Bank holding company subsidiaries, banks (generally through operating subsidiaries), Edge Act corporations, and foreign banking organizations (FBOs) operating in the United States may operate futures brokerage and clearing services involving a myriad of financial and nonfinancial futures contracts and options on futures. These activities can involve futures exchanges and clearinghouses throughout the world. In general, most institutions conduct these activities as futures commission merchants (FCMs). FCM is the term used in the Commodity Exchange Act to refer to registered firms that are in the business of soliciting or accepting orders, *as broker,* for the purchase or sale of any exchange-traded futures contract and options on futures contracts. In connection with these activities, institutions may hold customer funds, assets, or property and may be members of futures exchanges and their associated clearinghouses. They may also offer related advisory services as registered commodity trading advisors (CTAs).

The Federal Reserve has a supervisory interest in ensuring that the banking organizations subject to its oversight conduct their futures brokerage activities safely and soundly consistent with Regulations Y and K (including any terms and conditions contained in Board orders for a particular organization). Accordingly, a review of futures brokerage activities is an important element for inspections of bank holding companies (BHCs), examinations of state member banks, and reviews of FBO operations. The following guidance on evaluating the futures brokerage activities of bank holding company subsidiaries, branches and agencies of foreign banks operating in the United States, or any operating subsidiaries of state member banks provides a list of procedures that may be used to tailor the scope of an examination or inspection of these activities at individual institutions. For the purposes of this discussion, the term *FCM activities* is used in a broad context and refers to all of an institution's futures brokerage activities and operations.

SCOPE OF GUIDANCE

Examiners are instructed to take a risk-based examination approach to evaluating FCM activities—including brokerage, clearing, funds management, and advisory activities. Significant emphasis should be placed on evaluating the adequacy of management and the management processes used to control the credit, market, liquidity, legal, reputational, and operations risks entailed in these operations. Both the adequacy of risk management and the quantitative level of risk exposures should be assessed as appropriate to the scope of the FCM's activities. The objectives of a particular inspection or examination should dictate the FCM activities to be reviewed and set the scope of the inspection.

Examiners are also instructed to take a functional-regulatory approach to minimize duplicative inspection and supervisory burdens. Reviews and reports of functional regulators should be used to their fullest extent. However, absent recent oversight inspection, or if an examiner believes particular facts and circumstances at the banking organization or in the marketplace deem it necessary, a review of operations that would normally be assessed by the appropriate commodities regulator may be appropriate (such as review of front- or back-office operations).

When futures brokerage occurs in more than one domestic or foreign affiliate, examiners should assess the adequacy of the management of the futures brokerage activities of the consolidated financial organization to ensure that the parent organization recognizes and effectively manages the risks posed by its various futures subsidiaries. Accordingly, in reviewing futures brokerage operations, examiners should identify all bank holding company, bank operating, or FBO subsidiaries that engage in FCM activities and the scope of those activities. Not all subsidiaries may need to be reviewed to assess the risk management of the consolidated organization. Selection of the particular FCM subsidiaries to be reviewed should be based on an assessment of the risks posed by their activities to the consolidated organization.

This guidance primarily addresses the assessment of activities associated with futures brokerage operations. Any proprietary trading that occurs at an FCM should be assessed in connection with the review of proprietary trading activities of the consolidated financial organization, using the appropriate guidance from other sections of this manual. Similarly, when a review of futures advisory activities is planned, examiners should refer to investment advisory inspection guidance in the *Bank Holding Company Supervision Manual* and the *Trust Examination Manual* as appropriate.

EVALUATION OF FCM RISK MANAGEMENT

Consistent with existing Federal Reserve policies, examiners should evaluate the risk-management practices of FCM operations and ensure that this evaluation is incorporated appropriately in the rating of risk management under the bank (CAMELS), BHC (BOPEC), and FBO (ROCA) rating systems. Accordingly, examiners should place primary consideration on findings related to the adequacy of (1) board and senior management oversight; (2) policies, procedures, and limits used to control risks; (3) risk measurement, monitoring, and reporting systems; and (4) internal controls and audit programs. General considerations in each of these areas are discussed below.

Board and Senior Management Oversight

The board of directors has the ultimate responsibility for the level of risks taken by the institution. Accordingly, the board, a designated subcommittee of the board, or a high level of senior management should approve overall business strategies and significant policies that govern risk-taking in the institution's FCM activities. In particular, the board or a committee thereof should approve policies that identify authorized activities and managerial oversight, and articulate risk tolerances and exposure limits of FCM activities. The board should also actively monitor the performance and risk profile of its FCM activities. Directors and senior management should periodically review information that is sufficiently detailed and timely to allow them to understand and assess the various risks involved in these activities. In addition, the board or a delegated committee should periodically reevaluate the institution's business strategies and major risk-management policies and procedures, emphasizing the institution's financial objectives and risk tolerances.

For their part, senior management is responsible for ensuring that policies and procedures for conducting FCM activities on both a long-range and day-to-day basis are adequate. These policies should be approved and reviewed annually by senior management or a designated subcommittee of the board; the consistency of these policies with parent-company limits or other directions pertaining to the FCM's activities should be confirmed. Management must also maintain (1) clear lines of authority and responsibility for managing operations and the risks involved, (2) appropriate limits on risk-taking, (3) adequate systems and standards for measuring and tracking risk exposures and measuring finanical performance, (4) effective internal controls, and (5) a comprehensive risk-reporting and risk-management review process. To provide adequate oversight, management should fully understand the risk profile of their FCM activities. Examiners should review reports to senior management and evaluate whether the reports provide both good summary information and sufficient detail to enable management to assess and manage the FCM's risk. As part of their oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound.

Management should also ensure that activities are conducted by competent staff whose technical knowledge and experience are consistent with the nature and scope of the institution's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that back-office and financial-control resources are sufficient to effectively manage and control risks. Risk-measurement, monitoring, and control functions should have clearly defined duties. Separation of duties in key elements of the risk-management process should be adequate to avoid potential conflicts of interest. The nature and scope of these safeguards should be in accordance with the scope of the FCM's activities.

Policies, Procedures, and Limits

FCMs should maintain written policies and procedures that clearly outline their approach for managing futures brokerage and related activities. Such policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risk. Policies, procedures, and limits should address the relevant credit, market, liquidity, reputation, and operations risks in light of the scope and complexity of the FCM's activities. Policies and procedures should establish a logical framework for limiting the various risks involved in an FCM's activities and clearly delineate lines of responsibility and authority over these activities. They should also address the approval of new product lines, strategies, and other activities; conflicts of interest including transactions by employees; and compliance with all applicable legal requirements. Procedures should incorporate and implement the parent company's relevant policies, and should be consistent with Federal Reserve Board regulations and any applicable Board orders.

A sound system of integrated limits and risk-taking guidelines is an essential component of the risk-management process. This system should set boundaries for organizational risk-taking and ensure that positions that exceed certain predetermined levels receive prompt management attention, so they can be either reduced or prudently addressed.

Risk Measurement, Monitoring, and Reporting

An FCM's system for measuring the credit, market, liquidity, and other risks involved in its activities should be as comprehensive and accurate as practicable and should be commensurate with the nature of its activities. Risk exposures should be aggregated across customers, products, and activities to the fullest extent possible. Examiners should evaluate whether the risk measures and the risk-measurement process are sufficiently robust to reflect accurately the different types of risks facing the institution. Institutions should establish clear standards for measuring risk exposures and financial performance. Standards should provide a common framework for limiting and monitoring risks and should be understood by all relevant personnel.

An accurate, informative, and timely management information system is essential to the prudent operation of an FCM. Accordingly, the examiner's assessment of the quality of the management information system is an important factor in the overall evaluation of the risk-management process. Appropriate mechanisms should exist for reporting risk exposures and the financial performance of the FCM to its board and parent company, as well as for internal management purposes. FCMs must establish management reporting policies to apprise their boards of directors and senior management of material developments, the adequacy of risk management, operating and financial performance, and material deficiencies identified during reviews by regulators and by internal or external audits. The FCM should also provide reports to the parent company (or in the case of foreign-owned FCMs, to its U.S. parent organization, if any) of financial performance; adherence to risk parameters and other limits and controls established by the parent for the FCM; and any material developments, including findings of material deficiencies by regulators. Examiners should determine the adequacy of an FCM's monitoring and reporting of its risk exposure and financial performance to appropriate levels of senior management and to the board of directors.

Internal Controls

An FCM's internal-control structure is critical to its safe and sound functioning in general and to its risk-management system, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and appropriate separation of duties—such as trading, custodial, and back-office—is one of management's more important responsibilities. Appropriately segregating duties is a fundamental and essential element of a sound risk-management and internal-control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice, possibly leading to serious losses or otherwise compromising the financial integrity of the FCM.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting, safeguards assets, and helps to ensure compliance with relevant laws, regulations, and institutional policies. Ideally, internal controls are tested by an independent internal auditor who reports directly to either the institution's board of directors or its designated committee. Personnel who perform these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to them. In addition, communication channels should allow negative or sensitive findings to be reported directly to the board of directors or the relevant board committee.

FUTURES EXCHANGES, CLEARINGHOUSES, AND FCMs

Futures exchanges provide auction markets for standardized futures and options on futures contracts. In the United States and most other countries, futures exchanges and FCMs are regulated by a governmental agency. Futures exchanges are membership organizations and impose financial and other regulatory requirements on members, particularly those that do business for customers as brokers. In the United States and most other countries, futures exchanges also have quasi-governmental (self-regulatory) responsibilities to monitor trading and prevent fraud, with the authority to discipline or sanction members that violate exchange rules. FCMs may be members of the exchange on which they effect customers' trades. When they are not members, FCMs must use other firms who are exchange members to execute customer trades.[1]

Each futures exchange has an affiliated clearinghouse responsible for clearing and settling trades on the exchange and managing associated risks. When a clearinghouse accepts transaction information from its clearing members, it generally guarantees the performance of the transaction to each member and becomes the counterparty to the trade (that is, the buyer to every seller and the seller to every buyer). Daily cash settlements are paid or collected by clearing members through the clearinghouse. The cash transfers represent the difference between the original trade price and the daily official closing settlement price for each commodity futures contract. The two members settle their sides of the transaction with the clearinghouse, usually by closing out the position before delivery of the futures contract or the expiration of the option on the futures contract.

An exchange member that wishes to clear or settle transactions for itself, customers, other FCMs, or commodity professionals (locals or market makers) may become a member of the affiliated clearinghouse (clearing member) if it is able to meet the clearinghouse's financial-eligibility requirements. In general, these requirements are more stringent than those required for exchange membership. For example, a clearing member usually is required to maintain a specified amount of net capital in excess of the regulatory required minimum and to make a guaranty deposit as part of the financial safeguards of the clearinghouse. The size of the deposit is related to the scale of the clearing member's activity. If it is not a member of the clearinghouse for the exchange on which a contract is executed, an FCM must arrange for another FCM that is a clearing member to clear and settle its transactions.[2]

Margin requirements are an important risk-management tool for maintaining the financial integrity of clearinghouses and their affiliated exchanges. Clearinghouses require that their members post initial margin (performance bond) on a new position to cover potential credit exposures borne by the clearinghouse. The clearing firm, in turn, requires its customers to post margin. At the end of each day, and on some exchanges on an intraday basis, all positions are *marked to the market*. Clearing members with positions that have declined in value pay that amount in cash to the clearinghouse, which then pays the clearing members holding positions that have increased in value on that day. This process of transferring gains and losses among clearing-member firms, known as *collecting variation margin*, is intended to periodically

1. A firm or trading company that maintains only a proprietary business may become a member of an exchange without registering as an FCM.

2. The nonmember FCM opens an account, usually on an *omnibus* basis, with the clearing-member FCM. Separate omnibus accounts have to be maintained for customer and noncustomer or proprietary trading activity. If the FCM does not *carry* customer accounts by holding customer funds and maintaining account records, the clearing member will carry the customer's account on a *fully disclosed* basis and issue confirmations, account statements, and margin calls directly to the customer on behalf of the introducing FCM. In such cases, the introducing FCM operates as an introducing broker (IB) and could have registered with Commodity Futures Trading Commission as such.

eliminate credit-risk exposure from the clearinghouse.[3] In volatile markets, a clearinghouse may call for additional variation margin during the trading day, sometimes with only one hour's notice, and failure to meet a variation (or initial) margin call is treated as a default to the clearinghouse.

Some clearinghouses also require that their members be prepared to pay loss-sharing assessments to cover losses sustained by the clearinghouse in meeting the settlement obligations of a clearing member that has defaulted on its (or its customers') obligations. Such assessments arise when losses exceed the resources of defaulting members, the guaranty fund, and other surplus funds of the clearinghouse. Each clearinghouse has its own unique loss-sharing rules.[4] At least one U.S. and one foreign exchange have unlimited loss-sharing requirements. Most U.S. clearinghouses relate loss-sharing requirements to the size of a member's business at the clearinghouse. Given the potential drain on an institution's financial resources, the exposure to loss-sharing agreements should be a significant consideration in an institution's decision to become a clearing member.

COMMODITY EXCHANGE ACT, COMMODITY FUTURES TRADING COMMISSION, AND SELF-REGULATORY ORGANIZATIONS

In the United States, the primary regulator of exchange-traded futures activities is the Commodity Futures Trading Commission (CFTC), which was created by and derives its authority from the Commodity Exchange Act (CEA). The CFTC has adopted registration,[5] financial responsibility, antifraud, disclosure, and other rules for FCMs and CTAs, and has general enforcement authority over commodities firms and professionals that buy or sell exchange-traded futures contracts.

The futures exchanges, in addition to providing a marketplace for futures contracts, are deemed to be self-regulatory organizations (SROs) under the CEA. For example, a number of SROs have adopted detailed uniform practice rules for FCMs, including ''know your customer'' recordkeeping rules and other formal customer-disclosure requirements. The National Futures Association (NFA) also is an SRO, although it does not sponsor a futures exchange or other marketplace. The NFA has adopted sales-practice rules applicable to members who do business with customers. All FCMs that wish to accept orders and hold customer funds and assets must be members of the NFA.

The CEA and rules of the CFTC require the SROs to establish and maintain enforcement and surveillance programs for their markets and to oversee the financial responsibility of their members.[6] The CFTC has approved an arrangement under which a designated SRO (DSRO) is responsible for performing on-site audits and reviewing periodic reports of a member FCM that is a member of more than one futures exchange. The NFA is the DSRO for FCMs that are not members of any futures exchange.

Oversight of FCMs is accomplished through annual audits by the DSRO and the filing of periodic financial statements and early warning reports by FCMs, in compliance with CFTC and SRO rules. In summary, this oversight encompasses the following three elements.

1. *Full-scope audits at least once every other year of each FCM that carries customer accounts.* Audit procedures conform to a Uniform Audit Guide developed jointly by the SROs. The full-scope audit focuses on the firm's net capital computations, segregation of customer funds and property, financial reporting, recordkeeping, and operations.[7]

3. Some foreign exchanges do not allow the withdrawal of unrealized profits as mark-to-market variation.

4. Clearinghouses usually retain the right to use assets owned by clearing members, but under the control of the clearinghouse (for example, proprietary margin); require additional contributions of funds or assets or require the member to purchase additional shares of the clearinghouse; or perfect a claim against the member for its share of the loss.

