

## 3160.0.1 PROVISION OF DATA PROCESSING AND TRANSMISSION SERVICES

Under section 4(c)(8) of the BHC Act, the permissibility of bank holding company data processing activities is generally predicated upon the type of data processed or transmitted. Subsidiaries formed under this section may engage in business directly with outside customers, unlike section 4(c)(1) subsidiaries, which can act only as servicers for affiliates<sup>1</sup> and cannot deal directly with outside customers.

The intent of section 4(c)(8) is to permit bank holding companies and their nonbank subsidiaries to directly provide to customers financially or economically oriented services (or services that are similar to these services) that banks have traditionally used in their own internal operations and provided to their customers. Such services (with prior approval) are unrestricted as to location and may be provided from out-of-state locations.

## 3160.0.2 INCIDENTAL ACTIVITIES

The Board regards the following as incidental activities necessary to carrying on permissible data processing activities:

1. Making excess computer time available to anyone as long as the only involvement by the bank holding company system is furnishing the facility and the necessary operating personnel. This stipulation applies when—
  - a. the equipment is not purchased solely for the purpose of creating excess capacity to sell;
  - b. hardware is not offered in conjunction with excess capacity; and
  - c. the facilities for the use of the excess capacity do not include providing any software other than systems software (including language), network communications support, and the operating personnel and documentation necessary for maintaining and using these facilities.
2. Selling byproducts of permissible data processing and data transmission activities when they are not designed, or appreciably enhanced, for the purpose of marketability.
3. Furnishing any data processing service upon

request of a customer if the service is not otherwise reasonably available in the relevant market area.

## 3160.0.3 SECTION 4(c)(8) vs. SECTION 4(c)(1)

Section 4(c)(1) data processing subsidiaries, which do not require prior approval, are limited as follows:

1. They can furnish computer services *only* for the internal operations of the bank holding company and its bank affiliates.<sup>1</sup>
2. Direct computer services to nonaffiliated customers are not permitted. Any contract to furnish services to nonaffiliated customers must be between the affiliate bank and its customer, with the data processing subsidiary acting as a servicer for its affiliate bank. In addition, the kinds of services furnished are limited to those that a bank can normally provide.

Section 4(c)(8) data processing subsidiaries may deal directly with the customer. In accordance with section 4(c)(8) of the BHC Act and section 225.28(b)(14) of Regulation Y, the kinds of services nonbank subsidiaries of bank holding companies may provide to others are—

1. data processing and transmission services, facilities (including hardware, software, documentation, or operating personnel), databases, advice, and access to such services, facilities, or databases by any technological means, if—
  - a. the data to be processed or furnished are financial, banking, or economic data and
  - b. the hardware provided in connection with the data processing and transmission services is offered only in conjunction with software designed and marketed for the processing and transmission of financial, banking, or economic data, and the general-purpose hardware does not constitute more than 30 percent of the cost of any packaged offering.
2. data processing, data storage, and data transmission services for a third party that are not financial, banking, or economic related if the subsidiary's total annual revenue derived from

1. In this context, "affiliates" is limited to other organizations that have subsidiaries of the same parent bank holding company as the servicer.

those activities does not exceed 30 percent of its total annual revenues derived from data processing, data storage, and data transmission activities. On November 26, 2003, the Board approved an increase of this limit to 49 percent, effective January 8, 2004. See 1993 FRB 1158, 2004 FRB 55, and section 3160.2. The Board currently recognizes that, in certain situations, a bank holding company may have bona fide operational reasons for conducting its financial and related nonfinancial data processing activities through separately incorporated subsidiaries. In these cases, bank holding companies may request permission to administer the 49 percent revenue test on a business-line or multiple-entity basis. See section 225.28(b)(14) of Regulation Y (12 C.F.R. 225.28(b)(14)).

#### 3160.0.4 MINICOMPUTER ACTIVITIES

Some data processing subsidiaries are actively engaged in placing minicomputers with some of their customers. However, if the subsidiary acts as sales agent for the manufacturer and receives a commission, it is in violation of section 225.28(b)(14) of Regulation Y and should be advised to cease the practice.

#### 3160.0.5 HARDWARE AND SOFTWARE AS AN INTEGRATED PACKAGE

Customers of data processing services require that suppliers provide them with hardware and software as an integrated package. Providing general-purpose hardware is permissible only if the cost of the hardware does not exceed 30 percent of the cost of the packaged offering, and only in conjunction with permissible software. When hardware is provided in a specialized form (such as ATMs), its provision meets the *National Courier* test and is closely related to banking and therefore not subject to the 30 percent limitation.

#### 3160.0.6 PACKAGED FINANCIAL SYSTEMS

The Board found that providing packaged financial systems, including data processing hardware and software, to be installed on the prem-

ises of the customer is closely related to banking if conducted within the limits of Regulation Y.

#### 3160.0.7 EXCESS CAPACITY

The sale of excess computer time is currently treated in a Board interpretation as a permissible incidental activity. The interpretation (12 C.F.R. 225.123(e)(1)) currently permits a bank holding company to make excess computer time available to anyone so long as the only involvement of the holding company is furnishing the facility and the necessary operating personnel. Data processors that process time-sensitive data must maintain sufficient capacity to meet peak demand and provide backup in case of equipment failure. Excess capacity necessarily results from such needs; thus the sale of excess capacity is necessary to reduce costs and to remain competitive. Bank holding companies are limited in the sale of excess capacity as follows:

1. A bank holding company may not purchase data processing equipment solely for the purpose of creating excess capacity.
2. A bank holding company may not sell hardware in conjunction with excess capacity.
3. A bank holding company may provide only limited types of software in connection with its sale of excess capacity. This includes systems software (that is, software designed only to control and operate the hardware and not to perform substantive operations), network communications support, and the operating personnel and documentation necessary for maintaining and using these facilities.

#### 3160.0.8 BYPRODUCTS

The sale of byproducts for the development of a program for a permissible data processing activity is treated in a Board interpretation (12 C.F.R. 225.123(e)) as a permissible incidental activity. Byproducts may be data, software, or data processing techniques or information developed by the bank holding company. Byproducts *may not* be designed or appreciably enhanced for the purpose of marketability.

#### 3160.0.9 REQUIREMENT OF SEPARATE RECORDKEEPING

The Board's data processing interpretation is designed to minimize any possibility of unfair

competition. A bank holding company subsidiary or related entity that provides permissible data processing and data transmission activities (services, facilities, byproducts, or excess capacity) must keep separate books and records and provide the documents to any new or renewal customer upon request.

### 3160.0.10 SUMMARY

Holding company EDP proposals are evaluated from the standpoint of whether the proposed data processing activities involve banking, financial, or related economic data within the meaning of the Board's Regulation Y. Processing, storing, and transmitting data for third parties, when the data are not financial, banking, or economic, is permissible if the revenues derived from those activities do not exceed 49 percent of the subsidiary's total annual revenues derived from data processing, data storage, and data transmission activities. For examples of previous Board authorizations for data processing and transmission services in accordance with Regulation Y, see sections 3160.1 through 3160.5.

The data processing that is permissible under Regulation Y encompasses various data processing services, including sales analysis, inventory analysis, freight payment, municipal tax billing, credit union accounting, and savings and mortgage company bookkeeping and payroll processing.

### 3160.0.11 INSPECTION OBJECTIVES

1. To determine that the full range of EDP services performed are permissible financially oriented activities in compliance with applicable laws and regulations.
2. To review the relationship between the data processing subsidiary and its affiliates and the effect of those relationships on the affairs and soundness of the bank affiliate.
3. To determine if operating policies are adequate and if management is operating in conformance with the established policies.
4. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulation have been noted.

NOTE: All bank-related EDP servicers receive EDP examinations conducted by the primary bank regulator; these examinations cover detailed operations, audit, proper backup, and overall computer operations. The bank holding company-related inspection should focus on the types and

permissibility of services performed, the revenue limitations of section 225.28(b)(14) of Regulation Y, the types of customers serviced, and transactions between affiliates. The inspection should also provide an overall financial evaluation.

### 3160.0.12 INSPECTION PROCEDURES

#### 3160.0.12.1 Pre-Inspection

1. Where available, review the EDP examination report in conjunction with the lead bank examination for details of the subsidiary's operations and management.
2. Review correspondence files and the application memo for the history of the subsidiary.

#### 3160.0.12.2 On-Site

3. Have a brief meeting with the chief executive officer of the subsidiary to establish contact and present a brief indication of the scope of the inspection.
4. Ask the controller of the company for the schedules and other information requested in the entry letter.
5. Request the following information and schedules in addition to what was requested in the entry letter:
  - a. complete list of the computer applications the subsidiary performs
  - b. list of customers
  - c. policy and procedures manual, if any
  - d. copy of the latest internal and external financial and operational audits and internal control reviews
  - e. copy of the types of management reports the subsidiary submits to the parent company and directors
  - f. internal management organization chart
  - g. copy of the agreement executed with the affiliates concerning the services provided and the fees collected
6. Review minutes of meetings of the board of directors and of the executive committee to determine the broad types of the company's operations.
7. Determine the scope of the inspection, based on evaluations of—
  - a. corporate minutes,
  - b. schedules,

- c. accounting records,
  - d. internal controls, and
  - e. the scope of the work performed by the internal auditor.
8. Review the trial balances and compare them with the respective general ledger control accounts.
  9. Where necessary, interview pertinent division heads.
  10. Determine if management information systems are adequate and if regular periodic reports are made available. Determine if the reports provide sufficient segregated details on the annual revenues earned from (1) financial-, banking-, or economic-related data processing and data transmission services and (2) third-party nonfinancial data processing and data transmission services. Ascertain whether the information will allow verification of compliance with the revenue limitations found in section 225.28(b)(14) of the Board's Regulation Y.
  11. Verify that the subsidiary of the bank holding company is complying with the revenue limitations found in section 225.28(b)(14) of Regulation Y.
  12. Review the data processing, data storage, and data transmission services provided to customers for violations of the Board's regulations and interpretations. Obtain sufficient documentation for the workpapers.
  13. Prepare a statement of condition with a minimum two-year comparison. More than two years may be prepared if the information is available and meaningful.
  14. Prepare a statement of income using the same procedures outlined above.
  15. Review all significant internal policies. Determine if the policies were developed internally or by the parent company.
  16. Review the subsidiary's management reports to the parent company. Is the reporting complete and frequent (at least quarterly)? Is the parent company fully aware of the subsidiary's operations or problems?
  17. Review the adequacy of internal and external financial and operational audits and internal control reviews. Interview the EDP auditor and review the audit reports and CPA management letters (for the period of the inspection). Also conduct interviews with the auditors, including the EDP auditor (if one was engaged).
  18. Review the condition of the company's records, that is, their availability, completeness, and accuracy. Deficiencies should be discussed in detail with recommendations for improvement.
  19. Review all intercompany transactions. Be consistently alert for any transactions with affiliate bank(s) that would be a violation of Federal Reserve Act sections 23A and 23B and Regulation W.
  20. Review significant litigation and other contingent liabilities.

### 3160.0.13 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws<sup>1</sup></i>	<i>Regulations<sup>2</sup></i>	<i>Interpretations<sup>3</sup></i>	<i>Orders</i>
EDP auditing		225.28(b)(14)		
Types of activities—incidental activities		225.123 and 225.123(a)	4-176	1975 FRB 215
Data processing as an activity closely related to banking		225.123(e)		1974 FRB 58
Section 4(c)(1) type of EDP services		225.118	4-195	

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

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

3. *Federal Reserve Regulatory Service* reference.

<i>Subject</i>	<i>Laws<sup>1</sup></i>	<i>Regulations<sup>2</sup></i>	<i>Interpretations<sup>3</sup></i>	<i>Orders</i>
Retention of data subsidiary				1972 FRB 318
Order authorizing a bank holding company to engage in expanded data processing and data transmission activities				1982 FRB 505
Amendment of Regulation Y for expanded activities		225.28(b)(14)		1982 FRB 552 1997 FRB 275
Order authorizing a BHC to offer financial-office service and the service of designing and assembling data processing hardware. Receipt of hotel information and the ability to make airline and hotel reservations is not related to the provision of banking, financial, and economic data.		225.28(b)(14)		1986 FRB 497
Order authorizing engaging in electronic benefit services, stored-value-card services, and electronic data interchange services				1993 FRB 1158
Order authorizing the provision of a network for the processing and transmission of medical payment data				1994 FRB 139
Order authorizing the provision of traveler's checks and postage stamps via an ATM card and terminal				1994 FRB 1107
Order allowing a BHC to process certain nonfinancial data—personnel information for financial institutions for use in their internal operations				1995 FRB 295
Order authorizing optical scanning and database preparation				1995 FRB 1049
Order authorizing engaging in the development, production, and provision of customer home banking—personal financial management using personal computers				1996 FRB 363

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

3. *Federal Reserve Regulatory Service* reference.

<i>Subject</i>	<i>Laws<sup>1</sup></i>	<i>Regulations<sup>2</sup></i>	<i>Interpretations<sup>3</sup></i>	<i>Orders</i>
Order allowing a BHC to engage in—				1996 FRB 674
(1) providing data processing and data transmission services to non-affiliated financial institutions and				
(2) assisting the institutions in offering their customers banking and financial services over the Internet				1996 FRB 680
Order approving limited nonfinancial data processing and transmission services, including customer identification, account, and information or verification files for detecting fraudulent use.				1996 FRB 348
Order approving the development and provision of a data processing and data transmission system (“gateway”) to depository institutions and their affiliates. The system would make home banking and other financial services available to the institutions’ and affiliates’ customers. The gateway would provide customers with an electronic link to an Internet provider.				1997 FRB 135
Order approving the development and sale of computer software to broker-dealers and financial institutions that would allow customers to purchase and sell securities over the Internet using personal computers.				1997 FRB 335
Amendment of Regulation Y to expand the ability of BHCs, including FHCs, to process, store, and transmit nonfinancial data in connection with data processing, storage, and transmission activities.				2004 FRB 55

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

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

3. *Federal Reserve Regulatory Service* reference.

## Section 4(c)(8) of the BHC Act (EDP Servicing—Network for the Processing and Transmission of Medical Payment Data) Section 3160.1

A bank holding company applied for the Board's approval to acquire all the shares of a nonbank data processing company to engage in the processing and transmission of certain medical-payment data. The nonbank subsidiary plans to engage in activities that specialize in a range of medical-payment electronic funds transfer services, including the development of software products related to the processing of medical-claims payments.

*Basic network services.* The Board determined by order that a nonbank subsidiary of a bank holding company may provide a network for the processing and transmission of medical-payment data between health-care providers (such as physicians, hospitals, and pharmacies) and entities responsible for paying medical benefits (such as health insurers, health maintenance organizations, and preferred provider organizations). These nonbanking activities are permissible under the Bank Holding Company Act and the Board's Regulation Y (12 C.F.R. 225.28(b)(14)). The information on the patient's medical-benefits card (made available by paying organizations) would be used to access the system (similar to a debit or credit card). In general, health-care providers would enter claims information into the network with a request for payment, and the payers would authorize electronic fund transfers for full or partial payment of the claims.

The bank holding company's nonbank subsidiary would also process and transmit medical-treatment data necessary for the processing of claims, and would furnish providers with access to a coverage-information database. The database would transmit information about the terms of a particular payer's medical coverage contract, such as the extent to which specific medical treatments are covered by the patient's insurance policy. While such medical and coverage data are not financial data, the processing and transmission of these data are essential to the transmission and processing of the medical payments and financial information in the network. Also, these data processing services allow the electronic transfer of funds. The Board found that the processing and transmission of the medical and coverage data, in connection with the nonbank subsidiary's operation of a payments network, are permissible as incidental activities. The Board further determined that the nonbank subsidiary's operation of a medical-payments network would constitute permissible data processing and data transmission activities under the BHC Act.

*Adjudication software.* The Board also authorized the bank holding company's nonbank subsidiary to furnish claims-adjudication software to payers. The software is designed for the processing of routine claims and would include the basic rules of a payer's coverage contract. Claims-adjudication processing would involve the interaction of financial and banking data and medical and coverage data as a necessary prelude to electronic funds transfer. The Board found that the processing of medical and coverage data involved in claims adjudication is an integral and necessary part of the processing of related financial and banking information, and the nonbank subsidiary's processing of underlying payment transactions. The Board concluded that the nonbank subsidiary's provision of claims-adjudication software is permissible as an activity incidental to its provision of software for the processing of banking and financial data and to its operation of a medical-payments network.

*Electronic data interchange.* The bank holding company's nonbank subsidiary also plans to provide medical-payments system participants with statistical and other data derived from the information in its database. Each participant would have on-line access to all of the data it places into the system, and third parties designated by a payer or provider could also receive access to the data owned by that customer. The Board has previously stated that bank holding companies may provide byproducts of permissible data processing and data transmission activities as long as the byproducts are not designed, or appreciably enhanced, for the purpose of marketability (12 C.F.R. 225.123(e)(2)). The Board has also indicated that byproducts include data, software, or data processing techniques that may be applicable to the data processing requirements of other industries.

The nonbank subsidiary may perform limited selection, combination, and similar functions on raw data so that the data can be transmitted to the customer in a reorganized and more usable form. It may also design software that would enable customers to perform similar reorganization functions on raw data. The Board concluded that the proposed electronic data interchange services would constitute permissible byproducts of the nonbank subsidiary's primary data processing activities, and are therefore permissible as an incidental activity.

The Board's approval of the application on December 22, 1993, is based on the facts of record and is subject to the commitments and representations that were made by the applicant and the conditions referred to in the order. (See 1994 FRB 139.)



# Electronic Benefit Transfer, Stored-Value-Card, and Electronic Data Interchange Services

## Section 3160.2

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Four bank holding companies (the applicants) applied for the Board's approval under section 4(c)(8) of the Bank Holding Company Act to engage de novo, through their joint venture corporation (the company), in nonbanking activities consisting of engaging in electronic benefit transfer services, stored-value-card services, and electronic data interchange services. The applicants proposed to engage in the activities throughout the United States. The applicants provide data processing and transmission services through the company to retail merchants using point-of-sale (POS) terminals and to banks who are members of the company's automated teller machine (ATM) network.

### 3160.2.1 ELECTRONIC BENEFIT TRANSFER SERVICES

The electronic benefit transfer services would involve data processing and transmission services required to permit the delivery of governmental program benefits (such as welfare payments and food stamps) through the ATM and POS terminals of participating merchants and banks. Under a benefits-services system, a benefit recipient would be issued a magnetically encoded card similar to an ATM card, which could be used to obtain access to a government benefit account maintained on behalf of the recipient. The Board concluded that such activities are financial activities that are operationally and functionally similar to the electronic payment and data processing services provided by banks and bank holding companies in the operation of ATM and POS networks. In particular, the proposed benefit services involve the processing of access and authorization requests submitted to, and the processing of electronic payments originating from, financial accounts on the same basis as transactions initiated with traditional credit and debit cards. The Board thus concluded that such electronic benefit transfer activities are closely related to banking and permissible for bank holding companies under the BHC Act.

### 3160.2.2 STORED-VALUE-CARD SERVICES

Stored-value-card services would involve data processing and transmission services and electronic payment services related to stored-value cards. These cards are similar to credit or debit

cards in which authorized funds can be transferred and credited using magnetic stripe or computer chip technology. The services would be provided in connection with both "closed" and "open" stored-value-card systems. Closed systems include both single-vendor stored-value-card systems and systems designed for single-use sites. An open system, by contrast, refers to multiple-vendor, multiple-site stored-value-card systems.

#### 3160.2.2.1 Stored-Value-Card Closed Systems

In most current closed systems, cash must be deposited in a particular vendor's card-dispensing terminal, and the card received from the terminal may be used only for purchases from that specific vendor. The card itself is disposable, and the only account reconciliation that may be required would involve the vendor's own cash receipts, the amount of funds debited from the cards at turnstiles or other points of sale, and the amount of the vendor's liabilities stored on outstanding cards. The company intended to play a role in the operation of this basic type of closed system, as well as to help develop and operate more complex closed systems. These systems would use a plastic card containing electronic technology, such as a computer chip or magnetic stripe, to which funds could be credited and from which funds could be debited, for an indefinite period of time. The company proposed performing accounting functions in customer accounts and accounting for the level of the vendor's stored liabilities. In such a capacity, the company would be responsible for the settlement and reconciliation of these customer and vendor accounts. The company would also perform other functions, such as embossing and issuing cards and arranging for funds collection.

#### 3160.2.2.2 Stored-Value-Card Open Systems

The applicants anticipate that stored-value cards eventually will operate in an open system similar to a POS network, which allows value stored on a card to be used with a wide range of participating vendors. The applicants expect that

the company's principal stored-value-card activities would involve the development and operation of such open systems.

In an open system, customers' debit cards would hold an integrated computer chip or some type of comparable technology capable of storing value for use in stored-value-card transactions. Value could be placed on the card at an ATM adapted to read and place value on the chip, at a limited-purpose ATM-type machine whose only functions would be to add value to the chip and to transfer stored value back to the customer's account, or at a cash-to-card machine or other value-transfer device (collectively, value terminals). These value terminals would be operated, in at least some cases, by the company. Once value is placed on a card, equivalent funds could be transferred to the company, which would hold the funds for payment of stored-value-card transactions. Stored value would leave the chip when the customer purchases goods or services either at a POS terminal (which may be operated by the company) or at a vending machine, telephone booth, mass transit turnstile, or other unmanned delivery location (collectively, reader terminals), or when the customer transfers funds back to an account at a value terminal. Reader terminals generally would be offline devices not connected to the company's ATM or POS networks. Instead of a direct electronic connection, a reader terminal would retain, for a period of time, value representing the amount of customer purchases at the terminal. Then, at the vendor's convenience, the company, the vendor, or a third party would collect value from the reader terminals using specially designed collection cards issued by the company. The collection cards would then be submitted to the company so that funds can be properly credited. Once these transactions occur, the company would be responsible for making settlement by transferring funds to the accounts of participating merchants and other appropriate parties.

The Board concluded that the company's activities in providing stored-value-card services, in both closed and open systems, are closely related to banking. The activities involve processing debits and credits to the stored-value cards and performing related accounting and settlement functions, and are thus a data processing activity. Financial balances are maintained and adjusted at POS and other terminals as the customer purchases various items or adds value to the card, and the activity constitutes the

processing of banking, financial, or economic data within the meaning of Regulation Y. In addition, aspects of the company's stored-value-card services are functionally similar to the issuance and sale of consumer payment instruments such as traveler's checks, which are activities that banks conduct and that the Board has previously determined to be closely related to banking within the meaning of the BHC Act. The Board concluded that the company's proposed services in connection with stored-value cards, in either an open system or a closed system, are closely related to banking.

### 3160.2.3 ELECTRONIC DATA INTERCHANGE SERVICES

The company also proposes to furnish retail merchants with data collected from sales transactions consummated at the merchant's place of business (data services). The data collected and furnished would relate to specific items and quantities of products purchased by the customer, as well as to customer-purchasing patterns over a period of time. The data would be formatted so that it could be used by the merchant for inventory control, targeted marketing, and other purposes. The company's data services generally would be furnished to merchants as an adjunct to its POS-transaction-processing services and would be rendered through a retail merchant's POS terminals. The company does not intend to offer data services independently. In addition, the data that are collected by the company would be furnished only to the merchant that is a party to the underlying sales transaction; that is, the company does not intend to provide such information to third parties.

The company's data services would be limited to capturing, formatting, and furnishing data collected from sales transactions consummated at a particular merchant's place of business. In addition, the data collected would be furnished only to that merchant and only in accordance with the merchant's specific instructions. The company does not intend to provide software, render advice, or provide other services associated with the marketing or other uses of the data. The applicants do anticipate, however, that the company could provide additional related functions, such as issuing store coupons or credits related to a merchant's marketing programs at POS terminals. Based on the facts presented, the Board determined that the sales data that would be processed under the proposed data services are financial and economic data within the meaning of Regulation Y.

#### 3160.2.4 BOARD APPROVAL

Based on all the facts of record, the Board approved the applications. The Board's approval is specifically conditioned on compliance with the commitments made in connection with the applications and with the conditions referred to in the order. (See 1993 FRB 1158.)

Regulation Y provides that a bank holding company may render advice to anyone on processing and transmitting banking, financial, and economic data. On November 26, 2003, the Board approved an amendment to section 225.28(b)(14) of Regulation Y to expand the ability of all bank holding companies, including financial holding companies, to process, store, and transmit nonfinancial data in connection

with their financial data processing, storage, and transmission activities. The Board raised the total annual revenue limit from 30 percent to the 49 percent limit that applies to nonfinancial data processing activities. Specifically, a company (a nonbank subsidiary of a bank holding company) conducting data processing, data storage, and data transmission activities may conduct nonfinancial data processing, data storage, and data transmission activities (those that are not financial, banking, or economic in nature) if the total annual revenue derived from those activities does not exceed 49 percent of the company's total annual revenues derived from data processing, data storage, and data transmission activities. (See 12 C.F.R. 225.28(b)(14).)

Eleven bank holding companies (the applicants) applied for the Board's approval to engage through a joint venture corporation (the company) in certain nonbanking activities related to the operation of a retail electronic funds transfer network, including data processing and data transmission activities related to automated teller machine (ATM) and point-of-sale (POS) transactions, as well as electronic benefit transfer, stored-value card, and electronic data capture and interchange services. (A complete list of the proposed activities is found at 1994 FRB 1110-1111.)

