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an exemption to continue to cross-market products and services otherwise prohibited by the statute applies only to the specific company that was engaged in the activity as of March 5, 1987. Conference Report at 126. Thus, an affiliate that was not engaged in cross-marketing products or services as of the grandfather date may not commence these activities under the exemption even if such activities were being conducted by another affiliate. *Id.*; *see also* S. Rep. No. 100–19 at 33–34.

(e) *Eligibility for grandfathered nonbank bank status.* In reviewing the reports required by CEBA, the Board notes that a number of institutions that had not commenced business operations on August 10, 1987, the date of enactment of CEBA, claimed grandfather privileges under section 4(f)(3) of CEBA. To qualify for grandfather privileges under section 4(f)(3), the institution must have ''bec[o]me a bank as a result of the enactment of [CEBA]'' and must have been controlled by a nonbanking company on March 5, 1987. 12 U.S.C. 1843(f)(1)(A). An institution that did not have FDIC insurance on August 10, 1987, and that did not accept demand deposits or transaction accounts or engage in the business of commercial lending on that date, would not have become a *bank* as a result of enactment of CEBA. Thus, institutions that had not commenced operations on August 10, 1987, could not qualify for grandfather privileges under section 4(f)(3) of CEBA. This view is supported by the activity limitations of section 4(f)(3), which, as noted, limit the activities of grandfathered nonbank banks to those in which they were lawfully engaged as of March 5, 1987. A nonbank bank that had not commenced conducting business activities on March 5, 1987, could not after enactment of CEBA engage in any activities under this provision.

[Reg. Y, 53 FR 37746, Sept. 28, 1988, as amended by Reg. Y, 62 FR 9343, Feb. 28, 1997]

Subpart J—Merchant Banking Investments

SOURCE: Reg. Y, 66 FR 8484, Jan. 31, 2001, unless otherwise noted.

§ 225.170 What type of investments are permitted by this subpart, and under what conditions may they be made?

(a) *What types of investments are permitted by this subpart?* Section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) and this subpart authorize a financial holding company, directly or indirectly and as principal or on behalf of one or more persons, to acquire or control any amount of shares, assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for the financial holding company under section 4 of the Bank Holding Company Act. For purposes of this subpart, shares, assets or ownership interests acquired or controlled under section 4(k)(4)(H) and this subpart are referred to as ''merchant banking investments.'' A financial holding company may not directly or indirectly acquire or control any merchant banking investment except in compliance with the requirements of this subpart.

(b) *Must the investment be a bona fide merchant banking investment?* The acquisition or control of shares, assets or ownership interests under this subpart is not permitted unless it is part of a bona fide underwriting or merchant or investment banking activity.

(c) *What types of ownership interests may be acquired?* Shares, assets or ownership interests of a company or other entity include any debt or equity security, warrant, option, partnership interest, trust certificate or other instrument representing an ownership interest in the company or entity, whether voting or nonvoting.

(d) *Where in a financial holding company may merchant banking investments be made?* A financial holding company and any subsidiary (other than a depository institution or subsidiary of a depository institution) may acquire or control merchant banking investments. A financial holding company and its subsidiaries may not acquire or control merchant banking investments on behalf of a depository institution or subsidiary of a depository institution.

(e) *May assets other than shares be held directly?* A financial holding company may not under this subpart acquire or

control assets, other than debt or equity securities or other ownership interests in a company, unless:

(1) The assets are held by or promptly transferred to a portfolio company;

(2) The portfolio company maintains policies, books and records, accounts, and other indicia of corporate, partnership or limited liability organization and operation that are separate from the financial holding company and limit the legal liability of the financial holding company for obligations of the portfolio company; and

(3) The portfolio company has management that is separate from the financial holding company to the extent required by § 225.171.

