As a general rule, a bank holding company must provide 60 days' prior written notice to its Reserve Bank to engage in any nonbanking activity, or to acquire or retain the shares of a company engaged in an activity based on section 4(c)(8) or 4(a)(2). When a bank holding company gives notice to a Reserve Bank for approval to engage in, or retain or acquire shares in a company engaged in, a nonbank activity, the BHC must be of the opinion that the activity is closely related to banking and, assuming this test is met, that the activitiy is a proper incident thereto. In addition, a BHC that also is an FHC must provide 60 days' prior written notice to its Reserve Bank to engage in an activity that is complementary to a financial activity under section 4(k)(1)(B). In considering such a notice, the Board must determine whether performance of the activity can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

As an exception to the general rule, no prior notice is required for a bank holding company that is qualified under section 4(j)(4) of the BHC Act to engage de novo, directly or through a subsidiary, in an activity that the Board permitted under section 225.28 of Regulation Y before November 12, 1999. After passage of the Gramm-Leach-Bliley Act of 1999, this list of activities cannot be expanded. For all bank holding companies that are not qualified under section 4(j)(4), for all other nonbanking activities based on section 4(c)(8) or section 4(a)(2), and for all activities that are complementary to a financial activity under section 4(k)(1)(B), the bank holding company must provide the appropriate prior written notice of its proposal to its Reserve Bank.[1] The Board must review the notice without disapproving it each time the bank holding company wishes to engage in a proposed activity. The inspection objective and procedures set forth below can be implemented for each of the activities summarized in subsequent sections.

3600.0.1 INSPECTION OBJECTIVE

1. To determine what financial effect nonbanking activities have on the parent and the bank subsidiaries, and if there is any degree of exposure in the activities because of a lack of appropriate audit systems and controls.

3600.0.2 INSPECTION PROCEDURES

1. Review the company's financial statements for accuracy and determine if any factors or trends could have an adverse impact on the parent holding company or the bank subsidiaries.
2. Review the adequacy of the company's policies, procedures, practices, internal controls, and audit coverage regarding nonbanking activities, and whether they are adhered to.

1. A bank holding company that is qualified under section 4(j)(4) of the BHC Act may provide 12 calendar days' prior written notice before engaging by acquisition in an activity permitted under section 225.28 or engaging in an activity based on section 4(c)(8) and approved by the Board by order.

Two bank holding companies (Company A) and (Company B) had requested the Board to determine whether their planned nonbank subsidiary activities were of the kind described in Section 4(c)(8) of the BHC Act. The applications had been filed prior to the passage of the Bank Holding Company Act Amendments of 1970. The applicants proposed to expand their activities under a "pool reserve plan" to include correspondent banks. Such activities were limited to subsidiary banks.

The "pool reserve plan" was described as a method of pooling of loss reserves with respect to term loans to small businesses and the establishment of uniform credit standards in that regard. The "pool reserve plan" permitted banks to adopt a uniform and liberal credit policy in extending credit and the usual method of exchanging participations between the banks.

The General Counsel of the Board of Governors determined, on October 14, 1971, pursuant to delegated authority, that the proposed activities would be "so closely related to banking or managing or controlling banks as to be a proper incident thereto" in accordance with Section 4(c)(8) of the BHC Act, as amended by the BHC Act Amendments of 1970. The approval (1971 FRB 1037) included the following conditions that:

1. The subsidiary was to amend its charter so that the charter would authorize it to perform its functions, and make its services available to banks, but not to lenders other than banks, and to amend its proposed contracts with correspondent banks;
2. Any correspondent banks could terminate their contract with the subsidiary respecting future transactions upon 90-day prior written notice, and that;
3. The subsidiary be subject to the same limitations with the respect to the ownership of any collateral acquired in the course of the conduct of its proposed activities as were its parents, (Company A and Company B).

3600.5.1 NEW YORK INVESTMENT COMPANY

On May 10, 1977, the Board approved an application of a foreign-owned domestic bank to form a holding company, and, at the same time, for that holding company to acquire substantially all of the voting shares of an investment company organized and operating under article XII of the New York State Banking Law (a New York investment company).

The investment company at that time was engaged in providing lending and international banking services, including letters of credit, acceptances, and other financing facilities in connection with exports and imports, international transfers of funds, and foreign-exchange services; investments and foreign-exchange transactions for its own account; leasing improved real estate and data processing equipment; and maintenance of credit balances incidental to or related to the foregoing activities. Although the holding company believed that certain of the activities of the New York investment company had already been determined by the Board to be permissible for bank holding companies, it requested approval of its application on the basis that *all* the activities that a New York investment company is permitted to engage in under New York law are closely related to banking. A New York investment company had not previously been determined by the Board to be an activity permissible for bank holding companies.

The Board noted that the structural and competitive circumstances under which a New York investment company operates are unique to New York and have served in the past as a means for foreign-bank entry into New York in cases where entry through a direct branch or agency was either unavailable or undesirable for the purposes sought. Most of the lending and banking services offered by these companies are also offered by commercial banks generally and, in this connection, compete with foreign banking organizations and domestic commercial banks and their Edge corporation subsidiaries. However, under article XII of the New York State Banking Law, a New York investment company is permitted to engage in various other activities which the Board does not consider to be closely related to banking.

Based on the foregoing, the Board's approval in this case was limited to and contingent upon the New York investment company's (1) continuing to engage principally in transactions involving international or foreign commerce, and not accept demand deposits; (2) complying with all Board or legislatively imposed reserve and interest-rate requirements; (3) divesting of offices in another state within two years; (4) confining activities of its foreign branch to those permitted in the Board's order; and (5) not engaging in the activities of underwriting, selling, or distributing securities; buying or selling coin and bullion; or acting as a financial agent of the U.S. government or as a depositary of public moneys of the United States, or in any new activity which New York investment companies by subsequent enactment may be permitted to engage in, without the prior approval of the Board. (See 1977 FRB 595.)

3600.5.2 ENGAGING IN BANKING ACTIVITIES THROUGH FOREIGN BRANCHES OF A NONBANK COMPANY

A bank holding company applied for the Board's approval to retain direct or indirect ownership of a subsidiary, "CBC," a Delaware-chartered corporation, after it established branches in Nassau and Luxembourg, to engage in certain commercial banking activities. The activities included accepting funds in U.S. dollars or foreign currency in wholesale money markets in amounts over $100,000, making commercial loans in amounts over $100,000, placing funds with and making loans and advances to subsidiary and affiliated organizations, engaging in foreign-exchange transactions, and other activities constituting commercial banking outside the United States. CBC held the shares of a number of nonbanking subsidiaries of the BHC pursuant to section 4(c)(1)(C) of the BHC Act, which permits a subsidiary of a bank holding company to perform services for its parent company.

The purpose of the proposal was to provide the BHC with increased flexibility in funding its domestic operations by allowing CBC to gain access to the offshore wholesale money market. The proposed foreign branches of CBC, by obtaining banking licenses, would give direct access to Eurocurrency interbank markets, and the activities of the proposed branches were expected to be viewed as an integral part of a large U.S.–headquartered entity, making the branches competitive in the offshore interbank markets.

The Board decided that the lending and banking services that the proposed branches would offer were generally offered by commercial banks, and thus are permissible activities of foreign branches of domestic banks and foreign subsidiaries of bank holding companies. The proposed activities of CBC's branches were substantially similar to activities that the Board had previously approved under section 4(c)(8) of the BHC Act for the foreign branches of the New York investment company, incorporated under article XII of the New York Banking Law (see 1977 FRB 595 and 1979 FRB 667). CBC did not propose to engage in any activity that would not be permitted for a separately incorporated foreign subsidiary of a bank holding company. The Board, therefore, ruled that the proposed activities of CBC were closely related to banking (1982 FRB 251).

CBC proposed to engage in no banking activities in the United States, stating that its only U.S. activities would consist of its indirect nonbanking activities through subsidiaries. The subsidiaries would be funded through funds raised by the proposed foreign branches. In this connection, the BHC committed to accepting no placement of or deposits from,[1] or extending no credit to (other than a subsidiary or affiliated organization) a United States resident.[2] The BHC committed that the liabilities to CBC of any person, other than an affiliate, would not exceed 10 percent of the capital and surplus of CBC. The Board felt that these prudential conditions were adequate to meet any supervisory concerns to which the proposal might give rise and thus approved the application, subject to the obtaining of the necessary licensing requirements of the countries involved.

1. A placement or deposit received from a foreign branch, office, subsidiary, affiliate, or other foreign establishment (''foreign affiliate'') controlled by one or more domestic corporations is not regarded as a placement or deposit received from a U.S. resident if such funds are used in its foreign branches or that of other foreign affiliates of the controlling domestic corporation(s).

2. Credit extended to a foreign affiliate, controlled by one or more domestic corporations, is not regarded as credit extended to a U.S. resident if the proceeds will be used in its foreign business or that of other foreign affiliates of the controlling domestic corporation(s).

Permissible Activities by Board Order (Operating a Securities Exchange) Section 3600.6

A domestic bank holding company (the BHC) and a foreign banking organization (the FBO), subject to the BHC Act, applied for the Board's permission to engage in operating a securities exchange under the authority of section 4(c)(8) of the BHC Act and section 225.24 of Regulation Y. The BHC proposed to control approximately 17 percent of the voting shares of group (the group), and the FBO planned to control approximately another 11 percent of the voting shares of the group. The group owned about 54.1 percent of a financial network subsidiary (FNS), which operated an electronic securities exchange (the exchange) for the secondary trading of equity and equity-related securities listed on the London Stock Exchange (LSE). The BHC and FBO indicated that the group planned to establish an office in the United States. In anticipation of the establishment of this office, the BHC and FBO requested the Board's approval to acquire their interests in the group. A BHC must obtain the Board's approval if a foreign company held by the BHC seeks to engage in business in the United States.

The exchange is a screen-based electronic market that provides securities trade matching, trade execution, and related services to U.S. and foreign market makers, broker-dealers, and institutional investors that become members of the exchange. Members may access the exchange and enter bid and ask quotations using electronic terminals that are linked to designated financial networks (for example, a Bloomberg terminal) or through a personal computer linked directly to the exchange. The exchange can be accessed from terminals located anywhere in the world. Trading, however, may occur only during the operating hours of the LSE. Orders entered in the exchange's system appear on separate electronic order books for each security, which display the best bid and ask quotes for the security in descending order. The exchange automatically and continuously matches equal bid and ask offers for each listed security on a first-come, first-served basis.

FNS does not take a principal position in securities, clear or settle the securities transactions executed on the exchange, or assume any principal risk for securities trades executed on the exchange. FNS and its shareholders are not obligated to guarantee any member's trades. Each member of the exchange must be a member of the London Clearing House, or must appoint a member of the London Clearing House to clear the member's trades on the exchange. Trades matched by the exchange are registered at the end of each business day with the London Clearing House in the name of the appropriate clearing member. London Clearing House then becomes the counterparty to each side of the trade until the trade is settled. The trade is settled through a designated system operated by a corporation established by the Bank of England to settle uncertificated U.K. equities.

The exchange is a recognized investment exchange under section 37(3) of the U.K. Financial Services Act of 1986, and is regulated and supervised by the U.K. Financial Services Authority (FSA), under the securities laws of the United Kingdom. While FNS makes its services available to customers in the United States, the SEC has granted it a limited volume exception from the registration requirements of the Securities Exchange Act of 1934. The SEC exemptive order permits FNS to operate in the United States without registering as a securities exchange provided (1) the exchange's average daily volume of trades involving U.S. members does not exceed $40 million, and (2) the exchange's worldwide average daily volume does not exceed 10 percent of the average daily trading volume on the LSE. The SEC exemptive order requires the exchange to comply with other conditions that are designed to ensure orderly and fair markets and to protect U.S. investors.

The Board had not previously determined by regulation or order that the operation of a securities exchange is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. The principal function of a securities exchange is to provide a centralized facility for the execution, clearance, and settlement of securities transactions. The Board indicated in its order that banks and BHCs are authorized to provide securities brokerage services to their customers and, as part of those services, to execute and clear such transactions on a securities exchange. The Board also noted that BHC subsidiaries authorized to act as dealers in securities (section 20 subsidiaries) may provide securities execution, clearance, and settlement services in connection with their dealer operations. In addition, the Board noted that broker or dealer subsidiaries of banks and BHCs often become members of securities exchanges and thus acquire a small ownership (less than 5 percent) in a mutually owned exchange (for example, the New York Stock Exchange). Through the development of these relationships, banks and BHCs have gained considerable experience with and knowledge of the rules and operations of securities exchanges.

Banks and BHCs also provide services that are functionally and operationally similar to those of the exchange. Banks and BHC subsidiaries acting as securities brokers may execute cross-trades for their customers and thereby match equal bid and offer orders received from them. In addition, section 20 subsidiaries may, if authorized, act as a specialist or market maker on a securities exchange such as the NYSE or NASDAQ. A specialist generally maintains a book of current buy and sell orders received from other brokers and matches equal bid and offer quotes for execution. Market makers on NASDAQ also publish bid and ask prices at which they stand ready to execute transactions in the relevant security.

For the above reasons, and based on all the facts on record, the Board concluded that operating a securities exchange is an activity that is closely related to banking for the purposes of section 4(c)(8) of the BHC Act. The application was approved on November 8, 1999. See 2000 FRB 61 for the order and more specific information regarding the Board's approval.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2007, this section is amended to include another Board order in which the Board approved a notice for a foreign bank to act as a certification authority (CA) in connection with financial and nonfinancial transactions and to engage in related data processing activities. The bank planned to engage in the activities by entering into an agreement with a newly organized, wholly owned indirect subsidiary of the bank. (See 2006 FRB C150.) The proposed CA nonbanking activities are slightly different, but are consistent with those CA nonbanking activities that were previously approved by the Board (discussed below).

3600.7.1 ACTING AS CERTIFICATION AUTHORITY IN CONNECTION WITH FINANCIAL AND NONFINANCIAL TRANSACTIONS

A foreign banking organization (FBO)[1] subject to the BHC Act and several bank holding companies (BHCs), deemed to be BHCs (all referred to as the notificants) within the meaning of the BHC Act, requested the Board's approval under section 4(c)(8) of the BHC Act and section 225.24 of the Board's Regulation Y (12 C.F.R. 225.24) to retain 12.5 percent of the voting interests in Indent Company (Indent), and to engage through Indent and other nonbank subsidiaries in acting as a CA in the United States in connection with financial and nonfinancial transactions and other related activities. Indent represents a joint venture among the notificants and other commercial banks and foreign banking organizations. As proposed, Indent would act as the global rulemaking and coordinating body for a network of financial institutions that would act as CAs and thereby provide services designed to verify or authenticate the identity of customers conducting financial and nonfinancial transactions over the Internet and other "open" electronic networks. To provide these services, Indent and its network of participating financial institutions (the identity system) would use digital certificates and digital signatures created through the use of public-key cryptography.

In a CA system using public-key cryptography, a company generates (or is assigned) a public-key/private-key pair and registers with a CA as the unique "owner" of the key pair.[2] Private keys and public keys are a set of different but related mathematical functions that can be used to encrypt and decrypt electronic communications. A message encrypted by a particular private key can be decrypted only by its corresponding public key. Although a private key and its corresponding public key are related, a private key cannot feasibly be derived from its corresponding public key. Thus, while a private key must be kept confidential by the company that is the registered owner of the key pair, the company's public key can be made publicly available without jeopardizing the confidentiality of the company's private key.

A company sending a business communication (for example, a purchase order) to another entity over an open electronic network like the Internet uses its confidential private key to digitally sign the message being sent. A digital signature is a compressed and encrypted version of the message to which it is attached. The entity receiving the digitally signed message then uses the sender's public key to decrypt the digital signature.[3] If the receiver successfully decodes the signature with the sender's public key, the receiver can be assured that the message was created using the sender's private key.[4]

To be assured that the message was actually sent by the purported sender, however, the receiver must confirm that the private-key/public-key pair used to sign and decode the message is uniquely "owned" by the purported sender. A CA provides this assurance by issuing "digital certificates" certifying that the relevant private-key/public-key pair is uniquely associated with the message sender and by verifying upon request the validity of such digital certificates.

1. Foreign banks may engage in permissible nonbanking activities in the United States directly through a U.S. branch or agency. A foreign bank, however, must receive the Board's approval under section 4(c)(8) of the BHC Act to engage in the United States in activities that are deemed to be closely related to banking.

2. A number of nonbanking companies currently operate CA systems that rely on public-key cryptography to provide identity-authentication services to senders and receivers of electronic communications.

3. The sender's public key may be attached to the digitally signed communication, or the receiver of the message may obtain the sender's public key from a publicly available database.

4. The receiver also can confirm that the message was not altered after it was signed by comparing the message received with the decrypted version of the message text embedded in the digital signature.

