 percent of the property's fair value generally require such insurance.

Mortgage insurance. Life insurance that pays the balance of a mortgage even if the borrower dies. Coverage typically is in the form of term life insurance, with the coverage declining as the debt is paid off.

Multiperil insurance. An insurance contract providing coverage against many perils, usually combining liability and physical damage coverage.

Net premiums written. The amount of gross premiums written, after deduction for premiums ceded to reinsurers.

Ninety-day loss rule. A state requirement for an insurer to establish a loss provision for reinsurance recoverables over 90 days past due.

Obligatory treaty. A reinsurance contract under which business must be ceded in accordance with contract terms and must be accepted by the reinsurer.

Policyholder. The person or entity who owns an insurance policy. This is usually the insured person, but it may also be a relative of the insured, a partnership, or a corporation.

Premium. The payment, or one of the periodic payments, a policyholder agrees to make for insurance coverage.

Private mortgage insurance (PMI). Coverage for a mortgage lender against losses due to a collateral shortfall on a defaulted residential real estate loan. Most BHCs and banks require borrowers to take out a PMI policy if a downpayment of less than 20 percent of a home's value is made at the time the loan is originated. PMI does not directly benefit a borrower, although its existence provides the opportunity to purchase a home to many people who otherwise would not qualify for a loan.

Producer. A person licensed to sell, solicit, or negotiate insurance.

Professional designations and organizations. Three of the most common insurance professional designations are Chartered Life Underwriter (CLU), Chartered Property Casualty Underwriter (CPCU), and Chartered Financial Consultant (ChFC). Insurance agents also join professional organizations such as the American Society of Chartered Life Underwriters, the International Association of Financial Planning, the National Association of Life Underwriters, the National Association of Health Underwriters, the American Council of Life Insurance, the Life Insurance Marketing and Research Association, the Life Underwriter Training Council, and the Million Dollar Round Table.

Property insurance. Coverage for physical damage or destruction of real property (building, fixtures, and permanently attached equipment) and personal property (movable items that are not attached to land) that occurs during the policy period as a result of, for example, fire, windstorm, explosion, and vandalism.

Pro rata reinsurance. A generic term describing all forms of "quota-share" and "surplus reinsur-

ance,” in which the reinsurer shares a pro rata portion of the losses and premiums of the ceding company.

Protected cell. A structure available to captive insurers underwriting risks of unaffiliated companies whereby the assets associated with the self-insurance program of one organization are segregated to provide legal-recourse protection from creditors of protected cells providing insurance coverage to other organizations.

Quota-share reinsurance. A form of pro rata reinsurance indemnifying the ceding company for a fixed percent of loss on each risk covered in the contract in consideration of the same percentage of the premium paid to the ceding company.

Rebating. Directly or indirectly giving or offering to give any portion of the premium or any other consideration to an insurance buyer as an inducement to purchase or renew the insurance. Rebates are forbidden under most state insurance codes.

Reinsurance. Insurance placed by an underwriter (the ceding company or reinsured) in another company to transfer or reduce the amount of the risk assumed under the original insurance policy (or group of policies).

Reinsurance premium. The consideration paid by a ceding company to a reinsurer for the coverage provided by the reinsurer.

Residual market. Also known as the shared market, it covers applications for insurance that were rejected by underwriters in the voluntary market that is covered by agency direct-marketing systems, perhaps because of high loss experience by the insured party. The residual market includes government insurance programs, specialty pools, and shared market mechanisms such as assigned-risk plans.

Retrocession. A reinsurance transaction whereby a reinsurer (the retrocedant) cedes all or part of the reinsurance risks it has assumed to another reinsurer (the retrocessionaire).

Retrospective rating. An insurance plan in which the current year’s premium is based on the insured’s own loss experience for that same period, subject to a maximum and minimum.

Rider. A written attachment, also known as an endorsement, to an insurance policy that changes the original policy to meet specific requirements, such as increasing or decreasing benefits or providing coverage for specific property items beyond that provided for under the insurance company’s standard contract terms.