(f) *What type of affiliate is required for a financial holding company to make merchant banking investments?* A financial holding company may not acquire or control merchant banking investments under this subpart unless the financial holding company qualifies under at least one of the following paragraphs:

(1) *Securities affiliate.* The financial holding company is or has an affiliate that is registered under the Securities Exchange Act of 1934 (15 U.S.C. 78c, 78o, 78o–4) as:

(i) A broker or dealer; or

(ii) A municipal securities dealer, including a separately identifiable department or division of a bank that is registered as a municipal securities dealer.

(2) *Insurance affiliate with an investment adviser affiliate.* The financial holding company controls:

(i) An insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance), or providing and issuing annuities; and

(ii) A company that:

(A) Is registered with the Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 *et seq.*); and

(B) Provides investment advice to an insurance company.

§ 225.171 What are the limitations on managing or operating a portfolio company held as a merchant banking investment?

(a) *May a financial holding company routinely manage or operate a portfolio company?* Except as permitted in paragraph (e) of this section, a financial holding company may not routinely manage or operate any portfolio company.

(b) *When does a financial holding company routinely manage or operate a company?*

(1) *Examples of routine management or operation*—(i) *Executive officer interlocks at the portfolio company.* A financial holding company routinely manages or operates a portfolio company if any director, officer or employee of the financial holding company serves as or has the responsibilities of an executive officer of the portfolio company.

(ii) Interlocks by executive officers of the financial holding company. (A) *Prohibition.* A financial holding company routinely manages or operates a portfolio company if any executive officer of the financial holding company serves as or has the responsibilities of an officer or employee of the portfolio company.

(B) *Definition.* For purposes of paragraph (b)(1)(ii)(A) of this section, the term ''financial holding company'' includes the financial holding company and only the following subsidiaries of the financial holding company:

(*1*) A securities broker or dealer registered under the Securities Exchange Act of 1934;

(*2*) A depository institution;

(*3*) An affiliate that engages in merchant banking activities under this subpart or insurance company investment activities under section 4(k)(4)(I) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(I));

(*4*) A small business investment company (as defined in section 302(b) of the Small Business Investment Act of 1958 (15 U.S.C. 682(b)) controlled by the financial holding company or by any depository institution controlled by the financial holding company; and

(5) Any other affiliate that engages in significant equity investment activities that are subject to a special capital charge under the capital adequacy rules or guidelines of the Board.

(iii) *Covenants regarding ordinary course of business.* A financial holding company routinely manages or operates a portfolio company if any covenant or other contractual arrangement exists between the financial holding company and the portfolio company that would restrict the portfolio company's ability to make routine business decisions, such as entering into transactions in the ordinary course of business or hiring officers or employees other than executive officers.

(2) *Presumptions of routine management or operation.* A financial holding company is presumed to routinely manage or operate a portfolio company if:

(i) Any director, officer, or employee of the financial holding company serves as or has the responsibilities of an officer (other than an executive officer) or employee of the portfolio company; or

(ii) Any officer or employee of the portfolio company is supervised by any director, officer, or employee of the financial holding company (other than in that individual's capacity as a director of the portfolio company).

(c) *How may a financial holding company rebut a presumption that it is routinely managing or operating a portfolio company?* A financial holding company may rebut a presumption that it is routinely managing or operating a portfolio company under paragraph (b)(2) of this section by presenting information to the Board demonstrating to the Board's satisfaction that the financial holding company is not routinely managing or operating the portfolio company.

(d) *What arrangements do not involve routinely managing or operating a portfolio company?*—(1) *Director representation at portfolio companies.* A financial holding company may select any or all of the directors of a portfolio company or have one or more of its directors, officers, or employees serve as directors of a portfolio company if:

(i) The portfolio company employs officers and employees responsible for routinely managing and operating the company; and

(ii) The financial holding company does not routinely manage or operate the portfolio company, except as permitted in paragraph (e) of this section.