The applicants also proposed to offer through the company certain data processing and data transmission services not previously considered by the Board. Those services consisted of allowing customers to use their ATM cards at an ATM terminal to withdraw funds from a bank account in the form of travelers' checks or postage stamps. Payment for the transactions would be accomplished by a debit to a cardholder's deposit account.

The transactions would occur at terminals that would not be owned and operated by the company. Cardholders buying postage stamps or travelers' checks at an ATM terminal would

purchase those products from the bank owning the ATM. The decision on which travelers' checks to issue would remain with the bank that owns the ATM terminal, and the company would not be the issuer of the travelers' checks.

The company's primary activities would be processing and transmitting access requests and payment authorizations. The company would also provide terminal-driving services, load ATM terminals with postage stamps and travelers' checks, and market the products through the network.

The Board determined that the proposed activities involved the processing of access and authorization requests submitted to deposit accounts on the same basis as other transactions initiated with a traditional debit card. The activity is operationally and functionally similar to the data processing services provided by banks and bank holding companies in their operation of ATM and POS networks. Traditionally, banks have been permissibly engaged in the sale of travelers' checks and postage stamps. The Board thus found the company's proposed data processing and transmission activities, with respect to these transactions, to be closely related to banking. (See 1994 FRB 1107.)

Five bank holding companies (the applicants) applied for the Board's approval to engage, through a joint venture subsidiary (the company), in certain data processing activities pursuant to Regulation Y. The applicants, through the company, would provide data processing and related services to banks and other automated teller machine (ATM) owners in connection with the distribution through ATMs of tickets, gift certificates, prepaid telephone cards, and other documents evidencing a prepayment for goods or services.<sup>1</sup>

The company would provide the software and telecommunications channels necessary to transmit cardholder requests, card-issuer authorizations, and related switching and account reconciliation services. Specifically, the company would provide terminal driving services that include—

- establishing and maintaining an electronic link between an ATM and a telecommunications switch to transmit cardholder requests and card-issuer authorizations; and
- operating the feature and functions displays on an ATM screen using computer software to permit an ATM to dispense various products in addition to currency.

The company would also provide switching services and transaction processing to transmit account debiting, transaction authorization, and settlement data between the ATM owner, or its bank, and the cardholder's bank.

A typical transaction would consist of an ATM cardholder selecting a particular product, such as a concert ticket, from a menu displayed on the ATM screen. The electronic commands

transmitted by the company would verify that the deposit account or line of credit designated by the cardholder had sufficient funds to effect the purchase. Following authorization, the ATM would dispense the product and issue a receipt. The card-issuing bank would then debit an amount equal to the cost of the purchase from the cardholder's designated account and transfer the funds to the account of the merchant or ATM owner, using settlement procedures established by the company's ATM network.

The Board previously determined that a bank holding company could provide data processing and related services necessary to permit customers to use an ATM card to debit a deposit account or line of credit at an ATM terminal for cash and credit transactions, and for the purchase of travelers' checks, money orders, and postage stamps. The Board has further determined that a bank holding company may provide data processing services that support the use of credit cards by consumers in the direct purchase of goods and services from a merchant. (See 1995 FRB 492, 1990 FRB 549, and 1985 FRB 113.)

The data processing proposed in this case involves the same type of data processing support as the Board has previously approved for credit card transactions and other more traditional types of ATM transactions. The Board thus concluded that the activities proposed by the applicants are permissible, consisting of data processing and transmission services encompassed within the Board's Regulation Y, and are thus closely related to banking within the meaning of section 4(c)(8) of the Bank Holding Company Act. (See 1996 FRB 848.)

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1. The tickets would include public transportation tickets and tickets to entertainment events. Gift certificates and prepaid telephone cards would be issued in fixed denominations for a specific merchant or group of merchants, and they would evidence prepayment of the purchase price of merchandise or services to be selected by the bearer at some time in the future. The ATM owners would also sell products that could be offered for sale directly by a financial institution, such as mutual fund shares or insurance policies, where permitted by applicable law.

## 3160.5.1 ENGAGE IN TRANSMITTING MONEY IN THE UNITED STATES

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) to engage de novo through two companies (the companies) in the activity of transmitting money for customers within the United States and its territories ("domestic money transmission services") to third parties located in foreign countries.<sup>1</sup> The activity was to be conducted at first through a network of approximately 1,200 "outside representative offices" located in California, Florida, Illinois, and Texas that are under contract with the companies to provide money transmission services.<sup>2</sup> The bank holding company proposes to engage in the planned activity nationwide. The companies are corporations that currently engage in the business of money transmission to Mexico through representatives in California, Florida, Illinois, and Texas.

Domestic money transmission services would be provided in the following manner: A customer would contact the companies directly by means of a dedicated telephone located in the outside representative office to request that the companies transmit funds to a third party for a fee. The outside representative would collect cash and a fee from the customer, issue a receipt, and deposit funds in an account maintained by the outside representative solely for the purpose of receiving funds in trust to be transmitted to a third party. The outside representative may maintain this account at any bank, including a subsidiary bank, but would have no agreement with any bank to accept deposits on its behalf. Neither the outside representatives nor the companies would be FDIC-insured institutions.

The companies would collect funds deposited in an outside representative's account daily through an automated clearinghouse (ACH) or similar transaction and deposit an amount equal to the amount to be transmitted into an account they maintain at a bank, which may include one

of its subsidiary banks, located near the third party receiving the funds. The third party would be notified that money is available at a local disbursement site, which could include a bank subsidiary of the bank holding company or consumer finance office or an unaffiliated check-cashing, finance, or other type of office. Funds would be made available to the third party by a check drawn on the companies' account almost immediately after the transmission order is placed by the customer.<sup>3</sup>

A customer would not transmit funds to any bank account maintained by the customer or any third party. Thus, the bank holding company would not use this service to collect deposits for customers of its subsidiary banks or any other bank.

There was no agreement between a customer and a bank to accept money in an account for use by the bank in connection with the proposed domestic money transmission services. The companies and their outside representative would accept money from a customer for the sole purpose of transmitting funds to a third party. A customer would not give funds to the companies with the expectation that the companies would permit the customer to reclaim the funds on demand or after a period of time. Moreover, the companies would not maintain balances or pay interest on the money they receive, and they would only hold funds long enough to transmit them to the designated third party.<sup>4</sup>

The Board previously determined that money transmission abroad is closely related to banking.<sup>5</sup> The Office of the Comptroller of the Currency (OCC) also has concluded that it is permissible for a national bank to accept money from nonbank affiliates for the purpose of transmitting the funds to a foreign country and that a

1. The Board previously approved the bank holding company's acquisition of a company to engage in the activity of transmitting funds to third parties in Mexico by using an unaffiliated foreign bank to make the cash payments. See 1995 FRB 974.

2. Outside representative offices would be expanded to include consumer finance offices in addition to existing grocery stores, travel agencies, pharmacies, and insurance agencies.

3. The domestic money transmission services do not involve lending money because only funds provided by the customer would be transmitted to a third party. The plan does not involve the paying of checks. Although the third party receives money by means of a check drawn on an account maintained by the companies, the receipt of funds in check form is not the payment of a check (see *Independent Bankers Ass'n of America v. Smith*, 534 F.2d 921, 943-45 (D.C. Cir. 1976)).

4. Many states permit companies that are not chartered as banks to transmit money without deeming this activity to involve the taking of deposits. The bank holding company is required to conduct the proposed activities in compliance with licensing and other requirements of relevant state law.

5. See 1990 FRB 270.

nonbank affiliate that participates with the national bank in transmitting money abroad would not become a branch of the bank.<sup>6</sup> Based on all the facts of record and for the reasons discussed in this and the Board's previous orders, the Board concludes that domestic money transmission services are closely related to banking. The Board has relied on the fact that the companies are subject to licensing and examination by state authorities.<sup>7</sup> The companies have committed to comply with all applicable reporting requirements, including reporting all transactions over \$10,000 to the Internal Revenue Service. The bank holding company committed to apply the internal controls currently in place at the finan-

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6. The OCC has reasoned that nonbank offices that transmit funds through a national bank to a third party do not constitute "branches" under federal law.

7. This order was specifically conditioned on requiring the bank holding company to obtain all necessary state licenses.

cial services company to ensure compliance with the Bank Secrecy Act.<sup>8</sup>

Based on the foregoing and all the facts of record, the Board approved the notice on October 17, 1995 (see 1995 FRB 1130). The Board's decision was specifically conditioned on the bank holding company's complying with all the commitments made in connection with the notice and obtaining all necessary approvals from state regulators.

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8. These procedures include a weekly review of all transactions over \$10,000. In addition, the companies will require customer identification, including the customer's current address and occupation, for all transmissions above \$3,000. The companies also will run a computer match of all remitters and recipients by name and Social Security number so that reporting requirements cannot be evaded by means of a series of transactions.

The Board has included within Regulation Y (section 225.28(b)(10)(ii)(B)) the authority for bank holding companies to engage in the printing and selling of magnetic ink character recognition (MICR)-encoded items as part of support services. This activity includes this primary activity and also the printing and selling of corporate image checks, cash tickets, voucher checks, deposit slips, savings withdrawal packages, and other forms that require MICR encoding. The activity was initially authorized as a permissible activity by Board order, whereby such documents were to be printed for and sold exclusively to depository institutions. The applicant associated with that Board order proposed

to acquire a controlling interest in a printing company that prints and sells checks and related documents. It planned to engage in a joint venture with another company that engages in check printing and other printing activities. The Board concluded for that application that checks and other MICR-encoded documents used in the payments process are provided in specialized form and that they are an integral part of a fundamental banking service, and thus the activity is deemed closely related to banking. See 1986 FRB 794. The Board included the non-banking activity in the Regulation Y “laundry list,” effective April 1997.



# Section 4(c)(8) of the BHC Act (Insurance Agency Activities of Bank Holding Companies) Section 3170.0

## 3170.0.1 INSURANCE ACTIVITIES PERMISSIBLE FOR BANK HOLDING COMPANIES

Before the enactment of the 1970 amendments to the Bank Holding Company Act, the Board by order authorized certain bank holding companies to engage in insurance activities. The specific type of permissible insurance activity for each bank holding company was described in its Board order. These few bank holding companies that commenced insurance agency activities before January 1, 1971, have grandfather rights under the current statutes and regulations (section 4(c)(8)), exemption G and 12 (CFR 225.28(b)(11)(vii)). These bank holding companies may, with the prior approval of the Board, engage in general insurance agency activities without restriction as to location or type of insurance sold. (See section 3170.0.3.7)

The 1970 amendments to the Bank Holding Company Act authorized the Board to determine permissible nonbanking activities under section 4(c)(8). Subsequently, on September 1, 1971, the Board amended Regulation Y to permit bank holding companies to engage in certain insurance agency activities.

The Board further amended the section of Regulation Y concerning permissible insurance agency activities on September 1, 1981. The 1981 amendments limited permissible insurance activities previously authorized by Regulation Y. The first amendment deleted from the Board's regulations the authority for bank holding companies to act under section 4(c)(8) of the Bank Holding Company as agent for the sale of insurance for themselves and their subsidiaries. This amendment reflected a court decision of the United States Court of Appeals for the Fifth Circuit that acting as agent for the sale of insurance for the bank holding company and its nonbanking subsidiaries was impermissible (permissible for banks, however). Such insurance is permissible, however, if conducted pursuant to section 4(c)(1)(C) of the BHC Act.<sup>1</sup> The second 1981 amendment deleted from the Board's regulations the authority to act as agent for insurance

sold as a matter of convenience to the public. The opinion also found that the part of the Board's regulation relating to the sale of "convenience insurance"<sup>2</sup> exceeded the scope of the provisions of section 4(c)(8) of the Bank Holding Company Act. The sale of this other insurance was considered impermissible.

On October 15, 1982, Congress enacted the Garn-St Germain Depository Institutions Act (Public Law 97-320). Title VI of that act amended section 4(c)(8) of the Bank Holding Company Act. This amendment stated that insurance agency, brokerage, and underwriting activities are *not* "closely related" to banking within the meaning of section 4(c)(8) of the Bank Holding Company Act. However, the amendment provided for seven exceptions to the general prohibition of bank holding companies engaging in insurance activities. One of the seven exceptions contains grandfather exemptions for insurance agency activities conducted on May 1, 1982, or for those insurance activities approved by the Board on or before May 1, 1982. As a result, bank holding companies receiving Board approval on or before May 1, 1982, may continue to engage in their insurance agency activities. (See section 3170.0.3.4)

The seven types of insurance activities allowed as permissible for bank holding companies are as follows:

1. Acting as agent, broker, or principal (i.e., underwriter) for credit-related life, accident and health, or unemployment insurance.
2. For bank holding company finance subsidiaries, acting as agent or broker for credit-related property insurance in connection with loans not exceeding \$10,000 (\$25,000 in the case of a mobile home loan) made by finance company subsidiaries of bank holding companies. (The Board interpreted this provision as permitting only the sale of insurance that does not exceed the outstanding balance of the loan—vendor's single interest insurance rather than general property insurance that covers the borrower's equity interest.)

1. The Board's Regulation Y was amended as of December 1983 to include the sale of insurance for a holding company based on the services provision of section 4(c)(1)(C) of the BHC Act, which did not require any prior Board approval. Included in the regulation were the services of selling, purchasing, or underwriting such insurance as blanket bond insurance, group insurance for employees, and property and casualty insurance for the bank holding company or its subsidiaries.

2. "Convenience insurance" consisted of insurance that was sold as a matter of convenience to the purchaser. The premium income from the sale of this insurance was expected to constitute less than 5 percent of the aggregate insurance premium income of the holding company. The sale of this insurance was not designed to permit entry into the general insurance-agency business.

3. Acting as agent for the sale of any type of insurance in a place with a population not exceeding 5,000, or with insurance agency facilities that the bank holding company demonstrates to be inadequate.
4. Any insurance agency activity engaged in by a bank holding company or its subsidiaries on May 1, 1982 (or approved as of May 1, 1982), including (i) insurance sales at new locations of the same bank holding company or subsidiaries in the state of the bank holding company's principal place of business or adjacent states or any state or states in which insurance activities were conducted by the bank holding company or any of its subsidiaries on May 1, 1982, or, (ii) insurance coverage functionally equivalent to those engaged in or approved by the Board as of May 1, 1982.
5. Acting, on behalf of insurance underwriters, as supervisor of retail agents who sell fidelity insurance and property and casualty insurance on holding company assets or group insurance for the employees of a bank holding company or its subsidiaries.
6. Any insurance agency activities engaged in by a bank holding company having total consolidated assets of \$50,000,000 or less. Life insurance and annuities sold under this provision, however, must be authorized by (1), (2), or (3) above.
7. Any insurance agency activity that is performed by a registered bank holding company, which was engaged in some insurance activity before January 1, 1971, pursuant to the approval of the Board.

These seven types of insurance allowed by the amendment to section 4(c)(8) of the Garn-St Germain Act are generally consistent with the types of insurance activities previously authorized by the Board. The one general exception related to the prohibition of the sale of property and casualty insurance.

### 3170.0.2 INSURANCE AGENCY ACTIVITIES

Insurance agency activities are among the most widely practiced nonbank activities engaged in by bank holding companies. Many bank holding companies are involved in the sale of insurance at some level in the organization; however, the inspection focuses on these activities only when performed by the parent company or by a non-

bank subsidiary (excluding bank-owned subsidiaries). Many of the smaller bank holding companies engage directly in these activities rather than through insurance agency subsidiaries. In either arrangement, however, sales are usually conducted on the premises of the subsidiary bank by personnel who most often serve as officers or employees of the bank or parent company.

Performance of insurance agency activities has been profitable for most bank holding companies with many of the smaller companies relying heavily on the commissions generated to service acquisition or other related indebtedness. In most cases, little or no expenditures for fixed assets are required since the premises of the subsidiary banks or parent company are utilized. Likewise, little or no liabilities are incurred since there are minimal assets to be financed.

### 3170.0.3 PERMISSIBLE TYPES OF COVERAGE INCLUDING GRANDFATHER PRIVILEGES

As noted above, the Board, effective November 7, 1986, approved a revision of specific insurance agency and underwriting activities permissible for bank holding companies under section 4(c)(8) of the BHC Act (section 225.28(b)(11) of Regulation Y). In clarifying the scope of insurance activities that are closely related to banking and permissible for bank holding companies under the Garn-St Germain Act, the Board included in its revised Regulation Y the seven specific exemptions contained in that statute.

#### 3170.0.3.1 Insurance Activities Permissible for Bank Holding Companies per Section 225.28(b)(11)(i) of the Board's Regulation Y

Permissible insurance agency activities include the sale of life, accident and health, and involuntary unemployment insurance that is directly related to an extension of credit by a bank holding company with respect to its own extensions of credit and those of its subsidiaries. For the purpose of determining what activities are permissible, the Board interpreted the term "extension of credit" to include direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases meet all the criteria contained in section 225.28(b)(3) of Regulation Y, which

defines leases as the functional equivalent of an extension of credit. (See the discussion of leasing in section 3140.0.)

The regulation requires that insurance coverage be limited to the “outstanding balance due” on an extension of credit. The “outstanding balance due” is calculated as follows:

1. Include:
  - a. principal and interest
  - b. reasonable administrative fees outstanding on the loan
  - c. the balance of payments due in a lease transaction
2. Exclude:
  - a. the residual value of the leased item (since the lessor owns the leased item and the lessee is not obligated to purchase the item by paying the residual value)

The insurance may provide for total repayment of the extension of credit in the event of the death of the borrower or for periodic payments on the extension of credit when the borrower is temporarily disabled or unemployed. Such single or periodic payments may not exceed the balance on the loan and thus provide for additional general life or accident coverage.

While ordinarily such credit-related insurance coverage would be declining term as payments reduce the balance due on an extension of credit (loans in connection with first mortgages), a bank holding company may write or sell a level term policy on nonamortizing loans. Policies written or sold pursuant to this paragraph, moreover, may be individual rather than group policies, and the premiums on such policies may be age-related. The Board continues to require that insurance policies sold or written to cover the “outstanding balance due” insure only named borrowers or lessees of a particular bank holding company. Accordingly, such policies could cover both spouses jointly only if both spouses were actual borrowers or lessees under the terms of the agreement with the bank holding company.

The Board permits, with regard to an extension of credit, the sale and underwriting of credit-related life, accident and health, and involuntary unemployment insurance (1) with respect to lease transactions, as previously discussed, when such lease transactions are the equivalent of loans; (2) in connection with loans secured by residential first mortgages; and (3) in connection with the servicing of loans originated or purchased by the applicant bank holding company and subsequently sold.

The regulation explicitly permits the sale of life, disability, and involuntary unemployment

insurance with respect to a lease transaction, provided the lease is the type of nonoperating, full payout lease described as permissible for bank holding companies in section 225.28(b)(3) of Regulation Y. The Board has determined that such leases are the “functional equivalent of an extension of credit.” It believes that this type of lease is encompassed in the term “extension of credit” as it is used in exemption A of the Garn–St Germain Act.

As discussed previously, the first exemption of the Garn–St Germain Act permits the sale of any type of life, disability, and involuntary unemployment insurance relating to an extension of credit, including home mortgage redemption insurance. Home mortgage insurance insures the repayment of the unpaid balance of a residential first mortgage loan in the event of the death or disability of the mortgagor. The Board has determined that home mortgage redemption insurance is closely related to banking because it supports the lending function (1986 FRB 339 and 671) by providing for repayment of residential mortgage loans at a time when the death or disability of the borrower may delay or disrupt the scheduled repayment of such loans. Home mortgage redemption insurance in connection with residential mortgage loans is considered as fulfilling the same function as credit life and credit accident and health insurance with respect to other types of loans. The Board recognized that such insurance functions as credit insurance in supporting a bank’s lending function (see the Board’s approval for the *sale* of such insurance by bank holding companies within 1975 FRB 45).

In approving the activity of home mortgage redemption insurance by order, the Board previously relied on commitments by applicants to inform, in writing, borrowers who are prospective purchasers of such insurance that home mortgage redemption insurance is not required and that, if desired, it may be purchased from other sources. The Board has also relied on a commitment for written notice to borrowers that the insurance contract may be rescinded at any time after the loan commitment is made and before closing. The Board continues to require that such notices be provided to borrowers. In addition, the Board continues to rely on the fact that premiums for such insurance are payable periodically during the term of the extension of credit, so as to increase the borrowers’ ability to rescind the insurance and to limit premium financing as an incentive to sell such insurance.

The Board considers an “extension of credit” as covering loans that are made or purchased by the bank holding company or its subsidiaries. Credit-related insurance may be continued on the loans that were sold, and are now only being serviced, provided that they were made or purchased by the bank holding company or its subsidiaries. The Board permits bank holding companies to sell credit-related life, accident and health, and involuntary unemployment insurance where the bank holding company previously placed funds at risk. In this situation, the bank holding company must continue to limit its insurance coverage to the outstanding balance due on the extension of credit by the borrower.

A bank holding company may not sell or underwrite insurance when merely servicing a loan and *it has never placed its funds at risk* either by originating or purchasing the loan; the bank holding company is permitted to collect and transmit insurance premiums, act as intermediary in renewing existing policies or adjusting coverages, and engage in other activities which are incidental to the servicing of loans. The bank holding company may collect a fee for such services, providing that the fee is based on the provision of the service and is not a premium for insurance sold. In that case, the bank holding company would be engaging in loan servicing rather than insurance activities.

### 3170.0.3.2 Section 225.28(b)(11)(ii) of Regulation Y—Sale of Credit-Related Property Insurance by Finance Company Subsidiaries of a BHC

The Garn–St Germain Act restricts the authority of bank holding companies to engage in property and casualty insurance activities. Before 1982, the Board approved the sale of property and casualty insurance that was directly related to an extension of credit by a bank or bank-related firm in the bank holding company system. The sale of property insurance is now limited to an extension of credit made by a finance company that is a subsidiary of a bank holding company, acting as agent or broker. A finance company subsidiary may only engage in the sale of such property insurance if—

1. the insurance is limited to assuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit;

2. the extension of credit is not more than \$10,000, or \$25,000 if it is to finance the purchase of a residential manufactured home<sup>3</sup> and the credit is secured by the home; and
3. the applicant commits to notify borrowers in writing that—
  - a. they are not required to purchase such insurance from the applicant;
  - b. such insurance does not insure any interest of the borrower in the collateral; and
  - c. the applicant will accept more comprehensive property insurance in place of such single interest insurance.

#### 3170.0.3.2.1 Definition of a Finance Company

A “finance company” for purposes of the sale of property insurance includes all non-deposit-taking financial institutions that engage in a significant degree of consumer lending (excluding lending secured by first mortgages) and all financial institutions specifically defined by individual states as finance companies that engage in a significant degree of consumer lending. Finance companies, under this provision, include those entities that may be authorized to accept limited types of time or savings deposits under state law but which a state has defined to be a finance company. Since exemption B of the Garn–St Germain Act is directed to consumer loans, the regulation requires that a qualifying company be engaged in that type of lending to a significant degree as measured by either number of loans, percentage of loans, percentage of loan amounts outstanding, or some similar measure. The Board will evaluate the amount of the consumer lending on a case-by-case basis.

#### 3170.0.3.2.2 Property Insurance a Finance Company May Sell

Section 225.28(b)(11)(ii) of Regulation Y permits finance company subsidiaries of bank holding companies to engage in the sale of single-interest property insurance that insures against damage or loss only to the extent of the lender’s interest in the property that serves as collateral for a loan. The Garn–St Germain Act limits the permissible insurance coverage to “the out-

3. These limitations increase at the end of each year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

standing balance due on an extension of credit.” It does not contemplate general property insurance that covers the entire value of the property, including the balance due the lender and the equity interest of the borrower/owner. Generally such insurance is declining balance and the only interest in the collateral property that may be insured is that of the lender.

The sale of single-interest insurance is permitted provided that the BHC finance company subsidiary does not require such insurance of borrowers who have adequate property insurance on the loan collateral. In addition, the finance company subsidiary is required to disclose in writing that such insurance, if required, need not be purchased from the lender and that such insurance does not cover the borrower’s interest in the property. The requirement is also imposed by the Board’s Regulation Z, section 226.4(d)(2), if the premium is excluded from the finance charge.

### 3170.0.3.3 Section 225.28(b)(11)(iii) of Regulation Y—Insurance in Small Towns

Engaging in any insurance activity is permitted in a place where the bank holding company or a subsidiary of the bank holding company has a lending office in a community that—

1. has a population not exceeding 5,000 (as shown by the last preceding decennial census) or
2. has inadequate insurance-agency facilities, as determined by the Board, after notice and opportunity for hearing.

In order to provide insurance agency activities in a town with a population not exceeding 5,000, or in a community that has inadequate insurance agency facilities, the bank holding company must have a lending office that serves the public in the small town. The regulation specifically requires that the office be a lending office in order to provide the bank holding company with a link to the town, to avoid remote operation from a central location of a network of small-town insurance agencies, and generally to maintain insurance as a fee-generating activity to help sustain a small-town lending office as an independent, viable profit center.

The *current* requirement does not limit the sale of insurance to a “principal place of banking business” located in a community not exceeding a population of 5,000. Also, a bank holding company insurance agency is not precluded from selling insurance to those residing outside the community who initiate the transac-

tion at the agency’s place of business in the town of less than 5,000. Advertising in the community newspaper or a telephone book that may serve an area larger than the community of 5,000 is also not prohibited. The current regulation requires that the bank holding company or a subsidiary thereof establish or have a lending office in the community that has a population not exceeding 5,000.