The notificants and other financial institutions participating in the identity system (participants)[5] would create unique private-key/public-key pairs for, and issue digital certificates on behalf of, eligible customers that contract with one of the participants to receive Indent identity-authentication services.[6] Each participant would act as a repository for the digital certificates that it has issued, that is, it would maintain a database containing information on the status of the outstanding, expired, or revoked digital certificates that it has issued to customers. The participants also would verify for third parties the validity of digital certificates issued to their customers and, upon request of the third party, may provide an explicit warranty as to the validity of the customers' digital certificates.[7] The participants also may process and transmit verification and warranty requests received from customers concerning digital certificates issued by other participants in the identity system. In addition, the participants may provide customers with a limited range of software and hardware that is required for customers to use the identity system.[8]

Indent would provide the infrastructure framework within which the participants would act as CAs and provide related services. The primary function of Indent would be to act as the "root certification authority" of the identity system, that is, issuing digital certificates to the participants that establish their status as CAs in the identity system and authenticating for customers of, and the other participants in, the identity system the identity of the participants.[9] Indent also would (1) establish and maintain the operating rules governing the identity system, including the minimum technical requirements for digital certificates and other components of the system; (2) monitor compliance by the participants with the identity system's operating rules and technical standards; and (3) monitor collateral requirements and aggregate warranty exposure for the participants in the identity system.[10]

Section 4(c)(8) of the BHC Act provides that a bank holding company may, with the Board's approval, engage in any activity that the Board determines to be closely related to banking. The Board previously has authorized BHCs under section 4(c)(8) of the BHC Act to act as CAs and provide identity-authentication services in connection with payment-related and other financial transactions conducted over electronic networks.[11] The Board has not previously authorized BHCs under section 4(c)(8) to act as CAs or provide identity-authentication services in connection with nonfinancial transactions.

Banks and BHCs have long provided identity-authentication services in connection with nonfinancial transactions conducted by third parties and for their own traditional banking and lending activities. For example, banks and BHCs are authorized to provide notary services to customers.[12] The role of a notary is to authenticate signatures on financial or nonfinancial documents for the benefit of third parties.[13] To verify a signature on a paper-based document, a notary must verify the identity of the person signing

5. Participation in the identity system is available only to organizations that are engaged primarily in the business of providing financial services; are subject to regulation and examination by a government authority in their home country; and that meet certain eligibility criteria, such as minimum capital requirements and debt-rating criteria. A participant also must agree to be bound by the identity system operating rules and to execute certain participation agreements. Financial institutions would not be required to purchase an ownership interest in Indent to become a participant.

6. The participants may provide identity system–related services only to customers that have agreed to be bound by applicable provisions of Indent's operating rules and have signed the appropriate customer agreements. Indent's operating rules allow the participants to provide identity system–related services only to business entities, such as corporations and governmental organizations, and not to natural persons. Indent's operating rules and customer agreements would make each customer contractually responsible for ensuring that its private key is kept confidential.

7. The operating rules of the identity system would provide that a company relying on a digital certificate issued by the participant would have recourse against the participant only if the company purchased an explicit warranty from the participant, and then only up to the amount of the purchased warranty. The participant that issues a digital certificate could refuse to issue a warranty for a digital certificate for any bona fide reason. The identity system would limit the aggregate amount of warranties that the participant may have outstanding at any one time, and would require each participant to post collateral with Indent to cover its warranty exposure.

8. For example, the participants may provide smart cards containing digital certificates and smart-card readers to their customers.

9. Digital certificates issued by the participant to a customer are digitally signed by the participant with its own private key and are accompanied by a digital certificate issued by Indent. The digital certificates Indent issues would certify that the participant is an authorized participant in the identity system and that the private key the participant uses to digitally sign its certificates is uniquely associated with it, thereby authenticating the identity of the participant.

10. The activities of the notificants and Indent would be limited to providing the identity-authentication and related services described above. The notificants and Indent would not provide a general encryption or electronic message service, or any warranty of the underlying financial or nonfinancial transactions between customers whose identities are authenticated through the use of the identity system.

11. See Regulation Y, section 225.28(b)(14); 1997 FRB 602, 606; and 1982 FRB 505, 510.

12. See 1998 FRB 481.

13. 58 Am. Jur. 2d *Notaries Public* § 31 (2d ed. 1989).

the document. The Board noted that the role a CA serves with respect to electronic documents is functionally similar to the role a notary serves with respect to paper-based documents.[14]

Banks have traditionally identified their customers to third parties through the issuance of letters of introduction or letters of reference.[15] In addition, banks and BHCs routinely authenticate the identity of customers and noncustomers in connection with their authorized check-cashing functions.[16]

Banks and BHCs also have long been authorized to issue signature guarantees to issuers of securities and their transfer agents in connection with the transfer of securities.[17] A bank issuing a signature guarantee warrants that the customer's signature endorsing a certificated security or authorizing the transfer of an uncertificated security is authentic. The issuing bank also warrants that the signer was an appropriate person to endorse the security or authorization (or, if the signature is by an agent, that the agent had actual authority to act on behalf of the appropriate person) and that the signer had legal capacity to sign. In light of these warranties, a bank providing a signature guarantee must verify the identity of the customer providing the endorsement or signing the instruction.[18]

Identity-authentication services are an integral part of many traditional banking functions. Banks and BHCs have developed sophisticated methods for authenticating the identity of customers and noncustomers that transact business or communicate with the bank or BHC through electronic means or otherwise. Many of these activities are operationally and functionally similar to the proposed activities, and make banks and BHCs particularly well equipped to provide the proposed services. For example, banks and BHCs maintain systems to electronically authenticate the identity of persons engaged in credit and debit card, automated teller machine (ATM), home banking, and wire transfer transactions with the institution.[19] Banks and BHCs also electronically authenticate the identity of persons in connection with the check and credit card verification services they are authorized to provide to merchants and other businesses.[20]

The Board noted that state banks and national banks have recently been authorized to act as CAs and to provide identity-authentication services in connection with financial and nonfinancial transactions conducted over electronic networks. Based on the foregoing, the Board concludes that acting as a CA and, more generally, authenticating the identity of customers conducting financial and nonfinancial transactions are activities that are closely related to banking within the meaning of section 4(c)(8) of the BHC Act.

Indent and the notificants also propose to engage in a number of activities as part of and in connection with their proposed CA activities. These activities include (1) processing, transmitting, and storing data necessary for the operation of the identity system, such as digital certificates, requests for verification of digital certificates, and warranty requests; (2) developing and marketing software and hardware necessary for operating the identity system; and (3) complying with, monitoring, and enforcing the collateral-posting requirements associated with identity warranties. In addition, Indent would establish operating policies, procedures, and guidelines for the identity system.

The Board's Regulation Y permits BHCs to provide data processing and data transmission services and facilities (including software and hardware) for the processing and transmission of financial, banking, or economic data, and to engage in activities related to making, acquiring, brokering, or servicing extensions of credit, such as posting collateral and monitoring collateral requirements.[21] Regulation Y also permits BHCs to engage in incidental activities that are

14. The American Bar Association, for example, has noted that the issuance of digital certificates by CAs is "analogous to traditional certification processes undertaken by notaries with respect to documents executed with pen and ink." "Digital Signature Guidelines," published by the Information Security Committee of the Electronic Commerce and Information Technology Division, Section of Science and Technology, American Bar Association. (Aug. 1, 1996), p. 54.

15. Banks have drafted letters of introduction or letters of reference on behalf of their customers for the purpose of introducing the customer to other banks or third parties with which the customer seeks to do business.

16. Under the Uniform Commercial Code (UCC), a bank that accepts a check for deposit warrants to the drawee bank that all endorsements on the check are genuine, and the bank is liable to the drawee bank for the amount of the check plus expenses and lost interest if an endorsement on the check was forged.

17. Broker-dealer subsidiaries of BHCs also have provided signature guarantees.

18. A bank issuing a signature guarantee is liable to the issuer of the security or its transfer agent for any loss that results from a breach of any of these warranties by the bank.

19. Article 4A of the UCC encourages banks to develop and maintain commercially reasonable security procedures, such as algorithms or other encryption devices, for authenticating the identity of customers that transmit wire transfer instructions to the bank.

20. See Regulation Y, section 225.28(b)(2)(iii) and 1985 FRB 648.

21. See Regulation Y, section 225.28(b)(2) and (14). A BHC may develop and sell hardware and software that is

necessary to the conduct of an activity that is closely related to banking. Indent and the notificants have represented that they would engage in the additional activities only in connection with their CA activities and would not engage in such activities separate or apart from their CA activities. The notificants also have committed that the data processing and data transmission activities of the notificants and Indent, including any proposed development or sale of hardware and software, will comply with the Board's regulations and interpretations. In light of the nature of these additional activities and the fact that they would be conducted only in connection with the CA activities of Indent and the notificants, and all the other facts of record, the Board concludes that these activities are encompassed within the activities previously approved by the Board by regulation or are incidental to the permissible CA activities of Indent and the notificants and, therefore, are permissible under Regulation Y.[22]

Based on the facts stated in the Board's order, the Board determined that the certification authority and other activities discussed were closely related to banking under section 4(c)(8) of the BHC Act. The Board issued its approval order on November 10, 1999. (See 2000 FRB 56). See the Board's order for more specific information and for the more detailed information and references in the order's footnotes.

The Board approved another notice for a foreign bank, specifically a foreign banking organization that is subject to the BHC Act.[23] The foreign bank had requested the Board's approval under sections 4(c)(8) and 4(j) of the BHC Act[24] and section 225.24 of the Board's Regulation Y[25] to act as a CA in connection with financial and nonfinancial transactions and to engage in related data processing activities. It was proposed that the agreement be assigned to a newly organized wholly owned indirect subsidiary of the bank, CLX.

The proposed activities would be undertaken within the Identity Trust System (ITS), which would serve as a central rulemaking and coordinating body for a global network of institutions that would act as digital CAs. The CAs would verify or authenticate the identity of customers conducting financial and nonfinancial transactions over the Internet and on other "open" electronic networks. To provide these services, ITS and its network of participating financial institutions would use digital signatures created with encryption technology. These digital signatures would uniquely identify participants in the ITS who send signed messages over electronic networks. The CAs would issue digital certificates that certify that the digital signature is uniquely associated with a particular message sender so that the message recipient can be assured of the identity of its trading partner.

As a certification authority, CLX would provide the technical systems and support necessary for banks to verify and authenticate the identity of customers conducting electronic transactions and to register digital certificates to customers. These services would be provided to the foreign banking organization as well as to other banks that enter into contracts with CLX.[26] The foreign bank, and any other banks to which CLX may provide services, would be responsible for performing the due diligence on customers that request digital credentials, a role referred to as "registration authority." Bank and other registration authorities would register the digital certificates issued to their customers, and CLX would maintain a database of all certificates issued through its registration authorities. CLX would also provide registration authorities with the software and hardware required to use the ITS.

In this order, the Board referenced its previous approval (2000 FRB 56) in which it determined that the CA activities conducted in connection with financial and nonfinancial transactions and data processing were activities that are closely related to banking for the purposes of section 4(c)(8) of the BHC Act. Also for this latter order, the Board found that the foreign bank's proposed activities were consistent with those that it had previously approved. The foreign bank committed that it would conduct its proposed nonbanking activities in accor-

designed and marketed for processing and transmitting financial, banking, or economic data. It may also develop and sell general purpose hardware so long as it does not constitute more than 30 percent of the cost of any packaged offering.

22. The notificants may engage in data processing and data transmission activities, including the development and sale of hardware and software, pursuant to this order only to the extent such activities are necessary to permit the proper operation of the identity system. The notificants and Indent also must conduct their data processing and data transmission activities subject to the software and hardware limitations in Regulation Y.

23. As a foreign bank operating an agency in the United States, the foreign bank is subject to the BHC Act by operation of section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a)).

24. 12 U.S.C. 1843(c)(8) and 1843(j).

25. 12 C.F.R. 225.24.

26. These banks would also have to enter into agreements to participate with ITS.

dance with the limitations set forth in Regulation Y and the Board's above-mentioned previous order governing these proposed activities. The Board approved the notice on June 8, 2006 (2006 FRB C149).

3600.7.2 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Acting as a certification authority for financial and nonfinancial transactions and related data processing activities.	12 U.S.C. 1843(c)(8)	225.28(b)(14)		2000 FRB 56 2006 FRB 149

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

A bank holding company (the applicant) applied under section 4(c)(8) of the Bank Holding Company Act and the Board's Regulation Y to engage de novo through a wholly owned subsidiary (the company) in privately placing limited partnership interests in a group of partnerships having a limited number of investors. The company was to serve as the investment adviser, administrator, and sole general partner of a series of seven partnerships (the partnerships) that would be sold to a number of institutional investors. The company would maintain an equity interest of approximately 1.25 percent of the total capitalization in each partnership.

The partnerships were to be engaged solely in investing in limited amounts of debt and equity securities, including interests in real estate investment equity trusts (REITs).[1] The partnerships, together with the applicant and its other subsidiaries, were not to hold more than 5 percent of any class of voting securities of any issuer, and not more than 25 percent of the total equity of any issuer.[2] The equity investments were to be held in accordance with section 4(c)(6) of the BHC Act and section 225.22(d)(5) of Regulation Y.

The company also proposed to privately place limited partnership interests with new sophisticated institutional investors and possibly form similar additional partnerships in the future. The company was not to privately place debt securities issued by the partnerships without prior approval from the Federal Reserve System. The applicant committed that the private placement of limited partnership interests would conform to the limitations and conditions for private placements in previous Board orders approving private-placement activities (for example, 1990 FRB 26 and 1989 FRB 829).[3] Each investor was required to have an initial minimum investment of $100,000. Investors with $250,000 or more under management by the company, however, would be permitted to invest in any partnership in any amount. The applicant would continue the company's practice of allowing existing investors in a partnership to add to their investment in the partnership in any amount. The application was approved on June 28, 1994 (1994 FRB 736).

Subsequently, another bank holding company (the BHC applicant) applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y to engage de novo, through a wholly owned asset-management subsidiary (AMS), in establishing and serving as the general partner of limited partnerships (the limited partnerships) that would invest in a wide variety of commodities and exchange-traded and over-the-counter instruments including those specified in the Board order. AMS would be the general partner of each partnership and would hold a nominal equity interest in each one. In this case, AMS would not provide investment advice directly to the limited partnerships, but would employ unaffiliated investment advisers to manage the investments of the limited partnerships, pursuant to parameters set by AMS. Interests in the limited partnerships would be privately placed with institutional customers by the BHC applicant's subsidiary banks.

One or more of the limited partnerships could invest a substantial portion of their assets in commodity pools, which would require the applicant to register as a commodity pool operator (CPO). The interests purchased by the limited partnerships would consist of less than 5 percent of the outstanding voting securities of any commodity pool and less than 10 percent of the total equity of any commodity pool. The applicant proposed that the limited partnerships purchase such assets with debt. It further stated that it would not permit any limited partnership that invested in distressed debt instruments to use borrowed funds to purchase or carry distressed debt instruments or to use the distressed debt instruments as collateral in acquiring other assets. The applicant also indicated that the leverage employed by the limited partnerships would include margin credit from broker-dealers, reverse repurchase agreements, and short sales.

The limited partnerships would invest in debt and equity instruments and distressed debt instruments.[4] The applicant stated that invest-

1. The partnerships were not to invest in futures contracts or options on futures contracts on any financial or nonfinancial commodity, or knowingly invest in debt that, upon acquisition, is in default without the prior approval of the Federal Reserve System. The applicant further committed that it would not use the investments of the partnerships to obtain or exercise control over any issuer of securities owned or held by the partnerships. Also, no directors, officers, or employees of the applicant and its affiliates will serve as directors, officers, or employees of any issuer of which the applicant and its affiliates held more than 10 percent ownership of total equity.

2. The applicant committed that all subordinated debt of an issuer would be subject to this 25 percent limit.

3. See the current Regulation Y, section 225.28(b)(7)(iii), regarding private-placement services.

4. The Board had previously permitted bank holding com-

ments in debt and equity securities and distressed debt would be made in accordance with the BHC Act's limitations and those of previous Board decisions. (See 1995 FRB 1128 and section 3104.0.)

The limited partnerships, together with the applicant and its subsidiaries, would make investments not greater than 5 percent of any class of voting securities of any issuer, and not greater than 25 percent of the total equity, including the subordinated debt, of any issuer. No directors, officers, or employees of the applicant would serve as directors, officers, and employees of any issuer of which the applicant and its subsidiaries (that is, the limited partnerships) would hold more than 10 percent of the total equity. For this case, the Board required AMS to consolidate the assets and liabilities of the limited partnerships in the financial statements of AMS for regulatory capital purposes. In addition, AMS was required to establish an appropriate risk-management structure consisting of investment and position limits for each investment adviser before engaging in the proposed activities. Compliance and trading limits would be monitored by computerized systems to be established by the applicant. The Board approved the notice on April 24, 1996, subject to all the facts of record and the commitments furnished. See 1996 FRB 569. For more recent Board orders whereby bank holding companies propose to act as a CPO and to control a private limited partnership that invested solely in permissible investments for a bank holding company, see 1999 FRB 209, 1998 FRB 852, and 1998 FRB 361.

panies to sponsor, organize, and manage closed-end investment companies and unregistered limited partnerships that invest in securities.