5. Many FCMs also are SEC-registered as broker-dealers and are subject to SEC and CFTC financial responsibility rules.

6. CFTC Rule 1.51, contract market program for enforcement, requires that SROs monitor market activity and trading practices in their respective markets, perform on-site examinations (audits) of members' books and records, review periodic financial reports filed by members, and bring disciplinary and corrective actions against members for violations of the CEA, and of CFTC and SRO rules.

7. If an FCM is also a broker-dealer, the DSRO is not required to examine the FCM for compliance with net capital requirements if the DSRO confers with the broker-dealer's examining authority at least annually to determine that the FCM is in compliance with the broker-dealer's net capital requirements and receives the DSRO copies of all examinations.

The audit also reviews sales practices (including customer records, disclosures, advertisements, and customer complaints) and the adequacy of employee supervision. The audit's scope should reflect the FCM's prior compliance history as well as the examiner's on-site evaluation of the firm's internal controls. During the off-year, the DSROs perform limited scope audits of member FCMs. This audit is limited to financial matters such as a review of the FCM's net capital computations, segregation of customer funds, and its books and records.

2. *FCM quarterly financial reporting requirements.* FCMs are required to file quarterly financial statements (form 1-FR-FCM) with their DSROs. The fourth-quarter statement must be filed as of the close of the FCM's fiscal year and must be certified by an independent public accountant. The filings generally include statements regarding changes in ownership equity, current financial condition, changes in liabilities subordinated to claims of general creditors, computation of minimum net capital, segregation requirements and funds segregated for customers, secured amounts and funds held in separate accounts, and any other material information relevant to the firm's financial condition. The certified year-end financial report also must contain statements of income and cash flows.
3. *Early warning reports.* FCMs are required to notify the CFTC and the SROs when certain financial weaknesses are experienced.[8] For example, if an FCM's net capital falls to a specified warning level, it must file a written notice within five business days and file monthly financial reports (form 1-FR-FCM) until its net capital meets or exceeds the warning level for a full three months. If an FCM's net capital falls below the minimum required, it must cease doing business and give telegraphic notice to the CFTC and any commodities or securities SRO of which it is a member. Similar notices must be given by a clearing organization or carrying FCM when it determines that a position of an FCM must be liquidated for failure to meet a margin call or other required deposit.

8. CFTC Rule 1.12 requires the maintenance of minimum financial requirements by FCMs and introducing brokers. These requirements are similar to those applicable to broker-dealers under SEC rules.

FEDERAL RESERVE REGULATION OF FCMs AND CTAs

Bank holding companies are permitted, under Regulation Y, to engage in FCM and CTA activities on both domestic and foreign futures exchanges through separately incorporated nonbank subsidiaries. As a general matter, the nonbank subsidiaries of bank holding companies (and some foreign banks) provide services to unaffiliated customers in the United States under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and to unaffiliated customers outside the United States under Regulation K.[9] Banks and the operating subsidiaries of banks usually provide futures-related services to unaffiliated parties in the United States under the general powers of the bank and to unaffiliated parties outside the United States under Regulation K. These various subsidiaries may provide services to affiliates under section 4(c)(1)(C) of the BHC Act.

Regulation Y permits a bank holding company subsidiary that acts as an FCM to engage in other activities in the subsidiary, including futures advisory services and trading, as well as other permissible securities and derivative activities as defined in sections 225.28(b)(6) (financial and investment advisory activities) and 225.28(b)(7) (agency transactional services for customer investments). Section 225.28(b)(7) specifically authorizes FCMs to provide agency services for unaffiliated persons in execution, clearance, or execution and clearance of *any* futures contract and option on a futures contract traded on an exchange in the United States and abroad. It also includes the authority to engage in other agency-type transactions, (for example, riskless principal), involving a forward contract, option, future, option on a future, and similar instruments. Furthermore, this section codifies the longstanding prohibition against a parent bank holding company's issuing any guarantees or otherwise becoming liable to an exchange or clearinghouse for transactions effected through

9. Those nonbank subsidiaries that operate in the United States may open offices outside the United States if (1) the bank holding company's authority under Regulation Y is not limited geographically, (2) the foreign office is not a separately incorporated entity, and (3) the activities conducted by the foreign office are within the scope of the bank holding company's authority under Regulation Y. In addition, a bank holding company may operate a limited foreign-based business in the United States under Regulation K.

an FCM, except for the proprietary trades of the FCM and those of affiliates.

A *well-capitalized* and *well-managed* bank holding company, as defined in sections 225.2(r) and (s) of Regulation Y, respectively, may commence activities as an FCM or a CTA by filing a notice prescribed under section 225.23(a) of Regulation Y. Bank holding companies that are not eligible to file notices or wish to act in a capacity other than as an FCM or CTA, such as a commodities pool operator, must follow the specific application process for these activities. Examiners should ensure that all of these activities are conducted in accordance with the Board's approval order.

A bank holding company, bank, or FBO parent company of an FCM is expected to establish specific risk parameters and other limits and controls on the brokerage operation. These limits and controls should be designed to manage financial risk to the consolidated organization and should be consistent with its business objectives and overall willingness to assume risk.

PARTICIPATION IN FOREIGN MARKETS

Institutions frequently transact business on foreign exchanges as either exchange or clearinghouse members or through third-party brokers that are members of the foreign exchange. The risks of doing business in foreign markets generally parallel those in U.S. markets; however, some unique issues of doing business on foreign futures exchanges must be addressed by the FCM and its parent company to ensure that the activity does not pose undue risks to the consolidated financial organization.

Before doing business on a foreign exchange, an FCM should understand the legal and operational differences between the foreign exchange and U.S. exchanges. For example, the FCM should know about local business practices and legal precedents that pertain to business in the foreign market. In addition, the FCM should know how the foreign exchange is regulated and how it manages risk, and should develop policies and the appropriate operational infrastructure of controls, procedures, and personnel to manage these risks. Accordingly, examiners should confirm that, in considering whether and how to participate in a foreign market, an FCM performs due diligence on relevant legal and regulatory issues, as well as on local business practices. Foreign-exchange risks should be understood and authorized by the FCM's parent company, and any limits set by the parent company or FCM management should be carefully monitored. The FCM and its parent company also should assess the regulatory and financial risks associated with exchange and clearinghouse membership in a foreign market, including an understanding of the extent to which the foreign clearinghouse monitors and controls day-to-day credit risk and its loss-sharing requirements.

SPECIFIC RISKS AND THEIR RISK-MANAGEMENT CONSIDERATIONS

In general, FCMs face five basic categories of risk—credit risk, market risk, liquidity risk, reputation risk, and operations risk. The following discussions highlight specific considerations in evaluating the key elements of sound risk management as they relate to these risks. The compliance and internal-controls functions provide the foundation for managing the risks of an FCM.

Credit Risk

FCMs encounter a number of different types of credit risks. The following discussions identify some of these risks and discuss sound risk-management practices applicable to each.

Customer-Credit Risk

Customer-credit risk is the potential that a customer will fail to meet its variation margin calls or its payment or delivery obligations. An FCM should establish a credit-review process for new customers that is independent of the marketing and sales function. It is not unusual for the FCM's parent company (or banking affiliate) to perform the credit evaluation and provide the necessary internal approvals for the FCM to execute and clear futures contracts for particular customers. In some situations, however, the FCM may have the authority to perform the credit review internally. Examiners should determine how customers are approved and confirm that documentation in the customer's credit files is adequate even when the approval is performed by the parent. Customer-credit files should indicate the scope of the credit review and contain approval of the customer's account and credit limits. For example, customer-credit files may contain recent financial statements, sources of liquidity, trading objectives, and any other pertinent information used to support the credit limits established for the customer. In addition, customer-credit files should be updated periodically.

FCM procedures should describe how customer-credit exposures will be identified and controlled. For example, an FCM could monitor a customer's transactions, margin settlements, or open positions as a means of managing the customer's credit risk. Moreover, procedures should be in place to handle situations in which the customer has exceeded credit limits. These procedures should give senior managers who are independent of the sales and marketing function the authority to approve limit exceptions and require that such exceptions be documented.

Customer-Financing Risk

Several exchanges, particularly in New York and overseas, allow FCMs to finance customer positions. These exchanges allow an FCM to lend initial and variation margin to customers subject to taking the capital charges under the CFTC's (or SEC's) capital rules if the charges are not repaid within three business days. In addition, some exchanges allow FCMs to finance customer deliveries, again subject to a capital charge.

An FCM providing customer-financing services should adopt financing policies and procedures that identify customer-credit standards. The financing policies should be approved by the parent company and should be consistent with the FCM's risk tolerance. In addition, an FCM should establish overall lending limits for each customer based on a credit review that is analogous to that performed by a bank with similar lending services. The process should be independent of the FCM's marketing, sales, and financing functions but may be performed by the FCM's banking affiliate. Examiners should determine how customer-financing decisions are made and confirm that documentation is adequate, even when an affiliate approves the financing. In addition, the FCM should review financial information on its customers periodically and adjust lending limits when appropriate.

Clearing-Only Risk

FCMs often enter into agreements to clear, but not execute, trades for customers. Under a "clearing-only" arrangement, the customer gives its order directly to an executing FCM. The executing FCM then gives the executed transaction to the clearing FCM, which is responsible for accepting and settling the transaction. Customers often prefer this arrangement because it provides the benefits of centralized clearing (recordkeeping and margin payments) with the flexibility of using a number of specialized brokers to execute transactions.

FCMs entering into clearing-only arrangements execute written *give-up* agreements, which are triparty contracts that set forth the responsibilities of the clearing FCM, the executing FCM, and the customer. Most FCMs use the *uniform give-up agreement* prepared by the Futures Industry Association, although some FCMs still use their own give-up contracts. The uniform give-up agreement permits a clearing FCM, upon giving prior notice to the customer and the executing FCM, to place limits or conditions on the transactions it will accept to clear or terminate the arrangement. If an executed transaction exceeds specified limits, the FCM may decline to clear the transaction unless it is acting as the *qualifying* or *primary* clearing FCM for the customer and has not given prior notice of termination, as discussed further below.

Clearing-only arrangements can present significant credit risks for an FCM. An FCM's risk-management policies and procedures for clearing-only activities should address the qualifications required of clearing-only customers and their volume of trading, the extent to which customer-trading activities can be monitored by the clearing-FCM at particular exchanges, and how aggregate risk will be measured and managed.

The FCM should establish trading limits for each of its clearing-only customers and have procedures in place to monitor their intraday trading exposures. The FCM should take appropriate action to limit its liability if a clearing-only customer has exceeded acceptable trading limits either by reviewing and approving a limit exception or by rejecting the trade. Examiners should confirm that the FCM formally advises (usually in the give-up agreement) its customers and their executing FCMs of the trading parameters established for the customer. Examiners should also confirm that the FCM personnel responsible for accepting or rejecting an executed trade for clearance have sufficient current information to determine whether the trade is consistent with the customer's trading limits. Give-up agreements (or other relevant documents such as the customer account agreement) should permit the FCM to adjust the customer's transaction limits when appropriate in light of market conditions or changes in the customer's financial condition.

Some FCMs act as the primary clearing firm (also referred to as the sponsoring or qualifying firm) for customers.[10] A primary clearing firm guarantees to the clearinghouse that it will accept and clear *all* trades submitted by the customer or executing FCM, even if the trade is outside the agreed-on limits. Because an FCM is obligated to accept and clear all trades submitted by its primary clearing customers, the FCM must be able to monitor its customers' trading activities on an intraday basis for compliance with agreed-on trading limits. Monitoring is especially important during times of market stress. The FCM should be ready and able to take immediate steps to address any unacceptable risks that arise, for example, by contacting the customer to obtain additional margin or other assurances, approving a limit exception, taking steps to liquidate open customer positions, or giving appropriate notice of termination of the clearing arrangement to enable the FCM to reject future transactions.

Intraday monitoring techniques will vary depending on the technology available at the particular exchange. A number of the larger, more automated U.S. exchanges have developed technologies that permit multiple intraday collection, matching, and reporting of trades—although the frequency of such reconciliations varies. On exchanges that are less automated, the primary clearing FCM must develop procedures for monitoring clearing-only risks. For example, the FCM could maintain a significant physical presence on the trading floor to monitor customer trading activities and promote more frequent collection (and tallying) of trade information from clearing-only customers. The resources necessary for such monitoring obviously will depend on the physical layout of the exchange—the size of the trading floor and the number of trading pits, the floor population and daily trading volumes, and the level of familiarity the FCM has with the trading practices and objectives of its primary clearing customers. The FCM should be able to increase its floor presence in times of market stress.

Carrying-Broker Risk

An FCM may enter into an agreement with another FCM to execute and clear transactions on behalf of the first FCM (typically, when the first FCM is not an exchange or clearing member of an exchange). In such cases, the FCM seeking another or carrying FCM to execute its transactions should have procedures for reviewing the creditworthiness of the carrying FCM. If the FCM reasonably expects that the carrying FCM will use yet another FCM to clear its transactions (for example, if the carrying FCM enters into its own carrying-broker relationship with another firm for purposes of executing or clearing transactions on another exchange), the first FCM should try to obtain an indemnification from the carrying FCM for any losses incurred on these transactions.[11] When carrying transactions occur on a foreign exchange, an FCM should know about the legal ramifications of the carrying relationship under the rules of the exchange and laws of the host country. Moreover, it may be appropriate for an FCM to reach an agreement with its customers that addresses liabilities relative to transactions effected on a non-U.S. exchange by a carrying broker.

Executing-FCM Risk

When an FCM uses an unaffiliated FCM to execute customer transactions under a give-up

10. Primary clearing customers include institutions and individuals, as well as other nonclearing futures professionals (locals or floor traders), who execute their own trades on the exchange and other nonclearing FCMs that execute trades for unaffiliated customers.

11. The CFTC takes the position that an FCM is responsible to its customers for losses arising from the failure of the performance of a carrying broker. The industry disagrees with this position, and the issue has not been resolved by the courts.

arrangement, the clearing firm that sponsors the executing FCM guarantees its performance. Therefore, the first FCM should review the subcontracting risk of its executing FCMs and their sponsoring clearing firms. However, unlike the clearing risk inherent in a carrying-broker relationship, the subcontracting risk for an FCM using an executing FCM is limited to transaction risk (execution errors). An FCM's management should approve each executing broker it uses, considering the broker's reputation for obtaining timely executions and the financial condition of its sponsoring clearing firm.

Pit-Broker Risk

Usually, FCMs will subcontract the execution of their orders to unaffiliated pit brokers who accept and execute transactions for numerous FCMs during the trading day. The risk associated with using a pit broker is similar to that of using an executing broker: the risk is limited to the broker's performance in completing the transaction. If the pit broker fails, then the primary clearing firm is responsible for completing the transaction. Therefore, an FCM should approve each pit broker it uses, considering the pit broker's reputation for obtaining timely executions and the resources of its sponsoring clearing firm.

Clearinghouse Risk

Clearinghouse risk is the potential that a clearinghouse will require a member to meet loss-sharing assessments caused by another clearing member's failure. Before authorizing membership in an exchange or clearinghouse, an FCM's board of directors and its parent company must fully understand the initial and ongoing regulatory and financial requirements for members. The FCM's board of directors should approve membership in a clearinghouse only after a thorough consideration of the financial condition, settlement and default procedures, and loss-sharing requirements of the clearinghouse.