### 3170.0.3.4 Section 225.28(b)(11)(iv) of Regulation Y—Insurance Agency Activities Conducted on May 1, 1982

This provision of the regulation includes engaging in any specific insurance agency activity<sup>4</sup> if the bank holding company, or subsidiary conducting the specific insurance agency activity, conducted the insurance agency activity on May 1, 1982, or received Board approval to conduct the insurance agency activity on or before May 1, 1982. Activities engaged in on May 1, 1982, include activities carried on subsequently as the result of an application to engage in such activities pending before the Board on May 1, 1982, and approved subsequently by the Board or as the result of an acquisition by such company pursuant to a binding written contract entered into on or before May 1, 1982, of another company engaged in such activities at the time of the acquisition.

A bank holding company or subsidiary engaging in a specific insurance-agency activity under section 225.28(b)(11)(iv) of Regulation Y may—

1. engage in such specific insurance-agency activity only at locations—
  - a. in the state in which the bank holding company has its principal place of business (as defined in 12 U.S.C. 1842(d));
  - b. in any state or states immediately adjacent to such state; and
  - c. in any state in which the specific insurance-agency activity was conducted (or was

4. Nothing in paragraph (iv) precludes a BHC subsidiary that is authorized to engage in a specific insurance-agency activity under this clause from continuing to engage in the particular activity after merger with an affiliate, if the merger was for legitimate business purposes and prior notice has been provided to the Board.



approved to be conducted) by such bank holding company or subsidiary thereof or by any other subsidiary of such bank holding company on May 1, 1982; and

2. provide other insurance coverages that may become available after May 1, 1982, so long as those coverages insure against the types of risks as (or are otherwise functionally equivalent to) coverages sold or approved to be sold on May 1, 1982, by such bank holding company or subsidiary.

This provision of the regulation parallels exemption D of the Garn–St Germain Act and grandfathered those insurance agency activities in which individual bank holding companies were engaged on May 1, 1982. Under this provision, a bank holding company or subsidiary thereof may continue to engage in particular types of insurance agency activities that were permissible before the passage of the Garn–St Germain Act but which are now prohibited by that act. A qualifying bank holding company may engage, for example, in the sale of property and casualty insurance on property serving as collateral for loans made by a lending subsidiary of the holding company.

A qualifying bank holding company may also engage in grandfathered insurance related to the provision of “other financial services” previously authorized under section 225.28(b)(11)(i)(B) of Regulation Y. This type of insurance is not considered to be related to an extension of credit under the Garn–St Germain Act. As a result, the Board *no longer permits* the sale of insurance related to the provision of the general financial services offered by a bank or bank-related firm. Such insurance included, for example, insurance on the contents of safe deposit boxes, or savings completion insurance on certificates of deposit, Christmas club accounts, individual retirement accounts, tuition completion plans, or credit-related insurance for serviced loans. Prior to the Garn–St Germain Act, insurance related to the provision of general financial services was permitted to be sold to borrowers whose loans were neither purchased nor originated, but may have been serviced by the bank holding company. Insurance with respect to loan servicing was the primary type of insurance previously permitted by the Board as related to such financial services. Now, the Garn–St Germain Act limits the sale of insurance by bank holding companies in general to insurance related to an extension of credit.

#### *3170.0.3.4.1 Limitations on Expansion of Grandfather Rights*

Exemption D provides for limited expansion of grandfathered insurance agency activities in order to permit qualifying bank holding companies to remain effective insurance agent competitors. The exemption presented three issues that the Board resolved in paragraph (iv) of the regulation: (1) defining which subsidiaries of a bank holding company may engage in otherwise impermissible insurance agency activities under exemption D; (2) the scope of permissible geographic expansion; and (3) the scope of product-line expansion.

#### *Specific Subsidiaries That May Engage in Grandfathered Activities*

Grandfather rights do not inure to the benefit of the entire holding company system by virtue of the fact that a particular subsidiary was engaged in insurance agency activities before May 1, 1982. Only the subsidiary of the bank holding company that was engaged in insurance activities on May 1, 1982, or received Board approval to engage in insurance activities before May 1, 1982, has grandfather status.

The Board believes that the emphasis in the legislative history on the transfer of grandfather rights shows the intent of Congress to prohibit not only the transfer of such rights from “grandfathered” subsidiaries to those affiliates wholly without grandfather rights, but also to prohibit the transfer of grandfather rights with respect to particular kinds of insurance from one “grandfathered” subsidiary to another. Thus, a subsidiary that sold only credit life insurance before the grandfather date should not acquire grandfather rights to sell property and casualty insurance solely because an affiliate sold property and casualty insurance before the grandfather date. The grandfather rights of a particular subsidiary are limited to the precise activities (or their functional equivalent) engaged in before May 1, 1982. This requirement does not preclude the transfer of grandfather rights in the case of a bona fide merger (1983 FRB 554, 555).

Section 225.28(b)(11) of the Board’s Regulation Y is only intended to clarify the exemptions in title VI of the Garn–St Germain Act. It does not authorize any bank holding company to commence any insurance activity, or to acquire a company with insurance activities, without compliance with the notice and application requirements of section 4(c)(8) of the BHC Act.

*Geographic Expansion by a Grandfathered Subsidiary of a Bank Holding Company.*

The language of exemption D of the Garn–St Germain Act, while limiting the grandfathered activities to those agency activities conducted by the specific grandfathered subsidiary, *does allow* expansion into states where such specific types of agency activities “were conducted by the bank holding company or any of its subsidiaries on May 1, 1982 . . .” If a bank holding company subsidiary is selling a particular type of insurance in a given state, the Board does not believe there is any regulatory or business purpose served by restricting another grandfathered subsidiary from engaging in the same activity in the same location.

*Product-Line Expansion*

The Board’s regulation provides for product-line expansion. A grandfathered subsidiary of a bank holding company may seek approval from the Board to engage in the sale of new types of insurance that protect against the same types of risks as, or are otherwise functionally equivalent to, insurance sold on the grandfather date.

*3170.0.3.4.2 Transfer of Grandfather Rights among Subsidiaries*

A grandfathered subsidiary of a bank holding company (or its successor) may retain its grandfather rights after merger with an affiliate, if such merger is based on legitimate business concerns, for example, centralized management or increased efficiency, rather than as a means of extending insurance powers. The regulation further provides that bank holding companies must advise the Board before any such merger for legitimate business purposes in order to confirm the transfer of grandfather rights.

*3170.0.3.5 Section 225.28(b)(11)(v) of Regulation Y—Bank Holding Company’s Insurance Coverage for Internal Operations*

The Garn–St Germain Act approved, and the revised Regulation Y included, insurance agency activities where the activities are solely limited to supervising on behalf of insurance underwrit-

ers the activities of retail insurance agents who sell—

1. fidelity insurance and property and casualty insurance on the real and personal property used in the operations of the bank holding company or its subsidiaries and
2. group insurance that protects the employees of the bank holding company or any of its subsidiaries.

This provision of Regulation Y is reflective of an intent on the part of Congress to avoid preempting certain practices permissible under Texas law. This insurance relates to a particular situation that may have little applicability elsewhere.

*3170.0.3.6 Section 225.28(b)(11)(vi) of Regulation Y—Small Bank Holding Companies*

The Board has determined in section 225.28(b)(11)(vi) of its Regulation Y that engaging in any insurance agency activity is permissible if the bank holding company has total consolidated assets of \$50 million or less. A bank holding company performing insurance agency activities under this paragraph *may not* engage in the sale of life insurance or annuities except as provided in section 225.28(b)(11)(i) and (iii) of Regulation Y, and it may not continue to engage in insurance agency activities pursuant to that provision more than 90 days after the end of the quarterly reporting period in which total assets of the holding company and its subsidiaries exceed \$50 million.

A bank holding company is required to cease general insurance-agency activities pursuant to this provision within 90 days after the end of the quarterly reporting period in which the bank holding company’s total assets exceed \$50 million. Thereafter, the bank holding company may continue to engage in the sale of insurance pursuant to other exemptions.

*3170.0.3.7 Section 225.28(b)(11)(vii) of Regulation Y—Insurance Agency Activities Conducted before 1971*

The Board has determined in section 225.28(b)(11)(vii) of its Regulation Y that any insurance agency activity performed at any loca-

tion in the United States directly or indirectly by a bank holding company that was engaged in insurance agency activities before January 1, 1971, as a consequence of approval by the Board before January 1, 1971, is permissible.

### *3170.0.3.7.1 Agency Activities*

The Board adopted a position in section 225.28(b)(11)(vii) permitting any qualifying bank holding company to engage in general insurance-agency activities without restriction as to location or to type of insurance sold (1985 FRB 171 and 1984 FRB 235, 470). A company qualifies under this provision if it was engaged in insurance agency activities as a consequence of Board approval before January 1, 1971. A very limited number of active bank holding companies received such Board approval in the period from passage of the BHC Act in 1956 until January 1, 1971.

The regulation does not limit the insurance agency activities of a qualifying company by requiring that the company engage only in the sale of such types of insurance as it sold before 1971 from such locations as it conducted insurance agency activities before 1971. The Board's regulation permits the limited number of qualifying companies to engage in general insurance-agency activities pursuant to exemption G regardless of their precise insurance agency activities before 1971 (1985 FRB 171 and 1984 FRB 470).

## **3170.0.4 INCOME FROM THE SALE OF CREDIT LIFE INSURANCE**

### **3170.0.4.1 Policy Statement on Income from Sale of Credit Life Insurance**

Effective May 1, 1981, the Board adopted a policy statement (1981 FRB 431) generally prohibiting employees, officers, directors, or others associated with a state member bank from profiting personally from the sale of life insurance in connection with loans made by the bank. The bank may, however, allow their employees and officers to participate in the income under a bonus or incentive plan not to exceed 5 percent of the recipient's annual salary. Income from the sale of credit-related life insurance should most appropriately be credited to the bank, or alternately to a bank

holding company or other affiliate of the bank so long as the bank receives reasonable compensation for its role in selling the insurance. As a general rule, "reasonable compensation" means an amount equivalent to at least 20 percent of the affiliate's net income attributable to the bank's credit life insurance sales. (Insurance agency activities engaged in directly by a bank subsidiary are regulated by the chartering authority. However, intercompany transactions should be reviewed by BHC inspection personnel.)

### **3170.0.4.2 Disposition of Credit Life Insurance Income**

The Comptroller of the Currency has issued a regulation dealing with sales of credit life, health, and accident insurance by national banks which prohibits transfer of insurance commissions to an affiliate of the bank unless commission income in proportion to the shares held by the bank's minority shareholders is placed in trust and paid to them periodically. Where the subsidiary bank is wholly owned by a bank holding company, however, the regulation allows the commissions to be credited to the holding company or to its wholly owned subsidiaries (12 C.F.R. 2).

## **3170.0.5 INSPECTION OBJECTIVES**

1. To determine the extent of insurance operations and the overall condition of subsidiaries engaged in insurance agency and underwriting activities.
2. To determine whether the types of insurance sold are in accordance with the provisions of section 225.28(b)(11) of Regulation Y.
3. To determine the impact of the performance of the activities on the parent bank holding company and its subsidiaries.
4. To suggest corrective action when necessary in the areas of policies, procedures, or laws and regulations.

## **3170.0.6 INSPECTION PROCEDURES**

Where the insurance activities are performed through an insurance agency or underwriting subsidiary, perform the following activities:

1. Compare the company's general ledgers with statements prepared for the latest FR Y-6 and the annual report to the state insurance department.



2. Review minutes of the board of directors meetings.
  3. Review the activity's compliance with the Board's policy statement on income from the sale of credit life insurance (See section 3170.0.4.1) and the Comptroller of the Currency's regulation dealing with the sales of credit life, health, and accident insurance by national banks (12 C.F.R. 2).
  4. Review any agreements, guarantees, or pledges between the subsidiary and its parent holding company or affiliates.
- Where the insurance activities are performed through an insurance agency or underwriting subsidiary or directly by the parent company, perform the following procedures:
1. Obtain copies of insurance policies issued to determine that the types and terms of insurance coverage sold are within the scope of those permitted by the Board under section 225.28(b)(11) of Regulation Y.
  2. Check for compliance with section 106(b) of the 1970 Amendments to the BHC Act (prohibition against tie-in arrangements).

### 3170.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
General description of permissible insurance agency and underwriting activities		225.28(b)(11)	4-050.1	1986 FRB 829
Garn-St Germain Depository Institutions Act, title VI amending section 4(c)(8) of the BHC Act	1843(c)(8)			
Insurance agency activities permitted for national banks	Section 13, paragraph 11 of the Federal Reserve Act			
Permissibility of some types of mortgage insurance				40 <i>Federal Register</i> 2766 40 <i>Federal Register</i> 13042 1975 FRB 45 1975 FRB 678
Impermissibility of mortgage guarantee insurance				40 <i>Federal Register</i> 44624
Court review of activity				533 F. 2d 224 (5th Circuit, 1976) 558 F. 2d 729 (5th Circuit, 1977)

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

3. Federal Reserve Regulatory Service reference.

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Level term credit life insurance				39 <i>Federal Register</i> 26318 39 <i>Federal Register</i> 32796 40 <i>Federal Register</i> 11647
Permissible insurance coverage limited to actual debtors				39 <i>Federal Register</i> 7493
Sale of home mortgage redemption insurance				1986 FRB 339, 671 1975 FRB 45
Joint credit life insurance				39 <i>Federal Register</i> 38942 1974 FRB 138
Tie-in arrangements	Section 106(b) of the Bank Holding Company Act Amendments of 1970	225.7		38 <i>Federal Register</i> 6441 1975 FRB 693, 678, 686
Permissibility of selling insurance in small communities				44 <i>Federal Register</i> 65051
Policy statement on income from sale of credit life insurance			3–1556	1981 FRB 431
Transfer of insurance agency grandfather rights in the case of a bona fide merger				1983 FRB 554, 555
Permissibility of credit-related property and casualty insurance activities				1984 FRB 452
Insurance agency activities conducted before 1971—BHCs permitted to engage in insurance agency activities without restriction as to location or to type of insurance sold				1985 FRB 171 1984 FRB 235, 470
General insurance-agency subsidiary qualifies for grandfather privileges under exemption D of the Garn–St Germain Act; grandfather privileges do not terminate upon its acquisition by a nongrandfathered BHC				1987 FRB 276, 672

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

3. Federal Reserve Regulatory Service reference.

3180.0.1 INSURANCE  
UNDERWRITING ACTIVITIES

On December 11, 1972, after consideration of a public hearing held on March 24, 1972, the Board amended Regulation Y to add the activity of underwriting credit life insurance and credit accident and health insurance to the list of activities in which a bank holding company may engage, provided that such insurance is directly related to an extension of credit by the holding company system. Such insurance ensures a bank or bank-related firm of repayment of a credit extension in the event of death or disability while at the same time providing the borrower with financial security in either event. In approving this activity, the Board set forth, in a footnote to Regulation Y, requirements to ensure that performance of the activity would result in demonstrable benefits to the public. The Board stated that applications to engage in underwriting activities would be approved only in cases in which the applicant demonstrates that such approval would benefit the consumer or result in other public benefits and that normally such a showing would be made by a projected reduction in rates charged the public for the insurance or an increase in other public benefits resulting from bank holding company performance of this service.

On October 3, 1986, the Board adopted a revision of the provisions of Regulation Y that deals with permissible insurance agency and underwriting activities for bank holding companies. The general revision of the insurance provisions of Regulation Y combined both the insurance agency and insurance underwriting activities reflects amendments to the Bank Holding Company Act by the Garn–St Germain Depository Institutions Act of 1982. The revision of the provisions relating to insurance underwriting eliminated the rate-reduction requirement that previously applied to those companies engaged in the underwriting of credit life, credit accident and health, and involuntary unemployment insurance. Accordingly, bank holding companies engaging in this activity may charge premiums as permitted by the states.

In order for insurance underwriting (including home mortgage redemption insurance) to be permissible in accordance with section 225.28(b)(11) of the Board’s revised Regulation Y, the insurance must—

1. be directly related to an extension of credit<sup>1</sup> by the bank holding company or any of its subsidiaries and
2. be limited to ensuring the repayment of the outstanding principal balance due on the extension of credit in the event of the death, disability, or involuntary unemployment of the debtor.

3180.0.1.1 Insurance Underwriting  
Activities Permissible for Bank Holding  
Companies per Section 225.28(b)(11)(i)  
of the Board’s Regulation Y—Credit  
Insurance

The Board permits the insurance underwriting activities described above as well as the insurance agency activities described in section 3170.0.

In section 225.28(b)(11)(i) of Regulation Y, the Board issued three significant interpretations of the term “extension of credit” as contained in the Garn–St Germain Act. It permits the underwriting of credit-related life, accident and health, and involuntary unemployment insurance (1) with respect to lease transactions where such lease transactions are the equivalent of loans (leasing is addressed in section 3140.0), (2) in connection with loans secured by residential first mortgages, and (3) in connection with the servicing of loans originated or purchased by the applicant bank holding company and subsequently sold.

Permissible insurance underwriting requires that the credit insurance must be directly related to an extension of credit by the bank holding company or any of its subsidiaries. An “extension of credit” includes direct loans to borrowers, and the lease of real or personal property, and loans purchased from other lenders. The first significant interpretation, noted above, allows the inclusion of leasing personal or real property, provided the lease is a nonoperating and full-payout lease, the insurance ensuring the payment of the remaining lease payments that are due in the event of the death, disability, or involuntary unemployment of the lessee.

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1. “Extension of credit” includes direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases are nonoperating and full-payout leases.

The interpretation thus defines leases as the functional equivalent of an extension of credit.

The second interpretation in paragraph (i) of the regulation involving the definition of “extension of credit” is the permissibility of underwriting home mortgage insurance, which ensures the repayment of the unpaid balance of a residential first mortgage loan in the event of the death or disability of the mortgagor. Exemption A of the Garn–St Germain Act permits the underwriting of any type of life, disability, and involuntary unemployment insurance related to an extension of credit by a bank holding company as long as the face value of the insurance policy does not exceed the “outstanding balance due” on the extension of credit. The Board continues to require that insurance policies written insure only named borrowers or lessees of a particular bank holding company. Such policies could cover both spouses jointly, but only if both spouses were actual borrowers or lessees under the terms of the agreement with the bank holding company (see 1974 FRB 138).

The Board had previously held that the underwriting of home mortgage insurance is not closely related to banking in part because it is more like general life insurance than credit life insurance and in part because banks have not generally underwritten such insurance (see 1980 FRB 660 and 1982 FRB 318). Recently, however, the Board permitted bank holding companies to underwrite such insurance (see 1986 FRB 339 and 1986 FRB 671). In permitting this activity by order, the Board provided detailed findings that the underwriting of home mortgage redemption insurance is permitted by exemption A of the Garn–St Germain Act, is closely related to banking, and does not present the possibility of such significant adverse effects that it should not be added to the list of activities permissible for bank holding companies. The Board also found that home mortgage insurance supports the lending function. The Board thus believes, for the reasons cited in the above-cited orders, that the underwriting of home mortgage redemption insurance is permissible for bank holding companies.

In approving the underwriting of home mortgage insurance by order, the Board relied on commitments by applicants to inform, in writing, borrowers who are prospective purchasers of such insurance that home mortgage redemption insurance is not required and that, if desired, it may be purchased from other sources. The Board has also relied on a commitment for

written notice to borrowers that the insurance contract may be rescinded at any time after the loan commitment is made and before closing. In processing applications to engage in the underwriting of home mortgage redemption insurance pursuant to the current regulation, the Board, and the Reserve Banks acting pursuant to delegated authority, will continue to require that such notices be provided to borrowers. In addition, the Board will continue to rely on the fact that premiums for such insurance are payable periodically during the term of the extension of credit, so as to increase the borrower’s ability to rescind the insurance and to limit premium financing as an incentive to sell and underwrite such insurance.

A third significant interpretation of the term “extension of credit” found in exemption A of the Garn–St Germain Act involves the underwriting of insurance in connection with the serviced loans (see section 3170.0.3.1) The Garn–St Germain Act limits bank holding companies in general to insurance related to an extension of credit. The term “extension of credit” is used in exemption A to describe transactions in which the funds of the bank holding company or its subsidiaries have been placed at risk, including direct loans or leases or loans that have been purchased. Loans that are merely being serviced by the bank holding company generally would not be covered by this definition.

The underwriting of insurance on loans being serviced is necessary only when the term of the insurance was originally shorter than that of the loan. The bank holding company that is selling and underwriting insurance on the loan that it originated and is servicing is, in effect, only extending the term of its original insurance policy to be coterminous with the duration of the loan. It is providing insurance that it could have provided previously. A bank holding company may not underwrite insurance in the case where it is merely servicing a loan and it has never placed its funds at risk either by originating or purchasing the loan.

#### 3180.0.2 LIMITED PROPERTY INSURANCE RELATED TO AN EXTENSION OF CREDIT (FINANCE COMPANY SUBSIDIARY OF A BANK HOLDING COMPANY)

The Board’s revised regulation does not permit the underwriting of this type of insurance. See section 225.28(b)(11)(ii) of Regulation Y and section 3170.0.3.1 for information on authorized insurance agency activities.

### 3180.0.3 INSURANCE ACTIVITIES BEFORE 1971

The Board's revised regulation (section 225.28(b)(11)(vii)), as it relates to exemption G of the Garn–St Germain Act, does not authorize underwriting activities for bank holding companies. See section 3170.0.3.7 for information on the respective authorized insurance-agency activities under exemption G.

### 3180.0.4 UNDERWRITING AS REINSURER

The majority of bank holding company subsidiaries engaged in insurance underwriting are reinsurers rather than direct underwriters. As reinsurer, these companies engage a direct insurer to issue the policies, collect the premiums, pay claims, maintain accounting books and records, prepare federal and state tax returns, and perform other services necessary to conduct the insurance activities. Usually, such reinsurance companies will have executed a reinsurance agreement and a service agreement with the direct underwriter which spell out all services to be performed and set the fees to be paid for such services. The above arrangement involves a minimum of activity by the reinsurer and is probably most often chosen by bank holding companies since it does not place additional burdens on management and precludes hiring actuaries and other professional personnel to manage the insurance company.

There are many ratios or measures used to evaluate the condition of insurance underwriters. The National Association of Insurance Commissioners has developed a system consisting of nine ratios that measure various aspects of life and health insurance companies' financial condition and stability (*The Early Warning System for Life and Health Insurance Companies*). These tests establish benchmarks which are likely to distinguish between troubled and sound companies. The examiner may wish to compare the subject company's ratios to these benchmarks. When making comparisons, however, the examiner should recognize that one insurer may require a somewhat better ratio than another due to greater underwriting and investment risks. Smaller companies will generally maintain a proportionately larger surplus account since loss experience on a small volume of business tends to fluctuate more widely.

Another possible source of information available to help determine a company's condition is *Best's Insurance Reports*. The report is pub-

lished annually and provides pertinent financial and historical data for legal reserve life insurance companies operating in the United States and Canada. It assigns a rating for each company in the report. Information presented in the report is taken from annual statements filed with the state insurance departments. It should be noted that reports filed with the insurance departments are prepared using the statutory method of financial accounting and presentation rather than generally accepted accounting principles. Beginning in 1973, insurance companies were required to adhere to generally accepted accounting principles for certification of financial statements (see *Audits of Stock Life Insurance Companies*, American Institute of Certified Public Accountants), however, they continue to report under the statutory method to the state insurance departments. The statutory method is basically a cash-basis accounting presentation which generally depicts a more conservative position. Certain assets are "not admitted" by regulatory authorities in the financial presentation because they are not readily convertible into cash for the payment of claims and expenses.

Policy reserves represent the primary liability portion of underwriters' balance sheets. There are several acceptable methods permitted by state authorities for calculating these reserves. Most of these methods are rather complicated and a description of their calculation is beyond the scope of this manual. However, insurance companies are generally closely regulated by state authorities, which place primary importance on determining the adequacy of the policy reserves. A review of the latest available insurance examination report should give an evaluation of the adequacy of the reserves.

Reinsurance arrangements may distribute the insurance and losses in many different ways between the direct insurer and the reinsurer. An understanding of such arrangements is essential in determining the extent of risk incurred by the company being inspected.

### 3180.0.5 INSPECTION OBJECTIVES

1. To determine the extent of underwriting activities and the overall condition of subsidiaries engaged in underwriting.
2. To determine whether the activities performed are within the scope of those permitted under section 225.28(b)(11) of Regulation Y.

3. To determine the impact of the underwriting operations on the parent bank holding company and its subsidiaries.
4. To suggest corrective action where necessary in the areas of policies, procedures, or laws and regulations.
4. Review intercompany transactions, including balances maintained with or assets purchased from affiliated banks.
5. Review any agreements, guarantees, or pledges between the company and its parent holding company or affiliates.

Where the insurance activities are performed either directly or through an underwriting subsidiary, perform the following procedures:

### 3180.0.6 INSPECTION PROCEDURES

Where the insurance underwriting activities are performed through an underwriting subsidiary, perform the following procedures:

1. Compare the company's general ledgers with statements prepared for the latest FR Y-6. (Generally, records are maintained on the statutory accounting basis and are more easily tied to the financial statements in the annual report to the state insurance department).
2. Review minutes of the board of directors meetings.
3. Review the quality and liquidity of the subsidiary company's investments in CDs, stocks, bonds, or other marketable securities.
1. Review copies of any reinsurance and/or service agreements executed with other insurance companies.
2. Review the latest annual report submitted to the state insurance department.
3. Review the latest report of examination prepared by the state insurance department.
4. Check calculation of premium charges by a random sample of policies for adherence to the state rate structure.
5. Obtain copies of insurance policies issued to customers to determine that the types of insurance coverage and terms offered are within the scope of those permitted under section 225.28(b)(11) of Regulation Y.