3600.13.1 SERVING AS AND CONTROLLING A PRIVATE LIMITED PARTNERSHIP AS A COMMODITY POOL OPERATOR

A bank holding company applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to engage de novo through a wholly owned asset-management subsidiary (ASM) that would be established to serve as the general partner of limited partnerships (the partnerships) that would invest in a wide variety of commodities and exchange-traded and over-the-counter instruments, including interests in investment funds that invest in futures and options on futures on financial and nonfinancial commodities (commodity pools). It was indicated that the partnerships would not directly invest in futures or options on futures contracts for purposes other than hedging. The partnerships would purchase and sell derivative contracts on precious metals and financial commodities, instruments, and indices for hedging purposes. It was further stated that one of the limited partnerships may invest a substantial portion of its assets in commodity pools, which would require the ASM (the general partner) to become a registered commodity pool operator (CPO) with the Commodity Futures Trading Commission (CFTC). As such, the ASM would register as a CPO with the CFTC, and a portion of the general partner's activities would become subject to the recordkeeping, reporting, fiduciary standards, and other requirements of the Commodity Exchange Act (7 U.S.C. 2 et seq.), CFTC, and National Futures Association.

The Board previously has found that a subsidiary of a state member bank may serve as the CPO of investment funds engaged in purchasing and selling futures and options on futures on certain commodities.[1] In addition, the Board has permitted bank holding companies to trade futures and options on futures on financial and nonfinancial commodities.[2] For these reasons, the Board has concluded that serving as a CPO, and controlling as a CPO a private limited partnership that invests solely in investments that a bank holding company is permitted to make directly, under the circumstances of this case (1996 FRB 569) are closely related to banking. See also 1998 FRB 1075, 1998 FRB 852–854, 1998 FRB 361, and 1994 FRB 736.

1. See 1996 FRB 239.
2. See 1995 FRB 185.

3600.17.1 ENGAGING IN TITLE INSURANCE AGENCY ACTIVITIES PURSUANT TO REGULATION Y

A bank holding company applied under section 4(c)(8) of the BHC Act and section 225.23(a) of the Board's Regulation Y to acquire all the outstanding shares of a title insurance agency. The title insurance agency is to conduct activities pursuant to exemption G of the Garn–St Germain Depository Institutions Act of 1982 (the act) and section 225.28(b)(11)(vii) of Regulation Y. Title VI of the act amended section 4(c)(8) of the BHC Act to provide that insurance agency, brokerage, and underwriting activities are not "closely related to banking" and thus are not permissible activities for bank holding companies, unless the activities are included within one of seven specific exemptions (A through G) in section 4(c)(8).

The applicant claimed that it was authorized to operate a title insurance agency under exemption G, which authorizes those bank holding companies that engaged in insurance agency activities before 1971 to engage, or control a company engaged in, insurance agency activities. The company has been engaged in the sale of insurance related to extensions of credit by its subsidiary banks since 1939.

The bank holding company applicant was one of 16 active companies with grandfather rights under exemption G.[1] Previously, the Board determined (1985 FRB 171) that those companies that had received Board approval to engage in general insurance agency activities before 1971 would be grandfathered under exemption G with respect to the sale of any type of insurance that is within the scope of general insurance agency activities—even an insurance agency activity (such as title insurance) not actually offered by the applicant bank holding company before 1971. The Board found that there is no requirement in the statute that a company qualifying for exemption G engage only in those insurance agency activities it conducted with Board approval before 1971. Thus, although the Board may not have specifically approved title insurance before 1971, provided the proposed activity is encompassed within the authorization of insurance agency activities, the activity falls within exemption G.

The Board determined selling title insurance through a title insurance agency to be permissible pursuant to exemption G and the Board's regulations. The Board approved the application on November 17, 1988 (1989 FRB 31).

1. There are currently 12 companies remaining.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, this section has been revised to incorporate a name change to the Financial Industry Regulatory Authority, or FINRA (formerly, the National Association of Securities Dealers, or NASD).

3600.21.1 UNDERWRITING AND DEALING IN COMMERCIAL PAPER TO A LIMITED EXTENT

A bank holding company applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y to underwrite and deal in third-party commercial paper to a limited extent. As proposed, the activity will be conducted through a commercial finance subsidiary (the company). The company is to act for issuers as an underwriter of commercial paper, purchasing commercial paper for resale to institutional investors such as banks, insurance companies, mutual funds, and nonfinancial businesses. In addition, the company may place commercial paper as agent for issuers and advise issuers on the rates and maturities of proposed issues that are likely to be accepted in the market—activities previously approved by the Board (1987 FRB 138). The activities in this order (1987 FRB 367) differ from those previously authorized (1987 FRB 138) in that the applicant will underwrite and deal in commercial paper as principal.

The Board may not approve a proposal of a member bank affiliate if upon consummation it would be "engaged principally" in the flotation, underwriting, public sale, or distribution of commercial paper (hereafter referred to as "underwriting and dealing in") within the meaning of the former section 20 of the Glass-Steagall Act (12 U.S.C. 377). The Board concluded that even if placement of commercial paper were deemed to constitute an activity, the commercial lending subsidiary would not be "engaged principally" in underwriting and dealing in securities. The subsidiary's activity was not substantial under a former 5 percent limit on the subsidiary's gross income (increased to 25 percent, effective March 6, 1997) from its commercial paper activities and a former 5 percent limit on its market share. The company is required to restrict its commercial paper activities so it does not exceed these limits.

The Board concluded that underwriting and dealing in commercial paper is closely related to banking on the same basis as acting as placement agent and adviser to issuers in commercial paper (1987 FRB 138). Banks provide services that are operationally and functionally similar to the services of underwriting and dealing in commercial paper. Banking organizations are particularly well equipped to provide such services. In the Board's view, the underwriting and dealing activity represents a natural extension of commercial lending activities traditionally conducted by banks, involving little additional risk or new conflicts of interest, and potentially yielding significant public benefits in the form of increased competition and convenience.

The Board concluded that the applicant could conduct the activities to the extent and in the manner described in the order, consistent with the former section 20 of the Glass-Steagall Act and section 4(c)(8) of the BHC Act. The Board's approval extended only to commercial paper underwriting, dealing, placement, and advisory activity conducted in accordance with the limitations stated in the order (1987 FRB 367).

3600.21.2 ENGAGE IN UNDERWRITING AND DEALING, TO A LIMITED EXTENT, IN MUNICIPAL REVENUE BONDS, MORTGAGE-RELATED SECURITIES, AND COMMERCIAL PAPER

On April 30, 1987, the Board approved by order the applications of three bank holding companies to engage through subsidiaries in underwriting and dealing in commercial paper, one- to four-family mortgage-backed securities, and municipal revenue bonds.[1] (For a complete description of the nonbanking activities authorized by the Board in this order, see 1987 FRB 473.) The subsidiaries are to be involved in underwriting and dealing in U.S. government securities as their major activity. Board approval

1. The applicants had previously received Board approval under section 4(c)(8) of the BHC Act for the subsidiaries mentioned in the order to engage in underwriting and dealing in U.S. government and agency and state municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Glass-Steagall Act. The newly proposed underwriting and dealing activities were approved in addition to the previously approved activities.

could only occur if the affiliates would not be "principally engaged" in underwriting and dealing in "securities" under the provisions of the former section 20 of the Glass-Steagall Act.

A hearing was held on February 3, 1987, because of the important legal and factual issues involved. The Board reaffirmed its finding in its previous decisions (1987 FRB 138 and 367) that the applicants were not principally engaged in the proposed securities activities if they limited their underwriting and dealing income from these securities to 5 percent of the total gross income of the affiliate, and if they limited their market share in each of these securities to 5 percent of the total domestic market.[2] The Board established a number of conditions to ensure that the underwriting activity would be consistent with safe and sound banking practices and would avoid conflicts of interest, undue concentration of resources, and other adverse effects.

The Board determined, consistent with its previous underwriting and dealing decisions in administering the Glass-Steagall Act, that a range of between 5 percent and 10 percent of gross revenue and market share is the appropriate framework for determining whether an affiliate is engaged principally in securities activities. The lower end of the range—5 percent—was the level applied at the time. The Board noted that it would review this level within a year on the basis of experience gained from operations to determine whether a higher level would be permissible. On September 21, 1989, the Board modified section 20 orders to increase from 5 percent to 10 percent the revenue limit on the amount of total revenues a section 20 subsidiary may derive from ineligible securities underwriting and dealing activities (increased to 25 percent, effective March 6, 1997) (1989 FRB 751).[3]

The Board's approval of the applications extends only to the activities conducted within the limitations of the order and is subject to the gross revenue limitation discussed above. Two of the applicants also proposed to underwrite and deal in consumer-receivable-related securities (CRRs). Although the companies noted certain similarities between these securities and mortgage-related securities, the Board did not believe that the record before the Board provided a sufficient basis for it to make a formal finding (as required by the BHC Act) that underwriting and dealing in CRRs is closely related to banking and a proper incident thereto. The Board noted that the market for CRRs was relatively new and untested compared with the market for one- to four-family mortgage-related securities and municipal revenue bonds. The Board indicated that it would reconsider the matter within 60 days on the basis of more complete information to be submitted by the applicants regarding the types of assets that would be securitized, the manner in which this would be accomplished, and other matters bearing on risk.

In a subsequent order, six BHCs applied for and received the Board's conditional approval (1987 FRB 731) for the activity, but the Board stayed its order for the same period of time applicable to the stay issued by the Second Circuit Court of Appeals (see footnote 2 and section 3600.21.3). After approving the order set out in 1987 FRB 731, the Board approved several other orders that rely on this order and the limitations imposed therein. (See the following Board orders: 1987 FRB 607, 616, 618, 620, 622, 731, 738, 742, 928; 1988 FRB 133, 500, 699, 700, 706, 819; 1989 FRB 33, 190, 396, 398, 520, 645, 647; 1990 FRB 79, 158, 256, 461, 554, 568, 573, 652, 682, 756; 1991 FRB 954; 1992 FRB 338; 1993 FRB 141, 716; and 1994 FRB 249, 346.)

The major difference between the three applications decided on April 30, 1987, and the two applications previously approved by the Board (1987 FRB 138 and 367) is that the underwriting would take place in an affiliate engaged in underwriting and dealing in U.S. government securities. This arrangement raised the major legal question of whether these government securities could serve as a basis for measuring the principal activity of the affiliate. In its approval, the Board took into account the fact that the Glass-Steagall Act specifically

2. The U.S. Court of Appeals for the Second Circuit upheld the Board's determination that the underwriting subsidiaries would not be engaged principally in ineligible securities underwriting and dealing under the above revenue limitation; the U.S. Supreme Court declined to review that decision (*Securities Industry Association v. Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 108 S.Ct. 697 (1988)). The Supreme Court also let stand the lower court's determination that the 5 percent market share limitation was not adequately supported by the facts of record, thus sustaining elimination of the market share test that had been invalidated by the U.S. Court of Appeals. Accordingly, the Board decided not to impose a market share limitation on orders approved on August 4 and 8, 1988.

3. The Board in this order also modified its section 20 orders to permit underwriting and dealing in securities of affiliates if the securities are rated by a nonaffiliated, nationally recognized rating organization or are issued or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Corporation, or represent interests in such obligations.

allows member banks to underwrite U.S. government securities and that the act intends affiliates to have a broader scope for underwriting than member banks. On that basis, the Board had previously allowed affiliates of member banks to engage in underwriting of U.S. government securities.

3600.21.3 ENGAGE IN LIMITED UNDERWRITING AND DEALING IN CONSUMER-RECEIVABLE-RELATED SECURITIES

Six bank holding companies applied for the Board's approval to engage in limited underwriting and dealing in consumer-receivable-related securities (CRRs). CRRs, which were first issued in 1985, consist of debt obligations that are secured by or represent an interest in a diversified pool of loans to or receivables from consumers, such as loans to individuals to finance the purchase of automobiles or personal credit card accounts.

The Board concluded that underwriting and dealing in CRRs is an activity closely related to banking on the basis that banks provide services that are operationally and functionally so similar to the services proposed that banking organizations are particularly well equipped to provide them. In accordance with section 16 of the Glass-Steagall Act, banks underwrite and deal in certain mortgage-related securities that are issued or guaranteed by the United States or by U.S. government agencies. Some of the securities represent interests in pools of mortgage loans for residential housing purposes made by banks and other financial institutions. Such securities are very similar to CRRs.

Both CRRs and bank-eligible mortgage-related securities represent interests in pools of loans made by financial institutions to individuals to finance the purchase of housing or consumer goods and services.

The techniques involved in underwriting and dealing in bank-eligible mortgage-related securities are also very similar to those that would be involved in conducting the approved activity with respect to CRRs. In each case, the underwriter must perform substantially identical functions of evaluating prepayment risk, analyzing credit and cash flow from a pool of numerous individuals' loans, negotiating or bidding, and distributing and dealing.

In addition, banks now directly perform some of the functions involved in the approved activity. Banks select the consumer loans that form the pool of interests that are then sold to investors. Banks also advise issuers of CRRs and assist issuers in privately placing these securities.

Because of the similarity between securities involved in CRRs and the previously approved bank-ineligible one- to four-family mortgage-related securities nonbanking activities set forth in a previous order (1987 FRB 473), the Board required that this activity be conducted in accordance with the same requirements established in that order. This includes a requirement that the securities be rated for investment quality by a nationally recognized agency.

The Board concluded, based on the reasons set forth in its previous order (1987 FRB 473), that the approved activity would not result in a violation of the former section 20 of the Glass-Steagall Act and is closely related and a proper incident to banking. The Board's approval of these applications is restricted to underwriting and dealing to a limited extent in securities representing an interest in or backed by a diversified pool of loans to or receivables from individuals for the purchase of consumer goods and services, and the limitations of section 225.25(b)(16) of Regulation Y (1987 FRB 731).

3600.21.4 LIMITED UNDERWRITING AND DEALING IN DEBT AND EQUITY SECURITIES

Five bank holding companies applied for the Board's approval under section 4(c)(8) of the BHC Act for their wholly owned subsidiaries to underwrite and deal in, on a limited basis—

1. debt securities, including, without limitation, sovereign debt securities, corporate debt, debt securities convertible into equity securities, and securities issued by a trust or other vehicle secured by or representing interests in debt obligations; and
2. equity securities, including, without limitation, common stock, preferred stock, American Depositary Receipts, and other direct and indirect equity ownership interests in corporations and other entities.

Section 16 of the Banking Act of 1933 (the Glass-Steagall Act) prohibits a member bank from underwriting and dealing in these securities (referred to hereafter as "bank-ineligible securities"). However, as far as the Glass-Steagall Act is concerned, an affiliate of a member bank may underwrite and deal in bank-ineligible securities so long as it is not engaged principally or substantially in that activity (12 U.S.C. 377).

The applicants had previously received Board approval to underwrite and deal in U.S. government and agency securities and state and municipal securities that state member banks are specifically authorized to deal in under section 16 of the Glass-Steagall Act (referred to hereafter as ''bank-eligible securities''). The Board had also authorized the subsidiaries to underwrite and deal in commercial paper, one- to four-family mortgage-backed securities, municipal revenue bonds, and consumer-receivable-related securities—all securities that member banks may not underwrite or deal in under section 16 of the Glass-Steagall Act.[4]

To ensure that the subsidiaries would not be principally or substantially engaged in underwriting or dealing in the ineligible securities in violation of the former section 20 of the Glass-Steagall Act, the Board's approval was made subject to the requirement that gross revenues from those ineligible securities activities would not exceed 5 percent of the subsidiary's total gross revenues on average (moving average) over any two-year period. (See 1989 FRB 192 and 196–197.) The Board increased this level to 10 percent on September 5, 1989.

The subsidiaries are also subject to a framework of structural and operating limitations established to avoid the potential for conflicts of interest, unsound banking practices, unfair competition, loss of public confidence in affiliate banks, and other adverse effects from the conduct of the bank-ineligible securities underwriting and dealing activity.

The Board recognized that underwriting and dealing in securities is a natural extension of activities currently conducted by banks, involving manageable risks and potential conflicts of interest when conducted in an organizational structure that insulates these activities from banking activities supported by the federal safety net of deposit insurance and access to Federal Reserve lending. The Board has acknowledged that certain bank holding companies have an existing expertise in securities underwriting, dealing, brokerage, investment advisory activities, and broad financial skills that make them well equipped to provide the new services.

The Board's approval of each application is subject to the conditions stated in previous orders (see 1989 FRB 192; 1990 FRB 158, 455, 573, 652, 683, 756; 1991 FRB 672; 1993 FRB 133, 719; and 1994 FRB 249, 449). The conditions consist of structural and operating limitations designed to avoid conflicts of interest and potential adverse effects, and other conditions designed to ensure safe and sound operations. The conditions include requirements, limitations, and prohibitions with regard to—

1. capital adequacy;
2. credit extensions to customers of the underwriting subsidiary;
3. maintaining the separateness of an underwriting affiliate's activity;
4. disclosures by the underwriting subsidiary;
5. marketing activities on behalf of an underwriting subsidiary;
6. investment advice by bank or thrift affiliates;
7. extensions of credit to the underwriting subsidiary and to purchasers or issuers of ineligible securities (or to major users of projects funded by industrial revenue bonds);
8. transfers of information;
9. reporting and recordkeeping requirements;
10. transfer of activities and formation of subsidiaries of an underwriting subsidiary to engage in underwriting and dealing; and
11. reciprocal arrangements and prohibitions against discriminatory treatment regarding unaffiliated securities firms.