Particularly when it is considering membership in a foreign exchange or clearinghouse, an FCM's board should examine any regulatory and legal precedents related to how the exchange, clearinghouse, or host country views loss-sharing arrangements. As in the United States, some foreign clearinghouses have unlimited loss-sharing requirements, and some have ''limited'' requirements that are set at very high percentages. However, the loss-sharing provisions of some of the foreign clearinghouses have not yet been applied, which means that there are no legal and regulatory precedents for applying the stated requirements. In addition, the board should be apprised of any differences in how foreign accounts are viewed, for example, whether customer funds are considered separate from those of the FCM, whether the relationship between an FCM and its customer is viewed as an agency rather than a principal relationship, and whether there are material differences in the way futures activities are regulated.

The board also should be apprised of any material changes in the financial condition of every clearinghouse of which the FCM is a member. Senior management should monitor the financial condition of its clearinghouses as part of its risk-management function.

Guarantees

FCM parent companies often are asked to provide assurances to customers and clearinghouses that warrant the FCM's performance. These arrangements may take the form of formal guarantees or less formal letters of comfort.

Under Regulation Y, a bank holding company may not provide a guarantee to a clearinghouse for the performance of the FCM's customer obligations. A bank holding company may provide a letter of comfort or other agreement to the FCM's customers that states the parent (or affiliate) will reimburse the customers' funds on deposit with the FCM if they are lost as a result of the FCM's failure or default. Customers may seek this assurance to avoid losses that could arise from credit exposure created by another customer of the FCM, since the clearinghouse may use some or all of the FCM's customer-segregated funds in the event of a default by the FCM stemming from a failing customer's obligations.[12] Examiners should note any permissible guarantees for purposes of the consolidated report of the parent bank holding company, as

12. The letter of comfort would protect customers whose funds were used to cover other customer losses by the clearinghouse. U.S. clearinghouses also have guarantee funds that can be used to reimburse customers at the clearinghouse's discretion.

they are relevant to calculating the consolidated risk-based capital of the bank holding company.

Market Risk

When an FCM acts as a broker on behalf of customers, it generally is only subject to market risk if it executes customers' transactions in error. In this regard, operational problems can expose the FCM to market fluctuations in contract values. However, when an FCM engages in proprietary trading, such as market making and other position-taking, it will be directly exposed to market risk. Potential market-risk exposure should be addressed appropriately in an FCM's policies and procedures.

An FCM that engages in proprietary trading should establish market-risk and trading parameters approved by its parent company. The FCM's senior management should establish an independent risk-management function to control and monitor proprietary trading activities. Finally, the FCM should institute procedures to control potential conflicts of interest between its brokerage and proprietary trading activities.

Liquidity Risk

Liquidity risk is the risk that the FCM will not be able to meet its financial commitments (end-of-day and intraday margin calls) to its clearing FCM or clearinghouse. Clearing FCMs are required to establish an account at one of the settlement banks used by the clearinghouse for its accounts and the accounts of its clearing members. In some foreign jurisdictions, the central bank fulfills this settlement function. An FCM should establish and monitor daily settlement limits for its customers and should ensure that there are back-up liquidity facilities to meet any unexpected shortfalls in same-day funds. To ensure the safety of its funds and assets, an FCM should also monitor the financial condition of the settlement bank it has chosen and should be prepared to transfer its funds and assets to another settlement bank, if necessary.

To control other types of liquidity risks, an FCM should adopt contingency plans for liquidity demands that may arise from dramatic market changes. An FCM, to the extent posible, should monitor the markets it trades in to identify undue concentrations by others that could create an illiquid market, thereby creating a risk that the FCM could not liquidate its positions. Most U.S. clearinghouses monitor concentrations and will contact an FCM that holds more than a certain percentage of the open interest in a product. In some situations, the exchange could sanction or discipline the FCM if it finds that the FCM, by holding the undue concentration, was attempting to manipulate the market. These prudential safeguards may not be in place on foreign exchanges; consequently, an FCM will have to establish procedures to monitor its liquidity risk on those exchanges.

Reputation Risk

FCMs should have reporting procedures in place to ensure that any material events that harm its reputation, and the reputations of its bank affiliates, are brought to the attention of senior management; the FCM's board of directors; and, when appropriate, its parent company. Reports of potentially damaging events should be sent to senior management at the parent bank holding company who will evaluate their effect on the FCM to determine what, if any, steps should be taken to mitigate the impact of the event on the whole organization.

Commodity Trading Advisor

Acting as a commodity trading advisor (including providing discretionary investment advice to retail and institutional customers or commodity pools) may pose reputational and litigation risks to a CTA or FCM, particularly when retail customers are involved. Accordingly, the FCM's board should adopt policies and procedures addressing compliance with CFTC and NFA sales-practice rules (including compliance with the know-your-customer recordkeeping rules).

Operations Risk

Operations risk is the potential that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk at FCMs include inadequate procedures, human error, system failure, or fraud. For FCMs, failure to assess or control operating risks accurately can be a likely source of problems.

Adequate internal controls are the first line of defense in controlling the operations risks involved in FCM activities. Internal controls that ensure the separation of duties involving account acceptance, order receipt, execution, confirmation, margin processing, and accounting are particularly important.

An FCM's approved policies should specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents, consistent with legal requirements and internal policies. Relevant personnel should fully understand documentation requirements. Examiners should also consider the extent to which institutions evaluate and control operations risks through internal audits, contingency planning, and other managerial and analytical techniques.

Back-office or transaction-processing operations are an important source of operations-risk exposures. In conducting reviews of back-office operations, examiners should consult the appropriate chapters of this manual for further guidance.

Operations risk also includes potential losses from computer and communication systems that are unable to handle the volume of FCM transactions, particularly in periods of market stress. FCMs should have procedures that address the operations risks of these systems, including contingency plans to handle systems failures and back-up facilities for critical parts of risk management, communications, and accounting systems.

When FCMs execute or clear transactions in nonfinancial commodities, they may have to take delivery of a commodity because a customer is unable or unwilling to make or take delivery on its contract. To address this situation, the FCM should have in place the procedures it will follow to terminate its position and avoid dealing in physical commodities. Internal controls should also be established to record, track, and resolve errors and discrepancies with customers and other parties.

INTERNAL AUDITS

An FCM should be subject to regular internal audits to confirm that it complies with its policies and procedures and is managed in a safe and sound manner. In addition, the internal-audit function should review any significant issues raised by compliance personnel to ensure that they are resolved. Other staff within the FCM should be able to reach internal audit staff to discuss any serious concerns they might have. Internal audit reports should be forwarded to the FCM's senior management and material findings should be reported to the FCM's board of directors and the parent company. Frequently, the internal audit function is located at the parent company, and audit reports are routinely sent to senior management at the parent company.

EXAMINATION AND INSPECTION PROCEDURES

The review of an FCM's functions should take a functional regulatory approach, using the findings of the FCM's primary regulators as much as possible. Examiners should especially focus on the risks that the FCM poses to the parent company and affiliated banks. These risks should be assessed by reviewing the adequacy of the FCM's policies and procedures, internal controls, and risk-management functions. Compliance with policies and procedures, and with any conditions on the FCM's activities imposed by regulatory authorities (including the Federal Reserve Board), should be fully reviewed.

Bank holding companies, banks, and FBOs may have more than one subsidiary that acts as an FCM in the United States or that engages in futures transactions for customers in foreign markets. To ensure that the FCM/CTA activities of a banking organization are evaluated on a consolidated basis, a cross-section of affiliated futures brokerage and advisory firms should be reviewed periodically—particularly those that present the greatest risk to the consolidated financial organization. Relevant factors to consider when identifying firms for review include (1) the volume of business; (2) whether the FCM has unaffiliated customers; (3) the number of customers; (4) whether the firm provides customer financing; (5) the number of brokers effecting transactions; (6) whether exchange or clearinghouse memberships are involved; (7) whether the FCM provides clearing-only services; and (8) the date and scope of the last review conducted by the Federal Reserve, SRO, or other regulator.

The scope of any review to be conducted depends on the size of the FCM and the scope of its activities. The draft first-day letter should provide an overview of an FCM's authorized activities and conditions, as well as a description of the actual scope of its business. Examiners should review the most recent summary of management points or other inspection results issued by the FCM's SRO or other regulator, as well as any correspondence between the FCM and any federal agency or SRO. If examiners should have any questions about the findings of an SRO's or a regulator's results, they should contact the organization to determine whether the matter is material and relevant to the current inspection. The status of any matters left open after the SRO's or regulator's review should also be inquired about.

An important factor in determining the scope of the inspection is whether the FCM has unaffiliated customers or conducts transactions solely for affiliates. Other factors include whether the FCM is a clearing member of an exchange, particularly of a non-U.S. exchange; it acts as a carrying broker on behalf of other FCMs; it has omnibus accounts with other brokers in markets in which it is not a member (U.S. or foreign); it provides advisory or portfolio management services, including discretionary accounts, or has been authorized to act as a commodity pool operator (CPO); it provides clearing services to locals or market-makers; and it provides financing services to customers.[13]

Examiners are not expected to routinely perform a front- or back-office inspection unless (1) the FCM's primary regulator found material deficiencies in either office during its most recent examination or (2) if front- or back-office operations have not been examined by the primary regulator within the last two years. However, examiners may still choose to review a small sample of accounts and transactions to confirm that appropriate controls are in place. In addition, net capital computations of U.S. FCMs do not need to be reviewed; they are reviewed by the FCM's DSRO, and the FCM is subject to reporting requirements if capital falls below warning levels. Examiners should perform a front- and back-office review of the FCM's operations outside of the United States.[14]

Examiners may rely on well-documented internal-audit reports and workpapers to verify the adequacy of risk management at the FCM. If an examiner finds that an internal audit adequately documents the FCM's compliance with a policy or procedure pertaining to the management of the various risk assessments required by the current inspection, he or she should document the audit finding in the workpapers and complete inspection procedures in any area not adequately addressed by the internal audit report. Examiners should periodically spot check areas covered by internal audits to ensure the ongoing integrity of the audit process. Examiners should also review internal-audit reports and workpapers for their scope and thoroughness in complying with FCM policies and procedures. Finally, examiners should ensure that internal auditors have adequate training to evaluate the FCM's compliance with its policies and procedures and with applicable laws and regulations (both inside and, if applicable, outside the United States).

If an examiner has determined that it is not necessary to perform a routine back-office review, he or she should confirm that the FCM has addressed operations risks in its policies and procedures. Examiners also should review the internal controls of an FCM to ensure that the firm is operated safely and soundly according to industry standards and that it complies with any Board regulations or conditions placed on the FCM's activities. Examiners should be alert to any "red flags" that might indicate inadequate internal controls. An FCM must be organized so that its sales, operations, and compliance functions are separate and managed independently. If an FCM engages in proprietary trading, examiners should confirm that the firm has procedures that protect against conflicts of interest in the handling of customer orders (examples of these conflicts of interest include front-running or ex-pit transactions). To make an overall assessment of the FCM's future business, the results of any review should be consolidated with the results of reviews by other FCMs inspected during this cycle.

13. If the FCM engages in proprietary trading for its own account, particularly for purposes other than hedging (market making or position-taking), or if the FCM acts as an intermediary in any over-the-counter futures or other derivative activities, the examiner should advise the examiner in charge of the inspection so that the firm's proprietary trading can be evaluated in connection with similar activities of the consolidated financial organization.

14. The inspection procedures for reviewing front- and back-office operations may be found in sections 2050.3 and 2060.3, respectively.

Futures Brokerage Activities and Futures Commission Merchants
Examination Objectives

1. To identify the potential for and extent of various risks associated with the FCM's activities, particularly credit, market, liquidity, operations, and reputation risks.
2. To evaluate the adequacy of the audit function and review significant findings, the method of follow-up, and management's response to correct any deficiencies.
3. To assess the adequacy of the risk-management function at the FCM.
4. To assess the adequacy of and compliance with the FCM's policies and procedures and the adequacy of the internal-control function.
5. To evaluate and determine the FCM's level of compliance with relevant Board regulations, orders, and policies.
6. To assess the adequacy of risk management of affiliated FCMs on a consolidated basis.

1. Identify all bank holding company subsidiaries that engage in FCM- or CTA-type activities in the United States or abroad or identify U.S. FCM or CTA subsidiaries of FBOs. Determine which firms should be inspected to provide a global view of the adequacy of management of these activities on a consolidated basis, based on the scope of activities and degree of supervision by other regulators. Complete applicable procedures below for firms selected for inspection.
2. Review first-day letter documents; notices filed under Regulation Y; Board orders and letters authorizing activities; previous inspection reports and workpapers; and previous audits by futures regulators (CFTC, designated self-regulatory organization (DSRO), National Futures Association, foreign futures regulator); and reports by internal or external auditors or consultants.
3. Note the scope of the FCM's activities, including—
   a. execution and clearing;
   b. execution only for affiliates and third parties;
   c. clearing only for affiliates, third parties, professional floor traders (locals);
   d. pit brokerage;
   e. advisory;
   f. discretionary portfolio management;
   g. commodities pool operator (in an FCM or affiliate);
   h. margin financing;
   i. proprietary trading;
   j. exchange market maker or specialist;
   k. types of instruments (financial, agricultural, precious metals, petroleum);
   l. contract markets where business is directed;
   m. other derivative products (interest rate swaps and related derivative contracts, foreign-exchange derivative contracts, foreign government securities, and others);
   n. other futures-related activities, including off-exchange transactions;
   o. riskless-principal transactions; and
   p. registered broker-dealers.
4. Review exchange and clearinghouse memberships here and abroad, noting any financial commitments and guarantees by the FCM or its parent to the exchange or clearinghouse with respect to proprietary, affiliate, or customer transactions.
5. Note any new lines of business or activities occurring at the FCM or any changes to exchange and clearinghouse memberships since the last inspection.
6. Note what percentage of business is conducted for—
   a. affiliate banks,
   b. nonbank affiliates,
   c. customers (note the breakdown between institutional and retail, and any guarantee or letter of comfort to customers in which the parent company provides that it will reimburse customers for loss as a result of the FCM's failure or other default),
   d. proprietary accounts (hedging, position-taking), and
   e. professional floor traders (locals, market makers).
7. Determine the quality of the internal audit program. Assess the scope, frequency, and quality of the audit program for the FCM and related activities.
   a. Review the most recent audit report, noting any exceptions and their resolution.
   b. Verify that audit findings have been communicated to senior management and that material findings have been reported to the FCM's board of directors and parent company.
   c. Identify any areas covered by these procedures that are not adequately addressed by the internal audit report.
   d. Identify areas of the internal audit report that should be verified as part of the current inspection.
8. Determine the scope of review that is appropriate to the activities and allocate resources, considering the adequacy of internal audit workpapers. Complete appropriate front- or back-office inspection procedures if—
   a. front- and back-office operations have not been examined by the designated self-regulatory organization (DSRO) within the last two years,

b. material deficiencies in front- or back-office operations were found by the DSRO during the most recent audit, or
c. the primary regulator for the FCM is not a U.S. entity.

9. Advise the examiner who is in charge of inspection of the parent company if the FCM engages in proprietary trading or over-the-counter futures or derivative business as principal or agent.