### 3180.0.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Permissible underwriting activities	12 U.S.C. 1843(c)(A)–(G)	225.28(b)(11)	4–050.1	
Underwriting of permissible credit-related home mortgage insurance				1986 FRB 671, 339
Nonpermissibility of mortgage guarantee insurance				1974 FRB 727
Underwriting of joint credit life insurance			4–337	39 Federal Register 7493 1974 FRB 138

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

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

3. Federal Reserve Regulatory Service reference.

Courier activities are permissible for bank holding companies if the items being transported by the courier are themselves related to bank operations. Examples of such items are drafts, money orders, travelers' checks, commercial papers, written instruments, and data processing material. Currency and bearer-type negotiable instruments which require more than normal security measures may not be transported by the company.

If the courier company operates under the exemptive provision of section 4(c)(8) of the Bank Holding Company Act, the following restrictions are placed on its operations to ensure competition:

1. The company must be a separate, independent corporate entity.
2. The company must be profit-oriented and not subsidized by the holding company system.
3. Services of the company must be performed on a specific-fee basis with direct payment from the customer. Payment may not be made indirectly such as through maintenance by the customer of deposit balances at an affiliated bank.
4. Upon request, the company must furnish comparable services at comparable rates to firms which compete with banking or data processing subsidiaries of its parent company, unless compliance with the request would be beyond the practical capacity of the company.

The last restriction was intended to prevent use of bank-affiliated courier services for the purpose of gaining an advantage over competitors to whom courier services were not otherwise available.

## 3190.0.1 INSPECTION OBJECTIVES

1. To determine if the company is operating in compliance with applicable laws and regulations, and ensure that corrective action will be taken, if appropriate.

2. To determine if courier services are provided to competing institutions upon their request if courier services are not otherwise available.

## 3190.0.2 INSPECTION PROCEDURES

1. Determine whether the company makes known to its customers its minimum rate schedule for services and its general pricing policies.
2. Determine whether the company maintains for a period of two years or more the records of each request for service which it has denied to firms competing with the banking and data processing subsidiaries of its parent company. The reasons for the denial must also be recorded and maintained for a like period.
3. Review income statements of the company to ascertain whether the company is operating profitably, without a subsidy in any manner from any entity within the holding company system. Any operating losses sustained over an extended period of time are inconsistent with continued authority to engage in courier services.
4. Determine whether the materials transported by the company are restricted to those which would normally be exchanged among banks and banking institutions, including audit and accounting media of a banking or financial nature, and other business records or documents used in processing such media.

## 3190.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Courier activities of bank holding companies		225.28(b)(10)		1973 <i>Fed. Reg.</i> 32136 1975 <i>Fed. Reg.</i> 36309
Conditions of entry into courier activities		225.129	4-180	

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

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

3. Federal Reserve Regulatory Service reference.



On February 26, 1974, the Board amended Regulation Y to permit bank holding companies to engage in the activity of providing bank management consulting services to nonaffiliated commercial banks. The advisee institution must be a “bank” as that term is defined by section 2(c) of the BHC Act or an operations subsidiary of such an institution. (See 12 C.F.R. 250.141.) Effective April 20, 1982, the Board expanded this activity by permitting holding companies to provide management consulting advice to nonbank depository institutions. When expanding the activity to include management consulting advice to nonbank depository institutions, the Board indicated that the advisory services provided to nonbank institutions should generally be the services that were then being provided to banks.

Effective April 21, 1997, management consulting was expanded in Regulation Y (section 225.28(b)(9)) to allow bank holding companies to provide management consulting services to any customer on any matter so long as the total annual revenue derived from third-party management consulting services by a nonbank subsidiary of the bank holding company is less than 30 percent of the subsidiary’s total annual revenues derived from all management consulting activities. The Board continues to view “management consulting” as including, but not limited to, providing analysis or advice as to a firm’s—

1. purchasing operations, such as inventory control, sources of supply, and cost minimization subject to constraints;
2. production operations, such as quality control, work measurement, product methods, scheduling shifts, time and motion studies, and safety standards;
3. market operations, such as market testing, advertising programs, market development, packaging, and brand development;
4. 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;
5. personnel operations, such as recruitment, training, incentive programs, employee compensation, and management-personnel relations;
6. internal operations, such as taxes, corporate organization, budgeting systems, budgeting control, evaluation of data processing systems, and efficiency evaluations; and

7. research operations, such as product development, basic research, and product design and innovation.

By interpretation, the Board previously determined that it considers bank management consulting advice to include, but not be limited to, advice concerning (1) bank operations, systems, and procedures; (2) computer operations and mechanization; (3) implementation of electronic funds transfer systems; (4) site planning and evaluation; (5) bank mergers and the establishment of new branches; (6) operation and management of a trust department; (7) international banking and foreign-exchange transactions; (8) purchasing policies and practices; (9) cost analysis, capital adequacy, and planning; (10) auditing; (11) accounting procedures; (12) tax planning; (13) investment advice as authorized in section 225.28(b)(6) of Regulation Y; (14) credit policies and administration, including credit documentation, evaluation, and debt collection; (15) product development, including specialized lending provisions; (16) marketing operations, including research, market development, and advertising programs; (17) personnel operations including recruiting, training, evaluation, and compensation; and (18) security measures and procedures. Providing management consulting advice on compliance with laws and regulations may be accomplished only when these activities are incidental to a primary consulting activity and when such advice would not constitute the rendering of legal advice.

In general, those consulting services that correspondent banks traditionally have provided to their respondents (both bank and nonbank depository institutions) are considered to be included within the scope of Regulation Y as permissible services to be provided by nonbank holding company subsidiaries to nonaffiliated bank and nonbank depository institutions.

### 3200.0.1 MANAGEMENT CONSULTING LIMITATIONS

Recognizing the potential for conflict-of-interest situations, such as the possibility for anticompetitive cooperative arrangements, improper use of confidential information, and similar abuses that this activity could entail, the Board incorporated in Regulation Y a few restrictions on a

bank holding company. With regard to affiliation status, neither the bank holding company nor any of its subsidiaries may own or control directly or indirectly more than 5 percent of the voting securities of the client institution. The prohibition would not apply when the shares were acquired in satisfaction of a debt previously contracted or to shares acquired in a fiduciary capacity without sole discretionary voting authority. A bank holding company may offer consulting advice to a client institution whose shares it holds in a fiduciary capacity with sole discretionary voting rights if said holding company does not hold more than 5 percent of the voting shares of that institution. Bank holding companies are permitted to have common management officials with the client institution to which they provide management consulting services if such interlocks would be permissible under exceptions found in the Board's Regulation L (Management Official Interlocks) that apply to such institutions in need of management or operating expertise (12 C.F.R. 212.4(b)).

Management consulting services may not be provided to a client on a daily or continuing basis except where necessary to instruct the client on how to perform the services for itself. The Board has informed bank holding companies that their management consulting subsidiaries should refrain from entering relationships on a daily or continuing basis even when the client institution may be experiencing financial or managerial difficulties. Particular caution should be exercised when a bank holding company contemplates the subsequent acquisition of the client institution. However, when a bank holding company is attempting to acquire a troubled depository institution, limited management consulting services may be offered via an on-premises bank holding company employee. Nevertheless, the representative should not have the authority to lend or make personnel decisions. Failure to heed these guidelines not only would cause the bank holding company to exceed the permissible bounds of the activity, but also could cause the BHC to acquire control of the client institution that might constitute an acquisition of a subsidiary within the meaning of section 3(a) of the BHC Act. Section 225.31(d)(2)(i) of Regulation Y indicates that a rebuttable presumption of control shall exist when a company enters into an agreement, such as a management contract, with a bank or other company pursuant to which the first company or any of its subsidiaries exercises significant influ-

ence over the general management or overall operations of the bank or other companies. Reserve Bank personnel are encouraged to contact the Board's applications section to discuss the restrictions on this activity whenever a BHC proposes to have its personnel assist a troubled or problem institution.

When evaluating a BHC's application to engage in management consulting, it is important to note whether the applicant bank holding company has exhibited the necessary expertise in operating its own subsidiaries—and whether this expertise qualifies it to offer advice to others.

### 3200.0.2 INSPECTION OBJECTIVES

1. To verify that the bank holding company is performing only those types of management consulting services at the locations for which it received prior regulatory approval.
2. To verify that the advice being provided is within the scope of the approval and consistent with the activities of the interpretation (12 C.F.R. 225.131) and section 225.28(b)(9) of Regulation Y.
3. To determine that the bank holding company does not own or control, directly or indirectly, securities of its client depository institutions except for shares acquired as the result of a default on a debt previously contracted or shares held in a fiduciary capacity (within certain limits), provided the holding company does not have sole discretionary authority to vote more than 5 percent of the client's shares. (See 12 C.F.R. 225.131.)
4. To determine that the bank holding company does not control the activities of a client institution by virtue of nonexempt interlocking directors.
5. To determine that services rendered to the client institutions are not being provided on a daily or continuing basis.
6. To determine that disclosure is made to each client of (1) the names of all depository institutions that are affiliates of the consulting company and (2) the names of all existing client institutions located in the same county (or counties) or standard metropolitan statistical area (or areas) (SMSA) as the client institution.

### 3200.0.3 INSPECTION PROCEDURES

A thorough review of pertinent records, contracts, lists of clients, and documentation of the

services being provided to clients should be undertaken to determine that adequate management information systems and detailed revenue and other reports are available to verify the BHC's compliance with the Board's rule on the revenue limitations in section 225.28(b)(9) of Regulation Y. Determine that services are being provided to the appropriate customer base and within the scope of the Board's approval. Further, the examiner should ascertain the existence of procedures to inform each potential client of the names of all depository and client institutions that are affiliates of the consulting company and of the names of all existing clients located in the same market area as the prospective client.

For management consulting services that do not involve any financial, economic, accounting, and auditing matters, verify that the revenues earned are within the limits permitted by the Board's regulations and interpretations. The basis for any fee structure should be determined to ascertain that the advice is being rendered on an explicit-fee basis, such as an hourly or daily

rate. Such fees should not be affected by factors not directly related to the service, such as balances maintained by the client at any subsidiary depository institution of the bank holding company. The extent of the consultant company's involvement in the day-to-day affairs and operation of the client should also be reviewed.

The absence of parent company control, direct or indirect, over the clients of the management consulting subsidiary should be established. The examiner should compare listings of directors and principal officers of the bank holding company, its various affiliates, and the clients with due regard to exempt interlocks. The examiner should determine the extent of ownership or control by the bank holding company and its affiliates of any equity securities in its clients by requesting a listing of all shares owned in outside organizations. Overall conclusions, including recommendations concerning the operation, apparent violations, and any possible control of client institutions and conflicts of interest, should be discussed with parent company management and detailed in the inspection report.

### 3200.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Orders, interpretation preceding permissibility of bank management consulting	225.131 225.113		4-194	1972 FRB 676 1972 FRB 674
Bank management consulting authorized as permissible nonbank activity		225.28(b)(9)	4-181	1974 FRB 226 1974 FRB 675
Presumption of control		225.31(d)		
Exemption from section 8 of Clayton Act for banks in low-income areas			3-830	
Bank management consulting as possible rendering of legal advice				39 <i>Fed. Reg.</i> 41586
Other approvals				39 <i>Fed. Reg.</i> 39106 39 <i>Fed. Reg.</i> 36508 1976 FRB 725

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

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

3. *Federal Reserve Regulatory Service* reference.

<i>Subject</i>	<i>Laws<sup>1</sup></i>	<i>Regulations<sup>2</sup></i>	<i>Interpretations<sup>3</sup></i>	<i>Orders</i>
Justice Department concern over possible conflicts of interest				1977 FRB 950
Limitations on activity when acquisition of bank is involved				1976 FRB 699 1977 FRB 1088
Permissible interlocking directors		212.4(a)(1)		1979 FRB 654
Deferral of decision to consider offering of management consulting advice to unaffiliated savings banks as a permissible activity				42 <i>Fed. Reg.</i> 22560
Expanding activity to include non-bank depository institutions				1982 FRB 237 and 238
Management consulting to failed savings associations				1988 FRB 771
Expansion of the activity to include—		225.28(b)(9)(i)		1997 FRB 275
1. services regarding financial, economic, accounting, or audit matters to any company;				
2. the ability of the BHC's non-bank subsidiary to provide limited management consulting services to any third-party customer on any matter.				

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

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

3. *Federal Reserve Regulatory Service* reference.

Within Regulation Y (section 225.28(b)(9)(ii)), management consulting and counseling activities include employee benefits consulting services. These employee benefits consulting services include providing consulting services to employee benefit, compensation, and insurance plans, including designing plans, assisting in the implementation of plans, providing administrative services to plans, and developing employee communication programs for plans.

The initial Board orders that were issued to permit employee benefit consulting services are summarized here as historical examples of the nonbanking activity. Commitments made in those Board orders should not be relied upon. Refer only to the provisions within the current Regulation Y, as cited above.

### 3202.0.1 BOARD ORDERS INVOLVING EMPLOYEE BENEFITS CONSULTING

A bank holding company (the applicant) applied for the Board's approval under section 4(c)(8) of the BHC Act and Regulation Y to acquire 100 percent of the voting shares of a company that provides a full range of services involving employee benefits plans. The services are divided into four basic types of activities:

1. *Plan design.* Designing employee benefit plans, including determining actuarial funding levels and cost estimates.
2. *Plan implementation.* Providing assistance in implementing plans, including assistance in the preparation of plan documents and in the implementation of employee benefit administration systems.
3. *Administrative services.* Providing administrative services with respect to plans, including recordkeeping services, calculating and certifying employment reports and government filings pursuant to ERISA, and providing information to a client's legal counsel in labor relations and negotiations.
4. *Employee communications.* Developing employee communication programs with respect to plans for the benefit of the client.

The applicant represented that all of the proposed activities were included in trust company or financial or investment advisory service activities permissible under Regulation Y. Although certain employee benefits consult-

ing activities (as conducted by the company being acquired, particularly activities involving plan administration) are conducted by trust companies or trust departments of banks in their capacities as trustees or custodians of employee benefit plans and investment managers of plan assets, it was not apparent that the *complete range* of employee benefits consulting services were generally conducted by trust companies or authorized by the Board as permissible trust company activities under Regulation Y.

The Board believed that employee benefits consulting was essentially a financial planning activity involving preparing and conveying financial data to a client, which it had previously determined to be closely related to banking and permissible under Regulation Y in the areas of investment advisory services, data processing services, and courier services. The record did not indicate, however, that employee benefits consulting is wholly encompassed within *any or all* of those activities. The Board, therefore, did not agree with the applicant that *all* of the proposed activities were currently authorized for bank holding companies under existing provisions of Regulation Y.

A review of the four basic types of activities revealed that many of the proposed employee benefits consulting activities either were already specifically engaged in by banks and trust companies, or were functionally related to activities in which banks and trust companies were regularly engaged. The Board recognized, however, that the actuarial aspect of the employee benefits consulting activities is not generally included in trust company or bank activities. Such activities are limited in scope and purpose in that they are conducted primarily as a means to ensure adequate funding of defined benefits plans. In this case, they were performed solely as a means for the applicant to provide a full range of benefits-planning activities for its clients. The acquired company's actuarial services would not be conducted as an independent activity, but only as a necessary and integrally related component of employee benefits consulting.<sup>1</sup>

1. As part of its acquisition, the bank holding company proposed to assist firms in IRS audits of plans; inform clients of developments in employee benefit programs through newsletters and other correspondence and through participation in seminars, public programs, and other forums; and engage in professional actuarial activities and other activities incidental

In *Association of Data Processing Organizations, Inc. v. Board of Governors*, 745 F.2d 277 (D.C. Cir. 1984), the court of appeals held that the Board may permit those activities that are “a part of” the overall permissible activity where, as here, “in both market contemplation and technological reality, the service is a unitary one.” Based on this ruling, the Board concluded

that the applicant’s proposed activities are permissible as closely related to banking, and were approved on June 19, 1985 (1985 FRB 656).

Another Board order permitting the provision of employee benefits consulting services, which is slightly different from the order cited above, is found in 1986 FRB 337. See also 1986 FRB 729 and 1987 FRB 158, 681.

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to the actuarial profession. The activities are generally related to the type of actuarial activities performed for purposes of engaging in employee benefits consulting and that would not generate any significant income. Such activities were, therefore, permissible as incidental to the bank holding company’s approved activities. The applicant also proposed to provide expert actuarial opinions of a general nature for purposes such as divorce actions and personal injury litigation. The Board believed that such activities were beyond the scope of incidental activities and were not permissible.



Career counseling services may be provided to—

1. a financial organization<sup>1</sup> and individuals currently employed by, or recently displaced from, a financial organization;
2. individuals who are seeking employment at a financial organization; and
3. individuals who are currently employed in or who seek positions in the finance, accounting, and audit departments of any company.

The initial Board order that was issued to permit the provision of career counseling services is summarized below as a historical example on the origination of this nonbanking activity. Commitments made in the Board order should not be relied upon. See the current provisions of Regulation Y (section 225.28(b)(9)(iii)) for that purpose.

## 3204.0.1 CAREER COUNSELING— INITIAL BOARD ORDER

A bank holding company (the applicant) applied for the Board's approval under section 4(c)(8) of the BHC Act and the Board's Regulation Y to provide career counseling services to unaffiliated parties through its wholly owned nonbank subsidiary. The applicant proposed to expand its employee benefits consulting services to include career counseling activities. The nonbank subsidiary currently provides these services to the applicant and its affiliates under section 4(c)(1)(C) of the BHC Act. It plans to expand the provision of these services nationwide to unaffiliated companies and individuals in a wide array of industries. The services would provide assistance to individuals who are employed and seeking advancement in their careers and to unemployed individuals who are seeking new employment. The nonbank subsidiary plans to provide these services directly to companies and advise these companies on effective methods of providing career counseling services to their employees.

The nonbank subsidiary will advise unaffiliated organizations on the advantages of including career counseling services as part of a comprehensive employee benefits plan. It will assist

these organizations in establishing their own facilities to implement career counseling services for their current or former employees. If the organization does not want to operate its own counseling facility, the nonbank subsidiary will provide the services directly to the organization's current or former employees at the nonbank subsidiary's career assistance center.

The proposed career counseling services include (1) assessing an individual's education, prior business experience, salary history, interests, and skills to aid in finding employment or evaluating opportunities for career development; (2) assisting in the preparation of résumés and cover letters; (3) contacting employers regarding employment opportunities and making this information available to clients; (4) conducting general workshops on the financial aspects of unemployment, current economic trends, the process of finding a job, and alternative career options; and (5) providing individual counseling on setting and obtaining employment goals.

The issue presented to the Board was whether the proposed activities are closely related to banking. The Board had not previously determined whether providing career counseling services to unaffiliated parties is closely related to banking under section 4 of the BHC Act and permissible for bank holding companies. The Board viewed the applicant's proposal in four parts: (1) career counseling services for financial organizations (that is, banks, bank holding companies and their subsidiaries, thrift institutions, and thrift holding companies and their subsidiaries) and employees of financial organizations; (2) career counseling services for individuals who are unemployed or employed outside the banking industry and who seek employment at banks and other financial institutions; (3) career counseling for individuals seeking financial positions (such as chief financial officer, cash management positions, and accounting and auditing personnel); and (4) career counseling services generally for any individual seeking any type of employment at any type of company.

The Board determined that career counseling services are closely related to banking when they are provided for (1) financial organizations and individuals currently employed at, or recently displaced from, a financial organization; (2) individuals who seek employment at a financial organization; and (3) individuals who

1. Financial organization means insured depository institution holding companies and their subsidiaries, other than nonbanking affiliates of diversified savings and loan holding companies that engage in activities not permissible under section 4 (c)(8) of the BHC Act.



are currently employed in, or who seek, financially related positions at any company. The Board concluded that the record does not presently support a finding that general career counseling services are otherwise closely related to banking.<sup>2</sup>

The applicant will provide career counseling services on a fee basis with no guarantee of

employment. The Board approved the order on November 8, 1993. As a condition to its approval, the applicant must comply with all commitments made in connection with the application, as well as with other conditions stated within Regulation Y and the Board's order. (1994 FRB 51)

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2. When providing career counseling for an individual within one of the three proposed categories, the applicant was permitted to provide limited career counseling services regarding positions outside of these categories as "incidental" to the proposed career counseling services. However, the applicant is not permitted to hold itself out as a provider of general career counseling services for individuals seeking career opportunities outside the banking or financial industries. Regulation Y and judicial decisions construe "incidental activities" as activities that must be necessary to the provision of a closely related activity in order to be considered incidental. (See 12 C.F.R. 225.21(a)(2) and *National Courier Association v. Board of Governors*, 516 F.2d 1229, 1240-41 (D.C. Cir. 1975).)

# Section 4(c)(8) of the BHC Act (Money Orders, Savings Bonds, and Travelers' Checks) Section 3210.0

The Board has included in Regulation Y (see section 225.28(b)(13)) the authority to issue and sell at retail money orders and similar consumer-type payment instruments; the sale of U.S. savings bonds; and the issuance and sale of travelers' checks. Previously, the Board, through various orders, had authorized over time various nonbanking activities in this regard. Initially, it permitted by order and then the Board had included in the list of permissible activities the sale and issuance at retail of money orders having a face value of not more than \$1,000, the sale of U.S. savings bonds, and the issuance and sale of travelers' checks. In its original order, effective February 26, 1979, the Board did not include the issuance of travelers' checks. However, after overwhelmingly favorable responses to its proposal to include the issuance of travelers' checks to the list of permissible activities, the Board included this activity effective December 21, 1981. As part of the Board's regulatory review of Regulation Y, and its subsequent overhaul, which was finalized and made effective February 4, 1984, the *issuance* of money orders was listed as a permissible activity. On March 16, 1984, the Board, by order, increased the face value of the payment instruments that the bank holding company could issue to \$10,000, if the bank holding company agreed to meet certain weekly reporting requirements (1984 FRB 364). Also, by order dated December 16, 1985, the Board allowed the sale of official checks with no maximum limitation as long as the proceeds of checks in excess of \$10,000 were deposited in a demand account and the bank holding company made weekly reports of these checks as well as money orders that had a face value of up to \$10,000 (1986 FRB 148). The Board later authorized the issuance and selling of variably denominated payment instruments without limitation as to face value. (See 1993 FRB 42.) As part of the comprehensive revision of Regulation Y, effective April 21, 1997, the Board removed the limitation of the face amount of payment instruments. (See section 225.28(b)(13) of Regulation Y.)

## 3210.0.1 INSPECTION OBJECTIVES

1. To determine that the scope of the activity is within the parameters established by the Board.
2. To determine if there is any loss exposure due to the lack of systems and controls.

## 3210.0.2 INSPECTION PROCEDURES

In determining whether a significant degree of risk exposure to the BHC exists, the examiner should address the following questions to management, when considered appropriate:

1. Are there written agreements between the bank and its parent concerning the obligations of each for the sale of money orders and U.S. savings bonds and for the issuance and sale of travelers' checks? Do the agreements provide information on the fees, reimburseable expenses, sharing of overhead expenses, and taxes?
2. Who prints the travelers' checks and money orders?
3. Is the printer bonded or covered by insurance?
4. Is the newly printed inventory of travelers' checks and money orders received in dual custody?
5. If check inventory sent to outlets is on a consignment basis, does the consignee acknowledge receipt on a "trust receipt"?
6. Does the consignment "inventory invoice" describe, in complete detail, the number of checks, serial numbers, and denominations?
7. How are inventories and sales monitored at the outlet level?
8. What are the maximum dollar shipments for the day, per outlet and per package?
9. Does the subsidiary bank maintain the settlement account?
10. What procedures are in effect to establish the checks that have been sold?
11. What are the remittance requirements for the agents for checks sold?
12. If losses and redemptions exceed proceeds from sales, who makes up the deficiency?
13. Does the parent invest the settlement account's float, generated by the excess of proceeds received over checks redeemed, in long-term investments?
14. If a nonbank subsidiary acts as agent on behalf of its parent, what fee is paid by the parent other than commissions on the sale of checks?
15. Is the subsidiary reimbursed for its expenses?
16. What has been the history of losses?
17. How long are losses carried in suspense accounts before being charged off?
18. Does the subsidiary bank maintain compensating balances in financial institutions as

an inducement for the financial institutions to carry the holding company's travelers' checks? If so, does the parent compensate

the bank for lost income?

19. What internal audit procedures are in place? Discuss frequency, scope, and follow-up.

## 3210.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Adding activity to permissible list (excluding issuance of travelers' checks)		225.28(b)(13)		1979 FRB 265
Adding the issuance of travelers' checks to permissible list		225.28(b)(13)		1981 FRB 912
Increased face value or payment instruments to \$10,000, if weekly reports provided				1984 FRB 364
Sale of official checks with no maximum amount, if checks in excess of \$10,000 deposited in demand deposit account, if weekly reports of checks made as well as money orders with face value up to \$10,000				1984 FRB 148
Sale of official checks with no maximum limitation provided the proceeds of checks in excess of \$10,000 were deposited in a demand account and that weekly reports of the official checks were made as well as the total value of official checks with face values exceeding \$10,000				1986 FRB 148
Issuing and selling drafts and wire transfers in foreign currencies				1988 FRB 252
Issuing and selling variably denominated payment instruments without limitation as to face value				1993 FRB 42
Removal of the limitation on the face amount of payment instruments		225.28(b)(13)		1997 FRB 275

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

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

3. Federal Reserve Regulatory Service reference.

As noted in section 3210.0, the Board has authorized the issuance and sale of various payment instruments. This section provides brief historical summaries of the initial Board orders that led to the incorporation of the activity into the Regulation Y “laundry list.” Provisions within the Board orders, including commitments and any regulatory references, should not be relied upon as provisions that are currently authorized. For the current regulatory authorization, see section 225.28(b)(13) of Regulation Y, effective April 1997.