Self-insured retention (SIR). The percentage of a risk or potential loss assumed by an insured, whether in the form of a deductible, self-insurance, or no insurance at all.

Separate accounts. Certain life insurance assets and related liabilities that are segregated and maintained to meet specific investment objectives of contract holders, particularly those assets and liabilities associated with pension plans and variable products offered by life insurers, wherein the customer and not the insurer retains most of the investment and interest-rate risk.

Split-dollar life insurance. An arrangement that typically involves an agreement between an employer and an employee whereby the premium payment, cash values, policy ownership, and death benefits may be split. There are many variations of split-dollar arrangements, including arrangements in which a trust is created to facilitate estate planning. Split-dollar life insurance is designed to serve as a supplemental benefit to a particular company executive. The arrangement typically involves the payment of the insurance premium by the employer, with the death benefit accruing to the employee.

Subrogation. An insurance carrier may reserve the “right of subrogation” in the event of a loss. This means that the company may choose to take action to recover the amount of a claim paid to a covered insured if a third party caused the loss. After expenses, the amount recovered must be divided proportionately with the insured to cover any deductible for which the insured was responsible.

Term life insurance. An insurance product that provides, for a specified period of time, death coverage only. Typically, it has no savings component and, therefore, no cash value. Because term insurance provides only mortality protection, it generally provides the most coverage per premium dollar. Most term life insurance policies are renewable for one or more time periods up to a stipulated maximum age; however, premiums generally increase with the age of the policyholder.

Title insurance. Insurance that protects BHCs, banks, and mortgagees against unknown encumbrances against real estate by indemnifying the mortgagor and property owner in the event that clear ownership of the property is clouded by the discovery of faults in the title. Title insurance policies may be issued to either the mortgagor or the mortgagee or both. Title insurance is written largely only by companies specializing in this class of insurance.

Treaty reinsurance. A reinsurance contract under which the reinsured company agrees to cede, and the reinsurer agrees to assume, risks of a particular class or classes of business.

Twisting. In insurance, twisting involves making misrepresentations to a policyholder to induce the policyholder to terminate one policy and to take out another policy with another company, when it is not to the insured's benefit. Twisting is a violation of the Unfair Trade Practices Act. Twisting is similar to the "churning" concept in securities sales, and it results in increased commissions for the inducing agent.

Umbrella liability insurance. This type of liability insurance provides excess liability protection over the "underlying" liability insurance coverage to supplement underlying policies that have been reduced or exhausted by loss.

Underwriting. The process by which a company determines whether it can accept an application for insurance and by which it may charge an appropriate premium for those applications selected. For example, the underwriting process for life insurance classifies applicants by identifying such characteristics as age, sex, health, and occupation.

Unearned reinsurance premium. The part of the reinsurance premium that is applicable to the unexpired portion of the policies reinsured.

Universal life insurance. A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a high cash surrender value. Alternatively, the policyholder can make minimal payments in an amount only large enough to cover mortality and other expense charges.

Variable annuity. See Annuity.

Variable life insurance. A form of whole life, or universal life, insurance in which the policy-

holder's cash value is invested in "separate accounts" of the insurer. These accounts are segregated from the insurance carrier's other asset holdings. Such separate account investments are generally not available to a carrier's general creditors in the event of the carrier's insolvency. The policyholder assumes the investment and price risk. Because variable life policies have investment features, life insurance agents selling these policies must be registered representatives of a broker-dealer licensed by the National Association of Securities Dealers and registered with the Securities and Exchange Commission.

Vendors' single-interest insurance. A form of force-placed insurance that is typically purchased by the BHC or bank to protect against loss or damage to loan collateral in which the BHC or bank has a security interest. The banking organization passes its expense for this insurance on to the consumer who has either refused or is unable to obtain property insurance.