BOARD AND SENIOR MANAGEMENT OVERSIGHT

10. Review the background and experience of the FCM's board of directors and senior management, noting prior banking and futures brokerage experience.
11. Determine if the board of directors of the FCM has approved written policies summarizing the firm's activities and addressing oversight by the board or a board designated committee of—
    a. the risk appropriate for the FCM, including credit, market, liquidity, operations, reputation, and legal risk (see SR-95-51);
    b. the monitoring of compliance with risk parameters;
    c. exchange and clearinghouse memberships; and
    d. the internal audit function.
12. Determine if senior management of the FCM has adopted procedures implementing the board's policies for—
    a. approval of new-product lines and other activities;
    b. transactions with affiliates;
    c. transactions by employees;
    d. compliance with applicable regulations, policies, and procedures;
    e. management information reports;
    f. the separation of sales, operations, back-office, and compliance functions; and
    g. reports to FCM boards of directors that describe material findings of the complaint or audit functions and material deficiencies identified during the course of regulatory audits or inspections.
13. Determine if policies and procedures are periodically reviewed by the board of directors or senior management, as appropriate, to ensure that they comply with existing regulatory and supervisory standards and address all of the FCM's activities.
14. Review management information reporting systems and determine whether the board of directors of the parent company (or a designated committee of the parent's board) is apprised of—
    a. material developments at the FCM;
    b. the financial position of the firm, including significant credit exposures;
    c. the adequacy of risk management;
    d. material findings of the audit or compliance functions; or
    e. material deficiencies identified during the course of regulatory reviews or inspections.
15. Review the FCM's strategic plan.
    a. Assess whether there are material inconsistencies between the stated plans and the FCM's stated risk tolerances.
    b. Verify that the strategic plan is reviewed and updated periodically.

CREDIT RISK

16. Review credit-risk policies and procedures.
    a. Verify the independence of credit-review approval from the limit-exceptions approval.
    b. Verify that the procedures designate a senior officer who has responsibility to monitor and approve limit-exception approvals.
17. Determine whether the FCM has authority to open customer accounts without parent-company approval.
18. Review the customer base (affiliates, third parties) for credit quality in terms of affiliation and business activity (affiliates, corporate, retail, managed funds, floor traders).
19. Evaluate the process for customer-credit review and approval. Determine whether customer-credit review identifies credit risks associated with the volume of transactions executed or cleared for the customer.
20. Evaluate the adequacy of credit-risk-management policies. Determine that they—
    a. establish credit limits for each customer that reflect the respective financial strengths, liquidity, trading objectives, and potential market risk associated with the products traded,
    b. require periodic updates of such credit limits in light of changes in the financial

condition of each customer and market conditions, and
   c. do not permit the FCM to waive important broker safeguards, such as the right to liquidate customer positions upon default or late payment of margin.
21. Verify this information by sampling customer credit files.
22. Verify that up-to-date customer credit files are maintained on site or are available for review during the inspection. If the customer credit approval was performed by the parent company or an affiliate bank, verify that the FCM's files contain information indicating the scope of the credit review, the approval, and credit limits.
23. Review notifications and approval of limit exceptions for compliance with FCM procedures.
24. Determine whether the FCM has adopted procedures identifying when the FCM should take steps to limit its customer credit exposure (for example, when to refuse a trade, grant a limit exception, transfer positions to another FCM, or liquidate customer positions).
25. Evaluate the adequacy of risk management of customer-financing activities.
   a. Determine that the credit-review process is independent from the marketing and sales and financing functions.
   b. Verify that the FCM has policies that identify customer-credit standards and establish overall lending limits for each customer.
   c. Assess the adequacy of the credit-review process and its documentation, even when credit review is performed by an affiliate.
26. Review the instances when the FCM has lent margin to customers on an unsecured basis. If the FCM does not engage in margin financing as a business line, verify that extensions are short term and within the operational threshold set for the customer.

CLEARING-ONLY RISK

27. Determine whether each clearing arrangement is in writing and that it—
   a. identifies the customer and executing brokers, and defines the respective rights and obligations of each party;
   b. establishes overall limits for the customer that are based on the customer's creditworthiness and trading objectives; and
   c. permits transaction limits to be adjusted to accommodate market conditions or changes in the customer's financial condition.
28. When the FCM has entered into a clearing-only agreement with a customer, verify that it has reviewed the creditworthiness of each executing broker or its qualifying clearing firm identified in the agreement.
29. If the FCM acts as the primary clearing firm for locals or other customers, confirm that the firm has adopted procedures for monitoring and controlling exposure. Note whether the firm monitors customer positions throughout the trading day and how this monitoring is accomplished.

CARRYING BROKERS, EXECUTING BROKERS, AND PIT BROKERS

30. If the FCM uses other brokers to execute or clear transactions, either on an omnibus or a fully disclosed basis, determine that it has adequately reviewed the creditworthiness and approved the use of the other brokers. If the FCM uses nonaffiliated executing brokers, confirm that it also has considered the reputation of the broker's primary clearing firm. If the other broker is likely to use another broker, determine whether the broker has given the FCM an indemnification against any loss that results from the performance or failure of the other broker.
31. If the FCM uses other brokers to execute or clear transactions in non-U.S. markets, determine whether senior management understands the legal risks pertinent to doing business in those markets and has adopted policies for managing those risks.
32. When the FCM utilizes third-party "pit brokers" to execute transactions, verify that the FCM has reviewed and approved each broker after considering the reputation of the pit broker's primary clearing firm.

EXCHANGE AND CLEARINGHOUSE MEMBERSHIP

33. Verify that the FCM completes a due diligence study of each exchange and clearing-

house before applying for membership in the organization.

a. Determine whether board minutes approving membership demonstrate a thorough understanding of the loss-assessment provisions and other obligations of membership for each exchange and clearinghouse, as well as a general understanding of the regulatory scheme.
b. Determine whether, in approving membership in a non-U.S. exchange or clearinghouse, the minutes indicate a discussion of the regulatory environment and any relevant credit, liquidity, and legal risks associated with doing business in the particular jurisdiction. Minutes also should reflect discussion of any material differences from U.S. precedent in how foreign accounts are viewed. For example, are customer funds held in an omnibus account considered separate (segregated) from those of the FCM, or is the relationship between the FCM and its customers viewed as an agency or principal relationship in the host country?

34. Verify that the FCM has apprised its parent company of the results of its study of the exchange or clearinghouse and that it has written authorization from the senior management of its parent company to apply for membership.
35. Verify that the FCM monitors the financial condition of each exchange and clearing organization for which it is a member.
36. Review all guarantees, letters of comfort, or other forms of potential contingent liability. Verify that the parent company has not provided a guarantee to the clearinghouse for the performance of the FCM's customer obligations. Note any guarantees against losses the parent bank holding company incurred from the failure of the FCM and advise the examiner who is in charge of the parent company's examination, who can confirm that guarantees are included in the bank holding company's calculation of consolidated risk-based capital.

MARKET RISK

37. If an FCM engages in proprietary trading, determine whether policies and procedures are in place to control potential conflicts of interest between its brokerage business and trading activities.

LIQUIDITY RISK

38. Verify that the FCM has established and monitors daily settlement limits for each customer to ensure that its liquidity is sufficient to meet clearinghouse obligations.
39. Determine whether the FCM has established back-up liquidity facilities to meet unexpected shortfalls.
40. Verify that the FCM monitors by product the amount of open interest (concentrations) that it, holds at each exchange either directly or indirectly through other brokers. If positions are held on foreign exchanges in which concentrations are not monitored, verify that the FCM is able to monitor its positions and manage its potential liquidity risks arising from that market.
41. Review liquidity contingency plans for dealing with dramatic market changes.

REPUTATION RISK

42. Review management information reporting systems to determine whether the FCM is able to assess the extent of any material exposure to legal or reputation risk arising from its activities.
43. Review management information reporting systems to determine whether the parent company receives sufficient information from the FCM to assess the extent of any material exposure to litigation or reputation risk arising from the FCM's activities.
44. If the FCM provides investment advice to customers or commodities pools, determine whether it has procedures designed to minimize the risks associated with advisory activities. Procedures might address the delivery of risk disclosures to customers, the types of transactions and trading strategies that could be recommended or effected for retail customers, compliance with the know-your-customer recordkeeping and other sales practice rules of the SROs, and conformance to any trading objectives established by the customer or fund.

45. If the FCM acts as a commodities pool operator, verify that it has obtained prior Board approval and is in compliance with any conditions contained in the Board order.

OPERATIONS, INTERNAL CONTROLS, AND COMPLIANCE

46. Review the most recent summary of management points or similar document issued by the FCM's DSRO or other primary futures regulator. Discuss any criticism with FCM management and confirm that corrective action has been taken.
47. Review the organizational structure and reporting lines within the FCM, and verify separation of sales, trading, operations, compliance, and audit functions.
48. Determine that FCM policies and procedures address the booking of transactions by affiliates and employees and other potential conflicts of interest.
49. If the FCM is authorized to act as a commodity pool operator, review the most recent NFA or other primary futures regulator's audit, including any informal findings by examiners. Discuss any criticism with FCM management and confirm that corrective action has been taken.
50. If the FCM executes and clears nonfinancial futures, verify that it has procedures to avoid taking physical possession of the nonfinancial product when effecting "exchange for physical transactions" for customers.
51. When the FCM takes physical delivery of commodities due to the failure or unwillingness of a customer to make or take delivery of its contracts, determine whether the FCM has and follows procedures to close out its position. Note if the FCM frequently takes delivery of physical commodities.
52. Assess the adequacy of customer-complaint review by reviewing the complaint file and how complaints are resolved. Note if the FCM receives repeat or multiple complaints involving one or more of its activities or employees.
53. Determine whether the FCM has developed contingency plans that describe actions to be taken in times of market disruptions and whether plans address management responsibilities including communications with its parent bank holding company, liquidity, the effect on customer credit quality, and communications with customers.

CONCLUSIONS

54. Prepare inspection findings and draw conclusions on the adequacy of the FCM's risk-management, compliance, operations, internal controls, and audit functions.
55. Present findings to FCM management and submit inspection findings to the examiner who is in charge of the parent company's inspection.

INTRODUCTION

Equity investment activities have had a significant impact on earnings and business relationships at a number of banking organizations. The Gramm-Leach-Bliley Act (GLB Act), enacted in November 1999, enhanced the potential growth of equity investment activities, as well as the potential for institutions new to the equity-investing business to undertake these activities. The merchant banking provisions of the GLB Act authorized financial holding companies (FHCs) to make investments, in any amount, in the shares, assets, or ownership interests of any type of nonfinancial company. While equity-investing activities can contribute substantially to earnings when market conditions are favorable, they can entail significant market, liquidity, and other risks and give rise to increased volatility of earnings and capital. Accordingly, sound investment- and risk-management practices are critical to successfully conducting equity investment activities in banking organizations.

This section provides a supervisory framework and examination procedures for reviewing the soundness of the investment-management and risk-management techniques used to conduct equity investment activities. Guidance on evaluating the impact of these activities on the risk profile and financial condition of the banking organization is included. The section incorporates and expands on guidance on sound practices for managing the risk of equity investments that was provided in SR-00-9, issued on June 22, 2000.

Goals of Supervision

As in the examination or review of any financial activity that a banking organization conducts, the supervisory assessment of equity investment activities should be risk-focused and structured to identify material risks to the safety and soundness of the depository institution that is conducting the activity, or to identify risks that are attributable to affiliates of FHCs and bank holding companies (BHCs) engaged in these business lines. Consistent with the Federal Reserve's role as umbrella supervisor of FHCs and BHCs, examiners should, where appropriate and available, use the findings of primary bank supervisors and functional regulators of holding company affiliates in reviewing the potential risks of equity investment activities. The supervisory assessment should include a review of the banking organization's compliance with the laws, regulations, and supervisory guidance applicable to this business line. (See ''Compliance with Laws and Regulations'' below.)

TYPES OF EQUITY INVESTMENTS

Banking organizations may make a variety of equity investments with different characteristics and risk profiles, under different regulatory authorities. Equity 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. Alternatively, banking organizations may hold interests in mature companies for long-term investment.

Equity investments may be in publicly traded securities or privately held equity interests. The investment may be made as a direct investment in a specific portfolio company or 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.

Direct investment holdings can be in the form of common stock, preferred stock, convertible securities, and options or warrants to purchase the stock of a particular portfolio company. Direct equity investors often play an active role in the strategic direction (but not the day-to-day management) of the portfolio company, typically through board representation or board visitation rights.

A banking organization may make indirect equity investments by acquiring equity interests in either a single company or a portfolio of different companies as a partner in a limited partnership. Indirect investments are typically made in the form of commitments to limited partnership funds; these commitments are funded when capital calls are made by the fund's general partner (or partners). The liquidity of indirect fund investments may be more constricted since fund managers may limit investors' ability to sell investments. However, these fund investments often provide the advantages of increased diversification.

Indirect ownership interests can also be made through limited partnerships that in turn hold only ownership interests in other limited partnerships of equity investments. Such tiered partnership entities are often termed "funds of funds." Fund-of-funds investments are professionally managed limited partnerships that pool the capital of investors for investment in other equity investment limited partnerships. While fund-of-funds investments may generally involve high administrative costs, they also have the benefit of providing generally high levels of diversification.

A banking organization can act as the general partner or manager of a limited partnership fund. As the general partner of a fund, the banking organization earns management fees and a percentage of the earnings of the fund, often termed "carried interest." Management fees can range between 1.5 percent and 2.5 percent of fund net asset value (NAV) or committed capital, and these fees may decline in later years of the partnership as investments mature. Carried interest, generally ranging from 20 percent to 25 percent of earnings, is the general partner's share of the fund profits.

Banking organizations may offer fund investments as an asset-management product to high net worth private-banking and institutional clients. Fund investments provide private-banking and institutional investors with access to investments that they may not otherwise have access to because of minimum investment size and marketing restrictions. However, securities laws and regulations may apply to these sales, and banks engaged in sales of fund investments to customers should establish a comprehensive securities law compliance program. (See "Other Laws and Regulations" at "Compliance with Laws and Regulations" below.) In addition, when a banking organization acts as a general partner of a limited partnership fund, it must have adequate operational and system support capabilities in place. System support capabilities may be established internally or outsourced.

ACCOUNTING AND VALUATION

The accounting for and valuation of equity investments can be varied and complex. The supervisory review of accounting and valuation methodologies is critical, as the methodology used can have a significant impact on the earnings and earnings volatility of the banking organization. For some equity investments, valuation can be more of an art than a science. 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 may involve 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. Formal valuation policies that specify appropriate and sound portfolio-valuation methodologies should be established for investments in public companies; direct private investments; indirect fund investments; and, where appropriate and to the extent possible, other types of investments with special characteristics. Portfolio-valuation methodologies should conform to generally accepted accounting principles (GAAP) and be based on sound, empirically based approaches that are clearly articulated, well documented, and applied consistently across similar investments over time.

Accounting Methods

Several methods are used in accounting for equity investments. The key methods are (1) mark-to-market accounting, (2) available-for-sale (AFS) accounting, (3) cost-basis accounting, and (4) equity-method accounting.

Mark-to-Market Accounting

Under GAAP, equity investments held by investment companies or broker-dealers, as well as securities held in the trading account, are reported at fair value, with any unrealized appreciation or depreciation included in earnings and flowing to tier 1 capital. Securities for which market quotations are readily available are valued at prevailing closing prices derived from market-pricing sources or at an average market price. Banking organizations that employ average price ranges typically do so for varying periods after the initial public offering (IPO) for issues in more volatile sectors, such as technology, media, and telecommunications. Most institutions revert to closing prices after an issue is seasoned.