### 3210.1.1 ISSUING CONSUMER-TYPE PAYMENT INSTRUMENTS HAVING A FACE VALUE OF NOT MORE THAN \$10,000

A bank holding company applied for the Board’s approval under section 4(c)(8) of the BHC Act and section 225.23 of the Board’s Regulation Y to engage de novo in the issuance and sale of variably denominated payment instruments with a maximum face value of \$10,000. The instruments would be sold in U.S. dollars and foreign currency by the holding company’s subsidiaries and unaffiliated financial institutions and would consist of domestic and international money orders and official checks. They would also be used for certain internal transactions, such as payroll. The Board had recently amended Regulation Y to include on the list of permissible nonbanking activities the issuance or sale of money orders and other similar consumer-type instruments with a face value not exceeding \$1,000. The Board concluded that an increase in the denomination of such instruments would not affect their fundamental nature.

As a condition to its approval, the Board required the bank holding company to file with the Board weekly reports of daily data on the activity. The issuance of such instruments with a face value of more than \$1,000 could have an adverse effect on the bank holding company’s reserve base. Because reserve requirements serve as an essential monetary policy tool, the Board was concerned that the proposal might result in adverse effects resulting from an erosion of reservable deposits within the banking system (1984 FRB 364).

### 3210.1.2 ISSUING AND SELLING OFFICIAL CHECKS WITH NO MAXIMUM FACE VALUE

Effective December 16, 1985, the Board approved by order a bank holding company’s application to sell official checks with no maximum limitation on the face value, so long as the proceeds of checks in excess of \$10,000 were deposited in a demand account at its subsidiary until the respective payment instrument was paid. To address the Board’s monetary policy concerns about the activity potentially causing a significant reduction in the reserve base or resulting in other adverse effects on the conduct of monetary policy, the bank holding company agreed to make weekly reports of all outstanding instruments (including money orders and official checks) with face values of up to \$10,000, and also the aggregate value of all official checks with face values exceeding \$10,000 (1986 FRB 148).

### 3210.1.3 ISSUING AND SELLING DRAFTS AND WIRE TRANSFERS PAYABLE IN FOREIGN CURRENCIES

A foreign bank subject to the BHC Act applied for the Board’s approval under section 4(c)(8) of the act and section 225.23(a)(3) of Regulation Y to engage de novo through a wholly owned subsidiary in the issuance and sale of foreign drafts and wire transfers with unlimited face amounts that are payable in foreign currencies. The applicant proposed to conduct these activities through the subsidiary as well as through a nationwide network of unaffiliated selling agents, including commercial banks, thrift institutions, and others.

The Board previously determined that the issuance and sale of money orders and similar payment instruments with a maximum face value of \$1,000 is closely related to banking. (See former section 12 C.F.R. 225.25(b)(12).)<sup>1</sup> The Board also approved by order a limited number of applications to engage in the issuance and sale of (1) payment instruments with a \$10,000 maximum face amount (see 1987 FRB 727) and

1. Effective April 21, 1997, the \$1,000 limit was eliminated. The revised Regulation Y (see section 225.28(b)(13)) authorizes the issuance of payment instruments of any amount.

(2) payment instruments with unlimited face amounts, subject to certain operational and reporting requirements (see 1986 FRB 148).

In considering the previous applications, the Board expressed concern that the issuance of payment instruments in denominations larger than \$1,000<sup>2</sup> would have an adverse effect on the reserve base because such instruments are not subject to the transaction reserve account requirements of the Board's Regulation D. The Board noted that because reserve requirements serve as an essential monetary policy tool, the conduct of monetary policy could be adversely affected by the erosion of reservable deposits in the banking system.

To address the concerns expressed in previous Board orders, the applicant committed that the proceeds of all sales of foreign-currency-denominated instruments will be held in demand deposit accounts at U.S. commercial banks. Deposits stemming from the sale of instruments with denominations of \$10,000 or less are to be swept daily into nonreservable instruments. The total proceeds of the sale of any payment instruments with denominations greater than \$10,000 will be deposited in a demand deposit account at a U.S. depository institution, to be used to purchase foreign currency for each particular payment instrument at the time of the transaction. The Board determined that these commitments and other procedures outlined in the order adequately addressed its concerns about the potential adverse effects on the reserve base. The Board approved the application on February 3, 1988, subject to the continued evaluation of its potential for adverse effects on the conduct of monetary policy (1988 FRB 252).

#### 3210.1.4 ISSUING AND SELLING VARIABLY DENOMINATED PAYMENT INSTRUMENTS WITHOUT LIMITATION AS TO FACE VALUE

A bank holding company applied for the Board's approval under section 4(c)(8) of the BHC Act

to engage both directly and indirectly through a bank holding company nonbank subsidiary in the issuance and sale of variably denominated payment instruments without limitation as to face value and without the reporting and reservable deposit requirement previously imposed by the Board on issuers of such instruments.

The Board previously determined by regulation that the issuance and sale of money orders and other similar consumer-type payment instruments with a face value not exceeding \$1,000<sup>3</sup> is an activity that is closely related to banking and is therefore permissible for bank holding companies (see former section 225.25(b)(12) of Regulation Y (12 C.F.R. 225.25(b)(12))).

Effective December 22, 1992, the Board amended Regulation D to impose reserve requirements on teller's checks. The Board's notice amending Regulation D stated that bank holding companies that had received prior approval under section 4(c)(8) of the BHC Act to issue and sell variably denominated payment instruments—subject to the demand deposit requirement, reporting requirement, or limits on the denomination of payment instruments—could request relief by letter from those conditions. The Board believes that the adverse effect of erosion of the reserve base is addressed in the Regulation D revisions, and special reporting and demand deposit requirements previously imposed by the Board in connection with approvals to engage in the issuance and sale of variably denominated payment instruments in amounts over \$10,000 are no longer needed. As a result, the Board determined not to impose those requirements on the applicant and to grant the applicant's request for relief from the reporting requirement to which it was subject. The Board approved the application on November 12, 1992, subject to the Regulation D effective date of December 22, 1992, and the conditions and commitments stated in the order (1993 FRB 42).

2. See footnote 1.

3. See footnote 1.

# Section 4(c)(8) of the BHC Act (Arranging Commercial Real Estate Equity Financing) Section 3220.0

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Effective September 1, 1982, the Board approved an application of a bank holding company to engage in, through a nonbank subsidiary, the activity of arranging equity financing for certain types of income-producing properties (1982 FRB 647). The Board limited the activity by requiring that the holding company act only as an intermediary between developers and investors to arrange financing, and imposed certain other conditions to prevent the holding company from engaging in real estate development or syndication. At that time, however, the Board did not expand the Regulation Y list of permissible activities for bank holding companies to include this activity.

In February 1984, the Board added the arranging of commercial real estate equity financing to the list of permissible nonbanking activities in Regulation Y (section 225.28(b)(2)(ii)). Regulation Y incorporated the limitations placed on the activity by the Board's 1982 order, which is discussed below.

Equity financing involves arranging for the financing of commercial or industrial income-producing real estate through the transfer of the title, control, and risk of the project from the owner or developer to one or more investors. In performing the equity-financing activity for commercial or industrial income-producing real estate, consultations should be made with the owner or developer to determine the nature, objectives, and financing arrangements for the property or project. The project's concept, architectural design, building layout, suitability for its purpose and prospects, traffic flow, as well as competing projects, source(s) of customers, nature of the market, projected rentals and income flows, timetables for completion, and the avail-

ability of construction and long-term financing for the property, have to be carefully reviewed. Financing alternatives, including equity financing, should be predetermined.

The Board has found that the particular expertise and analysis required to provide equity financing for large commercial or industrial income-producing properties is functionally and operationally similar to the analysis and expertise that is required when a bank provides traditional mortgage financing services for such properties. This finding is supported by the fact that equity financing can be viewed as an economic substitute for long-term mortgage financing. The Board's view is that equity financing, subject to the limitations described below, bears a functional relationship to investment advisory services that are traditionally and lawfully performed by commercial banks with respect to commercial and industrial real estate.

The Board therefore, in 1984, approved adding the arranging of commercial real estate equity financing to the list of permissible nonbanking activities in Regulation Y. On April 21, 1997, the comprehensive revision of Regulation Y removed certain restrictions from this nonbanking activity. The activity currently consists of acting as an intermediary for the financing of commercial or industrial income-producing real estate by arranging for the transfer of title, control, and risk of such a real estate project to one or more investors, if the bank holding company and its affiliates do not have an interest in, or participate in, managing or developing a real estate project for which it arranges equity financing, and do not promote or sponsor the development of the property.



## 3220.0.1 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Application to engage in equity-financing activities				1982 FRB 647 1983 FRB 817 1984 FRB 50
Adding activity to permissible list		225.28(b)(2)(ii)		1997 FRB 275

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

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

3. Federal Reserve Regulatory Service reference.

# 4(c)(8)—Agency Transaction Services for Customer Investments (Securities Brokerage) Section 3230.0

## 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).*

### 3230.0.1 OVERVIEW OF SECURITIES BROKERAGE AS A NONBANKING ACTIVITY

In addition to providing a full panoply of financial services to their customers, banks and bank holding companies seek “off-balance-sheet” or non-asset-building sources of revenue. Securities brokerage is one type of endeavor perceived to have growth and profit potential. The main reasons for this are easy market entry, low start-up costs, and maximum use of a branch system and customer base.

After the deregulation of brokerage commissions in 1975, certain brokers began to compete for securities business by drastically reducing their commissions. In order to reduce operating expenses, yet still remain profitable at reduced commission rates, these firms ceased investment research and offered their customers a reduced level of service by “unbundling” brokerage services and offering only the execution of securities transactions. Brokers who offer this reduced level of service have come to be known as “discount brokers.”

The Board, in 1983, added “securities brokerage” to the list of permissible activities for bank holding companies shortly after it approved the application of BankAmerica Corporation to acquire Charles Schwab & Co., as discussed below. In 1984, the U.S. Supreme Court sustained the Board’s approval order and ruled that it is not a violation of the Glass-Steagall Act for banks and bank-affiliated brokers to buy and sell securities as agent for customers (*SIA v. Board of Governors*, 104 S. Ct. 3003). For additional historical information regarding the expansion of securities brokerage nonbank activities by Board order or by incorporation into Regulation Y, see sections 3230.1 through 3230.3.

Before April 21, 1997, Regulation Y differentiated between securities brokerage services provided alone (that is, discount brokerage services) and securities brokerage services provided in combination with investment advisory services (that is, full-service brokerage activities).

Regulation Y no longer distinguishes between discount and full-service brokerage activities.

Regulation Y currently authorizes securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or in combination with investment advisory services and incidental activities (including such related activities as securities credit, custodial services, individual retirement accounts, and cash-management services), if the services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing. In addition to the information and examiner guidance provided in this section, see the American Institute of Certified Public Accountants’ *Audit and Accounting Guide—Brokers and Dealers in Securities*.<sup>1</sup> The guide includes detailed information about the securities industry, broker-dealer functions, activities and operations, books and records, accounting and auditing standards and considerations, and other topics such as internal controls and regulatory considerations.

### 3230.0.2 INITIAL BOARD ORDER APPROVAL FOR SECURITIES BROKERAGE

On January 7, 1983, the Board approved the application of BankAmerica Corporation to acquire Charles Schwab & Co., which engaged in retail discount securities brokerage, securities credit lending, and certain incidental activities (1983 FRB 105). None of the proposed activities was among those the Board had previously designated in Regulation Y as being closely related to banking.

In its order approving the application, the Board found that the brokerage and securities credit activities were closely related to banking for purposes of section 4(c)(8) of the Bank Holding Company Act (“BHC Act”). That decision was based on the fact that many banks provide various types of securities brokerage services as an accommodation to customers and as an agent for trusts and other accounts managed by banks.

Banks also administer employee stock purchases, dividend reinvestment, and automatic

1. Issued as of May 1, 2007.

investment service plans, which involve the periodic purchase of a particular security or securities from a fixed list of securities, on behalf of the customer. Banks often execute orders involving securities not listed on an exchange by dealing directly with dealers making a market in a particular security or with other third parties. In performing these services, banks exercise the same type of discretion and judgment with respect to the best method of execution as brokers do with respect to similar types of orders. Further, national banks are expressly authorized by statute to purchase and sell securities without recourse, solely upon the order, and for the account of, customers (12 U.S.C. 24 (Seventh)).

The Board, in summary, noted that banks in fact had generally provided securities brokerage to some extent. The company that was acquired, pursuant to the January 1983 order, provided several other services incidental to its discount brokerage activities.

### 3230.0.2.1 Margin Lending

Historically, banks have had a significant amount outstanding in loans to borrowers for the purpose of purchasing or carrying securities. The extension of such credit secured by stock and other collateral, or margin lending, has long been an important bank activity. The Board, therefore, ruled that this activity was closely related to banking and incidental to the securities brokerage activities of the company being acquired.

### 3230.0.2.2 Maintenance of Customer Securities Accounts

Charles Schwab & Co. offered various services to its brokerage customers. These services included individual retirement accounts for which an unaffiliated savings and loan association served as a trustee; a “sweep” arrangement, pursuant to which idle customer balances exceeding a certain minimum were automatically invested in an unaffiliated money market mutual fund; the payment of interest on net free balances awaiting investment; and a specially named account that combined the payment of interest on free credit balances with customer access to such balances through a debit card and checking account offered under an arrangement with an

unaffiliated commercial bank. Increasingly, these types of services were being offered by other brokerage firms. The Board found that each of these services was identical, or functionally and operationally equivalent to, services generally offered by banks to customers directly or through bank trust departments. Based on that finding, the Board found that the provision of those accounts was closely related to banking as well as an incidental activity in connection with securities brokerage and margin lending activities.

### 3230.0.2.3 Custodial Services

The brokerage firm also provided various types of securities custodial services involving the safekeeping of customers’ securities, accounting for dividends or interest received on such securities, and other ancillary services. Banks generally offer securities custodial services in connection with their trust departments and other securities transaction services. Furthermore, in extending margin credit, a lender is required to maintain custody of the securities pledged to the lender as collateral to secure the loan. Accordingly, the Board found that the provision of securities custodial services was closely related to banking and that it was a necessary incident to permissible margin lending activities.

## 3230.0.3 MARGIN CREDIT ACTIVITIES AND SECURITIES BROKERAGE

When securities brokerage was added to the permissible activities within Regulation Y, it was contemplated that a bank holding company, or its nonbank subsidiary performing the permitted securities brokerage activities, would be required to register as a broker-dealer with the Securities and Exchange Commission and that its margin credit activities would therefore be subject to the Board’s Regulation T. Regulation T governs securities credit by broker-dealers (12 C.F.R. 220).

### 3230.0.4 ACTIVITY ADDED TO REGULATION Y

On August 10, 1983, the Board adopted a final rule deeming securities brokerage and margin lending “closely related” to banking, consistent with the Glass-Steagall Act, and are, therefore, generally permissible for bank holding companies. To clarify that services incidental to bro-

kerage services are permissible, the Board did include a list of permissible incidental services. The list included services such as offering custodial services, furnishing individual retirement accounts, and cash-management services, provided that the securities brokerage services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting.

As for cash-management services, such services are intended to include customer-account-related functions, such as paying interest on net free balances awaiting investment, providing arrangements under which free credit balances are automatically invested in money market mutual funds, and establishing arrangements under which access to such balances is provided by debit card or checking accounts.

The list of incidental activities in the regulation is not intended to be exhaustive. The Board believes that to compete effectively with other brokers, bank holding companies should have the flexibility to provide a full range of customer-account and custodial services, provided such services meet the test for permissible incidental activities under section 4(c)(8) of the BHC Act and are consistent with the Glass-Steagall Act.

As previously noted, Regulation Y, effective April 21, 1997, permits securities brokerage without distinguishing between discount and full-service brokerage activities. The previous regulatory requirement for certain disclosures has been eliminated. Those disclosure requirements are in an interagency policy statement that governs the sale of securities and other nondeposit investment products on bank premises (see sections 2010.6.1.3.1 and 2010.6.2.9), as well as in SEC rules. Similar disclosure requirements are required by the Board's policy statement that governs a bank holding company's sale of shares of mutual funds and other investment companies that it advises (see section 225.125 of Regulation Y).

### 3230.0.5 MARKET ENTRY INTO SECURITIES BROKERAGE

There are three general methods of market entry available to bank holding companies or nonbank subsidiaries of bank holding companies wishing to offer securities brokerage services: (1) become associated with a brokerage firm, (2) purchase an existing firm, or (3) establish their own brokerage operations. The most common mode is broker association, which is less costly and the most rapid form of entry. The

following broker relationships are presently established:

1. *Introducing broker.* The first level of involvement occurs when a BHC or a nonbank subsidiary of a BHC serves as an "introducing broker" in effecting securities transactions by accepting the customers' orders and transmitting the orders to the executing broker.<sup>2</sup> Order tickets and records of original entry are prepared by the BHC or nonbank subsidiary. In this situation, the executing broker generally produces customer confirmations and account statements. These documents often prominently display the BHC or the bank holding company's nonbank subsidiary's name and logo. The executing broker, the bank holding company, and/or its nonbank subsidiaries may offer safekeeping services and margin credit.
2. *Omnibus account.* A higher level of bank holding company nonbank subsidiary involvement occurs when the broker "carries" customer accounts by accepting and transmitting orders for execution, producing the customer confirmation, and maintaining all customer records. When carrying customers' accounts, the bank holding company's nonbank subsidiary may maintain a single customer account, called an omnibus account, with the executing broker. Safekeeping and margin credit services may be offered.
3. *Separately incorporated broker-dealer subsidiary affiliate.* The highest level of involvement occurs when a bank holding company organizes or acquires a separately incorporated broker-dealer subsidiary or affiliate, which transacts business like any other broker-dealer. This would include its own customer lists, both retail and wholesale; possible exchange membership; and executing and clearing its own transaction.

### 3230.0.6 PURPOSE OF INSPECTION OF SECURITIES BROKERAGE ACTIVITIES

The purpose of the inspection is to evaluate

2. There is a lower level of involvement wherein the BHC or nonbank subsidiary is responsible for making the brokerage services available to customers by advertising the distributing customer account applications. Account acceptances are generally made by the unaffiliated broker who will receive orders directly from customers.

any potential liability due to wrongful or negligent performance of responsibilities, to assess the level of management expertise, and to determine the degree of compliance with legal and policy parameters necessary to protect investors.

### 3230.0.7 INSPECTION OBJECTIVES

1. To determine the scope and nature of services provided.
2. To evaluate operations, audits, and controls.
3. To review the sufficiency of administrative policies and procedures.
4. To determine the level of responsibility.
5. To appraise the quality of management and staff.
6. To ascertain earnings, volume of business, and prospects.
7. To review compliance with applicable laws, regulations, and policies.

### 3230.0.8 SCOPE OF INSPECTION

The scope of inspection will vary depending on the nature of the brokerage operation. In defining the scope of inspection, it is first necessary to determine the extent of activities performed and the corporate structure. Any bank holding company subsidiary (that is not a bank), which functions as a securities broker, is required to register as a broker-dealer with the Securities and Exchange Commission (SEC).<sup>3</sup>

*In developing the scope of inspection, it is emphasized that Reserve Bank examiners can rely on the applicable self-regulatory organization's examination with respect to investor protection, compliance with SEC and SRO rules, and Regulation T.* The self-regulatory organizations do not furnish an examination report, but instead furnish a registered broker-dealer with a letter pertaining to examination findings. Hence, the scope of inspection for a registered broker-

dealer will commence with a review of a self-regulatory organization's most recent letter dealing with its examination of brokerage activities. A broker-dealer belonging to more than one self-regulatory organization will be examined only once in each examination cycle. Serious violations that could endanger a banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits) or significant violations that have not yet been corrected, should be noted in the bank holding company inspection report. Reserve Bank staff are responsible for evaluating all other aspects of securities brokerage activities.

The actual scope of this portion of the inspection will range from a brief visit for a limited service "arranger" relationship to extensive review for an omnibus relationship or registered broker-dealer.

### 3230.0.9 MATERIALS REQUIRED FOR INSPECTION

When commencing the securities brokerage portion of a bank holding company or its nonbank subsidiary inspection, the following material should be obtained:

1. contractual agreement with the executing and/or clearing broker
2. recent activity report (for at least six months)
3. income and expense reports
4. written policies and procedures regarding—
  - a. order processing,
  - b. settlements,
  - c. account reconciliations,
  - d. audit coverage, and
  - e. trust department relationship
5. account application forms
6. customer disclosure documents
7. organization chart
8. fee schedule
9. internal and external audit reports
10. a copy of the contingency plan for continuance in emergencies
11. the most recent SRO letter pertaining to the last brokerage examination

### 3230.0.10 INSPECTION PROCEDURES

If applicable, the following areas should be covered during the inspection.

3. A broker-dealer registered with the SEC (registered broker-dealer) is subject to SEC recordkeeping and confirmation rules, fair practice rules, professional qualification rules for individuals associated with securities firms, and the uniform net capital rule. Registered broker-dealers are also required to pay for insurance coverage on customers' assets by the Securities Investor Protection Corporation (SIPC) and are required to be members and subject to the rules of the Financial Industry Regulatory Authority (FINRA), or other self-regulatory organizations, such as the New York Stock Exchange. These self-regulatory organizations (SROs) also test for broker compliance with Regulation T (12 C.F.R. 220).

### 3230.0.10.1 Organization and Management

Review carefully the contractual agreement with the executing and/or clearing broker and list all duties and obligations of the respective parties. Determine that the agreement contains an indemnification clause insulating against broker error. Once the review is completed, the examiner can identify the type of relationship and plan the scope of the inspection.

Review the organization chart and match responsibilities and operational functions to the appropriate section. Evaluate management and staff based upon their education, experience, performance, and the profitability and efficiency of operations and any other relevant factors.

### 3230.0.10.2 Operations

A securities brokerage operation is organized along functional lines including—

1. execution,
2. settlement,
3. delivery,
4. custody,
5. recordkeeping, and
6. audits and controls.

Before review, prepare a flow chart of the operation to quickly overview the operational areas and to locate control points and identify potential weaknesses.

#### 3230.0.10.2.1 Execution

This area processes client orders. The orders may be received by telephone at the nonbank subsidiary or directly by the executing broker. When the nonbank subsidiary accepts customer orders, they can be transmitted by direct wire to the executing broker. Completed transactions initiated by the nonbank subsidiary are confirmed back to the nonbank subsidiary, which in turn sends a confirmation to the client. Examiners should determine that proper safeguards are in place to ensure valid orders are received, pending orders are controlled, and completed orders are reported for customer notification and record update. The examiner should also determine that the following are in place:

1. use of code numbers, names, or other verification devices when accepting orders
2. maintenance and reconciliation of a trade

log (orders received) and execution report (orders completed)

3. taping of telephone orders
4. confirmation of completed orders are confirmed to clients in a timely fashion
5. preparation and transmittal of input media for record update

#### 3230.0.10.2.2 Settlement

This area receives payments and proceeds, collects dividends and interest, and, in some instances, effects margin calls on broker instruction. Settlements are effected in two stages:

1. *Broker vs. customer.* Before settlement date, the customer must send cash or securities to the broker as requested in the broker's customer confirmation. Cash or securities are required to effect payment against delivery or delivery against payment in accordance with industry securities settlement procedures.
2. *Broker vs. broker.* When physical delivery of securities is required, it is generally done on a firm-to-firm basis or to a firm's safekeeping agent. Major equity securities, and an ever-increasing number of debt securities, are eligible for net settlement and securities immobilization with depositories. Usually, a net settlement account is used for cash and securities transactions; these accounts should be reconciled daily. The settlement process should include a procedure that verifies execution price and fees.

#### 3230.0.10.2.3 Delivery

Securities are delivered to the executing broker and purchased securities to clients. The examiner should determine that safeguards provide adequate control over certificates in process. Proper fail-to-deliver/receive and completed transaction records should be maintained.

The securities broker that accepts customer orders generally is exposed to *delivery risk* by customers. Basically, customers can take advantage of the broker by placing an order to buy securities when the customer has no funds available to purchase securities or by placing an order to sell securities that are not owned by the customer. Either type of transaction is permissible in a *margin account*, provided that the customer has the resources available to properly



margin the transaction. If the customer does not have a margin account, the broker should not purchase a security for the customer unless (1) there are sufficient funds in the customer's account or (2) the customer represents and the broker ascertains that the customer will promptly make full cash payment for the security before selling it and that the customer does not contemplate selling it before making payment. Alternatively, the broker should not sell a security for a customer unless (1) the security is held in the customer's account, or (2) the broker accepts in good faith the customer's statement that the security is owned by the customer and that it will be promptly deposited into the account.

By not executing a purchase or sale until the customer has deposited cash or securities, customer-default risks can be avoided on cash transactions. However, for competitive reasons, many brokers would not wish to place such stringent restrictions upon their customers—especially with respect to the purchase of securities. Lack of proper account supervision can lead to the fraudulent customer practice of “free riding,” wherein the customer will buy securities in anticipation of a price rise. Before settlement date, the customer will sell the securities to take the profits. If the market price of the securities declines, the customer will dishonor the trade, and thus attempt to leave the broker holding the depreciated securities. Securities brokerage procedures should be designed to look for generally abusive practices by customers.