3600.21.5 ACTING AS A DEALER–MANAGER IN CONNECTION WITH CASH-TENDER AND EXCHANGE-OFFER TRANSACTIONS

In connection with a bank holding company application to underwrite and deal in, to a limited extent, all types of equity securities through its section 20 nonbanking subsidiary, an applicant also proposed to act as a dealer–manager in connection with cash-tender and exchange-offer transactions. Dealer–managers generally act as agent for tender or exchange offerors in arranging or facilitating mergers, acquisitions, and other corporate transactions. All-cash tender offers do not, of themselves, involve the issuance, public sale, or distribution of securities. The Board thus concluded that all revenues

4. See the following Board orders: 1987 FRB 473, 607, 616, 618, 620, 622, 731, 738, 742, 928; 1988 FRB 133, 500, 699, 706, 819; 1989 FRB 33, 190, 396, 398, 520, 645, 647; 1990 FRB 79, 158, 256, 461, 554, 568, 573, 652, 682, 756; 1991 FRB 672; 1993 FRB 133, 719; and 1994 FRB 249, 449.

derived from the section 20 company acting as a dealer–manager in connection with such tender offers may be treated as bank-eligible revenues for purposes of determining compliance with the Board's 10 percent revenue limitation (changed to 25 percent, effective March 6, 1997) on bank-ineligible securities activities. The Board approved the application on November 24, 1993 (see 1994 FRB 49, footnote 5).

3600.21.6 UNDERWRITING "PRIVATE OWNERSHIP" INDUSTRIAL DEVELOPMENT BONDS

A bank holding company (the notificant) provided notice under section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its proposal to engage de novo through its section 20 subsidiary (the company) in underwriting, to a limited extent, certain "private ownership" industrial development bonds. The bonds are issued for the provision of the following governmental services: water facilities, sewer facilities, solid waste disposal facilities, electric energy and gas facilities, and local district heating or cooling facilities (collectively, traditional governmental services). The notificant controls one bank subsidiary.

The company is currently engaged in limited underwriting and dealing in certain municipal revenue bonds, activities permissible under section 20 of the Glass-Steagall Act (12 U.S.C. 377).[5] The company is a broker–dealer registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) and is a member of the Financial Industry Regulatory Authority (FINRA). Thus, the company is subject to the recordkeeping and reporting obligations, fiduciary standards, and other requirements of the Securities Exchange Act of 1934, the SEC, and the FINRA. The notificant engages directly and through subsidiaries in other permissible nonbanking activities.

The Board previously determined that the activities of underwriting and dealing in municipal revenue bonds, including industrial development bonds, are so closely related to banking as to be proper incidents thereto within the meaning of section 4(c)(8) of the BHC Act.[6] Certain bank holding companies previously requested approval to underwrite and deal in only municipal revenue bonds, as opposed to a full range of debt securities. Their requests were limited to underwriting and dealing in industrial development bonds that are "public ownership" industrial development bonds. Public ownership industrial development bonds are those "tax-exempt bonds where the issuer, or the governmental unit on behalf of which the bonds are issued, is the sole owner for federal income tax purposes of the financed facility."[7]

The notificant plans to engage through the company in underwriting private ownership industrial development bonds issued solely for the provision of traditional governmental services. It committed to conduct this activity subject to the same limitations and other conditions that govern underwriting and dealing in public ownership industrial development bonds.[8]

The underwriting risk and the risk analysis required to underwrite private ownership industrial development bonds issued for traditional governmental services is essentially the same as the risk and analysis related to underwriting traditional public ownership bonds. For each, the funds for the repayment of the bonds are derived from revenue generated by the financed facility, including revenue resulting from a service contract between the owner/lessor of the financed facility and a state or local government or political subdivision, pursuant to which the state or local government or political subdivision agrees to purchase the output of the facility.[9] The notificant committed that all the pri-

5. See 1993 FRB 716.

6. *Citicorp, J.P. Morgan & Co. Incorporated, and Bankers Trust New York Corporation*, 1987 FRB 473, *aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988), as modified by order approving modifications to section 20 orders, 1989 FRB 751 ("*Citicorp/Morgan/Bankers Trust*"). See also *J.P. Morgan & Co. Incorporated, et al.*, 1989 FRB 192, *aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*, 900 F.2d 360 (D.C. Cir. 1990).

7. See 1987 FRB 502. Examples of financed facilities include airports and mass-commuting facilities.

8. *Citicorp/Morgan/Bankers Trust*. All the bonds that the notificant proposed that the company underwrite would qualify as "exempt facility bonds" under the Internal Revenue Code (the code). See 26 U.S.C. 142. The types of exempt facility bonds that the company would underwrite may, subject to certain volume caps and other limitations, be tax-exempt under the code even if the proceeds of the bonds are used to finance facilities that are privately owned. See 26 U.S.C. 103, 141, 142, 146, and 147.

9. Typically, in the case of public ownership bonds, the governmental unit that issues the bonds owns the financed facility and repays the bonds from the revenue generated by the facility and this service contract. The governmental unit

vate ownership bonds that the company would underwrite would be rated "investment quality" by a nationally recognized rating agency to the same extent as are the municipal revenue bonds that the company currently underwrites.

Considering these circumstances, the Board concluded that underwriting and dealing in private ownership bonds issued for the provision of traditional governmental services is a permissible activity if conducted subject to the conditions and prudential limitations set forth in *Citicorp/Morgan/Bankers Trust* (1987 FRB 473 and 1989 FRB 751 (Modification Order)) and agreed to in 1993 FRB 716. The notification was approved on October 24, 1995 (see 1995 FRB 1116).

may also enter into a contract with a third party to operate the financed facility. In the case of the private ownership bonds that the notificant plans to underwrite, the governmental unit that issues the bonds either uses the proceeds of the bonds to acquire or construct a facility, which the governmental unit then leases to a third party, or lends the proceeds of the bonds to a third party to acquire or construct the facility. The third party agrees to make lease payments or loan repayments to the governmental unit that enable the governmental unit to pay debt service on the bonds. As security for the lease or loan agreement, the third party assigns and pledges the revenues generated by the facility and a service contract with a state or local government or political subdivision.

A foreign bank subject to the Bank Holding Company Act applied for the Board's approval to engage in various nonbanking activities, one being to purchase mortgage loans and to issue securities for its own account, through a wholly owned subsidiary or third party servicers, and to sell securities guaranteed by the Government National Mortgage Association (GNMA). Because National Banks are specifically authorized under the Glass–Steagall Act (12 U.S.C. 24) to issue and sell securities guaranteed by GNMA, as well as to underwrite and deal in such securities, the Board concluded that the issuance and sale of GNMA securities is closely related to banking (1988 FRB 573). In addition, the Board determined that the statutory exemption reflects a Congressional determination that GNMA securities are not the type of securities that would lead to unsound speculation or that the public interest in the issuance and sale of GNMA securities by banks outweighs any potential harm resulting therefrom. Also, the Board previously determined that underwriting and dealing in GNMA certificates is of sufficiently low risk to be generally permissible activities for bank holding companies (12 C.F.R. 225.25(b)(16)).

A foreign bank, subject to Section 4 of the BHC Act, applied for the Board's permission to acquire, through its wholly owned subsidiary, all the shares of a company located in New York, New York. The acquired company would engage in several nonbanking activities. Two of the activities, not previously approved by the Board for BHCs, consisted of acting as a sales tax refund agent for the State of Louisiana and Cashing U.S. Dollar Payroll Checks Drawn on Unaffiliated Banks. Both activities were found to be closely related to banking subject to the facts and conditions found in the Board order and briefly discussed below. The application was approved on August 15, 1990 (1990 FRB 860).

3600.24.1 ACTING AS A SALES TAX REFUND AGENT FOR THE STATE OF LOUISIANA

The company being acquired serves as the State's exclusive sales tax refund agent for its tax-free shopping program for foreign visitors. Under the program, foreign visitors present sales invoices evidencing sales taxes paid in Louisiana to the company's office in the state. It refunds the tax in U.S. dollars to the visitor, less a handling fee. A portion of the handling fee is then remitted to the State and local tax authorities refund to the company the amount of tax refunds advanced. The Board found the activity to be closely related to banking since banks: (1) routinely forward to taxing authorities tax receipts delivered to the bank on taxes due; (2) commonly act as fiscal agent for government authorities which involves disbursing funds on behalf of state and local governments.

3600.24.2 CASHING U.S. DOLLAR PAYROLL CHECKS DRAWN ON UNAFFILIATED BANKS

The company being acquired also cashes, and the Applicant plans to continue cashing, U.S. dollar payroll checks on a limited basis, primarily to accommodate employees in airport facilities that lack banking services, but where the company maintains offices. Since check cashing is a fundamental banking activity performed routinely by banks, and the company being acquired proposed to cash only checks drawn on unaffiliated banks, the Board found the activity to be closely related to banking. The Board stipulated, however, that the Applicant was not to use the acquired company's offices as branches of the Applicant or any affiliated bank.

A bank holding company (the notificant) requested the Board's approval, under section 4(c)(8) of the BHC Act and section 225.24(a) of Regulation Y, to acquire through its wholly owned subsidiary a cash-express company, certain assets of an exchange company, and another firm to engage in various nonbanking activities. Many of the nonbanking activities had previously been determined by the Board to be closely related to banking in Regulation Y, by order, or by interpretation. In addition to those nonbanking activities already approved, the notificant requested the Board's approval to engage in providing various governmental service activities at the offices of the cash-express company:

1. postage stamps and postage-paid envelopes
2. vehicle registration services, including the sale, distribution, and renewal of license plates and license tags for motor vehicles
3. public-transportation tickets and tokens
4. notary public services

The Board noted that banks are permitted to provide customer access to the type of government services involved in the proposal, whereby the banks may be acting in an agency capacity or accomplishing the distribution of some of the services using automated teller machines (ATMs).[1] The Board thus concluded that the proposed nonbank activities are closely related to banking. Based on all the facts and commitments provided by the notificant, and the representations and conditions relied upon in reaching a decision, the Board approved the proposal on April 2, 1998 (1998 FRB 481).

1. See 12 C.F.R. 7.1010 and OCC Interpretive Letter No. 718 (March 14, 1996) (postage stamps, acting as an agent for the state in selling and renewing license plates and license tags, and public-transportation tickets from ATMs). See also OCC Conditional Approval Letter No. 267 (January 12, 1988)(notary services).

Permissible Activities by Board Order (Real Estate Settlement Through a Permissible Title Insurance Agency) Section 3600.26

A BHC Applicant requested the Board's permission under section 4(c)(8) of the BHC Act to acquire all the outstanding shares of a company engaged in title insurance agency and real estate settlement activities. The Board previously determined that title insurance agency activities are permissible under section 4(c)(8)(G) of the BHC Act, for which the BHC Applicant qualifies.

The real estate settlement services consist of: (1) reviewing the status of the title in the title commitment, resolving any exceptions to the title, and reviewing the purchase agreement to identify any requirement in it in order to ensure compliance with them; (2) verifying payoffs on existing loans secured by the real estate and verifying the amount of and then calculating the pro rating of special assessments and taxes on the property; (3) obtaining an updated title insurance commitment to the date of closing, preparing the required checks, deeds, affidavits, and obtaining any authorization letters needed; (4) establishing a time and place for the closing, conducting the closing, and ensuring that all parties properly execute all appropriate documents and meet all commitments; (5) collecting and disbursing funds for the parties, holding funds in escrow pending satisfaction of certain commitments, preparing the HUD settlement statement, the deed of trust, mortgage notes, the Truth-in-Lending statement, and purchaser's affidavits; and (6) recording all of the documents required under law.

In reviewing the proposed activity, the Board noted that real estate settlement services are provided by the Applicant's bank subsidiaries in connection with their origination of mortgage loans, and banks within the Applicant's state are generally permitted to conduct real estate settlement activities. It was further noted that banks routinely prepare collateral security agreements and other documentation required to close loans in accordance with federal and state lending requirements as part of the general lending activities authorized under the Board's Regulation Y.

The Board concluded that aspects of the proposed real estate settlement activities are directly linked to permissible title insurance agency activities by BHCs. These activities can directly affect the insured risks under a title insurance policy. Title insurance agents have special experience in assessing potential title defects that can arise in real estate settlement. Title insurance agents thus have the expertise to generally engage in real estate settlements.

For these reasons, the proposed real estate settlement activities conducted through a permissible title insurance agency, were deemed by the Board to be closely related to banking for purposes of section 4(c)(8) of the BHC Act. The Board approved the application by order on October 15, 1990 (1990 FRB 1058).

A bank holding company (the applicant) applied under sections 3(a)(3) and 4(c)(8) of the BHC Act to acquire another company (the company), thereby indirectly acquiring its subsidiary (the subcompany) as well as the subsidiary bank and nonbank companies of the company and the subcompany. Upon consummation of the transaction, the company and subcompany would be subject to the provisions of the BHC Act. Both companies applied for permission under section 3(a)(1) of the BHC Act to become a bank holding company.

The applicant also applied for the Board's permission to engage, through one subsidiary of the subcompany (the adviser), in providing administrative and certain other services to mutual funds, nonbanking activities that the Board has not previously considered under section 4(c)(8) of the BHC Act. The applicant also applied for the Board's permission to acquire certain other nonbanking subsidiaries of the company (as listed in appendix B of the order) to engage in making or servicing loans, providing trust services, and providing investment advisory nonbanking services pursuant to section 225.28(b)(1), (b)(5), and (b)(6) of Regulation Y.

In addition, the applicant provided notice of its intent to indirectly acquire a foreign trust company, a trust administration company, and an advisory company. The companies engage in activities that are permissible under section 211.10 of Regulation K.

3600.27.1 GLASS-STEAGALL ACT ISSUES IN PROVIDING ADMINISTRATIVE SERVICES

The administrative services the applicant proposed to provide through the adviser and its affiliates raised a number of issues under the Glass-Steagall Act. Under that act, a company that owns a member bank may not control "through stock ownership or in any other manner" a company that engages principally in distributing, underwriting, or issuing securities.

Because mutual funds continuously issue and redeem securities, the Board in 1972 issued an interpretation setting out its position on the Glass-Steagall Act as it governs the relationship between mutual funds and companies that own member banks (12 C.F.R. 225.125). The Board found that the Glass-Steagall Act prohibits affiliates of banks from sponsoring, organizing, or controlling mutual funds or distributing their shares.

The Board also found, however, that the Glass-Steagall Act does not prohibit all relationships between a bank holding company and a mutual fund and that it is permissible, under the BHC Act and the Glass-Steagall Act, for bank holding companies to provide investment advice to mutual funds. Also, the Board found that the Glass-Steagall Act does not prohibit bank holding companies from providing certain other services to mutual funds, such as acting as custodian, transfer agent, or registrar.[1] Banks and affiliates of banks may serve as investment adviser, transfer agent, custodian, and registrar. *They may not act as distributor to the fund.* The application raised the question whether it was consistent with the Glass-Steagall Act for an affiliate of a member bank to act as an administrator to a mutual fund.

3600.27.2 PERMISSIBILITY OF PROPOSED ADMINISTRATIVE-SERVICES ACTIVITIES

The adviser furnishes a variety of services to open-end investment companies (mutual funds) and closed-end investment companies in the United States. Because certain of the activities of the adviser and its affiliates are prohibited by the Glass-Steagall Act, the applicant has taken steps and has committed to terminate the

1. The Board imposed a number of restrictions on the relationship between bank holding companies and mutual funds to avoid conflicts of interest and to address potential safety-and-soundness concerns. The Board's rule includes restrictions preventing a bank holding company or any of its subsidiaries from—

- acting as investment adviser to any investment company that has a name similar to the holding company or any of its subsidiary banks;
- purchasing for its own account shares of any investment company for which the holding company serves as investment adviser;
- purchasing in its sole discretion in a fiduciary capacity shares of an investment company advised by the holding company; or
- extending credit to an investment company advised by the holding company as collateral for a loan used to purchase shares of the investment company.

In addition, the rule requires that, in cases in which a customer purchases or sells securities of the fund through the holding company or is advised by the holding company to purchase shares of the fund, the customer be informed in writing of the holding company's involvement with the fund, and be informed that the shares of the fund are not federally insured and are not guaranteed by, or obligations of, a bank.

adviser's role as a sponsor of new mutual funds. The applicant also committed that it would not acquire those of the adviser's subsidiaries that engaged in the distribution of mutual fund shares. The applicant further committed that it would not be involved in the distribution of the shares of any mutual fund. The applicant represented to the Board, that, after the acquisition of the company, neither the adviser nor any of its affiliates would be obligated by any agreement to engage in any sales activities in connection with any mutual fund's shares and would not enter into any distribution agreement with any mutual fund, unless permitted to do so by a change in current law.

The adviser will not—

1. engage in the development of marketing plans except to give advice to the distributor regarding regulatory compliance;
2. engage in advertising activities with respect to the funds and will not be involved in the preparation of a fund's sales literature, except to review it for the sole purpose of ensuring compliance with pertinent regulatory requirements; or
3. permit employees of the adviser to engage in sales activities at meetings or seminars (such activities would be conducted solely by the fund's distributor).

It was noted that the applicant did not propose providing administrative services to those mutual funds that are marketed and sold primarily to customers of any of the applicant's subsidiary banks.