Viatical settlement. The cashing in of a life insurance policy at a discount from face amount by policyholders who are often terminally ill and need the money for medical care. The purchaser becomes the policyholder as well as the beneficiary and assumes the premium payments of the policy.

Whole life insurance. A fixed-rate insurance product, with premiums and death benefits guaranteed over the duration of the policy. There is a cash value (essentially a savings account) that accrues to the policyholder tax deferred. A policyholder receives the cash value in lieu of death benefits if the policy matures or lapses before the insured's death. A policyholder also may borrow against the policy's accumulated cash value or use it to pay future premiums. For most whole life insurance policies, premiums are constant for the life of the insured's contract.

3950.0.9 INSPECTION OBJECTIVES

1. To understand the volume and complexity of the banking organization's insurance or annuity program and insurance sales strategy.
2. To assess the financial results of the activity compared with planned results.
3. To determine if the insurance and annuity sales activities are effectively integrated into

the banking organization's risk-management, audit, and compliance functions and if the control environment is adequate.

4. To assess the adequacy of the banking organization's controls to ensure compliance with the applicable state and federal laws and regulations.
5. To assess the level and direction of operational, legal, and reputational risks to the consolidated banking organization and the bank from the insurance or annuity sales activity.

The following objectives apply if insurance products or annuities are sold by another person at an office of, or on behalf of, a state member bank subsidiary of the BHC.

6. To assess the adequacy of the BHC's oversight program for ensuring a state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation. (See section 3950.0.1.)
7. To assess the effectiveness of the BHC's oversight of a state member bank's compliance and audit programs with respect to the CPSI regulation.
8. To assess the BHC's oversight of a state member bank's compliance with the CPSI regulation.
9. To obtain commitments for a BHC's oversight for needed corrective action when a state member bank is in violation of the CPSI regulation or when applicable policies, procedures, practices, or management oversight to protect against violations is deficient.

3950.0.10 INSPECTION PROCEDURES

3950.0.10.1 Risk Assessment of Insurance and Annuity Sales Activities

The examiner should consider the following procedures, as appropriate, when conducting a risk assessment to determine the level and direction of risk exposure to the BHC that is attributable to insurance or annuity sales activity. If there are specific areas of concern, the examiner should focus primarily on those areas.

1. *Scope of activities and strategies.* Assess the significance and complexity of the insurance or annuity sales program.
 - a. Obtain a general overview of the scope

- of the BHC's insurance or annuity sales activities and any anticipated or recent change in or expansion of such activities.
- b. Determine the BHC's strategy for insurance or annuity sales, including strategies for cross-selling and referrals of insurance and banking products. Determine the institution's experience with any cross-marketing programs for both insurance business generated by the BHC and business generated by insurance producers.
- c. Obtain two years' worth of income statements, balance sheets, and budget documents for the agency's activities. Compare the expected budget items with their actual results.
- d. Determine the volume and type of insurance or annuity products and services sold or solicited.
- e. Determine what other related services the BHC provides in connection with its insurance or annuity sales activities, such as providing risk-management services to clients seeking advice on appropriate insurance coverages, claims processing, and other activities.
- f. If the BHC is not an FHC, confirm that any insurance sales activities conducted by the BHC or a nonbank subsidiary are within the limited scope of activities permissible for BHCs that are not FHCs.

2. *Insurance sales products and concentrations.*

- a. Determine the composition of sales—
 - by line of business, such as property/casualty insurance, life insurance including annuities, and health insurance;
 - by the proportion of sales to commercial and retail customers; and
 - by the portion of sales that is credit related, such as credit life and credit health insurance.
 - b. Determine any sales concentrations to particular entities, industries, or BHC customers.
 - c. Note any concentrations to large commercial accounts.
 - d. Determine what insurance services are provided to the BHC, its employees, and BHC or bank affiliates.
- #### 3. *Legal-entity and the risk-management structure for insurance or annuity sales.*
- a. Obtain an organizational chart for the legal-entity and risk-management structure for the insurance or annuity sales activities.
 - b. Determine—