When the resale or transfer of securities is not restricted, current market value is the quoted market price. Some publicly traded securities may not be freely liquidated because of securities law restrictions, underwriting lock-up provisions, or significant concentrations of holdings. The market value of restricted securities must be determined in good faith by the board of directors, taking into account factors such as (1) the fundamental analytical data relating to the investment, (2) the nature and duration of restrictions on disposition of the securities, and (3) an evaluation of the forces that influence the market in which the securities are purchased and sold.[1]

Liquidity discounts generally are applied to restricted holdings, based on the severity of the restrictions and the estimated period of time the investment must be held before it can be liquidated. Regardless of the method used, discounts should be consistently applied. Changes in discount rates should generally be based on objective and verifiable transactions or events.

While most banking organizations employ an objective approach for identifying appropriate discounts when specific discounts are applied to a given set of parameters, a limited number have adopted a model-driven approach. The model-driven approach considers the marketability discount as the value of a put option based on assumptions about volatility, trading volumes, market absorption, and interest rates.

The marketability discount increases as the length of the restriction period and the volatility of the share price increase. Discount ranges suggested by the model are reviewed for overall reasonableness and to evaluate additional factors not considered by the model, such as proprietary information, historical discount rates, hedging or exit opportunities, and other empirical data.

1. More specific factors may include the type of security, the financial condition of the company, the cost of the securities at the date of purchase, the size of the holding, the discount from market value of unrestricted securities of the same class at the time of purchase, special reports prepared by analysts, information about any transactions or offers on the security, the existence of merger proposals or tender offers affecting the security, the price and extent of public trading in similar securities of the issuer or comparable companies, and other relevant matters.

A banking organization using a model-driven approach should have policies and procedures that clearly specify the instruments for which the model is appropriate and should provide guidance for appropriate use of the model. Banking organizations that use models should maintain comprehensive written documentation of the assumptions, methodologies, and quantitative and qualitative factors contained in the model. Independent reviews of models should be conducted periodically to verify model inputs and results. (See ‘‘Valuation Reviews’’ below.)

Available-for-Sale Accounting

Equity investments (1) not held with the intent to hold to maturity or (2) held in the trading account that have a readily determinable fair value (quoted market value) are generally reported as available-for-sale (AFS). They are marked to market with unrealized appreciation or depreciation recognized in a separate component of equity (other comprehensive income), but not earnings. Appreciation or depreciation flows to equity, but for regulatory capital purposes only, depreciation is included in tier 1 capital. 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.

Under Statement of Financial Accounting Standards No. 115 (FAS 115), a firm must determine whether any decline in fair value below the cost basis of an equity investment held AFS is ‘‘other than temporary.’’ If the decline in fair value is judged to be other than temporary, the cost basis of the individual security must be written down to fair value to establish a new cost basis. The amount of the write-down must be charged against earnings. The new cost basis remains unchanged for subsequent fair-value recoveries.

Increases in the fair value of AFS securities after the purchase date are included in other comprehensive income. Subsequent decreases in fair value, if not an other-than-temporary impairment, are also included in other comprehensive income. SEC Staff Accounting Bulletin

(SAB) 59 specifies that declines in the valuation of marketable investment securities of SEC-registered companies caused by general market conditions or by specific information pertaining to an industry or individual company should cause management to consider all evidence to evaluate the realizable value of the investment. Under SAB 59, SEC-registered companies are expected to employ a systematic methodology that documents all of the factors, in addition to impairment, considered in valuing the security. These factors include the length of time and extent to which the market value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the holder to retain the investment for a period of time sufficient to allow for any anticipated market-value recovery.

It is a sound practice for banking organizations to clearly articulate events, criteria, or conditions that trigger an other-than-temporary impairment of value. Examples of criteria that may indicate other-than-temporary impairment of value include—

- a business model that is no longer viable;
- a material internal risk-rating decline;
- sustained cash flow or financial-performance problems (for more than one year);
- a dilutive subsequent private equity round of financing;
- major loan-provision defaults;
- management, customer, and competitive changes;
- a debt restructuring; and
- a material, adverse industry change.

Cost-Basis Accounting

For equity investments without readily determinable fair values, including many privately held companies, fair value generally is the cost of the investment, adjusted for write-downs reflecting subsequent impairments to the value of the assets. Periodic evaluations of the valuation are performed to confirm or reestablish fair value based on one or a combination of the following events or factors:

- a subsequent, significant round of financing in which a majority of the new funding is provided by unrelated, sophisticated investors, and the new securities issued are similar to the types and classes of existing shares held
- a recent IPO of the company
- a binding offer to purchase the company
- a transaction involving the sale of a comparable company
- comparable information on publicly traded companies that is based on meaningful industry statistics, such as multiples or earnings-performance ratios, and that takes into account appropriate liquidity or restricted-security discounts
- if comparable information for the public market is not available or relevant, private transactions involving comparable companies or indices of small-cap companies could provide benchmarks for valuation purposes
- net asset or liquidation values
- company-specific developments indicating an other-than-temporary impairment in the value of the investment
- market developments

Valuations of 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 exit, or take-out, strategies for equity investments should be emphasized. Secondary-market sales typically are made at a discount. A secondary sale of a limited partnership interest generally needs to be approved by the general partner or a percentage of the limited partners. Management should periodically review investment-exit strategies, with particular focus on larger or less-liquid 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 level of management or board approval required for the disposition of investments. In the case of investments held under the merchant banking provisions of the GLB Act, policies and procedures should take into account the time limits for holding merchant banking investments, as specified in the rules and regulations of the Board and the Department of the Treasury.

In addition, a discounted cash-flow approach may be used to value private portfolio companies with operating revenue. This approach to valuation estimates the value of the stream of future cash flows expected to be realized from the investment. The application of appropriate multiples and discounts should be well documented and reasonably similar to industry data for comparable companies. Any differences from industry data should be explicitly rationalized.

The valuation of private investment fund companies and private investment companies is based on fair value as determined by the general partner, or the valuation is developed internally through financial information produced by the general partner. Each portfolio company prepares financial statements, which are used to value the investments within the fund. Most financial statements are audited annually by independent auditors who express an opinion on the fair-value methodology of the limited partnership, in accordance with GAAP. Auditors' opinions are typically qualified. Private investment companies maintain capital accounts that reflect their proportional ownership in each fund and that are reconciled periodically (not less than annually) to fund financial statements. Write-downs are appropriate when this reconciliation process indicates unrealized losses in the fund.

Many banking organizations adjust the value reported by the general partner to account for management fees and carried interest, as well as liquidity discounts. Other banking organizations carry their investments in limited partnership funds at cost and write down investments to recognize other-than-temporary impairments in value below the cost basis.

Equity-Method Accounting

For investments in which the banking organization holds an ownership interest of between 20 and 50 percent, or for investments that are managed or significantly influenced by the banking organization, the equity method of accounting is appropriate. A banking organization using the equity method initially records an investment at cost. Subsequently, the carrying amount of the investment is increased to reflect the banking organization's share of the company's income and is reduced to reflect the organization's share of the company's losses or for dividends received from the company. The banking organization also records its share of the other comprehensive income of the company and adjusts its investment by an equal amount.

A loss in the value of an investment that is an other-than-temporary decline is recognized. In applying the equity method, a banking organization's share of losses may equal or exceed the carrying value of the investment plus advances made by the institution. The banking organization ordinarily should discontinue applying the equity method when the investments (and net advances) have been reduced to zero and should not provide for additional losses, unless the banking organization has guaranteed obligations of the company or is otherwise committed to provide further financial support. A banking organization should, however, provide for additional losses when the company appears to be positioned for an imminent return to profitability. For example, a company may incur a material, nonrecurring loss that may reduce the banking organization's investment below zero even though the underlying profitable pattern of the company is unimpaired. If the company subsequently reports net income, the banking organization should resume applying the equity method only after its share of the net income equals the share of the net losses not recognized during the period when the use of the equity method was suspended.

Valuation Reviews

Large complex banking institutions with material equity investment activities should have periodic independent reviews of their investment process and valuation methodologies by internal auditors or independent outside parties. In smaller, less complex institutions with immaterial equity holdings and in which limited resources may preclude independent review, alternative checks and balances may be established. In general, a banking organization should conduct valuation reviews semiannually. However, an immediate review should be initiated if deterioration in the value of an investment is identified. Valuation reviews should be documented in writing and readily available for examiner or auditor review. Examiners should review the frequency, scope, and findings of audits or reviews to determine whether they are commensurate with the size and complexity of the banking organization's equity-investing activities.

The two major components used to measure earnings, net income to assets (ROA) and net income to equity (ROE), generally are not used as a performance measurement for equity investments. ROA and ROE indicate the extent to which invested capital increased in value, but do not reflect how long it took the increase to occur. In addition, the volatility of earnings from equity investments makes net income-based measures a less reliable indicator.

The standard method of measuring the performance of private equity investments is the internal rate of return (IRR). The use of IRR has one major advantage over traditional profitability measurement tools: it incorporates assumptions about both reinvestment and the time value of money, thereby providing a more accurate measure of performance. IRR measures both the degree to which invested capital increases in value and the time it takes for the increase to occur. While increases in invested capital contribute to a higher IRR, the effect of the time is inversely related to IRR. Thus, the shorter the time for an increase to occur, the higher the IRR.

IRR is determined by a process of trial and error. When net present values of the cash outflows (the cost of the investment) and cash inflows (returns on the investment) equal zero, the discount rate used is the IRR. When IRR is greater than the required return, or the ‘‘hurdle rate,’’ the investment is considered acceptable. In other words, an IRR can be thought of as a yield to maturity. The longer an investment exists in an illiquid portfolio, the greater its appreciation must be to maintain a high IRR.

COMPLIANCE WITH LAWS AND REGULATIONS

In conducting equity investment and merchant banking activities, banking organizations should ensure compliance with the laws and regulations under which investments are made. Investments made under different laws and regulations may be subject to very different guidelines and limitations.

The board of directors and senior management of the banking organization should establish a compliance function that is commensurate with the complexity and risks of the equity investment activities the institution conducts. If the compliance function for the equity investment business line is decentralized, appropriate mechanisms should be in place to coordinate the equity investment compliance function with the corporate-wide compliance function. Compliance reports should be furnished to the board and senior management on a periodic basis and in a timely manner. The frequency and content of these reports necessarily depends on the complexity and risk of the institution’s activities.

Investment Authorities

BHCs, FHCs, and depository institutions are permitted to make direct and indirect equity investments under various statutory and regulatory authorities. The form and nature of equity investments are subject to the provisions of law and regulations that govern specific types of investments.

Bank Holding Companies and Regulation Y

Under section 4(c) of the Bank Holding Company Act (BHC Act), Congress exempted a limited number of investments from the general prohibition against bank holding companies’ owning or controlling shares of nonbanking companies. Section 4(c)(6) of the BHC Act authorizes ownership or control of 5 percent or less of the outstanding voting shares of any one company. The Board has interpreted section 4(c)(6) to authorize only noncontrolling investments. In this regard, the Board has indicated that a BHC cannot own or control 25 percent or more of the total equity of a company under section 4(c)(6). In addition, section 4(c)(7) of the BHC Act authorizes ownership or control of all of the shares of an investment company that restricts its investments to those permissible under section 4(c)(6).

Small Business Investment Companies

The Small Business Investment Act and section 4(c)(5) of the BHC Act permit bank holding companies and banks to make equity investments through small business investment companies (SBICs), which may be subsidiaries of banks or bank holding companies. Congress authorized the creation of SBICs to provide debt and equity financing to small businesses in the United States. SBICs are licensed and regulated by the Small Business Administration (SBA).

SBIC activities are subject to the following guidelines:

- An SBIC generally is permitted to own up to 49.9 percent of the outstanding voting shares of a portfolio company.
- An SBIC generally is not permitted to exercise control over the portfolio company. However, a presumption of control may be rebutted when the portfolio company's management owns at least 25 percent of the voting securities and can elect at least 40 percent of the directors and when the SBIC investor group cannot elect more than 40 percent of the directors. Moreover, temporary control may be permitted in certain circumstances, such as a material breach of the financing agreement by the portfolio company or a substantial change in the operations or products of the portfolio company.
- Portfolio companies must meet specific SBA criteria, which define a small business.
- Aggregate investment in the stock of SBICs is limited to 5 percent of the bank's capital and surplus or, in the case of a bank holding company, 5 percent of the bank holding company's proportionate interest in the capital and surplus of its subsidiary banks.

If the SBIC takes temporary control of a small business, a control certification (a divestiture plan) must be filed with the SBA within 30 days. The certification must state the date on which the control was taken and the basis for taking control.

Portfolio companies must meet the SBA definition of a small business, which requires that (1) the business be independently owned and operated, (2) the business not be dominant in its field of operation, and (3) the business meets either of the two SBA methods of determining compliance with its size and income limitations. Under the first method, a business, together with its affiliates, must have a consolidated net worth of less than $18 million and after-tax income of less than $6 million. The second method applies number-of-employee and revenue limits to the business based on standards set by the SBA for the particular industry.

There are also restrictions on the type of businesses in which an SBIC can invest: Investments cannot be made in offshore companies. SBICs may not provide financing to a small business that engages in re-lending or re-investing activities. At the time of the investment or within one year thereafter, no more than 49 percent of the employees or tangible assets of the business can be located outside of the United States.

Edge Corporations and Regulation K

Regulation K implements sections 25 and 25A of the Federal Reserve Act, which authorize banking organizations to invest in Edge corporations. One power of an Edge corporation is the ability to make investments in foreign portfolio companies, subject to the following limitations:

- Ownership may not exceed 19.9 percent of the portfolio company's voting equity or 40 percent of the portfolio company's total equity.
- The aggregate level of portfolio investments may not exceed 25 percent of the BHC's tier 1 capital. For state member banks, the relevant limitation is 20 percent of tier 1 capital.
- Investments may be made under the Board's general-consent provisions (which do not require prior notice or approval) if the total amount invested does not exceed the greater of $25 million or 1 percent of the tier 1 capital of the investor.

As a general rule, Edge corporations are prohibited from investing in foreign companies that engage in the general business of buying or selling goods, wares, merchandise, or commodities in the United States. In addition, an Edge corporation is limited to a 5 percent interest in the shares of a foreign company that engages directly or indirectly in business in the United States that is impermissible for an Edge corporation.

With Board approval, Edge corporations can hold investments in foreign companies that do business in the United States if (1) the foreign company is engaged predominantly in business outside the United States or in internationally related activities in the United States, (2) the direct or indirect activities of the foreign company in the United States are either banking or closely related to banking, and (3) the U.S. banking organization does not own 25 percent or more of the voting stock or otherwise control the foreign company.

Section 24 of the Federal Deposit Insurance Act

Section 24 of the Federal Deposit Insurance Act

(FDI Act) governs the equity investments made by insured state nonmember banks and generally prohibits such investments unless the equity investment is permissible for a national bank. Section 24(f) of the FDI Act permits state banks to retain equity investments in nonfinancial companies if the investments are made pursuant to state law under certain circumstances. Other provisions of section 24 of the FDI Act permit a state bank to hold equity investments in nonfinancial companies if the FDIC determines that the investment does not pose a significant risk to the deposit insurance fund.

Merchant Banking and the Gramm-Leach-Bliley Act

The GLB Act authorizes BHCs and foreign banks subject to the BHC Act to engage in merchant banking activities if the banking organization files with the Board a declaration that it elects to be an FHC and a certification that all of its depository institution subsidiaries are well capitalized and well managed. To continue conducting merchant banking activities, each of the depository institution subsidiaries of the BHC or foreign bank must continue to meet the well-capitalized and well-managed criteria. In addition, at the time it commences any new merchant banking activity or acquires control of any company engaged in merchant banking activities, a domestic bank subsidiary must have at least a satisfactory rating under the Community Reinvestment Act (CRA).