The Board believes that it is permissible under the Glass-Steagall Act for the applicant to provide the following administrative services to mutual funds as proposed:

1. maintaining and preserving the records of the fund, including financial and corporate records
2. computing the fund's net asset value, dividends, and performance data and financial information regarding the fund
3. furnishing statistical and research data
4. preparing and filing with the Securities and Exchange Commission (SEC) and state securities regulators registration statements, notices, reports, and other material required to be filed under applicable laws
5. preparing reports and other informational materials regarding the fund, including proxies and other shareholder communications, and reviewing prospectuses
6. providing legal and regulatory advice to the fund in connection with its other administrative functions
7. providing office facilities and clerical support for the fund
8. developing and implementing procedures for monitoring compliance with regulatory requirements and compliance with the fund's investment objectives, policies, and restrictions as established by the fund's board
9. providing routine fund accounting services and liaison with outside auditors
10. preparing and filing tax returns
11. reviewing and arranging for payment of fund expenses
12. providing communication and coordination services with regard to the fund's investment adviser, transfer agent, custodian, distributor, and other service organizations that render recordkeeping or shareholder communication services
13. reviewing and providing advice to the distributor, fund, and investment adviser regarding sales literature and marketing plans to ensure regulatory compliance
14. providing the distributor's personnel with information about fund performance and administration
15. participating in seminars, meetings, and conferences designed to present information to brokers and investment companies, but not in connection with the sale of shares of the funds to the public, concerning the operation of the funds, including administrative services provided by the bank holding company to the funds
16. assisting existing funds in the development of additional portfolios
17. providing reports to the fund's board regarding fund activities

A mutual fund administrator provides services that are essentially ministerial or clerical. The administrator does not have policymaking authority or control over the mutual fund. The policymaking functions rest with the board of directors of the mutual fund. The board of directors is responsible for the selection and review of the major contractors to the fund, including the investment adviser and, in certain circumstances, the administrator.

The Investment Company Act of 1940 requires that at least 40 percent of the board of directors of a mutual fund be disinterested persons who are not affiliated with the investment adviser, with any person that the SEC has determined to have a material business or professional relationship with the fund, with any employee or officer of the fund, with any registered broker or dealer, or with any other interested or affiliated person. These unaffiliated board members must approve the fund's contracts with its investment adviser, underwriter, and often its administrator. The applicant committed that the adviser will provide administrative services only to mutual funds whose board of directors consists of a majority of disinterested persons.

In situations in which the applicant's subsidiaries serve as administrator to the mutual fund, the Board permitted one representative of the administrator to serve as a director of the fund. The applicant contended that such an interlocking director would facilitate the provision of administrative services by providing the fund with a person knowledgeable in the operation of the fund who would be in a position to advise the board of directors on administration.

The applicant proposed that a director interlock would be used only in situations in which a company unaffiliated with it serves as the investment adviser to the mutual fund. With regard to the adviser's serving as an administrator, this interlocking director would be deemed an interested person and would be excluded from those actions that must be taken by disinterested board members, such as the approval of an investment advisory contract or a contract for the administrator. The applicant committed that the adviser would serve as administrator only to mutual funds for which a majority of the board of directors are disinterested individuals. The Board believed that, in this proposed arrangement, the applicant would not control a mutual fund if one employee of the adviser or an affiliate[2] would serve as a director of a mutual fund to which the advisor provides administrative services.

The applicant plans, in a small number of cases, to provide mutual funds with a combination of administrative, investment advisory, and other services. The OCC has permitted national banks that serve as investment adviser to mutual funds also to provide some administrative services to those mutual funds. In addition, a number of national banks have been providing these and other services as ‘‘subadministrator’’ to mutual funds that are advised by the bank or an affiliate.

In the Board's opinion, permitting a bank holding company that serves as investment adviser to a mutual fund and also in essence provides ministerial or supporting functions as administrator to that fund would not significantly increase the bank holding company's ability to control the mutual fund. In other words, the adviser would not, by virtue of becoming an administrator to a fund that it or an affiliate advises, become involved in policy-making functions of these funds to a greater extent than when it provides solely investment advisory services. The Board believes that control would continue to rest with the board of directors of the mutual fund.

With regard to providing a combination of advisory and administrative services, the applicant further committed that it would not have any director or officer interlocks with these mutual funds. It would also not have any director or officer interlocks with mutual funds to which it provides both advisory and administrative services.

In providing the combination of services, the applicant would be subject to the Board's interpretation on investment advisory activities (12 C.F.R. 225.125) and would therefore be required to conform the adviser's activities to the interpretation within two years. On this condition, and subject to the commitments made by the applicant, the Board concluded that the proposal was permissible under the Glass-Steagall Act.

3600.27.3 BOARD'S CONCLUSION ON PROVIDING ADMINISTRATIVE SERVICES

The Board found the applicant's proposed activities to be closely related to banking because (1) it had previously determined by regulation that a bank holding company could act as investment adviser to a mutual fund; (2) national banks, including national bank trust departments, provide administrative services to mutual funds; and (3) it had also permitted bank holding companies to provide certain individual financial data processing services (calculation of investment values and tax consulting) by a mutual fund administrator. The Board thus approved the application on April 21, 1993 (1993 FRB 626), based on the facts of record and all of the commitments and representations made by the applicant, and subject to the terms and conditions set forth in the order.

2. This director cannot serve as an officer, director, or employee of the applicant, its bank, or any subsidiary bank or bank holding company of the applicant.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, this section has been revised to incorporate a name change to the Financial Industry Regulatory Authority, or FINRA (formerly, the National Association of Securities Dealers, or NASD).

A foreign banking organization (FBO), subject to the provisions of the Bank Holding Company Act, had requested the Board's approval to acquire, through a wholly owned subsidiary (the company), substantially all the assets of an asset-management partnership (the partnership). The company would be an investment adviser registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940. The company's acquisition of the partnership would also include a membership interest in a services firm that would provide transfer-agency services to mutual funds advised by the company (the funds).

The FBO, among other things, proposed to provide marketing support to a mutual fund by directly contacting broker-dealers, 401(k) plan providers, financial planners, insurance companies, and other financial intermediaries to recommend the funds. It would be primarily responsible for the development of marketing plans and the preparation of advertising and sales literature materials for the funds. The Board had not previously considered whether a bank holding company could provide promotional or marketing services to the extent that was proposed.

3600.28.1 CONTROL CONSIDERATIONS INVOLVING PROMOTIONAL AND MARKETING ACTIVITIES

Under the Glass-Steagall Act, a company that owns a member bank may not own or control "through stock ownership or in any other manner" a company that engages principally in distributing, underwriting, or issuing securities.[1] The Board has found that this provision prohibits affiliates of banks from sponsoring, organizing, or controlling a mutual fund. The Board previously has determined, however, that the Glass-Steagall Act does not prohibit a bank holding company from providing advisory and administrative services to a mutual fund.[2]

The proposed promotional and marketing activities would not, it was believed, cause the FBO to control the funds or to be involved in the underwriting and distribution of the funds' securities to the public. The proposed promotional activities involved contact only with financial intermediaries. The activities are similar to the activities previously approved by the Board. The Board had previously permitted bank holding companies to present information about the operations of the mutual funds advised and administered by the bank holding company at meetings or seminars for brokers of mutual funds.[3] In addition, the Office of the Comptroller of the Currency (OCC) had also authorized subsidiaries of national banks to provide marketing and advertising support to mutual funds in connection with their brokerage and advisory services.

As for the distribution and sales of the funds, it was proposed that an independent distributor be given that responsibility.[4] The independent distributor would serve as the principal underwriter of the funds and would enter into sales agreements with financial intermediaries to sell shares of the funds on their behalf.[5] Actual sales would be conducted by the independent distributor or by an independent broker–dealer for the funds.

The FBO did not propose to solicit retail customers to purchase shares in particular funds, to accept orders for the purchase of shares, or to engage in any retail sales activities. Neither the company nor any of its employees would receive transaction-based income or commissions in connection with the company's promotional or marketing activities.

The company would have primary responsibility for preparing the advertising and marketing materials. The independent distributor, however, would be responsible for placing all

1. 12 U.S.C. 221a and 377.

2. See 12 C.F.R. 225.28(b)(6) and 12 C.F.R. 225.125.

3. See 1993 FRB 626 (footnote 15).

4. The FBO committed that none of its U.S. affiliates, including the company, would be obligated by any agreement to engage in any sales activities with regard to shares of the funds, nor would such affiliates enter into any distribution agreement with the funds without the prior approval of the Board.

5. The funds could enter into distribution agreements with intermediaries, but in no event could the company enter into such agreements.

advertisements. The independent distributor would also have legal responsibility, under the rules of the Financial Industry Regulatory Authority (FINRA), for the form and use of all advertising and sales literature prepared by the company, and would also be responsible for filing these materials with the FINRA or SEC.

For the reasons cited, the Board believed that the promotional and marketing activities proposed by the FBO would not involve the company in the underwriting or distribution of shares of the funds for the purposes of the Glass-Steagall Act.

3600.28.2 MANAGEMENT INTERLOCK CONTROL CONSIDERATIONS

The FBO also proposed that the chief executive officer serve as the chairman of the four-member board of trustees of the funds and that no more than three officers or employees of the company serve as junior-level officers of the funds. The employees would serve as assistant secretary, assistant treasurer, or assistant vice president of the funds and would be supervised by the board of trustees or senior-level officers. These employees would have no policymaking authority at the funds and would not be responsible for, or involved in, making recommendations on policy decisions. No employee or officer of the company would serve as a senior-level officer of the funds.

The Board had previously authorized a bank holding company to have director and officer interlocks with mutual funds that the bank holding company advises or administers.[6] The Board concluded that the proposed interlocks between the company and the funds, in this case, would not compromise the independence of the boards of trustees of the funds, compromise the independent distribution of the funds, or result in control of the funds by the FBO.

Based on the facts given, the Board concluded that the control of the funds would rest with the independent members of the boards of trustees of the funds and that the proposed interlocks between the company and the funds would not compromise the independence of the boards of the funds or permit the FBO to control the funds. The Board concluded that the proposal was consistent with the Glass-Steagall Act. The notice was approved on June 16, 1997. See 1997 FRB 679, 1998 FRB 1075–77, 1998 FRB 852–853, and 1998 FRB 680–82.

6. See 1996 FRB 1129.

A bank holding company gave notice under section 4(c)(8) of the Bank Holding Company Act (BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its intention to engage de novo through its mortgage subsidiary in providing employment histories to third parties for a fee.

The employment histories to be provided by the mortgage subsidiary would include the names of past and current employers of an individual and the salary and length of employment for each position, if the individual has consented to the release of such information. The mortgage subsidiary would compile an individual's employment history from information available from state departments of employment services and other similar sources. This information would be provided for a fee to any third-party credit grantor for the purpose of assessing the creditworthiness of a prospective borrower.[1]

3600.29.1 CREDIT-RELATED EMPLOYMENT HISTORIES

The mortgage subsidiary will provide employment histories to third-party credit grantors, including depository and nondepository grantors, for use in making decisions to extend credit only with the express consent of the individual involved. The bank holding company committed that the mortgage subsidiary will comply with the Fair Credit Reporting Act (15 U.S.C. 1681 et seq.) (FCRA) and all applicable state and federal laws and regulations.

In the normal course of their lending activities, banks collect and analyze employment and salary information, including names of past and current employers and salary histories. The Board previously determined that providing past credit information, which includes employment history information, to a credit grantor who is considering a borrower's application for credit is an activity that is closely related to banking and permissible for bank holding companies.[2] Accordingly, the Board concluded that providing employment histories to third-party credit grantors for use in making decisions to extend credit is an activity that is closely related to banking.

3600.29.2 NON-CREDIT-RELATED EMPLOYMENT HISTORIES

The bank holding company also intends to provide employment histories to third-party depository institutions and their affiliates, including credit unions and their affiliates, for use in the regular course of their business, including the hiring of employees. The mortgage subsidiary would provide this information to such entities only with the express consent of the individual involved. Regardless of whether the customer is a third-party depository institution or other credit grantor, the activity would only involve providing employment information. The bank holding company does not plan to provide any additional service, such as analyzing an individual's creditworthiness. The bank holding company committed that its mortgage subsidiary will comply with the FCRA and all applicable state and federal laws and regulations in performing the proposed activity.

The Board had not previously determined whether providing such employment information to third parties for a fee is closely related to banking under section 4 of the BHC Act and, therefore, permissible for bank holding companies. The Board had previously permitted bank holding companies to provide employment information, including employment histories, to depository institutions and their affiliates in connection with the provision of career counseling services (see section 3600.15.1.1).[3] To the extent that these organizations use the information to be provided by the mortgage subsidiary for other purposes, it will only be used in connection with the operation of their banking business.

The Board thus concluded that providing employment histories for use by depository institutions and their affiliates in the regular course of their business is an activity that is closely related to banking. For these reasons, the Board, on May 8, 1995, approved the bank holding company's notice to provide such employment information (1995 FRB 732). The

1. Credit grantors could include lessors if the leasing transaction was the functional equivalent of an extension of credit.

2. See Regulation Y, section 225.25(b)(24) (12 C.F.R. 225.25(b)(24)). The bank holding company committed that it would not promote its mortgage subsidiary as a provider of employment information to non–depository institutions for general business purposes unrelated to credit decisions.

3. See 1994 FRB 51.

approval was specifically conditioned on compliance with the commitments made in connection with the notice.

3600.30.1 REAL ESTATE TITLE ABSTRACTING ACTIVITIES

A bank holding company (the notificant) gave notice under section 4(c)(8) of the Bank Holding Company Act (the BHC Act) (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its intention to acquire a title abstracting company (the company) and thereby engage in real estate title abstracting in the state of Iowa.[1] Real estate title abstracting, as proposed by the notificant, is limited to reporting factual information concerning the interests or ownership of selected real property. An abstracter obtains this information by performing a title search of records maintained at a local public records office to determine the ownership history of the property, including any liens, encumbrances, mortgages, or future interests affecting it. The abstracter then prepares a written report, also known as an "abstract of title," that recites the results of the title search. Because Iowa state law does not permit the sale of title insurance, real estate lenders obtain the opinion of an attorney certifying that title to a particular parcel of real property is free of defects. The abstract of title provides the factual information necessary for the attorney to determine whether a lender would have an unencumbered security interest in the property to be mortgaged.

The notificant proposes to provide real estate title abstracting services to affiliated and unaffiliated lenders in an Iowa county. The company would perform the proposed activities in connection with real estate loans made by affiliates or unaffiliated companies and, in certain cases, when no financing is provided, such as in connection with intrafamily transfers of real estate and property distributed as part of estate planning.

The notificant would not provide any insurance against title defects, guarantee any title, or provide any certification with respect to a title. The notificant would be liable for damages caused by negligence in performing a title search but would not be responsible for any defects in the title.[2] The equivalent of title insurance in Iowa is provided by the attorney who certifies that the title is free from defects. The Board has not previously determined that providing real estate title abstracting is closely related to banking under section 4(c)(8) of the BHC Act and, therefore, permissible for bank holding companies.

The Board believes that the proposed real estate title abstracting activities are integrally related to the provision of loans secured by real estate. A bank must be aware of any encumbrances on property that serves as collateral for a loan made by the bank. Banks in the state typically rely on an attorney's opinion, based on information in an abstract of title, to determine that they have a secured position in real estate serving as collateral. The abstract of title provides information necessary to determine the adequacy of the real estate collateral for the loan and is an integral part of secured real estate lending in Iowa. Thus, the bank has a particular need for the information in the abstract of title. Accordingly, the Board believes that the proposed activities are integrally related to the provision of secured real estate lending and, therefore, are closely related to banking.

The Office of the Comptroller of the Currency (OCC) has authorized national banks to conduct this activity.[3] The OCC has concluded that the performance of a title search and the preparation of an abstract of title are necessary parts of the real estate lending process and that it would be convenient and useful under the applicable standards in the National Bank Act for national banks to be able to perform these tasks themselves.[4]

The proposed activities are not equivalent to providing title insurance—an activity that is not generally permissible under section 4(c)(8) of the BHC Act.[5] Title insurance generally includes providing an indemnification against losses resulting from a title defect discovered after the conveyance of property. Title insurance typically protects a purchaser or lender against claims not identified by a title search or claims not specifically exempted by the title insurance policy. The notificant does not propose to certify or guarantee title and would not be liable to the purchaser or the lender for any title defects.

1. The notificant would merge the company into its wholly owned leasing subsidiary.
2. Title abstracters may insure against liability for negligence by purchasing an errors and omissions policy.
3. OCC Interpretative Letter No. 450, September 22, 1988.
4. National banks are not permitted to sell title insurance.
5. Section 4(c)(8) provides that insurance agency, brokerage, and underwriting activities are not "closely related to banking" and, thus, are not permissible activities for bank holding companies, unless the activities are included within one of seven specific exemptions (A through G) in section 4(c)(8) (12 U.S.C. 1843(c)(8)(A)–(G)).

The Board concluded, based on all the facts of record, that the proposed activities are closely related to banking and approved the notice on June 30, 1995. (See 1995 FRB 805.) Approval of the proposal was specifically conditioned on the notificant's compliance with the commitments made in connection with the notice.