- whether the insurance or annuity sales activity is conducted in an affiliated producer, by the BHC itself, through another distribution arrangement, or by a combination of these entities;
 - the names of any affiliated insurance agencies and the states where the affiliated insurance agencies are licensed; and
 - the locations outside of the United States where insurance or annuities are sold or solicited.
- c. Determine if the insurance or annuity producer is acting as a managing general agent (MGA).¹⁷ If so, determine —
- the scope of the MGA activities;
 - the BHC management’s assessment of the risk associated with the MGA activity; and
 - what risk controls are in place to protect the BHC from potential loss that may arise from the MGA’s activities, such as loss arising from legal liability.
4. *Strategic and financial plans.* Assess management controls over the insurance annuity sales activities.
- a. Ascertain the BHC management’s strategic and financial plans and goals for the insurance or annuity sales activity.
- b. Review the BHC’s due-diligence process for acquiring and pricing agencies, if applicable.
- c. Review the BHC’s financial budgets and forecasts for the activity, particularly plans for new products, marketing strategies, and marketing arrangements, and the rate of actual and expected growth for the activity.
- d. Determine the cause for significant deviations from the plan.
- e. Determine if any agency acquired by the state member bank is providing the expected return on investment and if the agency’s revenues are covering the debt servicing associated with the purchase, if applicable.
5. *Review of board and committee records and reports.*
- a. Review the reports of any significant BHC oversight committees, including relevant board of directors’ and board
- committees’ minutes and risk-management reports.
- b. Determine if the BHC’s board of directors, a board committee, or senior management reviews reports pertaining to consumer complaints and complaint resolution, information pertaining to litigation and associated losses, and performance compared with the organization’s plan for the insurance and annuity sales activities.
6. *Policies and procedures.*
- a. Determine—
- the adequacy of the BHC’s policies and procedures for conducting and monitoring insurance or annuity sales activities, including those policies designed to ensure adherence with federal and state laws and regulations pertaining to consumer protection;
 - whether there are appropriate policies and procedures for the handling of customer funds collected on behalf of the underwriter; accurate and timely financial reporting; complaint monitoring and resolution; effective system security and disaster-recovery plans; and policy-exception tracking and reporting, and
 - if the board of directors or a designated committee of the board has formally approved the policies.
- b. Obtain a detailed balance sheet for agency subsidiaries, and determine if the assets held by insurance or annuity agency subsidiaries of BHCs and banks are all eligible investments.
- c. Determine the independence of the BHC’s audit program applicable to the insurance and annuity sales activity. Ascertain if the audit program’s scope, frequency, and resources are commensurate with the insurance and annuity activities conducted.
- d. Determine how the BHC selects insurance underwriters with whom to do business, as well as how the banking organization monitors the continuing performance of the underwriters.
- e. Determine the adequacy of the BHC board of directors’ oversight of the insurance management team’s qualifications, the training and licensing of personnel, and general compliance with state insurance regulations.

17. MGAs do not assume underwriting risk. Through contractual arrangements with an insurer, MGAs have the authority to write policies on behalf of the insurer in certain instances, thereby binding the insurer to the policy. Certain minimum provisions governing MGA agreements are delineated in the applicable National Association of Insurance Commissioners (NAIC) model law.