#### 3230.0.10.2.4 Recordkeeping

Any records that must be prepared by the broker under inspection are subject to the Securities and Exchange Commission's recordkeeping and confirmation rules 17a-3 and 17a-4. Compliance with those recordkeeping rules will be verified by stock exchange or FINRA examiners during their routine compliance inspections.

#### 3230.0.10.2.5 Audits and Controls

Complete the “Securities Brokerage/Internal Controls Checklist” to determine whether operations are satisfactorily controlled and audited by the bank holding company's or nonbank subsidiary's audit staff. All significant administrative and operational aspects should be cov-

ered. Management should receive reports of audit findings and respond in writing as to actions taken.

### 3230.0.10.3 Conflicts of Interest

Determine that policies have been effectively implemented covering relationships with affiliated trust departments, self-dealing, fee-splitting or rebate arrangements, and officer/employee transactions.

#### 3230.0.10.3.1 Relationship with Affiliated Trust Departments

Questions may arise concerning the permissibility of a securities broker's executing securities transactions for an affiliated trust department. In general, the receipt of commission income for securities brokerage transactions entered into on behalf of a trust account (in addition to the fee received for account administration) raises conflict-of-interest considerations to which traditional prohibitions of fiduciary law are directed. When a securities broker affiliate is used, the trust institution may be considered to share indirectly in the commission income of the affiliate even when there is no direct remittance of the fee to the bank. The staff letter at 3-447.11 of the *Federal Reserve Regulatory Service* provides guidance in determining whether and in what circumstances use of affiliated discount brokerage services may or may not be permissible. If questionable trust department use of affiliated broker services is disclosed, appropriate trust examiner(s) should be notified.

### 3230.0.10.4 Earnings, Volume Trends, and Prospects

Determine the present and future impact that the securities brokerage activities may have on the bank holding company and its subsidiaries. If possible, a separate profit center should be established, thus providing a useful management tool that facilitates analysis of current profitability, business volume, fixed and variable costs, and degree of goal actualization. Periodic review of these factors will enable management to direct available resources, aid in the budget process, and provide a basis for business planning. Prospects for profitable growth should be assessed by noting changes in aggregate account levels and trade activity. The local competitive environment should be gauged and



market-share information noted. In considering these factors, the examiner should attempt to determine what level of activity must be maintained or attained in order for the securities brokerage function to break even. Present a summary statement expressing an overall view on the current state and future viability of the operation.

### 3230.0.10.5 Compliance

The examiner should determine whether any additional state regulations must be complied with. Also determine that staff is aware of and complying with applicable regulations and laws, which may be outside the scope of an examination conducted by a self-regulatory organization.

### 3230.0.10.6 Presentation of Findings

The scope of inspection within the report should note that securities brokerage activities were reviewed. It should be noted that in order to avoid duplication of examination procedures, the inspection did not focus upon securities laws compliance (as verified by FINRA, or stock-exchange examiners), but instead focused upon financial and safety-and-soundness considerations. Appropriate nonbank subsidiary pages should be completed. Present a summary com-

ment in the confidential section reflecting an overall appraisal of the operation. The self-regulatory organization responsible for examining the securities brokerage operation should be identified. Identify also the associated broker, if any, with whom the organization conducts business. Any material exceptions should be noted with management's responses under an appropriate caption within the open section. Matters of importance should be brought forward to the Examiner's Comments and Matters Requiring Special Board Attention page. In addition, any other significant problems, detrimental practices, or potential liabilities that could have a negative impact on the organization should be commented upon.

### 3230.0.11 EXAMINATION CHECKLISTS

Two checklists are provided for use by the examiner to aid in evaluating securities brokerage activities:

1. Securities Brokerage Inspections
2. Securities Brokerage/Internal Controls

All questions are not applicable for each brokerage subsidiary. The nature and scope of brokerage activities determine the applicability of specific questions. The term "banking organization" refers to a bank holding company and any of its nonbank subsidiaries.

#### 3230.0.11.1 Securities Brokerage Inspection Checklist

	<i>Yes</i>	<i>No</i>
1. Is a contractual agreement between the banking organization and the executing and/or clearing broker on file?	_____	_____*
2. Does the agreement indemnify the banking organization against broker error?	_____	_____*
3. Does the agreement clearly define respective responsibilities of the banking organization and broker?	_____	_____*
4. Was the agreement reviewed by the banking organization's counsel?	_____	_____*
5. Was the agreement approved by the board of directors? If not, by whom?	_____	_____*
6. Are written procedures covering brokerage activities in effect?	_____	_____*
7. Have job descriptions been prepared?	_____	_____*
8. Have specific policies been developed regarding—	_____	_____*

\*Response may require report comment.

	<i>Yes</i>	<i>No</i>
• relationships with affiliated bank trust depts?	_____	_____*
• conflicts of interest?	_____	_____*
• investment advice?	_____	_____*
9. Are investment advice or research services being offered?	_____	_____*
10. Are income and expense records separately maintained?	_____	_____*
11. Are brokerage activities included in the audit program?	_____	_____*
12. Are customer orders placed with banking organization personnel?	_____	_____*
If so, is customer authorization on file?	_____	_____*
Are telephone conversations tape recorded?	_____	_____*
Are transaction records maintained by traders?	_____	_____*
13. How are payments effected? (check one)		
direct charge to customer account	_____	
payment through the mail	_____	
other _____		
14. What is the timeframe of payment?		
prior to execution	_____	
upon verbal notification of execution	_____	
upon customer's receipt of confirmation	_____	
after settlement date	_____*	
15. What is the frequency of settlement-account reconcilements?		
daily	_____	
biweekly	_____	
weekly	_____*	
other _____		
16. Does an affiliated trust department use the discount brokerage service?	_____	_____*
If yes, what type account? _____		
discretionary trust	_____**	
discretionary agency	_____**	
custody	_____	
employee benefit	_____**	
17. Is sufficient insurance coverage in effect?	_____	_____*
Describe types and limits.		
_____		
_____		
18. Does a review of records confirm that the broker functions solely as an agent, i.e., does not engage in underwriting or taking positions for its own account?	_____	_____*
19. Do monitoring and internal reporting procedures adequately track profitability and operating impact for management consideration?	_____	_____*

\*Response may require report comment.

\*\*If available documentation reveals that affiliated trust departments use brokerage services to execute transactions for this type of account, the appropriate federal regulator of trust activities should be notified.

## 3230.0.11.2 Securities Brokerage/Internal Control Checklist

The following questions should be answered, to the extent applicable, in reviewing a securities brokerage operation. Few brokers will perform all of the activities discussed below.

	<i>Yes</i>	<i>No</i>
1. Do internal audit procedures include the securities brokerage function?	_____	_____*
2. Has the banking organization adopted procedures for the periodic review of insurance coverage relating to securities brokerage activities (e.g., errors and omissions, fidelity bonding, and securities in transit)?	_____	_____*
3. Has the banking organization adopted procedures with respect to the accounts of directors, officers, or employees or their immediate families?	_____	_____*
4. Are procedures in place to prevent internally generated credits to the securities brokerage customers' accounts from being automatically recorded as collected funds?	_____	_____*
5. Are procedures in place to ensure that acceptance of a relatively large order will not be effected unless the order taker verifies that the customer placing the order has internal authorization to engage in large trades?	_____	_____*
6. Has the banking organization adopted written procedures prohibiting employees from furnishing investment advice?	_____	_____*
7. Are customer telephone orders tape recorded?	_____	_____*
8. Are tape recordings of telephone orders reviewed periodically to verify that employees have <i>not</i> made securities recommendations or furnished investment advice?	_____	_____*
9. Are persons responsible for taking and transmitting orders precluded from preparing accounting entries?	_____	_____*
10. Is there adequate separation of duties between persons responsible for making initial accounting entries and those responsible for making subsequent adjusting entries to prevent a concealment of theft or fraud?	_____	_____*
11. Does the securities brokerage function monitor and reconcile safe-keeping, clearing, payment, and income expense accounts on a regular basis?	_____	_____*
12. Has management developed a contingency plan to ensure continued brokerage operations of the securities brokerage operation in the event of fire, flood, power failure, or some other unforeseen event?	_____	_____*
13. With respect to termination of brokerage accounts, does the securities brokerage operation have procedures in place to prevent an account from being closed while an open securities order is outstanding?	_____	_____*
14. Does the credit-approval process require a credit decision to be made by someone who routinely makes credit decisions—as opposed to a manager of a securities brokerage operation?	_____	_____*
15. If securities received from customers are registered in the name of a third party, are procedures in place to ensure that such securities are accepted only upon satisfactory proof of ownership?	_____	_____*

\*Response may require report comment.

	<i>Yes</i>	<i>No</i>
16. Are procedures in place to ensure that customers delivering securities registered in a “street name” have title to such securities (i.e., they are not lost or stolen securities)?	_____	_____*
17. Is only a limited number of responsible employees authorized to execute or guarantee security assignments?	_____	_____*
18. Is the use of facsimile signature devices adequately controlled?	_____	_____*
19. Are procedures in place to control cash, securities, and documents pertaining to securities shipped for “delivery against payment”?	_____	_____*
20. Are adequate physical controls maintained over securities on hand (e.g., restricted access to the “cage area”)?	_____	_____*
21. Are detail records pertaining to securities in transfer and those pledged as collateral to borrowings agreed periodically (at least quarterly) with the securities record?	_____	_____*
22. Are security positions (and related general-ledger amounts) in suspense accounts investigated and resolved on a timely basis?	_____	_____*
23. Are fails to receive and fails to deliver periodically reviewed and reconciled?	_____	_____*

\*Response may require report comment.

### 3230.0.12 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws<sup>1</sup></i>	<i>Regulations<sup>2</sup></i>	<i>Interpretations<sup>3</sup></i>	<i>Orders</i>
Board’s authority for rulemaking and jurisdiction over BHCs	1843(c)(8), 1844(b)			
Order approving the application of a BHC to acquire a retail discount securities broker				1983 FRB 105
Order approving acquisition of retail discount broker by a BHC				1983 FRB 565
Securities brokerage as a permissible activity		225.28(b)(7)(i)		
Credit by brokers and dealers— Regulation T	220			
Order approving the provision of combined securities brokerage, investment advisory, and research services				1986 FRB 584
Securities brokerage subsidiary can exchange customer lists with affiliates and confidential customer information (with customer approval)				1988 FRB 571

<i>Subject</i>	<i>Laws<sup>1</sup></i>	<i>Regulations<sup>2</sup></i>	<i>Interpretations<sup>3</sup></i>	<i>Orders</i>
Securities brokerage with discretionary investment management and investment advisory services				1988 FRB 700 1987 FRB 930 1987 FRB 810
Full-service brokerage for institutional and retail customers—bank-ineligible securities				1989 FRB 396 1997 FRB 275

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

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

3. *Federal Reserve Regulatory Service* reference.

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This section serves as a prelude to the securities brokerage sections that follow. Sections 3230.1 through 3230.3 provide brief historical summaries of Board decisions on securities brokerage; these authorizations are now incorporated into Regulation Y for this activity. The summaries provide the reader with some historical perspective as to how and why the current provisions of Regulation Y evolved. The conditions and commitments within these orders may no longer apply to the current provisions of Regulation Y. Therefore, reference must be made to Regulation Y, section 225.28(b)(7)(i).

Before the 1997 revisions of the Board's Regulation Y (12 C.F.R. 225), the Board's rules differentiated between securities brokerage services provided alone (that is, discount brokerage services) and securities brokerage services provided in combination with investment advisory services (that is, full-service brokerage activities). The revisions to Regulation Y that became effective in April 1997 permit securities brokerage without distinguishing between discount and full-service brokerage activities.

Another major change for securities brokerage activities concerns the types of disclosures required of bank holding companies. Before the 1997 revisions, bank holding companies providing full-service brokerage services were required to make certain disclosures to customers regarding the uninsured nature of securities and were not permitted to disclose confidential custo-

mer information without the customer's consent. Effective in April 1997, these disclosure requirements were eliminated. The disclosure requirements—along with a number of other requirements that specifically address the potential for customer confusion, training requirements, suitability requirements, and other matters—are already contained in an inter-agency policy statement that governs the sale of securities and other nondeposit investment products on bank premises, as well as in rules adopted by the SEC. In addition, similar disclosure requirements are required by the Board's policy statement governing the sale by bank holding companies of shares of mutual funds and other investment companies that the bank holding company advises.

Banking organizations and their affiliates, in general, are becoming more effective in implementing the regulatory disclosure requirements. Customers are also becoming increasingly aware that such investment products purchased at banking organizations and their affiliates are not federally insured. Moreover, the Board and the SEC have adequate supervisory authority to ensure that bank holding companies comply with the applicable regulatory disclosure requirements. To the extent that disclosures to customers are appropriate in areas not covered by the regulatory policy statements or SEC regulations, the Board will consider whether to develop supervisory guidance.

## 4(c)(8) of the BHC Act—Securities Brokerage in Combination with Investment Advisory Services

### Section 3230.1

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Two bank holding companies jointly applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.23(a)(3) of Regulation Y to form a de novo subsidiary that would engage in the following nonbanking activities:

1. providing portfolio investment advice to "institutional customers"
2. providing securities execution (brokerage) services, related securities credit activities pursuant to the Board's Regulation T, and incidental activities
3. furnishing general economic information and advice, general economical statistical forecasting services, and industry studies to institutional customers
4. serving as an investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940) to investment companies registered under that act

Separate fees are to be charged for the advisory services and the securities brokerage services. The company would also provide incidental services such as custodial and cash-management services and acting as a registered investment adviser. The services are to be provided throughout the United States. The providing of advisory services to retail clients was not authorized by the Board. The applicant committed to create a "Chinese Wall" between the affiliated bank and the securities affiliate.

The Board determined that the activities would not violate Glass-Steagall Act prohibitions. Board approval was conditioned with the requirement that the standards of care and conduct applica-

ble to fiduciaries would be observed. The applicant would not allow the exchange of confidential information between the de novo subsidiary and its affiliates. The applicant further committed that employees of the de novo subsidiary would not be given customer lists and other confidential information obtained by its affiliates in connection with commercial banking operations. Transmission of advisory research and recommendations to the commercial lending department of any of the bank holding company's affiliates was not permitted.

The proposal represented the combination of activities, previously determined to be closely related to banking, in such a way that the functional nature and scope of the combined activities conducted would not be altered. By Board order, the applicants' application was approved on June 13, 1986 (see 1986 FRB 584), subject to the conditions stated therein. Other orders were approved by the Board on August 5, 1987 (1987 FRB 810), and October 1, 1987 (1987 FRB 930), which also authorized a bank holding company to engage in combined investment advisory and securities brokerage activities. In this order, the Board lowered the threshold for defining an "institutional investor" from \$5 million to \$1 million.

The Board, effective September 10, 1992, added this nonbanking activity to those activities that are permissible by regulation, currently found in section 225.28(b)(7)(i) of Regulation Y, subject to the disclosure requirements, restrictions on exchanging confidential customer information, and other limitations stated therein.



## 4(c)(8)—Securities Brokerage with Discretionary Investment Management and Investment Advisory Services Section 3230.2

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A bank holding company applied to the Board to expand the authority of its subsidiary to engage in offering investment advisory services for “institutional customers” and its affiliates<sup>1</sup> in conjunction with its previously approved brokerage services. The Board previously approved by order (1986 FRB 584) an application for a different bank holding company to offer the combination of investment advice and securities execution services for institutional customers.

The proposed activities in this order (1987 FRB 810) are similar except that the subsidiary would additionally exercise limited investment discretion at a customer’s specific request. Under this plan, the subsidiary would offer as a service, within defined parameters established by the client, discretion in buying and selling securities on behalf of the client.

Such investment discretion would be exercised only at the request of a client; the subsidiary does not plan to market or solicit managed accounts. Each client will receive confirmation of each transaction, as well as monthly statements which would indicate in detail the terms of each transaction executed on its behalf. Each client would always be aware of the scope of the subsidiary’s activity for its account. The subsidiary would receive a single fee for the combined activities of providing investment advice and exercising limited investment discretion.

The application was approved on August 5, 1987, subject to the commitments made by the applicant and the conditions (whether explic-

itly stated or incorporated by reference) in the order.

The Board approved another order on October 1, 1987 (1987 FRB 930), similar to the August 5, 1987, order, except that (1) the applicant proposed to lower the test for institutional customers from the \$5 million threshold to \$1 million; (2) the applicant’s wholly owned brokerage subsidiary would share customer lists with its affiliates, but not confidential information obtained from the customer; and (3) the brokerage subsidiary would have officer and director interlocks with the parent bank holding company, but not with its bank affiliates. In the Board’s view, these modifications did not alter the underlying rationale of its earlier decision.

The Board approved another order on August 10, 1988 (1988 FRB 700). The principal difference between the August 5, 1987, order and this proposal was the provision of such combined services to *retail* as well as *institutional* customers. The provision of services to retail customers does not include discretionary investment management. To further ensure the separation of the BHC and its bank affiliates and to avoid potential conflicts of interests, the applicant made several commitments, as detailed within the order.

The Board, effective September 10, 1992, added the providing of discretionary investment management to the nonbanking activities that are permitted by regulation, currently found in section 225.28(b)(7)(i) of Regulation Y.

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1. The provision of such services by the subsidiary to other affiliates is a permissible servicing activity under section 225.22(a) of Regulation Y.

## 4(c)(8) of the BHC Act—Offering Full Securities Brokerage Services for Bank-Ineligible Securities

### Section 3230.3

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A bank holding company (applicant) applied for the Board's permission for its subsidiary to provide investment advisory and brokerage services on a combined basis ("full-service brokerage") to institutional and retail customers and to engage, to a limited extent, in underwriting and dealing in one- to four-family mortgage-related securities and consumer receivable-related securities (herein referred to as "ineligible securities"). The applicant committed to conduct its ineligible securities underwriting and dealing activities subject to the revenue test and the prudential limitations established by the Board in 1987 FRB 473, except for a market-share limitation which the Board decided not to require for this BHC.

The Board determined previously that full-service brokerage for both institutional and retail customers is closely related and a proper incident to banking under section 4(c)(8) of the BHC Act and does not violate the Glass-Steagall Act (1988 FRB 700 and 1986 FRB 584). This BHC's proposal differs from prior cases in that the subsidiary will provide full-service brokerage to retail customers for ineligible securities that it may hold as principal. The BHC has committed that the subsidiary will provide full and appropriate disclosure of its interest in the transaction as required by the securities laws, the National Association of Securities Dealers, and fiduciary principles.

The Board had previously authorized an underwriting subsidiary to provide full-service brokerage with respect to ineligible securities that it holds as principal, *but only to institutional customers* (1988 FRB 695). Applicant made the

same commitments regarding disclosures as found in 1988 FRB 695. The BHC committed further that its subsidiary would prominently disclose in writing to each customer, at the commencement of the relationship, that it is not a bank; that it is separate from any affiliated bank; and that the securities sold, offered, or recommended by the subsidiary are not deposits, are not insured by the FDIC, are not guaranteed by an affiliated bank, and are not otherwise an obligation of an affiliated bank, unless such is in fact the case. The Board emphasized that confirmations sent to customers will state whether the subsidiary is acting as agent or principal with respect to a security. The Board concluded that such disclosure commitments would be adequate. It recognized that in performing the full-service brokerage activity, the underwriting subsidiary would be operating under a more extensive framework of prudential limitations than would be the case if the full-service brokerage activity were conducted by a bank, a subsidiary of a bank, or by another holding company subsidiary. Based on the commitments made, the Board decided on March 14, 1989, to approve the proposed activities (see 1989 FRB 396) subject to all the terms and conditions found in 1987 FRB 473, except for the market-share limitation.

Effective September 10, 1992, the Board added this nonbanking activity to the activities permitted by regulation, currently found in section 225.28(b)(7)(i) of Regulation Y and subject to the Board's disclosure and other requirements and the limitations on exchanging confidential information, as stated therein.

This section discusses and provides a historical reference of previous Board orders that initially authorized, by order, a bank holding company's acting as agent in the private placement of securities and engaging in riskless-principal nonbanking activities. *With the Board's incorporation of private-placement and riskless-principal activities into its adoption of changes to Regulation Y, effective April 21, 1997, the majority of the previous private-placement and riskless-principal commitments are not effective. Only those current requirements listed for private-placement and riskless-principal activities in section 225.28(b)(7) of Regulation Y (the laundry list of permissible nonbanking activities) should be used by the examiner in conducting the supervision and inspection of bank holding companies and their subsidiaries.*

### 3230.4.1 ENGAGING IN COMMERCIAL-PAPER PLACEMENT ACTIVITIES TO A LIMITED EXTENT

A bank holding company (the applicant) applied pursuant to section 4(c)(8) of the Bank Holding Company Act and section 225.23(a) of the Board's Regulation Y to act as an agent and adviser to issuers of commercial paper in connection with the placement of commercial paper with institutional purchasers. The commercial-paper-placement activity, as proposed, is to be conducted from a wholly owned commercial finance subsidiary (the company) of the applicant's direct subsidiary.

The Board concluded that the proposed commercial-paper-placement activity was so functionally and operationally similar to the role of a bank that arranges a loan participation or syndication as to be a proper incident thereto and that banking organizations are particularly well suited to perform the commercial-paper-placement function. The Board found that the proposal, as limited by the applicant, was consistent with section 20 of the Glass-Steagall Act, and could reasonably be expected to result in public benefits that would outweigh possible adverse effects. The Board found, further, that the applicant could conduct the proposed activities to the extent and in the manner described in the order. The Board's approval (1987 FRB 138) extended only to the activities conducted within the limitations proposed by the applicant for company and the BHC's subsidiary banks and other subsidiaries. The placement of commercial paper in any manner other than as

described within the limitations and conditions of the order would not be within the scope of the Board's approval. The Board also required that no lending affiliate of the company would disclose to the company any nonpublic customer information concerning an evaluation of the financial condition of an issuer whose paper is placed by the company or of any other customer of the company, except as expressly required by securities law or regulation.

On May 25, 1988, the Board approved an order (1988 FRB 500) for a bank holding company to engage de novo, through a subsidiary, in acting as an agent and adviser to issuers of commercial paper in connection with the placement of commercial paper with institutional customers, as well as to engage in certain other securities and financial advisory activities. The applicant proposed to place commercial paper in accordance with all the terms and conditions of the above order (1987 FRB 138), except one. The applicant did not propose any quantitative limitations on its placement activity. The Board concluded that the proposed commercial-paper placement did not constitute underwriting or distributing under the Glass-Steagall Act and that the quantitative limitations on the activity were not necessary to ensure compliance with that act. (See section 3230.4.2, in which a subsidiary of a bank holding company was authorized to privately place all types of debt and equity securities.)

### 3230.4.2 ACTING AS AGENT IN THE PRIVATE PLACEMENT OF ALL TYPES OF SECURITIES AND ACTING AS RISKLESS PRINCIPAL

A bank holding company (the applicant) applied for the Board's approval to transfer the private-placement business of its commercial bank subsidiary to its designated nonbanking subsidiary for securities underwriting and dealing. The subsidiary would act as agent in the private placement of all types of securities, including the providing of related advisory services, and buy and sell all types of securities on the order of investors as a riskless principal.

Because the section 20 subsidiary would be affiliated through common ownership with a member bank, it may not be "principally

engaged” in the “issue, flotation, underwriting, public sale, or distribution” of securities within the meaning of the former section 20 of the Glass-Steagall Act. In an earlier decision (1989 FRB 751), the Board determined that a subsidiary is not engaged principally in section 20 activities if revenues from underwriting and dealing in securities that banks are not authorized to underwrite and deal in directly (bank-ineligible securities) do not exceed 10 percent of the subsidiary’s gross revenues (25 percent, effective March 6, 1997). The applicant contended that the proposed private-placement and riskless-principal activities are not the kind of securities activities described in section 20 and, thus, should not be subject to the revenue limit on bank-ineligible securities activities.

The private-placement market involves the placement of new issues of securities with a limited number of sophisticated purchasers in a nonpublic offering. In private-placement transactions, a financial intermediary acts solely as agent of the issuer in finding purchasers. The intermediary does not purchase the securities and then try to resell them.

Privately placed securities are *not* subject to the registration requirements of the Securities Act of 1933. Such securities are only offered to financially sophisticated institutions and individuals,<sup>1</sup> not to the public. The applicant stated that all of the individuals with whom the securities would be placed will qualify as “accredited investors” under SEC rules. The Board concluded that the subsidiary’s private placement of debt and equity securities within the limits proposed did not involve the underwriting or public sale of securities and that the revenues from the proposed activities should not be subject to the 10 percent revenue limitation (25 percent, effective March 6, 1997) on bank-ineligible securities activities.

The Board noted that other limitations on the activity should ensure that securities would not be offered to the public. First, the applicant agreed that the subsidiary would not make any general solicitation or advertisement to the public regarding the placement of particular securities. Second, the minimum denomination of

securities to be placed would be \$100,000. Third, the applicant agreed that the subsidiary would not privately place securities that are registered under the Securities Act of 1933 and that the subsidiary would be compelled to honor all provisions of that act, particularly those that limit the scope of private placements to nonpublic transactions. Fourth, the subsidiary agreed not to privately place as agent the securities of investment companies which are sponsored or advised by the applicant or its subsidiaries. Fifth, the subsidiary will not purchase or repurchase for its own account the securities being placed or will not inventory unsold portions of such securities. Sixth, the applicant further agreed to consult with its Federal Reserve Bank staff before transferring its private-placement activities from the subsidiary to any other nonbank subsidiary of the applicant to ensure that the transfer did not evade any of the firewall provisions committed to.