3600.30.2 AIRCRAFT TITLE ABSTRACTING ACTIVITIES

An attorney representing a bank holding company (BHC) requested an opinion as to whether the providing of title abstracts on U.S.-registered aircraft would be a permissible activity for a new subsidiary of a BHC. The aircraft title abstracting activities would be limited to reporting factual information concerning the ownership history of the relevant aircraft and the existence of liens or encumbrances affecting the aircraft. The information would be obtained by performing a title search of records. The title search would be documented in a written report, known as an "abstract of title," describing the factual information located by the title search concerning the existing title owner of the aircraft, previous transfers of the aircraft's title, and the existence of any liens or encumbrances affecting title to the aircraft.[6] The subsidiary would provide the information to affiliated and unaffiliated lenders and other parties in connection with aircraft financing and sales transactions. The aircraft title abstracting activities would not include providing insurance against defects in the title of any aircraft, guarantee any aircraft title, or provide any certification with respect to an aircraft title. Based on facts and information provided and other facts, the Legal Division staff issued an opinion on October 7, 2002, that concluded that the proposed aircraft title abstracting to be conducted by the subsidiary would be within the scope of the title abstracting activities previously authorized by the Board on June 30, 1995. (See 1995 FRB 805, 806.)

6. The attorney requesting the opinion reported that federal law requires that all changes in title of, and liens and encumbrances affecting, U.S.-registered aircraft must be filed with the Federal Aviation Administration.

A bank holding company (BHC), that has elected to be a financial holding company within the meaning of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.) (the BHC Act) inquired if it would be permissible under the BHC Act and the Board's Regulation Y (12 C.F.R. 225) for the BHC to engage in ''commodity purchase and forward sale'' (CPFS) transactions as a method of financing the commodity inventories of its customers.[1]

Two alternative structures were described for the CPFS transactions. In the first structure, the BHC would purchase a commodity from its customer and simultaneously enter into a forward sale agreement under which the customer would be obligated to repurchase the commodity from the BHC at a predetermined price on a predetermined future date. The second structure is similar to the first structure except that it would involve a third party, either as the initial seller of the commodity to the BHC or as the ultimate purchaser of the commodity from the BHC. During the term of a CPFS transaction, the BHC would hold title to the underlying commodity, would mark the commodity to market on a daily basis, and would call for additional margin if the market value of the commodity falls below a specific collateral threshold.

The BHC Act permits bank holding companies to engage in any activity that the Board had determined by regulation or order as of November 11, 1999, ''to be so closely related to banking as to be a proper incident thereto.''[2] The Board had determined by regulation issued prior to November 11, 1999, that ''[m]aking, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit and accepting drafts) for the company's account or for the account of others'' is such an activity.[3]

Under the proposed CPFS transactions, the BHC would earn a fixed return on a CPFS transaction, just as it would on an ordinary secured loan, and its risk exposure would effectively be limited to counterparty credit risk. The BHC would subject any prospective CPFS counterparty to the same credit-review process used for loan applicants, and the BHC's internal credit-review personnel would also review outstanding CPFS arrangements. As proposed, the BHC would never enter into an agreement to purchase a commodity unless it simultaneously enters into an agreement to sell the commodity to a creditworthy counterparty on a fixed future date at a fixed price. The BHC indicated that a fixed future sale price would be equal to the initial purchase price plus a fixed interest component (and thus would not vary based on movements in the price of the commodity). In other words, unless the ultimate purchaser defaults, the BHC would be repaid its principal plus a fixed amount of interest at maturity of the transaction. In addition, the BHC would not bear any commodity price risk; the price it would receive for the commodities on the maturity date of the transaction would be fixed on the date it enters into the transaction. If the ultimate purchaser defaults on its obligation to purchase the underlying commodity upon maturity, the BHC would have a claim against this purchaser to recover the equivalent of principal and interest. The BHC could then sell the commodity into the market to mitigate credit losses in the same manner as it would liquidate any collateral supporting a loan in default. Any commodities acquired by the BHC as a result of counterparty default would be held in accordance with the limits applicable to assets acquired by a BHC in the course of collecting a debt previously contracted.[4]

Moreover, the BHC represented that all non-price risks and costs of owning the commodity during the term of the CPFS transaction, such as storage risk and the cost of insurance, would be borne by the ultimate purchaser. In all cases, although the BHC would take title to the underlying commodity at the inception of a CPFS transaction, it would take title in the form of a warehouse receipt only; that is, the commodity would continue to be stored in a licensed warehouse owned and operated by an entity other than the BHC. The commodity would not be physically moved as a result of the transaction. The BHC would acquire title to the underlying commodity in a CPFS transaction as an incident

1. The BHC indicated that the commodities involved in these transactions would include agricultural commodities (such as corn, wheat, soybeans and other legumes, cotton, cocoa, coffee, sugar, various oilseeds and oils, and dairy products), live cattle, timber, and exchange-traded metals. The BHC's CPFS transactions would, in all cases, involve commodities (1) for which contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission or (2) which the BHC can show, to Board staff's satisfaction, have readily-available price quotes and are traded regularly in global commodity markets.

2. See 12 U.S.C. 1843(c)(8).

3. See 12 C.F.R. 225.28(b)(1).

4. See 12 C.F.R. 225.22(d)(1).

to the financing it provides to its customers and not for speculative purposes. The BHC represented that the BHC does not and will not hold itself out as making a market in the commodity. In addition, the BHC also represented that the BHC does not and will not (1) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities or (2) process, refine, or otherwise alter commodities.

The BHC would account for the CPFS transaction as an "asset purchased under an agreement to resell" and would recognize profit and loss on the transaction on an accrual basis, in a manner similar to a traditional loan. During the term of the transaction, the ultimate purchaser counterparty in a CPFS transaction would generally record the underlying commodity as an asset on its balance sheet and would record its obligation to purchase the commodity as a short-term debt liability.

The interpretation noted that the Board had previously found a three-party commodity financing arrangement similar to the BHC's proposed three-party CPFS transactions to be an extension of credit permissible for BHCs under Regulation Y. In a 1973 order, the Board approved as a permissible lending activity for bank holding companies an arrangement under which a BHC would finance a utility's coal purchases by purchasing from a third party, and taking title to, a quantity of coal on a monthly basis at the direction of the utility customer. (See 1973 FRB 698.) The BHC would store the coal on the premises of the utility under a lease arrangement with the utility. The utility would use the coal continuously throughout the following month and would pay the BHC monthly for the amount of coal used, at a price equal to the BHC's acquisition cost for the coal plus a fixed amount of interest. The utility explicitly bore the risk of loss or damage to the coal during storage. If the utility defaulted, the BHC had the right to sell the coal to cover its losses and the right to sue the utility for any shortfall in the liquidation proceeds. As with the proposed CPFS transactions, the utility's motive for the transaction was to obtain financing for its commodities inventory.

Based on the information the BHC provided and the Board's precedents, Board legal staff opined that the proposed CPFS transactions are within the scope of permissible lending activities for BHCs under section 225.28(b)(1) of Regulation Y. The BHC should have policies and procedures to identify whether a CPFS transaction would create heightened legal or reputational risk to the BHC, and to manage any such risk. In particular, the BHC should have policies and procedures to identify whether a particular CPFS transaction (1) lacks economic substance or business purpose; (2) may be designed by the counterparty for questionable accounting, regulatory, or tax purposes; or (3) may be accounted for or disclosed by the counterparty in a way that is misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

The Board legal staff's opinion is limited solely to the permissibility of the proposed CPFS activities described above under Regulation Y and does not address the permissibility of any other activities or authorize the BHC to engage in any other activities in the United States. (See the Board's staff legal interpretation dated May 15, 2006.)

A foreign bank (that qualifies as a financial holding company under section 4(k) of the BHC Act and is treated as a bank holding company (BHC) under section 4(c)(9) of the BHC Act requested a confirmation from the Board's legal staff on whether certain volumetric-production-payment (VPP) transactions involving physical commodities would be considered as extensions of credit that are permissible for a BHC under section 4(c)(8) of the BHC Act and section 225.28(b)(1) of the Board's Regulation Y.[1]

In 2004, the Board approved a proposal by the BHC to engage in physical-commodity trading as an activity that is complementary to the BHC's commodity derivatives activities.[2] The order limited the value of physical commodities that the BHC may hold under this authority to 5 percent of the BHC's tier 1 capital. The BHC also requested confirmation that VPP transactions and any physical commodities delivered to the BHC under a VPP would not count against the 5 percent of tier 1 capital limit.

A VPP is a royalty interest, typically in a hydrocarbon (such as oil or natural gas) reserve that entitles the VPP holder, in exchange for an upfront payment, to receive specified quantities of hydrocarbons on a regular basis during the life of the VPP transaction. A VPP is considered to be a real property interest in most states. Relying on its physical-commodity trading authority, the BHC had already entered into two VPP transactions in the United States. In each of these transactions, a wholly owned, consolidated, U.S. special-purpose-vehicle subsidiary of the BHC (the SPV) had acquired a VPP from a hydrocarbon producer (the customer) in exchange for cash.[3] The VPP transactions are designed to provide funding to the customers. The VPP does not give the BHC the right to control production of the oil or gas, and the BHC is therefore dependent on the customer meeting its contractual obligation to produce the agreed-upon volume of oil or gas according to the agreed-upon schedule.

Simultaneously with its purchase of the VPP interest from the customer, the SPV and the BHC enter into an agreement under which the BHC makes an upfront payment to the SPV and the SPV agrees to deliver to the BHC the volumes of oil or gas to be received by the SPV from the customer under the VPP. As the SPV delivers the oil or gas to the BHC under this agreement, the BHC arranges to sell it, either back to the customer or into the marketplace, at the then-current market price for the commodity.

The BHC also may decide to temporarily retain hydrocarbons it acquires pursuant to a VPP in order, for example, to take advantage of an anticipated rise in price for the relevant commodity. The BHC agreed that any hydrocarbons acquired under a VPP will be counted against the BHC's 5 percent of tier 1 capital limit under the order if they are not immediately sold to a third party. The BHC represented that it hedges its commodity-price risk from the VPP by entering into a fixed-rate commodity swap with a third party (which may be the customer) that converts the BHC's variable proceeds from the periodic sale of the oil or gas into fixed-rate payments. Accordingly, in the absence of counterparty defaults, by the end of the VPP term the BHC will have recouped the original amount advanced to the customer plus a fixed return.

The BHC stated that the VPP transactions generally are treated as loans for U.S. federal income tax purposes. In addition, the BHC indicated that it will treat VPP transactions as loans for accounting purposes. Board staff stated that it expects (1) the BHC will follow generally accepted accounting principles in reporting any VPP transactions and (2) all of the BHC's VPP transactions will be entered into for legitimate business purposes.

The BHC argued that a VPP transaction is very similar to a traditional lending arrangement because the discounted present value of the hydrocarbons to be delivered to the BHC over the life of a VPP transaction is estimated to equal the purchase price paid by the BHC for the VPP interest plus a margin meant to cover the BHC's cost of funds, risk associated with the transaction, and a fixed profit. Importantly, the VPP does not give the BHC any variable upside potential if there is excess production from the producer's hydrocarbon reserve.[4] Moreover, the commodity-price swap hedges the BHC's commodity-price risk associated with the VPP, thus guaranteeing the BHC a return of principal and a fixed amount of interest if nei-

1. 12 C.F.R. 225.28(b)(1).
2. See 2004 FRB 215.
3. [TEXT REDACTED]

4. If the reserve produces more hydrocarbons than are subject to the VPP, the production is for the benefit of the producer. If the reserve underproduces in a given period during the life of the VPP, the BHC would be entitled to an appropriate amount of overproduction in subsequent months (and extra reimbursement to reflect default interest).

ther the producer nor the swap counterparty defaults. Accordingly, the VPP transactions are not designed to serve as a vehicle for the BHC to take on commodity-price risk, own commodities, or engage in commodity dealing.[5]

As described above, as part of a VPP transaction, the BHC will hold a royalty interest in a hydrocarbon reserve and will periodically take title, if only momentarily, to physical commodities. The Board has previously concluded, however, that ownership of commodities in connection with a financing transaction does not prevent the transaction from being treated as a form of credit extension permissible for a BHC if the economics of the transaction are substantially the same as those of a loan.[6]

Based on the information provided by the BHC's counsel, Board legal staff opined that the above-described VPP transactions are a form of permissible lending activity for BHCs under section 225.28(b)(1) of Regulation Y when entered into for the purpose of providing financing to a third-party customer. Any commodities that the BHC receives pursuant to a VPP transaction and that are not immediately sold to third parties would be subject to the 5 percent of tier 1 capital limit on the value of commodities that the BHC may hold under its physical-commodity-trading authority.

The staff opinion informed the BHC that it should have in place policies and procedures to (1) identify whether a VPP transaction would create heightened legal or reputational risk to the BHC and (2) manage any such risk. In particular, the BHC should have policies and procedures to identify whether a particular VPP transaction (1) lacks economic substance or business purpose; (2) may be designed by the counterparty for questionable accounting, regulatory, or tax purposes; or (3) may be accounted for or disclosed by the counterparty in a way that is misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

The staff opinion is limited solely to the permissibility of the VPP transactions described in the opinion under Regulation Y. The opinion does not address the permissibility of any other activities or authorize the BHC to engage in any other activities in the United States. (See the Board legal staff's opinion dated May 15, 2006.)

5. As noted above, the BHC has the authority to engage in physical-commodity trading, including making and taking delivery of physical commodities, and may use this authority to retain ownership of hydrocarbons delivered under a VPP in order to benefit from anticipated changes in hydrocarbon prices.

6. See 1973 FRB 698.

The BHC Act states that a nonbank activity is impermissible unless explicitly exempt from the general prohibition of section 4. While this could cause an unlimited list of impermissible activities, the Board has compiled a list of activities which have been specifically determined to be impermissible (see Manual section 3000.0, Appendix 3).

The inspection objective is to determine whether a specific activity conducted by a bank holding company or its subsidiary is permissible for the bank holding company. The Board has ruled specific activities to be impermissible although it has stated also that certain impermissible activities may be engaged in under limited special circumstances.

In addition, a bank holding company may be entitled to grandfather privileges which are considered as either permanent (where there is no deadline for termination of an activity) or temporary, in which case the activity must have been terminated prior to December 31, 1980. A holding company may be granted an exemption from section 4 of the Act (i.e., family, hardships, etc.) which allows it to engage in activities that would otherwise be impermissible. Because of the variety of factors which must be considered, the examiner should exercise care when determining the permissibility of an activity for a bank holding company.

The subsections of this chapter present a *selected number* of those activities which have been determined to be impermissible for bank holding companies. While an activity is permissible only after it has been determined as such by the Board, it must be remembered that in determining permissibility, the Board has in some instances (i.e., data processing services, courier services, etc.) included restrictions which would limit the overall nature or performance of the activity. Therefore, even the permissible activities may become impermissible if the actions of the bank holding company are not in accordance with the stated restrictions.

The Board of Governors has ruled that land development[1] is impermissible for bank holding companies. However, for land acquired through foreclosure, a limited amount of development may be allowed in an effort to minimize the potential loss on the project. Each case must be considered separately to determine if it warrants additional development.

The basic determination of impermissibility was established by the Board in denying a portion of the application by UB Financial Corp., Phoenix, Arizona, to retain the H. S. Pickrell Company, Phoenix, Arizona (1972 FRB 429). The order stated in part, "The Board is of the opinion that the activities of purchasing and selling of land or participating as a joint venturer in real estate development are not so closely related to banking as to be a proper incident thereto, and that insofar as the application pertains to those activities, it should be denied."

The determination that limited development for land acquired through foreclosure is permissible is contained in a Board order dated November 1, 1973, in connection with an application by Liberty National Corporation, Oklahoma City, Oklahoma, to retain Liberty Mortgage Company, Oklahoma City, Oklahoma (1973 FRB 919), in which it is indicated that a limited amount of real estate development might be permissible if necessary to minimize losses on real estate acquired in connection with debts previously contracted.

1. The Board, by specific order, has permitted a limited incursion into this area as an accommodation to BHCs acquiring thrifts or to thrifts that qualify as "banks" and seek to form bank holding companies (1986 FRB 487, 731)

3700.2.1 PREMIUM FUNDING

Insurance premium funding, sometimes known as equity funding, is the financing of the sales of mutual fund shares and life insurance policies as a package. It should not be confused with loans made to an insured for the purpose of paying premiums on hazard insurance (insurance premium financing); in that case the lender may be named loss payee or owner of the policy and the lender has the right to submit the policy for cancellation in order to collect the amount owed. Insurance premium financing is a permissible activity pursuant to Section 225.25(b)(1) of Regulation Y (Refer to 1974 FRB 310).

The Board has determined insurance premium funding to be impermissible for bank holding companies (12 C.F.R. 225.126). This determination is based on the policies contained in sections 20, 21, and 32 of the Banking Act of 1933 (the Glass–Steagall Act Provisions) as described in the opinion of the United States Supreme Court in Investment Company Institute v. Camp, 401 U.S. 617 (1971).