- f. Review the internal controls of the BHC related to third-party arrangements, including arrangements for sales, processing, and auditing of insurance and annuity activities.
7. *Claims, litigation, and functional regulator supervision.* Assess legal and reputational risk.
 - a. Identify any significant litigation against the BHC arising from its insurance or annuity sales activity and the likely impact of the litigation on the BHC.
 - b. Obtain the insurance agency's errors and omissions claims records for the past several years, including a listing of claims it has made and the amount of claims, the claim status, and the amount of claim payments.
 - c. Review the BHC's policies and procedures for tracking and resolving claims. Determine if the policies and procedures appear adequate and if they are adhered to.
 - d. Determine if the applicable functional regulator has any outstanding supervisory issues with the insurance agency.
 8. *Consumer complaints.*
 - a. Determine if the BHC's management has policies and procedures in place to assess whether consumer complaints received are likely to expose the BHC to regulatory action, litigation, reputational damage, or other significant risk.
 - b. Obtain applicable consumer complaint files, and evaluate internal control procedures to ensure the complaints are being adequately addressed.
 9. *Audit and compliance functions.*
 - a. Determine the date of the most recent review of the insurance or annuity sales activities by the audit and compliance functions.
 - b. Determine the adequacy of the BHC's management policies and procedures for ensuring that any deficiencies noted in such reviews are corrected, and ascertain whether any such deficiencies are being adequately addressed.¹⁸
 10. *Insurance underwriter oversight of agent/agency activities.*
 - a. Determine if the banking organization has adequate policies and procedures to review and resolve any issues or concerns raised by an insurance underwriter regarding the producers used by, or affiliated with, the BHC.¹⁹
 - b. Determine whether any of the insurance underwriters conducted a periodic review of producers that they engaged to sell insurance.
 11. *State supervisory insurance authorities.*
 - a. During discussions with the BHC's management, determine whether state insurance regulators have raised any issues or concerns in correspondence or reports.
 - b. Consult with the state insurance regulator (or regulators), as appropriate, to determine any significant supervisory issues, actions, or investigations. (For multistate agencies, contacts with states may be prioritized on basis of the location of the agency's head office or by a determination of the significance of sales by state. Both financial examinations and market conduct examinations conducted by the state insurance departments are targeted at insurance underwriters, not agencies. Therefore, information available from the states pertaining to agencies may be very limited.)
 12. *Operational risk assessment.* Ascertain from BHC management whether there are—
 - a. any significant operational problems or concerns relating to insurance or annuity sales activities;
 - b. policies and procedures in place to ensure accurate and timely reporting to the BHC's management of insurance or annuity sales activity plans, financial results, and significant consumer complaints or lawsuits or compliance issues, such as errors and omissions claims;²⁰
 - c. appropriate policies and procedures at the BHC to ensure accurate reporting of

18. Enforcement of the privacy provisions of the GLB Act as they relate to state member banks is the responsibility of the Board's Division of Consumer and Community Affairs. However, enforcement of the privacy provisions of the GLB Act with respect to the insurance activities of nondepository subsidiaries of a state member bank is the responsibility of the state insurance regulators.

19. Insurance underwriters generally have procedures to determine whether individual producers affiliated with agencies are selling the underwriters' products in conformance with applicable laws and regulations. These reviews' findings and conclusions should be available to the state member bank's management.

20. Errors and omissions insurance should be in place to protect the state member bank against loss sustained because of an error or oversight, such as failure to issue an insurance policy. A tracking system to monitor errors and omission claims should be in place and monitored by the state member bank, as appropriate. See section 4040.1, "Management of Insurable Risks," of the *Commercial Bank Examination Manual*.

insurance or annuity sales activity on Federal Reserve regulatory reports (Determine from applicable Board or Reserve Bank contacts if there are any outstanding issues with respect to potential reporting errors on submitted Federal Reserve reports, BHC and bank call reports, or other applicable reports. If so, seek resolution of the issues); and

- d. adequate disaster-recovery plans and procedures to protect the BHC from loss of data related to insurance or annuity sales activities.

3950.0.10.2 Consumer Protection in Sales of Insurance Regulation

These examination procedures apply only to the examination of state member banks. The procedures are provided for the BHC examiner's information only.

The following procedures should be risk-focused in accordance with the Federal Reserve's risk-focused framework for supervising banking organizations. The procedures should be carried out as necessary to adequately assess the state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation.