### 3230.4.3 INCORPORATION OF PRIVATE-PLACEMENT NONBANKING ACTIVITIES INTO REGULATION Y

The Board has added the activity of acting as agent in the private placement of securities to the laundry list of nonbanking activities (see 12 C.F.R. 225.28(b)(7)(ii)). Regulation Y adopts the definition of private-placement activities that is used by the SEC and the federal securities laws. In taking this action, the Board removed all but one restriction on private placement. The remaining restriction prohibits a bank holding company from purchasing for its own account the securities being placed or holding in inventory unsold portions of issues of these securities. This restriction prevents a bank holding company from classifying its securities underwriting activities as private-placement activities.

### 3230.4.4 RISKLESS PRINCIPAL

“Riskless principal” is a broker-dealer that, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a simultaneous sale to (or purchase from) the customer.

1. The subsidiary would not only place securities with institutional customers but with individuals whose net worth (or joint net worth with a spouse) exceeds \$1 million. Such placement activities with individuals would not, in the Board’s opinion, result in a public offering.

#### 3230.4.4.1 Description of Riskless-Principal Transactions

When acting as a dealer, the securities firm maintains an inventory of securities for its own account and buys and sells securities as principal. Riskless-principal transactions are usually undertaken as an alternative method of executing orders by customers to buy or sell securities on an agency basis. In this situation, when a customer places an order to purchase securities that the broker-dealer does not maintain in its inventory, the firm must purchase the securities from a third party. At this point, the broker-dealer has the option of acting either as the agent for the customer or a riskless principal in making the purchase. If the decision is made to act as a riskless principal, the broker-dealer will purchase the securities from a third-party dealer at the dealer's "inside price" (confirming the transaction for its customer) and then, acting as principal, resell them to the customer, adding a markup over cost. If the broker-dealer does not complete the purchase of the securities ordered by the customer, it is not obligated to provide the securities.

#### 3230.4.4.2 Underwriting and Riskless Principal

In riskless-principal transactions, the subsidiary would execute orders by an investor and would not act on behalf of an issuer of new securities. The subsidiary would not be involved in making any public offering of securities as agent for the issuer. Thus, these activities would not constitute underwriting for Glass-Steagall purposes.

#### 3230.4.4.3 Summary of Board Action on Acting as Agent in Private Placement and as Riskless Principal in Buying and Selling Securities

The Board concluded that the securities underwriting and dealing of the subsidiary's riskless-principal activity did not constitute an underwriting of securities. The riskless-principal activity would not be a public sale or underwriting of securities and would not be viewed as a bank-ineligible securities activity for purposes of the current 25 percent revenue test. As a condition for the approval of the riskless-principal activity, the Board required the subsidiary to maintain specific records that would clearly identify such transactions so that examiners will be able to trace the resulting revenue.

The riskless-principal activity was found to be closely related to banking. The Board further concluded that the placement activity differed only slightly in scope from those approved previously and that the operational limitations agreed to by the applicant would ensure that the subsidiary would not become involved in the public offering of any securities. The Board approved the application on October 30, 1989 (1989 FRB 829). (See also 1997 FRB 146; 1996 FRB 350, 748; 1995 FRB 49, 880, 1133; 1994 FRB 554, 1014; 1993 FRB 1166; 1992 FRB 294, 335, 552, 868; 1991 FRB 61; and 1990 FRB 26, 79, 545, 567, 568 (footnote 7), 653, 659, 663, 667, 672, 674, 766, 857, 864.)

#### 3230.4.4.4 1996 Changes to the Underwriting Conditions for Riskless-Principal Activities

In connection with a bank holding company proposal considered by the Board on June 10, 1996, the Board reviewed the continued appropriateness of applying the underwriting conditions to the conduct of riskless-principal activities. In that case, the Board determined, based on its experience in monitoring and examining the conduct of riskless-principal activities by bank holding companies, that the underwriting conditions were not necessary to address identifiable adverse effects. Accordingly, the Board permitted the bank holding company to engage in riskless-principal transactions through a nonbank subsidiary without conducting this activity in accordance with the underwriting conditions (See 1996 FRB 748). The Board noted that riskless-principal transactions are essentially equivalent to securities brokerage transactions and, therefore, must be conducted in compliance with federal securities laws. The Board concluded that the definitional limitations (see section 225.28(b)(7)(ii) of Regulation Y) would be all that is needed to purchase (or sell) securities as a riskless principal. The conditions are designed to ensure that bank holding companies do not avoid the Glass-Steagall Act by classifying underwriting and dealing activities as riskless-principal activities. In the June 10 order, the bank holding company agreed that, if riskless-principal services were provided in combination with its advisory services, it would provide its customers with the disclosures established by the Board for full-service brokerage activities of bank holding companies. With respect

to its decision, the Board decided to grant identical relief to other bank holding companies that had been previously approved to conduct riskless-principal nonbanking activities.

#### 3230.4.4.5 Incorporation of Riskless-Principal Transactions into Regulation Y

As part of the Board's February 19, 1997, adoption of the final amendments to Regulation Y, it retained the requirement that riskless-principal transactions be conducted in the secondary market. It further determined to eliminate all but two restrictions with respect to riskless-principal transactions. A bank holding company may thus buy and sell in the secondary market all types of securities on the order of customers as a riskless principal, to the extent of engaging in a transaction in which the company, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or

purchase from) the customer. This does not include—

1. selling bank-ineligible securities at the order of a customer that is the issuer of the securities, or selling in any transaction in which the bank holding company has a contractual agreement to place the securities as agent of the issuer; or

2. acting as riskless principal in any transaction involving a bank-ineligible security for which the bank holding company or any of its affiliates acts as an underwriter (during the period of the underwriting or for 30 days thereafter) or dealer. A bank holding company or its affiliates may not enter quotes for specific bank-ineligible securities in any dealer quotation system in connection with the bank holding company's riskless-principal transactions, except that the company or its affiliate may enter bid or ask quotations, or publish "offering wanted" or "bid wanted" notices on trading systems other than NASDAQ or an exchange, if the company or its affiliate does not enter price quotations on different sides of the market for a particular security for any two-day period. (See 12 C.F.R. 225.28(b)(7)(ii).)

A BHC applied for the Board's approval, pursuant to section 4(c)(8) and 225.23(a) of the Board's Regulation Y, to acquire, through a securities brokerage subsidiary, a 49 percent interest in a joint venture partnership. The applicant was a one-bank holding company formed over a bankers' bank. The shareholders comprised several hundred banks. The joint venture partnership (the company) proposed to engage in the activity of acting as a municipal securities brokers' broker.<sup>1</sup> This consisted of providing municipal securities brokerage services to other registered securities brokers and dealers, including dealer banks. The company would act as an undis-

closed agent in the purchase and sale of municipal securities, including revenue bonds, for the account of its customers.

The applicant's proposal involved the purchase and sale of municipal securities as agent only and did not include dealing or otherwise taking a position in such securities. The activity fell within the third-party securities activities permitted for member banks under section 16 of the Glass-Steagall Act (12 U.S.C. 24), which allows banks to purchase and sell securities "without recourse, solely upon the order, and for the account of, customers." National banks had been permitted to engage in the activity of acting as municipal securities brokers' brokers.

The Board found the activity to be functionally similar to the retail securities brokerage activities performed by banks for their customers as permitted under section 16 of the Glass-Steagall Act. The Board thus concluded that the activity was closely related to banking. The Board's approval of the order was based on several commitments made by the applicant and the other joint venturer. The Board approved the application by order on June 26, 1985 (1985 FRB 651).

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1. Rule 15c3-1(a)(8)(ii) implementing section 15(c)(3) of the Securities and Exchange Act of 1934 defines a municipal securities brokers' broker as a "municipal securities broker or dealer who acts exclusively as an undisclosed agent in the purchase or sale of municipal securities for a registered broker dealer or registered municipal securities dealer" who has "no retail customers" and "maintains no municipal securities in its proprietary or other accounts." Municipal securities brokers' brokers are subject to the federal securities laws applicable to securities brokers and are governed by the rules of the Municipal Securities Rulemaking Board.



# Section 4(c)(8) of the BHC Act (Acting as a Conduit in Securities Borrowing and Lending) Section 3230.6

A foreign bank holding company (the applicant), and its wholly owned subsidiary (the company), a commercial banking organization located in New York state, applied pursuant to section 4(c)(8) of the BHC Act and section 225.23(a) of the Board's Regulation Y for prior approval to engage de novo on a domestic and international basis, through the company, in the following activities:

1. providing investment advisory services and financial advisory services, including advice regarding mergers, acquisitions, and capital-raising proposals by institutional customers, pursuant to section 225.28(b) of Regulation Y
2. providing securities brokerage services on an individual basis as well as in combination with investment advisory services ("full-service brokerage"), including exercising limited investment discretion on behalf of institutional customers
3. purchasing and selling all types of securities on the order of institutional and retail customers as a "riskless principal"
4. engaging in securities credit activities under section 225.28(b)(6) of Regulation Y, including acting as a "conduit" or "intermediary" in securities borrowing and lending

The Board previously determined by regulation that engaging in the above-listed nonbanking activities (1) and (2) is closely related to banking under section 4(c)(8) of the BHC Act (see section 225.28(b)(6) and (7) of the Board's Regulation Y). The Board previously determined by order that, subject to certain prudential limitations, the proposed riskless-principal activities (item 3) are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. The applicant has committed that the company will conduct its riskless-principal activities using the same methods and procedures and subject to the same prudential limitations established by the Board in its orders that are found at 1989 FRB 829 and 1990 FRB 26.

Banks and BHCs are permitted to borrow and lend securities held in their own portfolios (see the FFIEC's 1985 Supervisory Policy Statement on Securities Lending, *Federal Reserve Regulatory Service* 3-1579.5). In this case, the applicant proposed that the company borrow and lend the securities of noncustomer third parties. The company would seek out counterparties to securities borrowing and lending transactions

and would assume much the same risk in these transactions as if it was borrowing or lending its own securities or its customers' securities. In this capacity, it would act as a "conduit" or "intermediary" in securities borrowing and lending. The company would supply—upon the request of another broker-dealer who is unable to obtain securities needed to satisfy customer or investment or operational needs—securities not available in the company's accounts or customer accounts by seeking out third-party noncustomer lenders. In addition to locating the securities, the company proposes to coordinate, on behalf of the borrower and lender, the exchange of securities and collateral that is necessary to the transaction.<sup>1</sup>

The Board, in its review of this application, believed that banks generally perform services that are operationally or functionally similar to the proposed conduit services. The proposed conduit activity was believed to be similar to the securities borrowing and lending activities that banks conduct. National and state banks are permitted to lend securities from their own portfolio, and with the customer's consent, from the accounts of customers, and banks regularly borrow securities to meet their needs and the needs of customers. The fact that a third party is substituted in place of a trust or other customer of a bank would not change significantly the way in which the securities lending activity would be conducted. The same steps and procedures that would be necessary to effectuate the loan of a customer's securities would be followed in loaning the securities of a noncustomer third party.

The risk associated with the proposed activity is the same risk that a bank would incur in managing the lending of securities from its own portfolio or the portfolio of a customer. The risk to the company, in acting as a conduit, is limited to ensuring that the collateral posted by the

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1. The company agreed to coordinate this exchange through accounts established at a specifically named, privately held national clearinghouse for the settlement of transactions in corporate and municipal securities. Once the company had located the desired securities, the securities would be transferred to an account maintained by it at the clearinghouse and simultaneously delivered to an account of the borrower, also at that clearinghouse. At the same time, the borrower would be required to post collateral, which the company would receive into its clearinghouse account and simultaneously deliver to an account maintained by the lender at the clearinghouse.

borrower continuously reflects the market value of the securities loaned. The company committed to mark this collateral to market on a daily basis and to make calls for supplemental collateral where necessary.<sup>2</sup> The company also represented that it would not provide any indemnification to noncustomer third-party lenders of securities.

The Board determined, for the above reasons, that the proposed conduit activity is closely related to banking for the purposes of section 4(c)(8) of the BHC Act and approved the order on October 9, 1992 (1992 FRB 955).

The Board's approval was subject to the following specified conditions:

1. To minimize risk, the company is to act as a conduit only when the potential borrower and lender are matched before the transaction. In addition, it will take various measures to minimize operational risks,

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2. If the price of the borrowed securities increases, the borrower is required under the Board's Regulation T to provide additional collateral to the company. The company, in turn, through transactions at the clearinghouse, will pass the collateral to the initial lender of the securities. If the borrower is unable to satisfy this requirement, the company is to have the contractual right to terminate the borrowing transaction by purchasing the securities in the open market and delivering them to the lender, who will then be obligated to return the borrower's collateral to the company. Because the borrowed securities will be marked to market daily by the company, the maximum exposure to the company in directly or indirectly borrowing or lending securities is one day's change in the price of the borrowed securities.

including conducting its conduit activities in accordance with the collateral requirements imposed on the borrowers by the Board's Regulation T.<sup>3</sup> A conduit transaction will commence only when a broker-dealer approaches the company and needs to borrow securities. Securities will not be borrowed in anticipation of a transaction.

2. At the end of each day, the company will mark to market the collateral posted by the borrower in all transactions in which it loaned securities or acted as an intermediary for a lender. As proposed, the company would establish credit lines for potential borrowers and lenders.<sup>4</sup>
3. The applicant committed that the company will conduct its conduit activities in compliance with the FFIEC Supervisory Policy Statement on Securities Lending (*Federal Reserve Regulatory Service 3-1579.5*).

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3. The applicant committed that the Board's Regulation T—which requires that all securities borrowing and lending transactions be collateralized by at least 100 percent of the value of the securities as computed on a daily basis—shall be the company's minimum guideline for posting collateral, and that the company will require many transactions to be collateralized in excess of 100 percent of the value of securities marked to market.

4. These credit policies are to include a review of all lenders and borrowers and the establishment of a credit committee that will determine limits on the credit exposure of any single borrower. The applicant proposed that the company would transact its business only with a select group of well-capitalized broker-dealers that will not be brokerage customers of the company.

# 4(c)(8)—Underwriting and Dealing in U.S. Obligations, Municipal Securities, and Money Market Instruments

## Section 3240.0

The Board has authorized bank holding company subsidiaries to engage in investment or trading transactions as principal to underwrite and deal in certain securities and money market instruments that are eligible for bank underwriting and dealing by state member banks. Basically, the Board has subjected dealer subsidiaries to the same restrictions that govern underwriting and dealing by state member banks pursuant to 12 U.S.C. 24 and 335. Permissible activities include underwriting and dealing in type I securities as defined in 12 C.F.R. 1, including obligations of the United States, general obligations of states and their political subdivisions,<sup>1</sup> and type I municipal bonds; type II securities as defined in 12 C.F.R. 1, including, in part, municipal revenue obligations for housing, university, or dormitory purposes that do not qualify as type I securities; and banker's acceptances and certificates of deposit. In addition, such dealer subsidiaries are subject to the applicable capital restrictions (10 percent of the lead bank's capital and surplus) on dealing in type II securities in 12 C.F.R. 1.7. These underwriting and dealing activities were added to the permissible activities section of Regulation Y, effective February 6, 1984. Furthermore, dealer subsidiaries are permitted to furnish investment advice with respect to these bank-eligible securities.

The Board has authorized bank-affiliated securities dealers to underwrite, deal in, or privately place type III securities in separately capitalized nonbank subsidiaries subject to prudential limitations and restrictions to preclude such subsidiaries from being principally engaged in the underwriting and distribution of securities. In addition, the Board has authorized broker-dealer subsidiaries and brokerage subsidiaries to privately place any type of debt or equity security.

### 3240.0.1 HISTORY OF BOARD APPROVALS OF UNDERWRITING AND DEALING IN GOVERNMENT OBLIGATIONS AND MONEY MARKET INSTRUMENTS

On February 27, 1978, the Board approved an application to engage de novo in underwriting

1. The Gramm-Leach-Bliley Act authorized well-capitalized state member banks to deal in, underwrite, purchase, and sell all type I municipal securities and revenue bonds without any limitations relative to the bank's capital. See section 2020.1 of the *Commercial Bank Examination Manual* and SR-01-13.

and dealing activities then being conducted by the bank holding company's only subsidiary bank. Thus, the formation of the subsidiary transferred these operations from the bank to the nonbank subsidiary. The activity included the underwriting and dealing in obligations of the United States and general obligations of various states and of political subdivisions. The Board determined that this activity is closely related to banking. The Board also approved, on February 27, 1978, another application of a bank holding company that would permit it to retain shares in a firm engaged in U.S. government securities underwriting activities.

On March 20, 1979, the Board approved an application of a bank holding company to acquire a company that would engage de novo in the activities of underwriting and dealing in certain government and municipal securities and in providing portfolio investment advice to individuals, associations, corporations, state and local governments, and financial institutions ("non-bank entities") and to unaffiliated commercial banks. The Board determined that the proposed activities were closely related to banking.

On March 2, 1982, the Board approved an application of a bank holding company to form an incorporated securities company subsidiary that would engage de novo in the activities of soliciting, underwriting, dealing in, purchasing, and selling obligations of the United States, general obligations of various states, and money market instruments such as banker's acceptances and certificates of deposit. The Board regarded the government securities activities that the bank holding company proposed to engage in as substantially the same as the activities that the Board had approved in previous orders. Insofar as its proposal to deal in banker's acceptances, certificates of deposit, and other money market instruments that state member banks may from time to time be authorized to underwrite and deal in (such instruments are not regarded as "securities" subject to the prohibitions in sections 16 and 21 of the Glass-Steagall Act), the Board regarded such activities as closely related to banking because banks engage in such functions. The Board's approval of the bank holding company's application was subjected to the same restrictions and prudent limitations as if the activity were conducted in the affiliate's lead bank. For example, the nonbank subsidiary could not underwrite, deal in, or hold type II

securities of any issuer in amounts that would not be permitted if such activities were conducted by the subsidiary national bank, nor would it be permitted to sell securities to trust accounts of affiliated banks, except as permitted by regulations of the Comptroller of the Currency. Type II securities can consist of certain types of public housing and dormitory bonds of states and municipalities. The amount of such securities, of a single issue held by the bank, may not exceed 10 percent of the bank's capital and surplus (12 U.S.C. 24 (seventh) and (12 C.F.R. 1.3(d)). The Board further ruled that any purchase of securities from the bank holding company's nonbank subsidiary by any of the bank holding company's subsidiary banks at other than current market values would constitute an unsafe or unsound practice.

### 3240.0.2 ADDING THE ACTIVITY TO REGULATION Y

Effective February 6, 1984, underwriting and dealing in U.S. government obligations and certain money market instruments was added to the list of permissible activities of Regulation Y. The regulation, which was amended in 1997, continues to place the same limitations as would be applicable if the activity were performed by the bank holding company's subsidiary member banks or its subsidiary nonmember banks as if they were member banks. (See Section 225.28(b)(8)(i) of Regulation Y.)

### 3240.0.3 REGULATION OF DEALER ACTIVITIES

While municipal securities dealers and dealers in government/agency securities are required to register as broker-dealers pursuant to the Securities Exchange Act of 1934, there are at present no registration requirements for firms that deal only in money market instruments. Regardless of whether a bank holding company subsidiary is registered as a broker-dealer with the Securities and Exchange Commission (SEC), Federal Reserve System examiners will conduct inspections to determine whether the subsidiary is in compliance with the provisions of Regulation Y or any specific conditions in a bank holding company order pertaining to the organization under inspection. In addition, examiners will need to focus on financial, managerial, and

safety-and-soundness considerations in any bank holding company dealer subsidiary. In the event a firm is a registered broker-dealer subject to examination by the National Association of Securities Dealers (NASD), the inspection should be designed to prevent duplication of effort, relying on work performed by NASD examiners to the greatest extent possible, yet still evaluate the factors discussed above that are relevant for either registered or unregistered dealers.

Effective May 20, 1985, the Federal Reserve Bank of New York adopted a *Capital Adequacy Guideline for U.S. Government Securities Dealers*. The Federal Reserve Bank of New York recommends that U.S. government securities dealers that are not subject to federal oversight agree to comply voluntarily with the capital adequacy guideline. Hence, it is expected that any government securities dealer subject to System inspection will comply with the SEC's Uniform Net Capital Rule (17 C.F.R. 240.15c3-1).

### 3240.0.4 DEALER ACTIVITIES

A firm operates as a dealer when it underwrites or deals in securities or money market instruments. Those activities are usually distinguished as separate activities from normal investment activities. If the firm holds itself out to other dealers or investors as a dealer or engages in a repetitive pattern of short-term purchases and sales, the firm may be engaged in dealer activities, regardless of its stated investment activities.

As noted previously, when the Board added to the Regulation Y list of permissible activities the activities of underwriting and dealing in U.S. government securities, certain money market instruments, and municipal securities, the Board added a restriction that such nonbank activities be subject to the same restrictions as securities and money market instrument activities of member banks. Accordingly, the following discussion focuses upon *permissible securities activities of all member banks*.

### 3240.0.5 GOVERNMENT AND MUNICIPAL SECURITIES

The authority under which a bank may engage in securities trading and underwriting is found in section 5136 of the Revised Statutes (12 U.S.C. 24). That authority is restricted by limitations on percentage holding of classes of securities as found in 12 C.F.R. 1.3. That regulation allows banks to deal in, underwrite, purchase, and sell type I securities without

limit and type II securities limited to 10 percent of its capital and unimpaired surplus. Banks are prohibited from underwriting or dealing in type III securities for their own accounts. (See section 2020.1 of the *Commercial Bank Examination Manual* for further information on type I, II, and III securities.)

There are three major types of securities transactions in which banks are involved. First, the bank may buy and sell securities on behalf of a customer. Those are agency transactions in which the agent (bank) assumes no substantial risk and is compensated by a prearranged commission or fee. Second, as a dealer, the bank buys and sells securities for its own account. That is termed a principal transaction because the bank is acting as a principal, buying or selling qualified securities through its own inventory and absorbing whatever market gain or loss is made on the transaction. The third type of securities transaction frequently executed by banks is a contemporaneous “riskless-principal trade.” The dealer buys and sells qualified securities as a principal, with the purchase and sale originating almost simultaneously. Exposure to market risks is limited by the brief period of actual ownership, and profits result from dealer-initiated markup, the difference between the purchase and sale prices.

Dealers’ securities transactions involve customers and other securities dealers. The word “customer,” as used in this section, means an investor. Transactions with other dealers are not considered customer transactions unless the dealer is buying or selling for investment purposes. The following subsections include general descriptions of significant areas of permissible trading and underwriting activities.

### 3240.0.6 U.S. GOVERNMENT SECURITIES TRADING

U.S. government security trading inventories are generally held with the objective of making short-term gains through market appreciation and dealer-initiated markups. The size of a transaction, the dealer efforts extended, and the nature of the security are common factors that affect the markup differential. Markups on government securities generally range between one and four thirty-seconds of a point. Long maturity issues may have higher markups.

The market risk inherent in U.S. government trading portfolios should be controlled by policy. Standards should be established to limit the total securities inventory and the amount of securities with similar yield or maturity char-

acteristics. Limits imposed by policy should include commitments to purchase new governments on a when-issued basis.

Payments for and deliveries of U.S. government and most agency securities are settled on the business day following the trade. Government dealers and customers can negotiate same-day or delayed settlement for special situations, but the industry recognizes standard settlement as occurring on the trade date plus one business day.

#### 3240.0.6.1 “When-Issued” Trading

A significant source of risk to dealers involves “when-issued” (WI) trading in government securities. WI trading is the buying and selling of securities in the one- to two-week interim between the announcement of an offering and the security issuance and payment date. The Dealer Surveillance Staff at the Federal Reserve Bank of New York began to require WI position reports from primary government securities dealers and request voluntary WI reports from certain other government securities dealers in 1984. At the time the reporting requirements were adopted, a senior official stated, “The opportunity to trade with several dealers simultaneously without making payment could result in trading losses which exceed a participant’s ability to settle.” In essence, the fact that settlement date can extend to almost two weeks—as opposed to the ordinary next-day settlement—presents an opportunity for firms to engage in a large volume of trading without drawing on the firm’s ability to purchase securities or effect delivery against short positions. Hence, there is increased credit risk in such transactions. Consequently, the dealer’s trading position limits should include WI limits to protect against the increased credit risk associated with WI trading.

#### 3240.0.6.2 Due Bills

A “due bill” is an obligation that results when a firm sells a security or money market instrument and receives payment, but does not deliver the item sold. Due bills issued should be considered as borrowings by the issuing firm, and, alternatively, due bills received should be considered as lending transactions.

Registered broker-dealers are subject to the SEC’s rule 15c3-3 (17 C.F.R. 240.15c3-3), “Cus-



tomers Protection—Reserves and Custody of Securities.” Basically, this rule states the principle that a broker-dealer needs to safeguard customer assets and cannot use such assets to fund its own business activities. While this rule is not directly applicable to unregistered U.S. government securities or money market instrument dealers, the principle is transferable. Dealers should not issue due bills as a means of obtaining operating funds or where the underlying security can be delivered at settlement. Customers of the dealer enter transactions with an implicit understanding that securities transactions will be promptly executed and settled unless there is a clear understanding to the contrary. Consequently, dealers should promptly disclose the issuance of a due bill to a customer when funds are taken but securities or money market instruments are not delivered to the customer. Such disclosure should reference the applicable transaction; state the reason for the creation of a due bill; describe the collateral, if any, securing the due bill; and indicate that to the extent the market value of the collateral is insufficient, the customer may be an unsecured creditor of the dealer.