''In the Board's opinion, the Glass–Steagall Act provisions, as interpreted by the U.S. Supreme Court, forbid a bank holding company to sponsor, organize or control a mutual fund'' (12 C.F.R. 225.125). In enacting the Glass–Steagall Act, Congress indicated that affiliations of commercial banks and securities companies give rise to a potential conflict of interest and unsound banking practices. Pursuant to section 4(c)(8) of the Act, the Board is required to consider whether the performance of a particular nonbank activity by a holding company produces benefits to the public that outweigh possible adverse effects, such as potential conflict of interest and unsound banking practices. Therefore, the potential conflict of interest and unsound banking practices arising in the affiliation of commercial banks and mutual funds precludes the Board from approving insurance premium funding as a permissible banking activity.

3700.2.2 LIFE INSURANCE UNDERWRITING

The life insurance discussed in this section is that life insurance which is not sold in connection with a credit transaction by a bank holding company or its subsidiary. The Board has ruled that this activity is impermissible for bank holding companies (12 C.F.R. 225.126). The Board developed its position during consideration of the application of First Oklahoma Bancorporation, Inc., Oklahoma City, Oklahoma, for prior approval pursuant to section 4(c)(8) of the Act to acquire sufficient additional shares of Underwriters Life Insurance Company, Oklahoma City, Oklahoma, so as to own at least 80 per cent of the outstanding shares and thereby to engage in the activity of underwriting life insurance not sold in connection with a credit transaction by a bank holding company or a subsidiary.

In acting on the First Oklahoma application, the Board relied on an earlier decision denying an application by Transamerica Corporation, San Francisco, California, to retain its shares of Occidental Life Insurance Company of California (1957 FRB 1014). In the Transamerica case, a hearing examiner found that the life insurance underwriting activities of Occidental were not so closely related to banking to be a proper incident to managing and controlling banks. In the First Oklahoma case, the application was presented on the question of whether the activities of Underwriters Life were so closely related to banking or managing or controlling banks as to be a proper incident thereto. The Board determined in First Oklahoma, that there was no reasonable basis for the contention that the activities of Underwriters Life were permissible.

The activity of acting as an underwriter (reinsurer) for credit life and credit accident and health (disability) insurance is, however, considered a permissible activity (12 C.F.R. 225.135).

3700.2.3 SALE OF LEVEL-TERM LIFE INSURANCE

The Board has stated that the sale of level-term life insurance is not covered by section 225.25(b)(8)(ii) of Regulation Y. This position was stated in its order approving the application by Fidelity Corporation of Pennsylvania, Rosemount, Pennsylvania, to acquire Local Finance Corporation, Providence, Rhode Island, excepting those proposed activities of level-term life insurance sales (1973 FRB 472). Insurance that does not decline in coverage as the outstanding loan balance is reduced results in the insured party carrying more insurance than is necessary to cover the outstanding loan balance. Because of this position, the Board would not allow the sale of this type of insurance by the applicant and its subsidiary.

3700.2.4 UNDERWRITING REAL ESTATE MORTGAGE GUARANTEE INSURANCE

Mortgage guaranty insurance is essentially a limited guarantee of a mortgage loan. Such insurance typically covers the top 20 or 25 percent of a mortgage loan. In the event of default by the borrower, the lender acquires title to the property and then submits a claim to the insurer. The insurer then has a choice of two options: (1) take title to the property and pay the lender the unpaid principal and interest; or (2) pay the lender the 20 or 25 percent insured portion of the loan, with the lender retaining title to the property.

The Board has determined that "the underwriting of mortgage guarantee insurance is principally a credit determination, similar to those made by banks in their regular course of business" (1974 FRB 727). Therefore, this activity is considered closely related to banking for purposes of permissibility under section 4(c)(8) of the Act. However, the Board noted that the private mortgage insurance industry was relatively young and still developing with a limited, untested, operating history. In addition, the Board believed that the times were such that it was "desirable for bank holding companies generally to slow their present rate of expansion and direct their energies toward strong and efficient operations within their existing activities, rather than toward expansion into new activities" (the go-slow policy), and, therefore, concluded that it would not be appropriate to adopt the underwriting of mortgage guarantee insurance as permissible for bank holding companies.

3700.2.5 UNDERWRITING PROPERTY AND CASUALTY INSURANCE

On May 12, 1978, the Board denied NCNB Corporation's application to retain its indirect subsidiaries, Superior Insurance Company and Superior Claim Service, both of Florence, North Carolina. These companies engaged, respectively in the activities of underwriting property and casualty insurance related to extensions of credit by NCNB's affiliates, in adjusting insurance claims and in appraising and valuing property in connection therewith. Neither of these activities had previously been determined by the Board to be closely related to banking. The Board concluded that the circumstances presented did not provide a reasonable basis for believing that the proposed activity was closely related to banking or managing and controlling banks (1978 FRB 506).

3700.2.6 TITLE INSURANCE

The Board issued a letter (See Board letter re Independence Bancorp, Inc., dated 3/17/86) to a bank holding company which filed an application with the Board to acquire a *de novo* title abstract company which planned to engage in, among other things, the sale of title insurance. The sale of title insurance had not been previously approved by the Board as a permissible nonbanking activity. In responding to the application, the Board determined that the proposed title insurance activities were not closely related to banking.

The Board's discretion to decide what types of insurance activities are closely related to banking was removed by the Garn–St Germain Depository Institutions Act of 1982 ("Garn Act"), which amended section 4(c)(8) of the BHC Act. The Garn Act stated that "it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent, or broker. . . ." The Garn Act lists certain specific exceptions to this general prohibition, none of which permits the sale of title insurance. The Board thus concluded that the Garn Act does not allow it the discretion to approve this type of nonbanking activity.

3700.3.1 BROKERAGE

Real estate brokerage is the negotiating of a real estate contract between a buyer and seller for which the broker receives a fee or commission and in which the broker takes no possessory interest in the subject matter of the contract. The Board has stated that this activity is considered impermissible for bank holding companies. The Board's position was expressed in its order approving an application by Boatmen's Bancshares, Inc., St. Louis, Missouri, to acquire Williams, Kurrus and Company, St. Louis, Missouri (1972 FRB 428). The Board stated that it had determined that real estate brokerage activities were not so closely related to banking or managing or controlling banks as to be a proper incident thereto. Since Boatman's had not demonstrated to the Board's satisfaction that the real estate brokerage field activities are so closely related to banking or managing or controlling banks as to be a proper incident thereto, the Board approved the Boatman's application on the condition that Boatman's terminate its real estate brokerage activities.

3700.3.2 SYNDICATION

The Board ruled that this activity is not permissible for bank holding companies. The Board's position was developed during consideration of the application of BankAmerica Corporation, San Francisco, California, for prior Board approval to engage *de novo* under section 4(c)(8) of the Act in the activity of real estate syndication through a subsidiary, BankAmerica Realty Services, Inc., San Francisco, California. The Board concluded that the subsidiary's proposed activities of organizing, promoting, selling partnership interests, and acting as the sole general partner of real estate syndicates went beyond the functions performed by an advisory company to a real estate investment trust permissible under section 225.25(b)(4) of Regulation Y.

The Board also stated that it felt that the policies contained in sections 20 and 32 of the Banking Act of 1933 (the Glass–Steagall Act Provisions) must be considered in conjunction with section 4(c)(8) of the Act. These policies, described in the opinion of the United States Supreme Court in Investment Company Institute v. Camp, 401 U.S. 617 (1971), forbid a bank holding company to sponsor, organize or control an open-ended investment company (mutual fund) or a closed-end investment company primarily or frequently engaged in the issuance, sale and distribution of securities. Because the activities of real estate syndication resemble the issuance, sale and distribution of securities of a closed-end investment company, this activity is not permissible for a bank holding company (12 C.F.R. 225.125).

The Board has stated that general management consulting is not so closely related to banking or managing or controlling banks as to be a proper incident thereto. This ruling is contained in the Board's order denying the application of First Commerce Corporation, New Orleans, Louisiana, to acquire W. R. Smolkin & Associates, Inc., New Orleans, Louisiana. In its order the Board describes general management consulting as follows:

"... including, but not limited to, the provision of analysis or advice as to a firm's (i) purchasing operations, such as inventory control, sources of supply, and cost minimization subject to constraints; (ii) production operations, such as quality control, work measurement, product methods, scheduling shifts, time and motion studies, and safety standards; (iii) marketing operations, such as market testing, advertising programs, market development, packaging, and brand development; (iv) planning operations, such as demand and cost projections, plant location, program planning, corporate acquisitions and mergers, and determination of long-term and short-term goals; (v) personnel operations, such as recruitment, training, incentive programs, employee compensation, and management-personnel relations; (vi) internal operations, such as taxes, corporate organization, budgeting systems, budget control, data processing systems evaluation, and efficiency evaluation; or (vii) research operations, such as product development, basic research, and product design and innovation." (1972 FRB 674) The Board denied the case and determined that the activity of providing general management consulting services could lead to unwanted conflict of interest situations for BHCs that advised clients that were also customers of its own subsidiary banks. The Board also desired to maintain a distinct separation between banking and commerce.

In its order denying the application of Marine Midland Banks, Inc., Buffalo, New York, to acquire Carter H. Golembe Associates, Inc., Washington, D.C., the Board further defines the concept of management consulting by stating that Golembe, "... provides consulting services on a confidential basis to banks, bank holding companies and bankers' associations. It makes bank feasibility studies and renders advice with respect to geographic expansion, product extension, mergers and acquisitions and applications to State and federal regulatory agencies. A portion of Golembe's consulting services also relates to internal bank operations, such as marketing, trust and bank credit card operations and loan or interest rate policies. Other studies and analyses are performed upon request of individual banks. Golembe also provides advice with respect to the organization and operation of State Bankers' associations and serves as a consultant to various banking groups with respect to legislative and regulatory matters affecting the banking industry. The foregoing consulting services furnished by Golembe are considered by the Board to be but a specialized form of management consulting." (1972 FRB 676)

Management consulting to nonaffiliated commercial banks and nonbank depository institutions has been determined by the Board to be a permissible activity for bank holding companies under section 4(c)(8) of the Act (Regulation Y, section 225.25(b)11, as amended).

The Board has ruled that this activity is impermissible for bank holding companies. However, bank holding companies may conduct property management activities for three types of property as follows:

1. Property held in a fiduciary capacity;
2. Property owned by the holding company or its subsidiary for its own bank and bank-related operations;
3. Property acquired by the holding company or its subsidiary as a result of a default on a debt previously contracted.

The Board announced on June 30, 1972, that it would not include this general activity on the list of permissible activities. Because the Board did not intend to limit any authority given by statute or regulation to a holding company or its subsidiary concerning property management, the Board described in its order the three types of property, as shown above, for which a holding company or its subsidiary could engage in property management activities (1972 FRB 652).

In addition to the prohibition of property management activities in general, the Board has ruled that the operation of a commercial parking lot is impermissible. In its order approving the application by Multibank Financial Corporation, Boston, Massachusetts, to acquire the B. M. C. Durfee Trust Company, Fall River, Massachusetts, a commercial bank, the Board stated that operating a commercial parking lot was not considered closely related to banking and conditioned its approval on divestment of the parking lot operation (1973 FRB 679).

The Board through its rulemaking authority did not include operating a travel agency on the list of permissible activities for bank holding companies. This activity is considered not to be closely related to banking or managing or controlling banks (1976 FRB 148). The Board referenced a decision of the United States Court of Appeals for the District of Columbia, Courier Association vs. Board, 516 F. 2d 1229 (1975).

The Board felt the only relevant criteria for this activity was whether banks have generally provided the service. The Board noted that there were few bank-affiliated travel agencies, most of which had only been recently established. The Board concluded that operating a travel agency was not closely related to banking.

On June 1, 1978, the Comptroller of the Currency issued Banking Circular No. 108, which requested all national banks then operating travel agencies, to divest themselves of those agencies within a reasonable period of time not to exceed three years. The Comptroller's office concluded that the continued operation of a travel agency by a national bank is inappropriate and may expose the bank to a substantial risk of loss by litigation. This action by the Comptroller precludes bank holding companies from relying on section 4(c)(5) of the Act to conduct travel agencies. Thus, holding companies have no authority to engage in travel agency activities under the Act unless grandfathered.

On April 2, 1979, the Board issued a letter, a copy of which went directly to all bank holding companies engaging in the activity of operating a travel agency pursuant to section 4(c)(5) of the Act, indicating that no bank holding companies could engage in the activity solely pursuant to section 4(c)(5) and that those engaged in such activity had to terminate the activity by December 31, 1980 (Z–8421 on office copy only).

Subsequently, a bank holding company applied to the Board to acquire a company (''Company'') that engages in a variety of data processing and data transmission activities for customers. The Company's data bases that are provided to customers included a program by which customers could receive airline and hotel information and could make airline and hotel reservations. The Board determined that the receipt of such information and the ability to make airline and hotel reservations was not closely related to banking. Accordingly, the Board required, as a condition for approval of the application, the bank holding company to eliminate the travel reservation service from the roster of third party data base programs provided by Company (Refer to 1986 FRB 497).

As part of the Security Pacific Corporation's (bank holding company) application to acquire Duff & Phelps, Inc. (Company), which engaged in investment advisory, investment management, and financial advisory services, the Board, on December 11, 1984, denied the Applicant's request to engage in the activity of providing credit ratings on bonds, preferred stock and commercial paper. Private credit ratings were included as part of the investment research reports sold to institutional investors. The Company also provided credit ratings on a fee basis for companies that request public disclosure. As part of the public rating process, the rated company is given the opportunity to make a presentation to the Company's Credit Rating Committee.

In this situation, the Security Pacific Corporation had a vested interest in the ratings of the corporations to which it lends in the ratings of municipal bonds it underwrites, in the ratings of the commercial paper and municipal bonds for which it provides backup lines of credit, and in the ratings of fixed-income securities which it holds for trades. Numerous potential conflicts existed such as: possible inadvertent releases of confidential information obtained during the credit rating process; the advance release to the Applicant of credit ratings for companies to which the Applicant had very large loans outstanding; the potential for pressures by the Applicant on the Company to modify favorably the credit rating of one of the Applicant's major customers; and the subtle pressure on the Company's staff resulting from ownership by Applicant about companies in which the Applicant had a substantial interest. Similar conflicts could have also arisen between the Company's credit rating function and the Applicant's investment of trust assets.

The Applicant acknowledged the potential conflicts but argued that various steps could be taken to ameliorate them and bring them within a manageable framework. The Applicant therefore proposed a number of techniques for isolating the credit rating activities of the Company from influence by the Applicant, including the establishment of a separate corporation with a number of independent directors, a prohibition on contacts between the Applicant and the members of the Company's Credit Rating Committee, and also certain record keeping requirements for that committee.

The Board considered these positive suggestions as well as others to assure full disclosure of the relationships between the Applicant and any of the companies that would be rated by the Company as well as a prohibition on the Company rating the Applicant's securities, securities which the Applicant has underwritten, or securities for which the Applicant provided a guarantee or backup letter of credit. The Board, however, believed that the conflicts in the relationship between a major lender and a credit rating company were so pervasive that they could not be overcome through adoption of an information barrier. The employees of the Company would inevitably be aware of interests of the Applicant in firms being rated by them and, it seems reasonable to assume that this knowledge could, at times, influence their decisions.

The Board's concerns regarding conflicts of interest with respect to the credit rating activity were not based on any doubts regarding the integrity of the parties to the application, but rather were based on the Board's responsibility to assess the possible adverse effects that might be associated with an affiliation between a bank holding company and a public credit rating organization. Thus the Board was acting in furtherance of one of the general purposes of the Bank Holding Company Act, "to prevent possible future problems rather than to solve existing ones." The Board, in view of the pervasive conflicts of interest between the Applicant's existing operations and the Company's credit rating business, decided against approving the performance of public credit ratings.

Currency options are a new and innovative aspect of foreign exchange. A currency option represents the contractual right (but not the obligation) to purchase or sell a predetermined amount of currency at a specific price at any time before a specific date. Currency-options advocates argue that currency options eliminate the risk of a loss due to exchange movements and give the holder a chance to profit if the currency fluctuation is favorable. They require a premium to be paid when the contract is entered into. The premiums can run from about 1.5 percent to 5 percent, depending on the expiration date and the exercise price of the option.

Currency options are traded on two types of markets: the over-the-counter, or interbank market, and on three regulated exchanges, the Chicago Mercantile Exchange (CME), the Chicago Board Options Exchange (CBOE), and the Philadelphia Exchange (PHLX). The CBOE, a securities exchange, uses multiple "market makers" instead of specialist positions; the CME, a commodities exchange, like other commodities exchanges, does not use specialist positions.

Most of the writing of currency options is currently done by banks which will customize the option, with maturity dates and currency values in excess of the standardized exchange contracts. Banks developed the over-the-counter market where they trade currency options among themselves, and banks are also the largest customers on the exchanges where they hedge the risks associated with their foreign-exchange positions.

In general, the specialist system is unique to securities exchanges, and specialists exist for the purpose of achieving certain market results. Commodity exchanges do not use the services of specialists. The rules of the Securities and Exchange Commission permit the designation of specialists to "engage in a course of dealings for . . . their . . . own account to assist in the maintenance, so far as practicable, of a fair and orderly market . . ." provided that the securities exchanges adopt the following types of rules governing specialists: minimum capital requirements, rules to suspend or remove specialists if they fail to perform their designated market functions, rules restricting dealing activities to those reasonably necessary to permit the specialist to maintain a fair and orderly market or necessary to permit him or her to act as an odd-lot dealer, provisions governing his or her brokerage activities in specialist securities, and procedures to provide for the effective and systematic surveillance of the activities of specialists (17 C.F.R. 240.11(b)(1)). In addition, the IRS formerly granted special tax treatment to specialists transactions.