1. Determine the role of the state member bank's board of directors and management in ensuring compliance with the CPSI regulation and applicable state consumer regulations.
2. Evaluate the management information system (MIS) reports the state member bank's board or designated committee relies on to monitor compliance with the consumer regulations and to track complaints and complaint resolution.
3. Review the state member bank's policies and procedures to ensure they are consistent with the CPSI regulation, and conduct transaction testing, as necessary, in the following areas:²¹
 - a. disclosures, advertising, and promotional materials
 - b. consumer acknowledgments
 - c. physical separation from areas of deposit-

²¹ If the examiner determines that transaction testing of a functionally regulated nonbank affiliate of the state member bank is appropriate in order to determine the state member bank's compliance with the CPSI regulation, the examiner should first consult with and obtain approval from appropriate staff of the Board's Division of Banking Supervision and Regulation.

taking activities

- d. qualifications and licensing for insurance personnel
 - e. compliance programs and internal audits
 - f. hiring, training, and supervision of insurance or annuity sales personnel employed directly by the state member bank, or of third parties selling insurance or annuity products at a state member bank office or on behalf of the state member bank
 - g. compensation practices and training for personnel making referrals
4. If a third party sells insurance or annuities at the state member bank's offices or on behalf of the state member bank, review the state member bank's policies and procedures for ensuring that the third party complies with the CPSI regulation and other relevant policies and procedures of the bank.
 5. Review the state member bank's process for identifying and resolving consumer complaints related to the sale of insurance products and annuities.
 6. Obtain and review the record of consumer complaints related to the CPSI regulation. These records are available from the Board's Division of Consumer and Community Affairs' database. (See CP letter 2001-11.)
 7. Include examination findings, as appropriate, in the commercial bank examination report or in other communications to the bank, as appropriate, that pertain to safety-and-soundness reviews of the bank.

3950.0.11 INTERNAL CONTROL QUESTIONNAIRE

3950.0.11.1 Risk Assessment of Insurance and Annuity Sales Activities

3950.0.11.1.1 Program Management

1. Does the BHC have a comprehensive program to ensure that its insurance and annuity sales activities are conducted in a safe and sound manner?
2. Does the BHC have appropriate written policies and procedures commensurate with the volume and complexity of the insurance or annuity sales activities?
3. Has management obtained the approval of the board of directors for the program scope and the associated policies and procedures?
4. Have reasonable precautions been taken to ensure that disclosures to customers for

- insurance or annuity sales and solicitations are complete and accurate and are in compliance with applicable laws and regulations?
5. Does the BHC's management effectively oversee the insurance or annuity sales activities, including those involving third parties?
 6. Does the BHC have an effective independent internal audit and compliance program in place to monitor retail sales of insurance or annuity products?
 7. Does the BHC appropriately train and supervise employees conducting insurance or annuity sales activities?

3950.0.11.1.2 Management Information Systems

8. Does the BHC's insurance program management plan establish the appropriate management information systems (MIS) necessary for the banking organization's board of directors to properly oversee the insurance or annuity sales activities?
9. Does the MIS provide sufficient information to allow for the evaluation and measurement of the effect of actions taken to identify, track, and resolve any issues relative to compliance with the CPSI regulation?
10. Does the MIS include sales volumes and trends, profitability, policy exceptions and associated controls, customer complaints, and other information providing evidence of compliance with laws and established policies?

3950.0.11.1.3 Compliance Programs and Internal Audits

11. Are there policies and procedures in place to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations?
12. Do compliance procedures identify potential conflicts of interest and how such conflicts should be addressed?
13. Do the compliance procedures provide a system to monitor customer complaints and track their resolution?
14. When applicable, do compliance procedures call for verification that third-party sales are being conducted in a manner consistent with the agreement governing the third par-

- ty's arrangement with the BHC?
15. Is the compliance function conducted independently of the insurance or annuity sales and management activities?
 16. Do compliance personnel determine the scope and frequency of the insurance-product review?
 17. Are findings of insurance or annuity sales activity compliance reviews periodically reported directly to the BHC's board of directors or a designated committee thereof?