### 3240.0.6.3 Clearance

Securities clearance services for the bulk of U.S. government and federal-agency security transactions are provided by the Federal Reserve as part of its telegraphic securities transfer system. The various Federal Reserve Banks will wire transfer most government securities between the book-entry safekeeping accounts of the seller and buyer. The Federal Reserve’s systems also are used to facilitate security borrowings, loans, and pledges. Hence, the securities firm will need to use the services of a clearing bank.

### 3240.0.6.4 Short Sales

Another area of U.S. government security activity involves short-sale transactions. A short sale is the sale and delivery of a security that the seller does not own. It is accomplished by borrowing the security for delivery. The borrowed security is collateralized by an appropriate amount of a similar security. Short sales are conducted to accommodate customer orders, to obtain funds by leveraging existing assets, to hedge the market risk of other assets, or with the expectation

that the market price of the sold security will decline sufficiently to allow the bank to complete the transaction by purchasing an equivalent security at a later date and a lower price.

### 3240.0.6.5 Arbitrage

Arbitrage is the coordinated purchase and sale of two securities or of a security and a futures or options contract in which there is a relative market imbalance. The objective of such activity is to obtain earnings by taking advantage of changing yield spreads. Arbitrage opportunities take many forms and can exist whenever segments of the securities markets are subject to a yield variance.

Exposure on arbitrage and/or short sales should be closely monitored for compliance with predetermined objectives. Risk should be controlled by point-spread limits coordinated with stop-loss buy provisions or sell provisions and by guidelines on the length of time a short position can remain uncovered.

## 3240.0.7 MONEY MARKET TRADING

Aside from short-term securities, banks customarily trade a substantial volume of other money market instruments such as banker’s acceptances. It should be noted that the Supreme Court has opined that commercial paper is a Glass-Steagall security.

### 3240.0.7.1 Banker’s Acceptances

Banker’s acceptances are an obligation of the acceptor bank and an indirect obligation of the drawer. They are normally secured by rights to the goods being financed and are available in a wide variety of principal amounts. Maturities are generally less than nine months. Acceptances are priced like Treasury bills, with a discount figured for the actual number of days to maturity based on a 360-day year.

### 3240.0.7.2 Certificates of Deposit

Negotiable certificates of deposit (CDs) issued by money-center banks are actively traded in denominations of \$100,000 to \$1 million. Interest generally is calculated on a 360-day year and paid at maturity. Secondary market prices are computed based on current yield, net of accrued interest due the seller. Eurodollar CDs trade like

domestic CDs except their yields are usually higher and their maturities often longer.

Money market instruments trade with the same-day or one-day settlement. Publicly quoted yields or dollar prices are usually based on round lot trades of \$1 million, except for commercial paper, which trades in round lots of \$250,000. Odd-lot prices may vary, but because of the large dollar volume of most trades, the percentage spread between the acquisition cost and sale price is characteristically modest.

Management should attempt to minimize market risk by establishing a maximum holding limit for each class of money market instrument. Policy guidelines also should establish concentration limits for money market instruments issued by a single obligor. Such limits should include commitments.

A sound money market trading policy recognizes the need for a qualitative analysis of the issuers of instruments. Credit approvals should be obtained before trading in CDs and acceptances, and reviews should be conducted on a regular schedule.

Banks dealing in money market instruments are subject to a number of legal restrictions. The sale of federal funds by a member bank to a bank affiliate is limited under section 23A (12 U.S.C. 371(c)) and subject to the restrictions of section 23B of the Federal Reserve Act (12 U.S.C. 371(c-1)). The acquisition, as principal, of a certificate of deposit issued by an affiliate bank also is subject to section 23A limitations and section 23B restrictions. These restrictions do not apply to transactions between bank subsidiaries that are 80 percent or more commonly owned by a bank holding company. These transactions must be conducted on terms that are consistent with safe and sound banking practices.

### 3240.0.8 REPURCHASE AGREEMENTS AND SECURITIES LENDING

The overwhelming majority of a government security dealer's inventory is financed by repurchase agreements. In addition, many dealers operate a "matched book" repo operation whereby they finance the acquisition or carrying of securities by customers through reverse repurchase agreements and contemporaneously obtain funding for such transactions through the sale of the same or similar securities under a repurchase agreement. In addition, securities dealers often lend or borrow specific issues to effect delivery against short positions or because of failure to receive securities required to be

delivered. For prudential guidelines that have been issued to financial institutions in connection with repurchase agreements and securities lending, see the FFIEC supervisory policy statements at sections 2140.0 and 2150.0, which have been adopted by the Federal Reserve Board.

Firms enter into "reverse repos" to finance the U.S. government securities inventory of other dealers or mortgage bankers who have originated pools of mortgages to back federal housing agency securities. Repos are sold to customers in lieu of certificates of deposit. Customers find them attractive because interest can be paid on repos having maturities of less than seven days and because customer funds are collateralized by the security underlying the repurchase transaction.

The rate of interest received and paid is generally dictated by prevailing market rates. Profits are based on a modest positive spread between interest earned and interest paid. A dealer may attempt to improve that modest profit by increasing the volume of such transactions, using the proceeds to finance or pyramid the acquisition of reverse repos or securities to be used in additional repo arrangements.

A common dealer strategy is to vary resale and repurchase maturities in anticipation of interest-rate movements. If an upward rate trend is expected, the dealer will attempt to lock in a cheaper source of funds at the current low rate by negotiating longer maturities for repos and shorter maturities for reverse repos. Conversely, if interest rates are expected to decline, the dealer attempts to negotiate longer-maturity reverse repos to ensure continuing higher earnings, while negotiating shorter-maturity repos to take advantage of cheaper future sources of funds. Care should be taken to limit exposure by instituting policy guidelines that—

1. limit the aggregate amounts of reverse repo and repo positions,
2. specify acceptable amounts of funds for unmatched or extended maturity transactions,
3. determine maximum time gaps for unmatched maturity transactions and minimally acceptable interest-rate spreads for various maturity agreements, and
4. follow the prudential guidelines in the FFIEC's policy statement on repurchase agreements and securities lending. (See sections 2140.0 and 2150.0.)



### 3240.0.9 POLICY SUMMARY

The legal responsibilities of directors require that they ensure that dealer activities are conducted on a sound and legal basis that can only be accomplished if the directors endorse a written trading policy that addresses each area of market and legal risk. Written policy guidelines should be distributed to each individual engaged in trading activities.

### 3240.0.10 SCOPE OF THE INSPECTION

The scope of inspection will vary depending on the types of securities or money market instrument underwriting, dealing, and brokerage activities conducted by the subsidiary. Examiners may encounter situations in which a securities subsidiary is an SEC-registered broker-dealer because the subsidiary also executes transactions in municipal securities.

Registered broker-dealers are required to become members of the NASD or some other “self-regulatory organization.” To avoid unnecessary regulatory overlap, examiners can rely on the NASD’s compliance examination with respect to investor protection, including compliance with rules of the SEC, NASD, and Municipal Securities Rulemaking Board (MSRB), and the Board’s Regulation T governing securities credit (if applicable). Consequently, in commencing such an inspection, examiners should begin by requesting and reviewing the NASD’s most recent examination letter to the broker-dealer and serious violations that could endanger the banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits). Significant violations that have not yet been corrected should be noted in the bank holding company report.

Federal Reserve examiners retain responsibility for inspecting certain areas of registered broker-dealer operations regardless of whether the NASD reviews them. Specifically, System examiners should still evaluate management, financial results, and safety-and-soundness considerations, including internal controls. In addition, examiners still need to verify that registered broker-dealer subsidiaries comply with the provisions of Regulation Y, section 225.28(b)(8)(i), or specific Board orders pertaining to the firm under inspection. Finally, the examiner should be prepared to review

in-depth any activities or money market instruments that are not securities that might not have been reviewed by the NASD because the activities are outside their scope of examination.

### 3240.0.11 INSPECTION OBJECTIVES

1. To determine if the policies, practices, procedures, and internal controls regarding dealer activities are adequate.
2. To determine if officers are operating in conformance with the established guidelines.
3. To evaluate the trading portfolio for credit quality and marketability.
4. To determine the scope and adequacy of the audit-compliance functions.
5. To determine compliance with applicable laws and regulations, including 12 C.F.R. 225.28(b)(8)(i).
6. To ensure investor protection.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulation have been noted.

### 3240.0.12 INSPECTION PROCEDURES

1. Review the adequacy of the dealer’s internal controls. (See section 3240.0.13.)
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the inspection.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned “Internal and External Audits,” and determine if corrections have been accomplished.
4. Obtain a copy of the latest letter received from the self-regulatory organization responsible (if applicable) for examining broker-dealer activities of this subsidiary.
5. Request that the firm provide the following schedules:
  - a. aged schedule of securities that have been acquired as a result of underwriting activities
  - b. aged schedule of trading-account securities and money market instruments held for trading or arbitrage purposes, which should reflect commitments to purchase

- and sell securities and all joint-account interests
- c. schedule of short-sale transactions
  - d. aged schedule of due bills
  - e. list of bonds borrowed
  - f. aged schedule of “fails” to receive or deliver securities on unsettled contracts
  - g. schedule of approved securities borrowers and approved limits
  - h. schedule of loaned securities
  - i. schedule detailing account names and/or account numbers of the—
    - affiliated banks’ permanent portfolio accounts;
    - personal accounts maintained at the firm by its employees;
    - accounts of brokers or other dealers; and
    - personal accounts of employees of other brokers, dealers, or municipal securities dealers
  - j. list of all joint accounts entered into since the last examination
  - k. list of underwriting since the last examination and whether such securities were acquired by negotiation or competitive bid
  - l. list of all financial advisory relationships
6. Compare balances of appropriate schedules to the general ledger and review reconciling items for reasonableness.
  7. Determine the extent and effectiveness of trading-policy supervision by—
    - a. reviewing the abstracted minutes of meetings of the board of directors and/or of any appropriate committee,
    - b. determining that proper authorization for the trading officer or committee has been made,
    - c. ascertaining the limitations or restrictions on delegated authorities,
    - d. evaluating the sufficiency of analytical data used in the most recent board or committee trading-department review,
    - e. reviewing the methods of reporting by department supervisors and internal auditors to ensure compliance with established policy and law, and
    - f. reaching a conclusion about the effectiveness of director supervision of the trading policy. Prepare a memo for the examiner assigned “Duties and Responsibilities of Directors” stating your conclusions. All conclusions should be supported by factual documentation.
  8. Ascertain the general character of underwriting and direct-placement activities and ascertain the effectiveness of department management by reviewing underwriter files and ledgers, committee reports, and offering statements to determine—
    - a. the significance of underwriting activities and direct placements of securities as reflected by the volume of sales and profit or loss on operations (compare current data to comparable prior periods);
    - b. whether there is a recognizable pattern in—
      - the extent of analysis of material information relating to the ability of the issuer to service the obligation,
      - rated quality of offerings,
      - point spread of profit margin for unrated issues,
      - geographic distribution of issuers, and
      - syndicate participants, and
    - c. the volume of outstanding bids. Compare current data to comparable prior periods.
  9. Determine the general character of trading-account activities and whether the activities are in conformance with stated policy by reviewing departmental reports, budgets, and position records for various categories of trading activity and determining—
    - a. the significance of present sales volume compared to comparable prior periods and departmental budgets;
    - b. whether the firm’s objectives are compatible with the volume of trading activity;
    - c. significant inventory positions taken since the prior examination and determining if—
      - the quality and maturity of the inventory position was compatible with prudent practices, and
      - the size of the position was within prescribed limits and compatible with a sound trading strategy
    - d. the exposure on offsetting repurchase transactions by—
      - reviewing the maturities of offsetting “repo” and “reverse repo” agreements to ascertain the existence, duration, amounts, and strategy used to manage unmatched maturity “gaps” and extended (over 30 days) maturities;
      - reviewing records since the last inspection to determine the aggregate amounts of—

(Before continuing, refer to steps 14 and 15. They should be performed in conjunction with the remaining examination steps.)

- matched repurchase transactions and
  - “reverse repo” financing extended to one or related firms(s); and
  - performing credit analyses of significant concentrations with any single or related entities.
10. Determine the extent of risk inherent in trading-account securities which have been in inventory in excess of 30 days.
    - a. Determine the dollar volume in extended holdings.
    - b. Determine the amounts of identifiable positions with regard to issue, issuer, yield, credit rating, and maturity.
    - c. Determine the current market value for individual issues which show an internal valuation markdown of 10 percent or more.
    - d. Perform credit analyses on the issuers of nonrated holdings identified as significant positions.
    - e. Perform credit analyses on those issues with valuation writedowns considered significant relative to the scope of trading operations.
    - f. Discuss plans for disposal of slow-moving inventories with management and determine the reasonableness of those plans in light of current and projected market trends.
  11. Using an appropriate technique, select issues from the schedule of trading-account inventory. Test valuation procedures by—
    - a. reviewing operating procedures and supporting workpapers and determining if prescribed valuation procedures are being followed;
    - b. comparing dealer-prepared market prices, as of the most recent valuation date, to an independent pricing source (use trade date “bid” prices); and
    - c. investigating any price differences noted.
  12. Using an appropriate technique, select transactions from the schedule of short sales and determine—
    - a. the degree of speculation reflected by basis-point spreads,
    - b. present exposure shown by computing the cost to cover short sales, and
    - c. if transactions are reversed in a reasonable period of time.
  13. Analyze the effectiveness of operational controls by reviewing recent cancellations and fail items (fail to receive securities and fail to deliver securities) that are a week or more beyond settlement date and determine—
    - a. the amount of extended fails,
    - b. the planned disposition of extended fails,
    - c. if the control system allows a timely, productive follow-up on unresolved fails,
    - d. the reasons for cancellations, and
    - e. the planned disposition of securities that have been inventoried before the recognition of a fail or a cancellation.
  14. Determine compliance with applicable laws, rulings, and regulations by performing the following:
    - a. *12 C.F.R. 1.3—eligible securities.*
      - Review inventory schedules of underwriting and trading accounts and determine if issues whose par value is in excess of 10 percent of the affiliated lead bank’s capital and unimpaired surplus are type I securities.
      - Determine that the total par value of type II investments does not exceed 10 percent of the affiliated lead bank’s capital and unimpaired surplus, based on the combination of holdings and permanent portfolio positions in the same securities.
      - Elicit management’s comments and review underwriting records on direct placement of type II securities and determine if the broker-dealer is dealing or engaging in impermissible direct placement of type III securities.
    - b. *Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371(c) and 375)—preferential treatment.* Obtain a list of domestic affiliate relationships and a list of directors and principal officers and their business interests from appropriate examiners and determine whether transactions, including securities-clearance services, involving affiliates, insiders, or their interests are on terms less favorable to the bank than those transactions involving unrelated parties.
  15. Test for unsafe and unsound practices and possible violations of the Securities Exchange Act of 1934 by—
    - a. reviewing transactions, including U.S. government tender-offer subscription files, involving employees and directors of dealer or other banks, and determining if the funds used in the transactions were misused bank funds or the proceeds of reciprocal or preferential loans,
    - b. reviewing sales to affiliated companies to determine that the sold securities were not subsequently repurchased at an addi-

tional markup and that gains were not recognized a second time,

- c. reviewing securities position records and customer ledgers with respect to large-volume repetitive purchase and sales transactions and—
    - independently testing market prices of significant transactions which involve the purchase and resale of the same security to the same or related parties, and
    - investigating the purchase of large blocks of securities from dealer firms just prior to month-end and their subsequent resale to the same firm just after the beginning of the next month
  - d. reviewing customer-complaint files and determining the reasons for such complaints.
16. Discuss with an appropriate officer and prepare report comments concerning—
    - a. the soundness of trading objectives, policies, and practices;
    - b. the degree of legal and market risk assumed by trading operations;
    - c. the effectiveness of analytical, reporting, and control systems;
    - d. violations of law;
    - e. internal control deficiencies;
    - f. apparent or potential conflicts of interest; and
    - g. other matters of significance.
  17. Reach a conclusion regarding the quality of department management and state your conclusions on the appropriate inspection report pages.
  18. Update workpapers with any information that will facilitate future inspections.

### 3240.0.13 REVIEW OF INTERNAL CONTROLS

As a part of carrying out the inspection procedures for this activity, the examiner is expected to review the dealer's system of internal controls. The examiner should concentrate the internal controls review on the policies, practices, and procedures of the firm.

The system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. *Items marked with asterisks require substantiation by observation or testing.*

### 3240.0.13.1 Securities Underwriting Trading Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written securities underwriting/trading policies that—
  - a. outline objectives?
  - b. establish limits and/or guidelines for the following:
    - price markups?
    - quality of issues?
    - maturity of issues?
    - inventory positions (including when-issued (WI) positions)?
    - amounts of unrealized loss on inventory positions?
    - length of time an issue will be carried in inventory?
    - amounts of individual trades or underwriter interests?
    - acceptability of brokers and syndicate partners?
  - c. recognize possible conflicts of interest and establish appropriate procedures regarding—
    - deposit and service relationships with municipalities whose issues have underwriting links to the trading department?
    - deposit relationships with securities firms handling significant volumes of agency transactions or syndicate participations?
    - transfers made between trading-account inventory and affiliated investment portfolio(s)?
    - the affiliated bank's trust department acting as trustee, paying agent, and transfer agent for issues which have an underwriting relationship with the trading department?
  - d. state procedures for periodic, monthly or quarterly, valuation of trading inventories to market value?
  - e. state procedures for periodic independent verification of valuations of the trading inventories?
  - f. outline methods of internal review and reporting by department supervisors and internal auditors to ensure compliance with established policy?
  - g. identify permissible types of securities?
2. Are the underwriting/trading policies reviewed at least quarterly by the board of directors to determine their adequacy in light of changing conditions?

3. Is there a periodic review by the board to ensure that the underwriting/trading department is in compliance with its policies?

### 3240.0.13.2 Offsetting Resale and Repurchase Transactions

1. Has the board of directors, consistent with its duties and responsibilities, adopted written offsetting repurchase transaction policies that—
  - a. limit the aggregate amount of offsetting repurchase transactions?
  - b. limit the amounts in unmatched or extended (over 30 days) maturity transactions?
  - c. determine maximum time gaps for unmatched maturity transactions?
  - d. determine minimally acceptable interest-rate spreads for various maturity transactions?
  - e. determine the maximum amount of funds to be extended to any single or related firms through “reverse repo” transactions involving unsold (through forward sales) securities?
  - f. require firms involved in reverse repo transactions to submit corporate resolutions stating the names and limits of individuals who are authorized to commit the firm?
  - g. require submission of current financial information by firms involved in reverse repo transactions?
  - h. provide for periodic credit reviews and approvals for firms involved in reverse repo transactions?
  - i. specify types of acceptable offsetting repurchase transaction collateral?
  - j. require receipt of assurance letters that unregulated securities dealers comply with the Federal Reserve Bank of New York’s “Capital Adequacy Guideline for U.S. Government Securities Dealers?”
2. Are written collateral-control procedures designed so that—
  - a. collateral assignment forms are used?
  - b. collateral assignments of registered securities are accompanied by powers of attorney signed by the registered owner, and are registered securities registered in the dealer or dealer’s nominee name when they are assigned as collateral for extended maturity (over 30 days) reverse repo transactions?
  - c. funds are not disbursed until reverse repo collateral is delivered into the physical custody of the dealer or an independent safekeeping agent?
  - d. funds are only advanced against predetermined collateral margins or discounts?
  - e. collateral margins or discounts are predicated upon the following:
    - the type of security pledged as collateral?
    - maturity of collateral?
    - historic and anticipated price volatility of the collateral?
    - creditworthiness of the counterparty?
    - maturity of the reverse repo agreements?
    - accrued interest?
  - f. maintenance agreements are required to support predetermined collateral margin or discount by daily mark to market of repurchase agreement securities?
  - g. maintenance agreements are structured to allow for obtaining additional securities or cash calls in the event of collateral price declines?
  - h. collateral market value is frequently checked to determine compliance with margin and maintenance requirements?

### 3240.0.13.3 Custody and Movement of Securities

- \*1. Are the dealer’s procedures such that persons do not have sole custody of securities in that—
  - a. they do not have sole physical access to securities?
  - b. they do not prepare disposal documents that are not also approved by authorized persons?
  - c. for the security custodian, supporting disposal documents are examined or adequately tested by a second custodian?
  - d. no person authorizes more than one of the following transactions: execution of trades, receipt and delivery of securities, and collection or disbursement of payment?
2. Are securities physically safeguarded to prevent loss, unauthorized disposal, or use?
  - a. Are negotiable securities kept under dual control?
  - b. Are securities counted frequently on a surprise basis and reconciled to the securities record? Are the results of such counts reported to management?
  - c. Does the dealer periodically test for

compliance with provisions of its insurance policies regarding custody of securities?

- d. For securities in the custody of others—
  - are custody statements agreed periodically to position ledgers, and any differences followed up to a conclusion?
  - are statements received from brokers and other dealers reconciled promptly, and any differences followed up to a conclusion?
  - are positions for which no statements are received confirmed periodically, and stale items followed up to a conclusion?
3. Are trading-account securities segregated from other dealer-owned securities or securities held in safekeeping for customers?
- \*4. Is access to the trading-securities vault restricted to authorized employees?
5. Do withdrawal authorizations require countersignature to indicate security count verifications?
6. Is registered mail used for mailing securities, and are adequate receipt files maintained for such mailings (if registered mail is used for some but not all mailings, indicate criteria and reasons)?
7. Are prenumbered forms used to control securities trades, movements, and payments?
8. If so, is numerical control of prenumbered forms accounted for periodically by persons independent of those activities?
9. Do alterations to forms governing the trade, movement, and payment of securities require—
  - \*a. signature of the authorizing party?
  - b. use of a change-of-instruction form?
10. With respect to negotiability of registered securities—
  - a. are securities kept in non-negotiable form whenever possible?
  - b. are all securities received and not immediately delivered transferred to the name of the dealer or its nominee and kept in non-negotiable form whenever possible?
  - c. are securities received checked for negotiability (endorsements, signature, guarantee, legal opinion, etc.) and for completeness (coupons, warrants, etc.) before they are placed in the vault?

#### 3240.0.13.4 Purchase and Sales Transactions

1. Are all transactions promptly confirmed in writing to the actual customers or dealers?
2. Are confirmations compared or adequately tested to purchase and sales memoranda and reports of execution of orders, and any differences investigated and corrected (including approval by a designated responsible employee)? Are confirmations and purchase and sale memoranda checked or adequately tested for computation and terms by a second individual?
3. Are comparisons received from other dealers or brokers compared with confirmations, and any differences promptly investigated? Are comparisons approved by a designated individual?

#### 3240.0.13.5 Customer and Dealer Accounts

1. Do account bookkeepers periodically transfer to different account sections or otherwise rotate posting assignments?
2. Are letters mailed to customers requesting confirmation of changes of address?
3. Are separate customer-account ledgers maintained for—
  - a. employees?
  - b. affiliates?
  - c. affiliated bank's trust accounts?
4. Are customer inquiries and complaints handled exclusively by designated individuals who have no incompatible duties?

#### 3240.0.13.6 Other

1. Are the preparation, additions, and posting of subsidiary records performed and/or adequately reviewed by persons who do not also have sole custody of securities?
2. Are subsidiary records reconciled, at least monthly, to the appropriate general-ledger accounts, and are reconciling items adequately investigated by persons who do not also have sole custody of securities?
3. Are fails to receive and deliver under a separate general-ledger control?
  - a. Are fail accounts periodically reconciled to the general ledger, and any differences followed up to a conclusion?



- b. Are periodic aging schedules prepared?
  - c. Are stale fail items confirmed and followed up to a conclusion?
  - d. Are stale items valued periodically, and, if any potential loss is indicated, is a particular effort made to clear such items or to protect the bank from loss by other means?
- 4. With respect to securities loaned and borrowed positions—
    - a. are details periodically reconciled to the general ledger, and any differences followed up to a conclusion?
    - b. are positions confirmed periodically?
    - c. are all policies and procedures in conformance with the FFIEC policy on securities lending contained section 2140.0?



## 3240.0.14 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Authorization for state member banks of the Federal Reserve System to underwrite and deal in obligations of the United States, various states, and political subdivisions and other authorized obligations for state member banks	24 (7), 335	250.120 250.121 250.122 250.123 250.142	3–414.94 3–414.96 3–414.97 3–415.2 2–425.11	3–414.95
Initial October 19, 1976, order stating that the activity of underwriting and dealing in certain government and municipal securities was closely related to banking			41 <i>Federal Register</i> 47083 (1976)	
Order approving application to engage de novo in underwriting and dealing in municipal securities				1978 FRB 222
Order approving application of a BHC that would permit it to retain shares in a government and municipal securities dealer to engage in underwriting government securities				1978 FRB 222 1978 FRB 223
Order approving application of a BHC to acquire a company that would engage de novo in underwriting and dealing in government and municipal securities and providing investment portfolio advice to associations, state and local governments, and financial institutions (“nonbank entities”), and to unaffiliated banks				1979 FRB 363

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Order approving an application of a BHC to form an incorporated securities company that would engage de novo in the activities of underwriting and dealing in, purchasing, and selling U.S. government and municipal obligations, and money market instruments such as banker's acceptances and certificates of deposit. Securities company limited to permissible BHC activities.				1982 FRB 249
Adding of the activity to the list of permissible activities per Regulation Y		225.28(b)(8)(i)		1984 FRB 121 1997 FRB 275

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

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

3. Federal Reserve Regulatory Service reference.