A BHC or foreign bank must provide notice to the Board within 30 days after commencing merchant banking activities or acquiring any company that makes merchant banking investments. SR-00-1 (February 8, 2000) details the information required to be provided by BHCs and foreign banks electing FHC status and the procedures for processing FHC elections.

Merchant banking investments may be conducted by a securities affiliate of the FHC or by an insurance company affiliate that provides investment advice to the insurance company and is registered under the Investment Advisers Act of 1940, or by an affiliate of such an adviser. Merchant banking investments may also be made by other nonbank affiliates of FHCs, but may not be acquired or held by a depository institution affiliate or subsidiary of a depository institution. A U.S. branch or agency of a foreign bank is considered a depository institution for purposes of the rule and, therefore, may not acquire or hold merchant banking investments.

FHCs may make merchant banking investments only as part of a bona fide underwriting, merchant banking, or investment banking activity—that is, for resale or other disposition. Investments may not be made for purposes of engaging in the nonfinancial activities conducted by the entity in which the investment is made.

Rules adopted by the Board and the Department of the Treasury, effective February 15, 2001, impose the following limitations and requirements on the conduct of merchant banking activities.

Limitations on routine management. The GLB Act prohibits an FHC and its subsidiaries from being involved in the day-to-day ''routine management'' of a portfolio company. Certain activities, however, are deemed not to constitute routine management. These activities include (1) having one or more representatives on the board of directors of the portfolio company; (2) entering into covenants concerning actions outside of the ordinary course of business of the portfolio company; and (3) providing advisory and underwriting services to, and consulting with, a portfolio company. A December 21, 2001, staff opinion describes examples of covenants that Board staff believe would generally be permissible under the GLB Act and the implementing regulations. (See www.federalreserve.gov/boarddocs/legalint.) These include covenants that restrict the ability of the portfolio company to—

- alter its capital structure through the issuance, redemption, authorization, or sale of any equity or debt securities of the portfolio company;[2]
- establish the general purpose for funds sought 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);
- amend the terms of any equity or debt securities issued by the company;
- declare a dividend on any class of securities of the portfolio company or change the dividend-

2. 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.

payment rate on any class of securities of the portfolio company;
- engage in a public offering of securities of the portfolio company;
- register a class of securities of the portfolio company under federal or state securities laws;
- list (or de-list) any securities of the portfolio company on a securities exchange;
- create, incur, assume, guarantee, refinance, or prepay any indebtedness outside the ordinary course of business of the portfolio company;
- 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;
- 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);
- 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;
- 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—
  - — entering into a contractual arrangement (including a property lease or consulting agreement) that imposes significant financial obligations on the portfolio company;
  - — the sale of a significant asset of the portfolio company (for example, a significant patent, manufacturing facility, or parcel of real estate);
  - — the establishment of a significant new subsidiary by the portfolio company;
  - — the transfer by the portfolio company of significant assets to a subsidiary or to a person affiliated with the portfolio company; or
  - — the establishment by the portfolio company of a significant new joint venture with a third party;
- hire, remove, or replace any or all of the executive officers of the portfolio company;[3]
- 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;
- 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;
- 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;
- 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
- establish, dissolve, or materially alter the duties of a committee of the board of directors of the portfolio company.

Moreover, an FHC may routinely manage a portfolio company when it is necessary or required to obtain a reasonable return on the investment upon resale or disposition. The FHC may only operate the portfolio company for the period of time necessary to address the specific cause prompting the FHC's involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return upon resale or disposition of the investment. Written notice to the Board is required for extended involvement, which is defined as over nine months. The FHC must maintain and make available to the Board upon request a written record describing its involvement in routinely managing the portfolio company.

Permissible holding periods. An FHC may, without any prior approval, own or control a direct merchant banking investment for up to 10 years, and own or control an investment held through a private equity fund for up to 15 years. If an FHC wants to hold an investment longer

3. The term "executive officer" is defined in section 225.177(d) of Regulation Y.

than the regulatory holding periods, a request for approval must be submitted to the Board at least 90 days before the expiration of the applicable time period. When reviewing requests to hold investments in excess of the statutory time limits, the Board will consider all of the facts related to the particular investment, including (1) the cost of disposing of the investment within the applicable holding period, (2) the total exposure of the FHC to the portfolio company and the risks that disposing of the investment may pose to the FHC, (3) market conditions, (4) the nature of the portfolio company's business, (5) the extent and history of FHC involvement in the management and operations of the portfolio company, and (6) the average holding period of the FHC's merchant banking investments. The FHC must deduct from tier 1 capital an amount equal to 25 percent of the carrying value of the investment held beyond the regulatory holding period and abide by any additional restrictions that the Board may impose in connection with granting approval to hold the interest in excess of the time limit.

An FHC must provide a written notice to the Board within 30 days after acquiring more than 5 percent of the voting shares, assets, or ownership interests of any company under this subpart, including interest in a private equity fund, at a total cost to the FHC that exceeds the lesser of 5 percent of the tier 1 capital of the FHC or $200 million. No post-acquisition notice under section 4(k)(6) of the BHC Act is required by an FHC in connection with a merchant banking investment if the FHC has previously filed a notice under section 225.87 of Regulation Y indicating that it had commenced merchant banking investment activities, except for the notice of large individual investment requirements.

Equity investment policies and procedures. FHCs engaging in merchant banking activities must have appropriate policies, procedures, and management information systems. SR-00-9 identifies the structure of such policies and procedures not only for merchant banking activities but for all equity investments. The formality of these policies and procedures should be commensurate with the scope, complexity, and nature of the institution's equity investment activities and risk profile. The required policies, discussed in depth in subsequent sections, should address the following:

- types and amounts of merchant banking investments
- parameters governing portfolio diversification
- guidelines for holding periods and exit strategies
- hedging activities
- investment valuation and accounting
- investment-rating process
- compensation and co-investment arrangements
- periodic audits of compliance with established limits and policies and applicable laws

In addition to limiting and monitoring exposure to portfolio companies that arises from traditional banking transactions, banking organizations should adopt policies and practices that limit the legal liability of the banking organization and its affiliates to the financial obligations and liabilities of portfolio companies. These policies and practices may include the use of limited-liability corporations or special-purpose vehicles to hold certain types of investments, the insertion of corporations that insulate liability between a bank holding company and a partnership controlled by the holding company, and contractual limits on liability.

Sections 23A and 23B. Sections 23A and 23B of the Federal Reserve Act impose specific quantitative, qualitative, and collateral requirements on certain types of transactions between an insured depository institution and companies that are under common control with the insured depository institution. The GLB Act includes a presumption that an FHC controls a company for purposes of sections 23A and 23B if it owns or controls 15 percent or more of the equity capital of the company. This ownership threshold is lower than the ordinary definition of an affiliate, which is typically 25 percent. The final rule identifies three ways that the GLB Act presumption-of-control provision will be considered rebutted:

- 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.
- An independent third party owns or controls more than 50 percent of the voting shares of the portfolio company, and the officers and employees of the FHC do not constitute a majority of the directors, trustees, or general

partners (or individuals exercising similar functions) of the portfolio company.

- An independent third party 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, trustee, or general partner (or as an individual exercising similar functions) of the portfolio company.

If the FHC investment meets any of these conditions and there are no other circumstances that indicate that the FHC controls the portfolio company, the presumption of control will be deemed rebutted. However, if the FHC's investment does not meet one of these criteria, the holding company may still request a determination from the Board that it does not control the company.

Cross-marketing limitations. A depository institution controlled by an FHC may not cross-market the products or services of a portfolio company if more than 5 percent of the company's voting shares, assets, or ownership interests are owned or controlled by the FHC under the merchant banking authority. A portfolio company that meets the foregoing ownership criterion may not cross-market the products or services of the depository institution subsidiaries of the FHC. Management should ensure that these limits are observed through internal controls to monitor transactions with portfolio companies that are deemed affiliates.

Regulatory Capital Requirements

In January 2002, the Board, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (the agencies) jointly published a rule establishing special minimum regulatory capital requirements for equity investments in nonfinancial companies. The new capital requirements, which apply symmetrically to banks and bank holding companies, impose a series of marginal capital charges on covered equity investments that increase with the level of a banking organization's overall exposure to equity investments relative to tier 1 capital. The capital rules apply to equity investments made under—

- the merchant banking authority of section 4(k)(4)(H) of the BHC Act (12 USC 1843(k)(4)(H)) and subpart J of the Board's Regulation Y;
- the authority to acquire up to 5 percent of the voting shares of any company under section 4(c)(6) or 4(c)(7) of the BHC Act (12 USC 1843(c)(6) and (c)(7));
- the authority to invest in SBICs under section 302(b) of the Small Business Investment Act of 1958 (15 USC 682(b));
- the portfolio investment provisions of Regulation K (12 CFR 211.8(c)(3)), including the authority to make portfolio investments through Edge and agreement corporations; and
- the authority to make investments under section 24 of the FDI Act (other than under section 24(f)) (12 USC 1831a).

An equity investment includes the purchase, acquisition, or retention of any equity instrument (including common stock, preferred stock, partnership interests, interests in limited-liability companies, trust certificates, and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity. The rule generally does not apply to investments in nonconvertible senior or subordinated debt. The agencies, however, may impose the rule's higher charges on any instrument if an agency, based on a case-by-case review of the instrument in the supervisory process, determines that the instrument serves as the functional equivalent of equity or exposes the banking organization to essentially the same risks as an equity investment.

The capital charge applies to investments held directly or indirectly in ''nonfinancial companies'' under one of the authorities listed above. A nonfinancial company is defined as an entity that engages in any activity that has not been determined to be financial in nature or incidental to financial activities under section 4(k) of the BHC Act. For investments held directly or indirectly by a bank, the term ''nonfinancial company'' does not include a company that engages only in activities that are permissible for the parent bank to conduct directly.

The rule does not impose an additional regulatory capital charge on SBIC investments held directly or indirectly by a bank to the extent that the aggregate adjusted carrying value of all such investments does not exceed 15 percent of the tier 1 capital of the bank. For BHCs, no additional regulatory capital charge is imposed on

SBIC investments held directly or indirectly by the holding company to the extent the aggregate adjusted carrying value of all such investments does not exceed 15 percent of the aggregate of the holding company's pro rata interests in the tier 1 capital of its subsidiary banks. However, the adjusted carrying value of such investments must be included in determining the total amount of nonfinancial equity investments held by the banking organization in relation to its tier 1 capital, and thus the marginal capital charge that applies to the organization's covered equity investments. Investments made by a state bank under the authority in section 24(f) of the FDI Act are also exempt from additional regulatory capital charges. The rule does not apply the higher capital charges to equity securities acquired and held by a bank or BHC as a bona fide hedge of an equity derivatives transaction lawfully entered into by the institution.

The rule does not apply to investments made in community development corporations under 12 USC 24 (eleventh), or to equity securities that are acquired in satisfaction of a debt previously contracted (DPC) and that are held and divested in accordance with applicable law. The rule also does not apply to equity investments made under section 4(k)(4)(I) of the BHCA by an insurance underwriting affiliate of an FHC.

A grandfather provision exempts from the higher capital charges any individual investment made by a bank or BHC before March 13, 2000, or made after such date pursuant to a binding written commitment entered into before March 13, 2000. An investment qualifies for grandfather rights only if the banking organization has continuously held the investment since March 13, 2000. For example, if the banking organization sold 40 shares of a grandfathered investment in Company X on March 15, 2000, and purchased another 40 shares of Company X on December 31, 2000, the 40 shares would be ineligible for grandfathered status. Shares or other interests received by a banking organization through a stock split or stock dividend on a grandfathered investment are not considered new investments if the banking organization does not provide any consideration for the shares or interests and the transaction does not materially increase the organization's proportional interest in the portfolio company. The adjusted carrying value of grandfathered investments must be included in determining the total amount of nonfinancial equity investments held by the banking organization in relation to its tier 1 capital, and thus the marginal capital charge that applies to the organization's covered equity investments.

The marginal capital charges are applied by making a deduction from the banking organization's tier 1 capital. For investments with an aggregate adjusted carrying value equal to less than 15 percent of the banking organization's tier 1 capital, 8 percent of the aggregate adjusted carrying value is deducted from tier 1 capital. For investments with an aggregate adjusted carrying value equal to 15 to 24.99 percent of the banking organization's tier 1 capital, 12 percent of the aggregate adjusted carrying value is deducted from tier 1 capital. For investments with an aggregate adjusted carrying value in excess of 25 percent of the banking organization's tier 1 capital, 25 percent of the aggregate adjusted carrying value is deducted from tier 1 capital.

The adjusted carrying value of an investment is the value at which the investment is recorded on the balance sheet of the banking organization, reduced by (1) net unrealized gains that are included in carrying value but have not been included in tier 1 capital and (2) associated deferred tax liabilities. The total adjusted carrying value of a banking organization's nonfinancial equity investments that is subject to a deduction from tier 1 capital will be excluded from the organization's average total consolidated assets for purposes of computing the denominator of the organization's tier 1 leverage ratio.

The capital requirements established by the rule are minimum levels of capital required to adequately support a banking organization's equity investment activities. The rule requires banking organizations to maintain, at all times, capital that is commensurate with the level and nature of the risks to which they are exposed, including the risks of private equity and merchant banking investments. The Board may impose a higher capital charge on the nonfinancial equity investments of a banking organization if the facts and circumstances indicate that a higher capital level is appropriate in light of the risks associated with the organization's investment activities.

Internal Capital

Consistent with the guidelines identified in SR-99-18 (July 1, 1999), institutions conducting material equity investment activities are expected to have internal methods for allocating capital based on the inherent risk and control environment of these activities. These methodologies should identify material risks and their potential impact on the safety and soundness of the consolidated entity. Internal capital-allocation methodologies for equity-investing activities consider both the risks posed by the broader market and those risks specific to the underlying portfolio companies. Other relevant risks may include country, business, and operational risk. More sophisticated banking organizations also identify the risks inherent in and allocate capital to equity-investing activities based on the investment stage (early-stage seed investments to later-stage buyouts) and type of investment (public versus private).

The level of capital dedicated to equity-investing activities should be appropriate to the size, complexity, and financial condition of the banking organization. Accordingly, it is generally appropriate for banking organizations to maintain capital in excess of minimum regulatory requirements to ensure that equity investment activities do not compromise the integrity of the institution's capital. Examiners should not only assess the institution's compliance with regulatory capital requirements and the quality of regulatory capital, but also review an institution's methodologies for internally allocating capital to this business line. As set forth in SR-99-18, the fundamental elements of a sound internal analysis of capital adequacy include (1) identifying and measuring all material risks, (2) relating capital to the level of risk, (3) stating explicit capital adequacy goals with respect to risk, and (4) assessing conformity to the institution's stated objectives. For equity-investing activities in particular, changes in the risk profile of the banking organization's equity portfolio, including the introduction of new instruments, increased investment volumes, changes in portfolio composition or concentrations, changes in the quality of the bank's portfolio, or changes in the overall economic environment, should be reflected in risk measurements and internal capital levels.