3950.0.11.2 Consumer Protection in Sales of Insurance Regulation

This internal control questionnaire applies only to the examination of state member banks. It is provided for the BHC examiner's information only.

If applicable, review the state member bank's internal controls, policies, practices, and procedures for retail insurance or annuity sales activities conducted by the bank on bank premises or on behalf of the bank. The bank's program management for such activities should be well documented and should include appropriate personnel training, as well as compliance and audit-function coverage of all efforts to ensure compliance with the provisions of the Board's CPSI regulation.

3950.0.11.2.1 Advertising and Promotional Materials

1. Do advertising materials associated with the insurance or annuity sales program create an erroneous belief that—
 - a. an insurance product or annuity sold or offered for sale by the state member bank, or on behalf of the bank, is backed by the federal government or the bank, or that the product is insured by the FDIC?
 - b. an insurance product or annuity that involves investment risk does not, in fact, have investment risk, including the potential that principal may be lost and the product may decline in value?
2. Does a review of advertising for insurance products or annuities sold or offered for sale create an erroneous impression that—
 - a. the state member bank or an affiliate or subsidiary may condition the grant of an extension of credit to a consumer on the purchase of an insurance product or

- annuity by the consumer from the bank or an affiliate or subsidiary of the bank?
- b. the consumer is not free to purchase an insurance product or annuity from another source?

3950.0.11.2.2 Disclosures

3. In connection with the initial purchase of an insurance product or annuity by a consumer, does the initial disclosure to the consumer, except to the extent the disclosure would not be accurate, state that—
- the insurance product or annuity is not a deposit or other obligation of, or is not guaranteed by, the state member bank or an affiliate of the bank?
 - the insurance product or annuity is not insured by the FDIC or any other agency of the United States, the state member bank, or (if applicable) an affiliate of the bank?
 - in the case of an insurance product or annuity that involves an investment risk, there is risk associated with the product, including the possible loss of value?
4. In the case of an application for credit, in connection with which an insurance product or annuity is solicited, offered, or sold, is a disclosure made that the state member bank may not condition an extension of credit on either—
- the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates?
 - the consumer's agreement not to obtain, or a prohibition on the consumer's obtaining, an insurance product or annuity from an unaffiliated entity?
5. Are the disclosures under question 3 above provided orally and in writing before the completion of the initial face-to-face sale of an insurance product or annuity to a consumer?
6. Are the disclosures under question 4 above made orally and in writing at the time the consumer applies in a face-to-face interaction for an extension of credit in connection with which insurance is solicited, offered, or sold?
7. If a sale of an insurance product or annuity is conducted by telephone, are the disclosures under question 3 above provided in writing, by mail, within three business days?
8. If an application for credit is made by telephone, are the disclosures under question 4 above provided by mail to the consumer

within three business days?

9. Are the disclosures under questions 3 and 4 above provided through electronic media instead of on paper, only if the consumer affirmatively consents to receiving the disclosures electronically, and only if the disclosures are provided in a format that the consumer may retain or obtain later?
10. Are disclosures made through electronic media, for which paper or oral disclosures are not required, presented in a meaningful form and format?
11. Are disclosures conspicuous, simple, direct, readily understandable, and designed to call attention to the nature and significance of the information provided?
12. Are required disclosures presented in a meaningful form and format?

3950.0.11.2.3 Consumer Acknowledgment

13. At the time a consumer receives the required disclosures, or at the time of the consumer's initial purchase of an insurance product or annuity, is a written acknowledgment from the consumer that affirms receipt of the disclosures obtained?
14. If the required disclosures are provided in connection with a transaction that is conducted by telephone—
- has an oral acknowledgment of receipt of the disclosures been obtained and is sufficient documentation maintained to show that the acknowledgment was given?
 - have reasonable efforts to obtain a written acknowledgment from the consumer been made?