The rules of the PHLX require that odd-lot orders must be given to the specialist. The specialist functions as a broker with respect to certain transactions that cannot be executed by floor traders immediately, for example, stop-loss orders and limit orders. All such orders are given to the specialist for execution and become part of his "book"; PHLX rules address priority of orders (customers' orders receive priority) and conflicts of interest by governing specialists' trades and those of affiliated persons and firms in "securities" in which the person is designated as specialist.

There is one specialist position for each currency option traded on the PHLX, and the primary function of a specialist is to act as market maker, as necessary, for its assigned currency option. The specialist thus undertakes all activity, including dealing for its own account, to the extent necessary, as required to maintain a fair and orderly market in options on a particular currency. In essence, the specialist makes a continuous two-sided market in the assigned currency option when market forces do not.

Although currency options are functionally equivalent to other instruments which banks regularly deal in for their own account, the applicant's proposed activities were not considered as closely related to banking. The applicant's analysis did not focus on the critical components of the proposed specialist activities, which are distinct from the foreign-exchange brokerage and dealing activities generally conducted by banks. Because the proposed specialist activities are to be carried out in the context of market making on a regulated exchange, they were significantly different from the foreign-exchange activities currently conducted by banks. When a bank engages in foreign-exchange trading, it does so to service the needs of its customers and to generate trading profits. However, unlike traditional foreign-exchange trading, bank customers are not serviced directly by a specialist. Instead, the exchange benefits from the specialist's efforts if markets are perceived to be deep and liquid. Depth and liquidity make the contracts viable and the exchange profitable, and do not directly benefit the bank's customers.

The applicant's original proposal implicitly acknowledged that banks have not traditionally been involved with trading on stock exchanges, and thus have not generally possessed the experience and expertise in trading, hedging, and managing aggregate exposure required for the successful operation of a specialist position. The applicants originally proposed to engage in the activities through a joint venture because they lacked the requisite trading expertise to profitably undertake the activity alone. In its discussion of the management of risk exposure of the specialist, the applicants originally stated, "The choice of the appropriate hedge to start with and the monitoring over the life of the option of that hedge are specialized and difficult tasks that require expertise and experience." Conducting exchange specialist activities requires the floor-trading experience and back-office capabilities of an experienced exchange member.

As of December 1984, only one commercial bank, Bank of America, acted as a specialist in exchange-traded currency options. In January 1984, the Office of the Comptroller of the Currency granted permission for Bank of America to act as the specialist in PHLX-traded options on the Deutschemark through a joint venture subsidiary with Tague Securities Corporation. The Board, however, was not bound to a determination that specialist activities were closely related to banking simply because one bank engages in the activity. Bank of America apparently considered it necessary to conduct its specialist activity through a joint venture with a securities firm, which reinforced the view that the activity requires experience and expertise not generally possessed by banks.

Given the applicant's acknowledgment of the importance of floor-trading expertise and experience to the specialist function, and the substantive absence of bank involvement in such an activity, the Board concluded that the proposed activities were not closely related to banking and thus denied the applicant's request.

A bank holding company applied to acquire all the voting shares of a company ("Company") that engages in a variety of data processing and data transmission activities for customers such as securities and commodities exchanges, brokerage firms, commercial banks, savings and loan associations, insurance companies, and investment managers. In addition to engaging in other nonbanking activities, the company designs and assembles the hardware that is used in connection with the services it provides. The Board had not previously considered whether the assembly of hardware designed for the processing and transmission of banking, financial and economic data is closely related to banking or permissible as an incidental activity.

The bank holding company stated that Company's assembly of hardware was incidental to its provision of data processing services because such assembly was necessary to assure the availability, reliability, and quality of components used by Company, and that stock quotation firms like Company could only assure such product characteristics by the design and assembly of the hardware that provides the quotation information. In support of the argument, the bank holding company asserted that competitors of Company also design and assemble the hardware that provides the Company service.

In view of the fact that finished hardware of the type provided by Company is available, and, in fact, is marketed by companies providing services similar to Company, the Board found that the continuation of Company's design and assembly of hardware activities could not be considered "necessary" to the Company's provision of its permissible data processing services, and thus could not be considered incidental to Company's provision of permissible services. As a condition for approval of the bank holding company's application to acquire all of the voting shares of Company, the Board required the bank holding company to divest of Company's hardware assembly activities within two years of the acquisition (Refer to 1986 FRB 497).

In 1971 and again in 1984, the Board issued for public comment proposals to expand the activities permissible to bank holding companies under section 4(c)(8). Included in those proposals was the provision of armored car services. The proposals would have authorized bank holding companies to provide fully insured transportation of cash, securities, and valuables (primarily between commercial customers and financial institutions) and such ancillary services as coin wrapping, change delivery, mail delivery, payroll-check cashing, servicing of automatic teller machines, and leasing safes to commercial customers.

In response to both the 1971 and 1984 proposals, the Board received various comments against adding this activity to the Regulation Y list of permissible nonbanking activities, primarily from armored car operators and their trade associations. The commenters maintained that the activity is not closely related to banking but, rather, is essentially a transportation activity requiring no banking expertise.

In view of the issues raised by the comments on this activity and the minimal interest by bank holding companies, the Board decided not to add the activity to the Regulation Y list of permissible activities. However, the Board stated it would consider individual applications for this activity (1973 FRB 898); 51 *Federal Register* 39,999 (1986). The Board expressed no opinion as to whether the activity would meet the *National Courier* test and would be a proper incident to banking.

In 1988, a bank holding company (the applicant) filed an application to engage in armored car activities through a de novo nonbank subsidiary. After notice of the application was published, the Board received comments opposing the proposal and was requested to order a formal hearing. In response, the Board published an order requiring a formal public administrative hearing on the application. One issue, among others, that the Board directed to be considered was whether the proposed armored car services were "so closely related to banking or managing or controlling banks as to be a proper incident thereto" under section 4(c)(8) of the BHC Act.

An administrative hearing was held on June 16 and July 11, 1989, before an administrative law judge (ALJ). The ALJ issued a recommended decision in which he concluded that the proposed armored car activities were not "closely related to banking" and recommended that the Board deny the application. The ALJ found that none of the *National Courier* criteria were demonstrated by the record. The ALJ's conclusion relied on certain operational distinctions between the proposed armored car services and the services banks traditionally perform themselves.

Following receipt of exceptions to the recommended decision, the Board reviewed the entire record of the proceedings and determined that the ALJ had erred in concluding that armored car services were not "closely related to banking." The Board concluded that, even accepting the factual findings, the slight operational distinctions cited in the recommended decision were not significant. The Board found that although there may be some distinctions between bank-provided armored car services and the proposed full-service, for-hire armored car service, the nature of the customers served and the economic basis of the services provided do not fundamentally alter the nature of the services. It was therefore clear to the Board that the services then provided by the applicant as well as other banks and bank holding companies to themselves and their customers are sufficiently "operationally and functionally similar" to the proposed service as to equip banking organizations particularly well to perform the proposed service, and hence fulfill the second *National Courier* test.

The Board also noted that bank holding companies are permitted to provide courier services for unaffiliated parties under section 225.25(b)(10) of Regulation Y. The only essential difference between the two services relates to the intrinsic value of the materials transported. The Board concluded that the services themselves were certainly functionally and operationally similar, thereby lending additional support to its favorable finding under the second *National Courier* test.

The Board also found that the third *National Courier* test was met, that the applicant had demonstrated "the dependence of banks on a specialized form of the proposed services." The Board found that the record amply demonstrated that banks are highly dependent upon the specialized transportation services provided by armored cars, which transport cash and valuables with a high degree of security. The applicant was proposing to engage in just those specialized services; it did not propose to start a general moving or trucking service. The record therefore supported a determination that the third *National Courier* test was also satisfied. Accordingly, the Board found, based on the record before it, that providing for-hire armored car services to the general public was an activity that is closely related to banking.

This determination, however, is only one of two steps needed for the Board to approve a nonbank activity for a bank holding company. The Board must also find that the activity is a "proper incident thereto." On this issue, the ALJ declined to make any factual or legal determinations concerning the proper-incident test or state branching laws. However, under the Board's rules (12 C.F.R. 262.4 (1990)), the ALJ was required to provide a recommended decision with regard to *all* unresolved issues prior to a final Board determination (12 C.F.R. 263.11). A final disposition on the application therefore was not possible at that juncture, and the Board remanded the case to the ALJ for a recommended decision on the proper-incident standard and other unresolved issues (see 1990 FRB 676).

In accordance with the Board's remand order, a second formal hearing was held before the ALJ. Additional evidence and post-hearing briefs were submitted, including evidence on the proper-incident test, in support of this and other unresolved issues. The ALJ then issued his supplemental decision, which again recommended denial of the application. The ALJ found that, in this case, the applicant's record failed to provide a definitive proposal on which the Board could make a determination under the proper-incident test. The ALJ found that the applicant had offered only a skeletal structure and operation plan that was fleshed out only to a limited extent at the hearings. In addition, the ALJ found the application and other facts of record to be deficient with regard to possible public benefits and adverse effects. The ALJ further determined that the record had not shown that the proposed activity, as structured, would be lawful under the branch-banking laws of the states in which the applicant proposed to operate.

Based on its review of the ALJ's supplemental decision and the remainder of the record, the Board determined that the record failed to support a finding that the proposed armored car activities, in this particular instance, would be a "proper incident" to banking. The Board therefore adopted the ALJ's recommendation to deny the application, but only on the narrow grounds of inconsistency of the proposal, as then structured, with section 23B of the Federal Reserve Act.

In its order, the Board stressed that the burden of proof is upon an applicant to establish that the nonbanking activity it proposes to conduct—in this case the provision of armored car services—is *not only* closely related to banking, *but also* a "proper incident thereto." The Board's review of the entire proceeding disclosed certain aspects of the application that appeared on its face to violate the arm's-length transaction requirement of section FRA 23B. In the Board's view, a proposal to engage in nonbanking activities pursuant to section 4(c)(8) will not produce net benefits to the public, as required under the public-benefit test, if it violates the kind of statutory requirement, such as section 23B, that was specifically intended to prevent unsafe or unsound banking practices when a bank affiliate engages in nonbanking activities.

The first potential violation would arise from the fact that the proposed service by the bank holding company's nonbank subsidiary to its bank affiliate would cost more than the bank was paying for similar armored car services provided by an unaffiliated provider. The Board noted that although there may be a justification for the higher pricing structure that would meet the standards set forth in section 23B, no justification appeared in the record. The Board could therefore only conclude that the bank may not be obtaining services from the nonbank provider "on terms . . . at least as favorable to such bank . . . as those prevailing for comparable transactions with or involving other nonaffiliated companies," as required by section 23B.

The second potential violation of section 23B arose from the absence of a "precise breakdown of the services the nonbank subsidiary will purchase from the bank holding company's subsidiary bank and the projected cost of those services," as called for in the Board's prior order in this matter. The applicant provided no detailed cost figures for the wide variety of services the applicant's banking subsidiary was to provide to the nonbank subsidiary. The bank holding company proposed to charge the bank subsidiary an "estimated" percentage (the fee was admitted to have had no "factual basis" reflected in the record) of the nonbank subsidiary's direct operating expenses to cover all of the services provided by the bank holding company's banking subsidiary to its nonbanking subsidiary. Under section 23B, the provision of services by a bank to an affiliate must be paid for on an arm's-length basis. This requires, where there are no comparable transactions between a bank and a nonaffiliate, that the bank's provision of services to its affiliate be on terms that in good faith would be offered to, or would apply to, nonaffiliated companies. The Board found that the banking subsidiary would not in good faith have provided back-office services to an unaffiliated armored car company by charging a flat fee that had no factual basis and without determining the relationship of the fee to the actual costs of providing the services. Therefore, the potential violations of section 23B, on their face, constrained the Board to deny the application as it was structured (see 1993 FRB 352).

The Board noted its denial did not affect the Board's prior ruling in the case that armored car services are closely related to banking, and was without prejudice to the filing of a new proposal from which a favorable proper-incident finding could be made.

Impermissible Activities (Computer Output Microfilm Service) Section 3700.11

The authority of bank holding companies under section 225.25(b) of the Board's Regulation Y to engage in data processing activities is intended to limit those activities to providing facilities that perform banking functions, such as check collection, or other similar functions for customers that are depository or other similar institutions, such as mortgage companies. With respect to this activity, the Board issued an interpretation that authorizes bank holding companies to provide the formatting for computer output microfilm only as an output option for data otherwise permissibly processed by the holding company system (1982 FRB 552).

A foreign banking organization subject to the BHC Act applied for the Board's approval under section 4(c)(8) to engage *de novo* through its subsidiary (Company), in the exchange and clearance of: (1) exchange traded securities options and other securities and (2) futures and options on futures that relate to financial instruments. The proposed customer base was comprised primarily of market makers and other professional floor traders dealing for their own accounts. Most of the professional traders were expected to be market makers and specialists, including individuals, small partnerships, or small corporations, that were to trade primarily on the Chicago Board of Options Exchange (CBOE).[1]

Previously, the Board approved the execution and clearance of financial instruments as a permissible nonbanking activity.[2] Under Board precedent, the nonbanking subsidiary engaged in such services has generally serviced a broad range of retail and/or institutional customers. Under this proposal, Company was to clear trades for a specialized customer base comprised primarily of professional floor traders that executed trades for their own accounts.

Nonbanking subsidiaries of BHCs, operating in accordance with prior Board approvals, have generally performed both execution and clearance services. By performing both services, the nonbank subsidiary is able to control risk because it executes the majority of the transactions that it clears. The nonbank subsidiary can refuse to execute an order that it deems inappropriate or it can require additional funds or collateral from the customer *in advance of* and as a condition to executing the transaction.

Unlike prior Board cases, Company plans to provide primarily clearing services. As a clearing agent, it would guarantee the financial performance of its customers to the clearing organization of the exchanges on which it operates.[3]

After the start of trading on any day, Company would be obligated to settle each trade entered into by its customers even when the customer may not have the financial resources to honor its obligation. Since the trades have already been executed by the time that they would be presented to Company by these professional floor traders, Company would be unable to decline transactions that posed unacceptable risk. On an intraday basis, professional traders, who are not employees of Company and who trade in relatively volatile instruments, could expose Company to financial risks beyond the trader's capacity to repay and beyond Company's own resources.

The applicants proposed to limit the risk exposure created by Company's activities through the establishment of risk guidelines and procedures that were intended to monitor the intraday trading activities of its floor traders. No such system had been developed for the industry for monitoring the intraday activities of floor traders on a real-time basis. Most of Company's traders would primarily operate on exchanges that used an open outcry system rather than an electronic trading system. As a result, Company may not know its real-time committed positions until the end of the trading day and therefore the possibility existed that a floor trader could exceed Company's risk limits and incur substantial losses before Company could act to mitigate its credit risk exposure. Professional floor traders generally operate with much higher levels of leverage than the average brokerage customer of a securities firm. Since most of Company's customers were to be market makers, such traders could at times take positions contrary to the market.

1. Market makers on the CBOE are floor traders that perform a dealer function by trading for their own accounts, at their own risk, and for their own profit. Market makers compete with other market makers assigned to the same class of options. In contrast, floor brokers on the CBOE generally act only as an agent, executing customer and firm proprietary orders.

2. Refer to sections 225.25(b)(3) (trust companies engaging in agency activities related to the clearing of securities); 225.25(b)(15) (securities brokerage activities); 225.25(b)(18) (execution and clearance of futures and options on futures) of the Board's Regulation Y.

3. With this arrangement clearing firms may also be liable for the obligations of other members of the exchange. Generally, losses of a failed member firm are covered in the following order:

1. by the assets of the failed firm;
2. by the excess capital of the clearing organization;
3. by the guarantee fund of the clearing organization; and
4. by direct assessments made on surviving member firms.

Since member clearing firms are the ultimate source of capital for both the clearing association and the guarantee fund, the surviving firms will bear the ultimate burden of any loss.

Such circumstances potentially expose the clearing firms to substantial losses. If the clearing firm exhausts all or most of its capital in funding the obligations of floor traders that have lost substantial amounts of money in trading, parent companies of the clearing firm may have to cover the firm's remaining contingent liabilities. Such risks may be acceptable for some nonbanking institutions currently providing these services, but they may be inappropriate for U.S. domiciled banking organizations.

The Board carefully considered the benefits of the proposal, including the Applicants entry into a concentrated market, its experience with similar activities on foreign exchanges, and Company's proposed risk management systems. The Board concluded that the proposal, as it was currently structured (including the absence of an effective means to monitor and limit the potential credit risk exposure to the parent bank holding company) involved potential adverse effects that outweighed the potential public benefits. The Board thus determined that the balance of public interest factors that it is required to consider under section 4(c)(8) of the BHC Act were not favorable. The application was denied by the Board on January 9, 1991 (1991 FRB 189).