Risk-measurement methodologies for public securities generally reflect price declines based on standard stress scenarios. The selected stress-test benchmark should be appropriate to the characteristics of the portfolio holdings (for example, the sensitivity of small company–oriented portfolios may be more closely correlated to a Russell index rather than the S&P 500). A common approach to estimating industry-specific declines reflects the application of industry beta adjustments to each portfolio company.

Techniques can also be employed to measure the estimated exposure of the portfolio to unfavorable price moves over an extended holding period. The analysis is based on the historical volatility of each investment at a selected confidence interval. The process is based on the longest period for which historical volatility data are available.

Internal capital-allocation methodologies for private equity investments should consider both the market and credit risks inherent in this asset class. However, most methodologies employed to determine capital allocation for the market risk inherent in private equity investments are typically volatility-based approaches. Stress-test scenarios reflect conditions that prevailed during historically volatile equity markets with the results adjusted by industry betas. A number of banking organizations employ industry-adjusted, historical volatility–based measures to estimate the risk to private equity valuations from declines in earnings multiples. Some banking organizations base their stress scenarios on historical-volatility data provided by private equity vendors. While exposure to broader market risk is considered nondiversifiable, measurement of credit-specific risk should attempt to identify risk at the portfolio company–specific level, as well as identify other idiosyncratic factors that could result in impairments of value.

The amount of capital held should not only reflect measured levels of risk, but also consider potential uncertainties in risk measurement. A banking organization's internal capital should reflect an adequate cushion to take into account the perceived level of precision in the risk measures used, the potential volatility of exposures, and the relative importance to the institution of equity-investing activities.

Banking organizations should be able to demonstrate that their approach to relating capital to risk is conceptually sound and that results are reasonable. In assessing its approach, an institution may use sensitivity analysis of key inputs and compare its practices to peer practices.

Other Laws and Regulations

The conduct of equity investment activities is subject to different laws and regulations, depending on the authority under which the activities are conducted. Compliance with all laws and regulations applicable to the institution's investment activities should be a focus of the institution's system of internal controls. Regulatory compliance requirements should be incorporated into internal controls so that managers outside of the compliance or legal functions understand the parameters of permissible investment activities.

In particular, examiners should determine whether the institution has an effective program for compliance with federal and state securities laws and regulations. This is particularly important if the institution offers private equity fund investments to its private-banking customers. These investments generally represent a long-term and illiquid investment. Significant returns on investment may not be realized until the later stages of the funds' terms. Therefore, fund investments generally are suitable only for investors that can bear the risk of holding their investments for an indefinite time period and the risk of investment loss. Examiners should ensure that management has established a process to review to whom the funds are marketed and how the banking organization verifies that a customer's investment in the fund is suitable. As a general matter, fund investments are deemed to be suitable investments only after it is determined that—

- the client's investment in the fund is compatible with the size, condition, and nature of the client's investment objective, and
- the client has the capability (either personally or through independent professional advice) to understand the nature, material terms, conditions, and risks of the fund.

Examiners should encourage staff involved in marketing funds to private-banking clients to use an investor-suitability checklist. In addition, the Investment Company Act of 1940 and the Securities Act of 1933, as well as state securities laws, may impose restrictions on the sale of fund interests. Banking organizations involved in fund sales should consult with qualified securities counsel.

RISK MANAGEMENT

A banking organization engaged in equity investment activities must maintain policies, procedures, records, and systems reasonably designed to conduct, monitor, and manage such investment activities, as well as the risks associated with them, in a safe and sound manner. The banking organization 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 reviews of equity investment activities should be risk-focused, taking 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 the capital position of the institution.

Policies, procedures, records, and systems should be reasonably designed to—

- delineate the types and amounts of investments that may be made;
- provide guidelines on appropriate holding periods for different types of investments;
- establish parameters for portfolio diversification;
- monitor and assess the carrying value, market value, and performance of each investment and the aggregate portfolio;
- identify and manage the market, credit, concentration, and other risks;
- identify, monitor, and assess the terms, amounts, and risks arising from transactions and relationships (including contingent fees or interests) with each company in which the FHC holds an interest;
- ensure the maintenance of corporate separateness between the FHC and each company in which the FHC holds an interest under merchant banking authority, and protect the FHC and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of each such company; and
- ensure compliance with laws and regulations governing transactions and relationships with companies in which the FHC holds an interest.

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 and guidelines for the divestiture of an underperforming investment. Decisions to liquidate underperforming investments are necessarily made on a case-by-case basis considering all relevant factors; however, policies and procedures stipulating more frequent review and analysis are generally used to address investments that are performing poorly or have been in portfolio for a considerable length of time. Policies should identify the aggregate exposure that the institution is willing to accept, by type and nature of investment. Adherence to these exposure limits should take into consideration unfunded, as well as funded, commitments.

Many institutions have different procedures for assessing, approving, and reviewing investments based on the size, nature, and risk profile of an investment. Often, procedures used for direct investments are different from those used for indirect investments made through private equity funds. For example, different levels of due diligence and senior-management approvals may be required. Accordingly, management should ensure that the infrastructure for conducting these activities contains operating procedures and internal controls that appropriately reflect the diversity of investments. Supervisors should recognize this potential diversity of practice when conducting reviews of the equity investment process. Their focus should be on (1) the appropriateness of the process employed relative to the risk of the investments made, (2) the materiality of the equity investment business line to the overall soundness of the banking organization, and (3) the potential impact on affiliated depository institutions.

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 assess adequately 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 formal investment decision, should be documented and clearly understood by the staff conducting these activities.

An institution's evaluation of potential investments in private equity funds, as well as reviews of existing fund investments, should involve assessments of a fund's structure, with due consideration given to (1) management fees, (2) carried interest and its computation on an aggregate portfolio basis, (3) the sufficiency of general partners' capital commitments in providing management incentives, (4) contingent liabilities of the general partner, (5) distribution policies and wind-down provisions, and (6) performance-based return-calculation methodologies. A banking organization must make its policies, procedures, and records available to the Board or the appropriate Reserve Bank upon request. A banking organization must provide reports to the appropriate Reserve Bank in such format and at such times as the Board may prescribe.

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 elements of the investment-management process, focusing 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. Senior management should review and document departures from policies and procedures, and this documentation should be available for examiner review.

As with other financial activities, assessments of 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 organizations with material equity investment activities should have periodic independent reviews of their investment process and valuation methodologies by internal auditors or independent outside parties. In smaller, less complex institutions where limited resources may preclude independent review, alternative checks and balances should be established, such as random internal audits, senior management reviews of the function, or the use of outside third parties.

Management Information Systems and Reporting Mechanisms

The board of directors and senior management should ensure that the risks associated with private equity investments and merchant banking activities do not adversely affect the safety and soundness of the banking organization and its affiliated insured depository institutions. An adequate and detailed management information system (MIS) is essential for managing equity investments and allowing the board of directors to actively monitor the performance and risk profile of equity investment business lines in light of established objectives, strategies, and policies.

MIS should be commensurate with the scope, complexity, and nature of an institution's equity investment activities. The following MIS reports may be appropriate for a banking organization engaged in equity investment activities. Examples of annual reports include the—

- strategic plan, which should detail country and industry limits and concentrations, earnings goals based on IRRs, and investment plans;
- budget, which should show performance results versus projections and identify anticipated investments for the next annual period; and
- annual peformance review, which should clearly identify sources of revenue (such as unrealized gains or losses, dividend income, or realized gains or losses).

Examples of monthly and quarterly reports are—

- portfolio-valuation reports that provide, for each material investment, a brief overview of the investment, the unrealized gain or loss, any unfunded commitments or contingencies, and projected exit timetables;
- portfolio-wide performance and statistical data, including gains or losses on the portfolio for the period and the performance of any hedging strategies;
- the results of any stress tests;
- analyses of concentrations by sector, industry, geographic location, or type of investment;
- regulatory compliance reports;
- management and investment committee reports that make commitments for or approve new transactions or a redirection of corporate plans; and
- a semiannual investment-portfolio review, which is a full review of the equity investment portfolio that determines the quality (valuation) of the assets by reviewing and analyzing their financial condition, management assessment, future prospects, strengths and weaknesses, and exit strategies.

In addition to a review of the content of MIS reports, examiners should determine whether reports are prepared and disseminated to senior management and the board (or an appropriate committee of the board) on a timely basis. Reports provided to senior management and the board should be readily understandable by members who are not experts in the equity investment business line.

The sophistication of the software a banking organization employes to conduct equity-investing activities will depend on the complexity of those activities. Several software options are available to simplify portfolio management, monitoring, and reporting.

A quality portfolio database should be easy to use and logical, have general-ledger capabilities, access information readily, be network-ready and compatible with the operating system, and use a programming language based on industry-established sound practices. In general, a comprehensive software system should be able to produce the following reports:

- risk summary data for the investment portfolio, for example, by industry, investment stage, and geographic region;
- comprehensive data for each investment holding (its cost, market, IRR, net cash flows, and legal entity and authority); and
- the unfunded commitments schedule and stock distributions.

In addition, if the banking organization sponsors a fund of funds, additional features of a comprehensive software system could include the ability to provide information on—

- total commitments;
- individual-investor contributions;
- distributions to individual investors;

- IRRs and total returns by individual fund, vintage year, and portfolio; and
- exposures by stage, industry, geographic region, and company.

Hedging Activities

A limited number of banking organizations have engaged in hedging strategies in an effort to reduce the impact of volatility on their holdings. The expansion of international private equity investments in the increasingly global financial-products market has given rise to foreign-exchange risk exposure, as well as market-risk exposure. Hedging strategies have been developed to reduce these risks at some large complex banking organizations (LCBOs) that have material foreign equity investments.

The most basic hedging strategy is to capture a portion of an investment's unrealized increase in fair value through the purchase of a long put option. The cost of this strategy is the premium price of the option, which varies with the strike price and maturity. The closer the underlying instrument's market value is to the strike price, the more expensive the premium and vice versa.

To avoid the premium cost of the long put, the equity investor may instead purchase a ‘‘costless’’ collar, in which the premium paid for the put is offset by the premium received on the sale of the call. The collar limits both the upside potential and downside risk of the investment through the purchase of a put and the sale of a call. A collar strategy can be an effective hedging strategy if the value of the investment is expected to remain relatively stable or decline. However, if the value of the investment increases, the holder of the call option is likely to exercise, and the banking organization (the seller) will forgo the appreciation in the value of the investment.

Another transaction used to hedge equity exposure is an equity swap. A specific price is established for the investment, and cash flows are paid to the purchaser or seller of the swap, depending on whether the underlying security value increases or decreases.

Most of the hedging instruments described above, particularly the option strategies, are European in nature, meaning that the option or embedded option may only be exercised on the stated maturity date. This feature may pose liquidity issues for the banking organization if it desires to sell its directly held investment or if the general partner of a fund investment that holds marketable securities decides to liquidate a hedged investment before option maturity. In such cases, the banking company is effectively short the underlying investment until the maturity date. To maintain their business relationships, counterparties offering the hedging products will allow banking organizations to unwind contracts for a fee when an unanticipated sale occurs. In selected cases, the banking organization may be required to post collateral to the counterparty for the hedging transaction. Most banking organization equity-investing units do not hold U.S. Treasury obligations in portfolio; therefore, the most common form of collateral provided is cash. In certain cases, the parent company will provide a guarantee on behalf of the equity-investing unit if it is a standalone subsidiary engaged in these activities. Common currency-hedging strategies for investments made in the international markets are currency forward sales or, to a lesser extent, option transactions.

If a banking organization uses hedging strategies to conduct equity investment activities, examiners should assess whether the organization has in place—

- formal and clearly articulated hedging policies and strategies, approved by the board of directors or an appropriate committee, that identify limits on hedged exposures and permissible hedging instruments;
- procedures for the review of hedging transactions for compliance with Statement of Financial Accouting Standards No. 133 (FAS 133), as amended by Statement of Financial Accounting Standards Nos. 137 and 138 (FAS 137 and FAS 138); and
- appropriate management information systems and reporting systems for monitoring the hedge strategies. Systems should include mark-to-market valuation of the hedging instruments, premium amortization of purchased instruments, and an all-in performance evaluation that includes the current fair value of the underlying position.

COMPENSATION ARRANGEMENTS

The need to maintain a qualified staff is an extremely important aspect of risk management in equity investing. In many instances, the compensation package for professional equity investment staff includes a co-investment arrangement under which the professional staff invests on a percentage basis in each of the portfolio companies or funds in which the banking organization invests during the year. Generally, a new co-investment partnership is formed annually so that each partnership reflects investments made in a particular calendar year. The duration of the partnership corresponds to the expected holding period of the investments in the partnership.

Each professional staff member's percentage of ownership within the partnership generally is based on that individual's tenure, experience, or rank. Staff members generally contribute a portion of the partnership's investment in cash; the remaining portion of the investment may be borrowed from the parent bank holding company or a nonbank subsidiary at a market rate, such as the applicable federal rate (AFR), which is published monthly by the IRS. While the holding company or a nonbank subsidiary may provide loans to the investing employees, it is recommended that the employees be required to furnish a portion of the investment with funds that have not been borrowed.

The borrowings should be serviced according to formal written agreements, and full payment of amounts borrowed, with interest, should be made before any partnership distributions to the employees. A private equity subsidiary should establish clear policies and procedures governing compensation arrangements, including co-investment structures, terms and conditions of employee loans, and sales of participants' interests, before the release of any liens.

If a partnership does not participate in every investment of the venture subsidiary, the examiner should consider this practice, known as "cherry picking," to be an exception worthy of criticism, as the intent of co-investment arrangement is for senior management responsible for the business line to share the investment risks with the banking organization. Moreover, if the investments in the portfolio are hedged, the investments in the co-investment plan should also be hedged, regardless of whether the hedge is in place to protect the upside profit potential or to minimize the downside risk. The important point is that co-investment plans consistently share in both the upside potential and downside risks of investment activities.

Other equity investment compensation plans base remuneration in whole or in part on the performance of the equity investment portfolios. This method is less accepted within the industry. If compensation is based on investment performance, a thorough understanding of the formula used and the underlying accounting treatments must be determined. Unrealized gains generally should not be included in determining compensation, as they do not reflect funds taken into income by the banking organization and may not ultimately be realized.

NONINVESTMENT BUSINESS TRANSACTIONS

Additional risk-management issues 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 that is an investment or portfolio company of a general partner or fund manager with which the banking organization has other investments. Given their potentially higher than normal risk attributes, institutions should devote special attention to ensuring that the terms and conditions of such lending relationships are at arm's length, in accordance with section 23B of the Federal Reserve Act, and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivative 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 comply with sections 23A and 23B of the Federal Reserve Act. The holding company 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, as 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, with special attention paid to transactions that are not on market terms.

When a banking organization lends to a private-equity-financed company in which it has no equity interest but in which 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, care must be taken to ensure that the extension of credit is granted on reasonable terms. In some cases, 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 prevent the classification or special mention of a loan. Any tendency to relax this restriction when the general partners or sponsors of private-equity-financed companies have significant business dealings with the banking organization should be strictly avoided. Banking organizations that extend credit to companies in which the institution has made an equity investment should also be aware of the potential for equitable subordination of the lending arrangements.