3950.0.11.2.4 Physical Separation from Deposit Activities

15. Does the state member bank, to the extent practicable—
- keep the area where the bank conducts transactions involving the retail sale of insurance products or annuities physically segregated from the areas where retail deposits are routinely accepted from the general public?
 - identify the areas where insurance product or annuity sales activities occur?
 - clearly delineate and distinguish insurance and annuity sales areas from the

areas where the bank's retail deposit-taking activities occur?

3950.0.11.2.5 Qualifications and Licensing

16. Does the state member bank permit any person to sell or offer for sale any insurance product or annuity in any part of its office or on its behalf, only if the person is at all times appropriately qualified and licensed under applicable state insurance licensing standards for the specific products being sold or recommended?

3950.0.11.2.6 Hiring, Training, and Supervision

17. Have background investigations of prospective employees that will sell insurance products or annuities been completed?
18. When a candidate for employment has previous insurance experience, has a review to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators been completed?
19. Do all insurance or annuity sales personnel or third-party sales personnel conducting sales activities at or on behalf of the state member bank receive appropriate training and continue to meet licensing requirements?
20. Does training address policies and procedures for sales of insurance and annuity products, and does it cover personnel making referrals to a licensed insurance producer?
21. Does training ensure that personnel making referrals about insurance products or annuities are properly handling all inquiries so as not to be deemed to be acting as unlicensed insurance agents or registered (or equivalently trained) securities sales representatives (for insurance products that are also securities) if they are not qualified?
22. When insurance products or annuities are sold by the bank or third parties at an office of, or on behalf of, the organization, does the institution have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as the referral activities of bank employees not authorized to sell these products?
23. Does the bank designate supervisory per-

sonnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation?

3950.0.11.2.7 Referrals

24. Are fees paid to nonlicensed personnel who are making referrals to qualified insurance or annuity salespersons limited to a one-time, nominal fee of a fixed dollar amount for each referral, and is the fee unrelated to whether the referral results in a sales transaction?

3950.0.11.2.8 Third-Party Agreements

25. Does the state member bank's management conduct a comprehensive review of a third party before entering into any arrangement to conduct insurance or annuity sales activities through the third party?
26. Does the review include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including compliance with applicable consumer protection laws and regulations?
27. Does the board of directors or a designated committee thereof approve any agreement with the third party?
28. Does the agreement outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the bank's office space, equipment, and personnel?
29. Does the third-party agreement specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable?
30. Does the agreement authorize the bank to monitor a third party's compliance with the agreement, as well as to have access to third-party records considered necessary to evaluate compliance?
31. Does the agreement provide for indemnification of the institution by the third party for any losses caused by the conduct of the third party's employees in connection with its insurance or annuity sales activities?
32. If an arrangement includes dual employees, does the agreement provide for written employment contracts that specify the duties of these employees and their compensation arrangements?

33. If the bank contracts with a functionally regulated third party, does the bank obtain, as appropriate, any relevant regulatory reports of examination of the third party?
34. How does the bank ensure that a third party selling insurance or annuity products at or on behalf of the bank complies with all applicable regulations, including the CPSI regulation?
35. How does the bank ensure that any third party or dual employee selling insurance or annuity products at or on behalf of the bank is appropriately trained to comply with the minimum disclosures and other requirements of the Board's CPSI regulation and applicable state regulations?
36. Does the bank obtain and review copies of third-party training and compliance materials to monitor the third party's performance regarding its disclosure and training obligations?

3950.0.11.2.9 Consumer Complaints

37. Does the state member bank have policies and procedures for handling customer complaints related to insurance and annuity sales?
38. Does the customer complaint process provide for the recording and tracking of all complaints?
39. Does the state member bank require periodic reviews of complaints by compliance personnel? Is a review by the state member bank's board and senior management required for significant compliance issues that may pose risk to the bank?