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 markets to assess an institution's risk profiles and performance in the equity investment business line. Indeed, it is in the interests of the institution itself, as well as 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. Supervisors should use such disclosures, as well as periodic regulatory reports filed by publicly held banking organizations, as part of the information that they review routinely. The following topics are relevant for public disclosure, though disclosures regarding each of these topics may not be appropriate, relevant, or sufficient in every case:

- the size of the portfolio
- the types and nature of investments (for example, direct/indirect, domestic/international, public/private, equity/debt with conversion rights)
- the initial cost, carrying value, and fair value of investments, and, when applicable, comparisons to publicly quoted share values of portfolio companies
- accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices
- realized gains or losses arising from sales and unrealized gains or losses
- insights regarding the potential performance of equity investments under alternative market conditions

Reviews of the equity investment and merchant banking activities should be risk-focused and rely on any findings of the primary or functional supervisors, where available and applicable. In selecting investments for review, a cross-section of investments should be targeted. The selection process should extend across specific sectors in which the banking organization has material investments. A mix of both recent and seasoned investments should be selected to determine whether changes have occurred in the underwriting, accounting, or valuation processes or in investment performance. When preparing to review equity-investing activities, the review team should collect any available background information from prior reviews, risk assessments, regulatory reports, or publicly available information.

1. Identify the extent to which the banking organization is engaged in equity investment and merchant banking activities, the types of investments made, and activities conducted, and determine the materiality of these activities to the institution's earnings and capital.
2. Identify and, to the extent possible, quantify the material risks posed by the banking organization's equity investment and merchant banking activities.
3. Determine whether the board of directors and senior management understand the risk profile of the banking organization's equity-investing activities.
4. Determine whether the accounting and valuation policies and practices for the equity investment business line are appropriate, clearly articulated, consistently applied in accordance with generally accepted accounting principles (GAAP), and properly disclosed.
5. Determine whether write-downs or adjustments to the valuation of investments are made in appropriate amounts and in a timely manner.
6. Evaluate the quality and timeliness of portfolio-valuation reviews.
7. Evaluate the adequacy and effectiveness of the policies, procedures, and processes designed to ensure compliance with applicable laws, regulations, and supervisory guidance governing equity investment and merchant banking activities.
8. Determine the adequacy of the institution's regulatory and internally allocated capital relative to the activities conducted and the inherent risks.
9. Evaluate the institution's framework of policies, procedures, systems, and internal controls designed to measure, monitor, and control investment risks.
10. Determine whether the banking organization's management information systems (MIS) and reporting mechanisms are commensurate with the scope, complexity, and nature of its equity investment and merchant banking activities.
11. Determine the adequacy of internal and external risk-management and audit reviews.
12. Determine the adequacy of policies and procedures governing any hedging activities authorized in connection with the banking organization's equity investment and merchant banking activities, and determine whether any of these activities are conducted in accordance with Statement of Financial Accounting Standards No. 133 (FAS 133), as amended by Statement of Financial Accounting Standards Nos. 137 and 138 (FAS 137 and FAS 138).
13. Determine that personnel working in equity-investing activities are technically competent and well trained; ethical standards are established, communicated, and respected; and compensation arrangements are clearly documented and appropriate.
14. Assess any lending-based or noninvestment business relationships with portfolio companies, portfolio company managers, or general partners of equity investment ventures and funds, and determine whether such transactions are being conducted in accordance with applicable laws and supervisory guidance and in a manner that does not compromise the safety or soundness of insured depository institution subsidiaries.
15. Determine the adequacy of internal and public disclosures of equity investment activities, and recommend improvements when warranted.
16. Recommend corrective action when policies, procedures, practices, internal controls, or management information systems

are found to be deficient or when violations of laws, rulings, or regulations have been noted.

TYPES OF EQUITY INVESTMENTS

1. Assess the composition of investments among direct investments, indirect investments through limited partnership funds, and indirect investments through funds of funds. Identify the types of equity instruments the banking organization holds (for example, common and preferred stock, convertible debt, warrants, and partnership interests) and the stage of development of portfolio companies (for example, start-up, growth, buyout, and recapitalization). Identify any issuer or industry-sector concentrations.
2. Determine if activities are managed along legal-entity or functional-business-unit lines. Identify the number of geographic offices through which investment activities are conducted, including any non-U.S. sites. Where applicable, determine how foreign organizations book and manage investments (that is, whether investments are booked in offshore vehicles rather than in U.S.-domiciled entities).
3. Determine whether and to what extent the banking organization serves as the general partner of private equity funds, and review any partnership agreements, fund-offering documents, or other pertinent information. Determine whether private equity funds are offered to the banking organization's private-banking clients, and, if so, review relevant documentation.

ACCOUNTING AND VALUATION

1. Evaluate the appropriateness of the banking organization's accounting treatment of various types of equity investments.
2. Determine whether the banking organization has established a valuation policy that establishes appropriate methodologies for each type of equity investment held (for example, private direct, funds, public security investments) or stage of investment. Determine if the valuation policy is applied consistently over time.
3. Assess the banking organization's current year-to-date write-offs, write-downs, write-ups, and recoveries in light of past trends and current market conditions.
4. Determine the appropriateness of the factors the banking organization considered in determining whether to make private-security valuation adjustments, and assess whether the banking organization's policies clearly articulate conditions and criteria for indicating other-than-temporary impairment of private equity investments.
5. If the banking organization discounts public securities, determine whether policies establish a rigid matrix of discounts or provide for a more subjective approach. If a subjective approach is used, determine how it is applied and documented.
6. Determine how the banking organization values fund investments. Are fund-investment valuation adjustments based on quarterly general-partner statements, or does the banking organization monitor the potential impact on its fund valuations based on an analysis of the underlying portfolio companies?
7. Determine whether acceptable levels of documentation support valuation decisions. Determine whether reviews of valuation methodologies are supported by robust documentation (especially where valuations reflect consideration of subjective factors).
8. Assess whether valuation reviews are comprehensive and timely, given the nature and complexity of the banking organization's investment activities.
9. Identify the level of unfunded commitments and the banking organization's ability to meet those commitments.

COMPLIANCE WITH LAWS AND REGULATIONS

1. Identify and verify the various legal authorities through which the banking organization engages in equity-investing activities. If applicable, has the BHC (or foreign bank) properly notified the appropriate Reserve Bank that it has elected to become a financial holding company (FHC) and that it has initiated merchant banking investment activities?
2. Verify that the firm's FR Y-12 accurately reflects the activities as conducted.
3. Identify and assess the regulatory-compliance process for the equity investment business

line, and assess how the process is coordinated with the consolidated compliance function.

4. Verify that board and senior management oversight of investing activities is commensurate with the complexity of the portfolio (or portfolios). Are reports provided on a timely basis, and do reports reflect the complexity and risk profile of the institution's activities?
5. Determine if the banking organization has established written policies and procedures for monitoring compliance with the applicable laws, regulations, and supervisory guidance, including but not limited to the rules in subpart J of Regulation Y (governing merchant banking activities), sections 23A and 23B of the Federal Reserve Act, and SR-00-9.
6. Determine the process for monitoring compliance with sections 23A and 23B of the Federal Reserve Act. Identify what system or process has been established at the holding company to monitor transactions between (1) any portfolio companies or fund managers that are considered affiliates and (2) its affiliate banks.
7. Request and review documentation on the banking organization's capital-allocation oversight infrastructure, and review how the process incorporates all consolidated nontrading equity holdings. Determine if management has effectively related the level of capital allocated for equity-investing activities to the level of inherent portfolio risks. Do internal capital allocations distinguish between different types of equity-related investments, including public, private, limited partnership funds, and mezzanine holdings? Are unfunded commitments to limited partnership funds included?
8. For those banking organizations employing value-at-risk (VaR) and volatility techniques to estimate portfolio risk for internal capital-allocation purposes, assess the following:
   a. What is the simulation time horizon (quarterly or annual)?
   b. How appropriate is the historical data sample to be used (source and length of time)?
   c. How does the banking organization map its investments to industry-specific market indices to determine volatilities and cross-industry correlations?
   d. How frequently are positions and volatilities reviewed?
   e. Are the methodology and assumptions periodically reviewed by an independent source or function?
   f. Has the banking organization considered the feasibility of using other types of internal modeling methodologies (including non-VaR methods), such as historical-scenario analyses or stress tests, for measuring the risk of equity investments and determining regulatory capital charges?
9. Discuss the impact of regulatory capital requirements on portfolio and risk-management activities with the banking organization's management team. Ensure that management has established an appropriate infrastructure to meet regulatory capital requirements.

RISK MANAGEMENT

1. Assess the adequacy of the banking organization's policies, procedures, systems, and internal controls in light of the complexity and risk profile of the institution's equity investment activities. Determine whether these policies, procedures, systems, and controls are reasonably designed to—
   a. delineate the types and amounts of investments that may be made;
   b. provide guidelines on appropriate holding periods for different types of investments;
   c. establish parameters for portfolio diversification;
   d. monitor and assess the carrying value, market value, and performance of each investment and the aggregate portfolio;
   e. identify and manage the market, credit, concentration, and other risks;
   f. identify, monitor, and assess the terms, amounts, and risks arising from transactions and relationships (including contingent fees or interests) with each company in which the banking organization holds an interest;
   g. ensure the maintenance of corporate separateness between the banking organization and each company in which the banking organization holds an interest under merchant banking authority, and

protect the banking organization and its depository institution subsidiaries from legal liability for the operations conducted by and financial obligations of each such company; and

h. ensure compliance with laws and regulations governing transactions and relationships with companies in which the banking organization holds an interest.

2. Determine how risk exposures are aggregated on a consolidated basis at the bank holding company level. Determine how equity-ownership positions are aggregated if nontrading equity investments are made in other areas across the consolidated organization. Request a copy of any aggregation reports.
3. Review any internal audits, regulatory examinations, consultant reports, or other third-party reviews to identify significant supervisory issues.
4. Identify the investment strategy and whether it is consistent with the institution's risk profile and overall investment strategy.
5. Review and assess the adequacy and completeness of the investment process by reviewing investment memoranda, due-diligence reviews, and periodic portfolio reviews for information, including—
   a. an overall description of the investment, which generally includes the nature of the business and type of securities held;
   b. financial condition and trends; and
   c. the current valuation, exit strategies, the internal rate of return (IRR), and risk rating.
6. Assess the reasonableness of exit strategies for the investments reviewed.
7. If the banking organization is engaged in fund-management activities, assess the robustness of the following:
   a. the limited-partner due-diligence process, including suitability analyses
   b. the review of fund documentation by outside legal counsel with sufficient experience in such activities
   c. operational processing capabilities and limited-partner reporting capabilities
   d. the level of due diligence performed on third parties responsible for operational or reporting functions
8. If the banking organization acts as a general partner for private equity funds or sponsors funds of funds, determine the following:
   a. What is the business objective and strategy for launching limited partnerships or funds of funds?
   b. How is the fund (or funds) structured? Who is the general partner?
   c. What are the investment objectives (review a sample of private-placement memoranda)? Are the reviewed samples consistent with stated objectives?
   d. Does management understand the risks of launching limited partnerships or funds of funds?
   e. Does management use qualified internal counsel or retain outside counsel to ensure compliance with securities laws?
   f. Who is the client base for limited partnerships or funds of funds (that is, to whom are these funds marketed)? What is the process for determining investor suitability?
   g. Has the firm experienced any investor defaults on fund capital calls?
   h. Is the administration of funds of funds performed in-house or outsourced? If outsourced, has management established procedures for and does it perform a periodic review of the provider? How extensive is the provider's client base?
   i. How robust are the fund-of-funds selection and due-diligence processes? What is the valuation methodology for the funds?
   j. How are management fees generated on the banking organization's limited partnership or fund-of-funds activities?
9. Assess the robustness of the banking organization's risk-exposure measurement capabilities. Determine whether market scenarios employed for risk-exposure simulations of equity investments are consistent with those used in broader corporate market-risk modeling. Does the banking organization periodically stress-test the portfolio (or portfolios) to estimate the worst-case-scenario risk exposure in its portfolio?
10. Review the banking organization's investment-approval process to ensure that it is consistent with board-approved policies, procedures, limits, and supervisory guidance (such as in SR-00-9) and that it is appropriately documented.
11. Obtain and review formal hedging policies. The policies should include descriptions of approved hedging instruments for specific hedging strategies, definitive performance-related objectives, and appropriate risk

parameters, including both market- and credit-risk exposure.
12. If applicable, determine whether hedges comply with Statement of Financial Accounting Standards No. 133 (FAS 133), as amended by Statement of Financial Accounting Standards Nos. 137 and 138 (FAS 137 and FAS 138). Correlation between the derivative and the investment (or investments) to be hedged should be well documented and periodically validated by independent, external audits.
13. Assess the adequacy of management information systems (MIS), including systems for mark-to-market valuation of the hedging instruments, the premium amortization of purchased instruments, and performance evaluation.
14. If hedging strategies are developed and executed at the business unit, assess the background and experience level of staff who conduct these activities.
15. Obtain documentation summarizing the banking organization's MIS capabilities, including schematic diagrams, where available, to identify the level of automation and required manual processing. If MIS reports are generated manually, has the firm established a control process to ensure the integrity of the data in the reports?
16. Assess whether MIS is sufficiently robust for the size and complexity of the banking organization's investment activities. Does the management information system appropriately monitor and report on all material risks?
17. Determine whether the banking organization's MIS capabilities allow for tracking of ownership and risk exposures across entities in which equity investment activities are booked or conducted.
18. Identify and assess the level of MIS integration with corporate systems. Does the equity investment system feed into the corporate general-ledger system or is manual intervention required?
19. If applicable, request a demonstration of the MIS capabilities, including the various functions supporting a representative transaction.
20. Determine if management has established follow-up or escalation procedures to be implemented if management reports indicate emerging problems or abnormal conditions.
21. If the banking organization has launched a fund of funds, and if the reporting function for the fund is outsourced, review vendor reports for timeliness, accuracy, and completeness.

COMPENSATION ARRANGEMENTS

1. Assess whether clear policies and procedures are in place to govern compensation arrangements, including the co-investment structure and the terms and conditions of employee loans.
2. Determine if the co-investment partnership participates in every direct investment of the private equity subsidiary.
3. Determine the appropriateness of the repayment terms for any co-investment-plan borrowings. The loan should be serviced before any distributions are made to the co-investment partnership.
4. If the investments in the private equity portfolio are hedged, determine whether the co-investment-plan investments are similarly hedged.
5. If there are other forms of compensation besides a co-investment plan, determine if compensation is based on performance levels or operating results. Also determine if results are based on realized or unrealized gains and whether compensation incentives encourage the conduct of equity investment operations in a manner consistent with the institution's risk appetite. The income statement should be closely reviewed to determine what the firm represents are profits of these investments.

NONINVESTMENT TRANSACTIONS

1. Determine the extent to which the institution is engaged in lending or other noninvestment transactions with portfolio companies or with private equity fund managers or general partners of portfolio companies, including derivative transactions with or guaranteed by portfolio companies and general partners. Determine whether these transactions are conducted on terms and conditions that are

appropriate and reasonable from the standpoint of the institution.

2. Determine whether lending and other business transactions between an insured depository institution and a portfolio company that meets the definition of an affiliate comply with sections 23A and 23B of the Federal Reserve Act.
3. Determine whether the bank holding company has 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, including limits on exposures of the holding company on a consolidated basis to a single portfolio company.

DISCLOSURE OF EQUITY INVESTMENT ACTIVITIES

1. Determine the completeness and appropriateness of the institution's public disclosures of its equity investment activities, in light of the materiality and risk profile of these activities.
2. Advise management of any material concerns regarding the sufficiency of disclosure and encourage consultation with qualified securities counsel, as appropriate.