(2) *Covenants or other provisions regarding extraordinary events.* A financial holding company may, by virtue of covenants or other written agreements with a portfolio company, restrict the ability of the portfolio company, or require the portfolio company to consult with or obtain the approval of the financial holding company, to take actions outside of the ordinary course of the business of the portfolio company. Examples of the types of actions that may be subject to these types of covenants or agreements include, but are not limited to, the following:

(i) The acquisition of significant assets or control of another company by the portfolio company or any of its subsidiaries;

(ii) Removal or selection of an independent accountant or auditor or investment banker by the portfolio company;

(iii) Significant changes to the business plan or accounting methods or policies of the portfolio company;

(iv) Removal or replacement of any or all of the executive officers of the portfolio company;

(v) The redemption, authorization or issuance of any equity or debt securities (including options, warrants or convertible shares) of the portfolio company or any borrowing by the portfolio company outside of the ordinary course of business;

(vi) The amendment of the articles of incorporation or by-laws (or similar governing documents) of the portfolio company; and

(vii) The sale, merger, consolidation, spin-off, recapitalization, liquidation, dissolution or sale of substantially all of the assets of the portfolio company or any of its significant subsidiaries.

(3) *Providing advisory and underwriting services to, and having consultations with, a portfolio company.* A financial holding company may:

(i) Provide financial, investment and management consulting advice to a

portfolio company in a manner consistent with and subject to any restrictions on such activities contained in §§ 225.28(b)(6) or 225.86(b)(1) of this part (12 CFR 225.28(b)(6) and 225.86(b)(1));

(ii) Provide assistance to a portfolio company in connection with the underwriting or private placement of its securities, including acting as the underwriter or placement agent for such securities; and

(iii) Meet with the officers or employees of a portfolio company to monitor or provide advice with respect to the portfolio company's performance or activities.

(e) *When may a financial holding company routinely manage or operate a portfolio company?*—(1) *Special circumstances required.* A financial holding company may routinely manage or operate a portfolio company only when intervention by the financial holding company is necessary or required to obtain a reasonable return on the financial holding company's investment in the portfolio company upon resale or other disposition of the investment, such as to avoid or address a significant operating loss or in connection with a loss of senior management at the portfolio company.

(2) *Duration Limited.* A financial holding company may routinely manage or operate a portfolio company only for the period of time as may be necessary to address the cause of the financial holding company's involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return upon the resale or disposition of the investment.

(3) *Notice required for extended involvement.* A financial holding company may not routinely manage or operate a portfolio company for a period greater than nine months without prior written notice to the Board.

(4) *Documentation required.* A financial holding company must maintain and make available to the Board upon request a written record describing its involvement in routinely managing or operating a portfolio company.

(f) *May a depository institution or its subsidiary routinely manage or operate a portfolio company?*—(1) *In general.* A depository institution and a subsidiary of a depository institution may not routinely manage or operate a portfolio company in which an affiliated company owns or controls an interest under this subpart.

(2) *Definition applying provisions governing routine management or operation.* For purposes of this section other than paragraph (e) and for purposes of § 225.173(d), a financial holding company includes a depository institution controlled by the financial holding company and a subsidiary of such a depository institution.

(3) *Exception for certain subsidiaries of depository institutions.* For purposes of paragraph (e) of this section, a financial holding company includes a financial subsidiary held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the Federal Deposit Insurance Act (12 U.S.C. 1831w), and a subsidiary that is a small business investment company and that is held in accordance with the Small Business Investment Act (15 U.S.C. 661 *et seq.*), and such a subsidiary may, in accordance with the limitations set forth in this section, routinely manage or operate a portfolio company in which an affiliated company owns or controls an interest under this subpart.

§ 225.172 What are the holding periods permitted for merchant banking investments?

(a) *Must investments be made for resale?* A financial holding company may own or control shares, assets and ownership interests pursuant to this subpart only for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the financial holding company's merchant banking investment activities.

(b) *What period of time is generally permitted for holding merchant banking investments?*—(1) *In general.* Except as provided in this section or § 225.173, a financial holding company may not, directly or indirectly, own, control or hold any share, asset or ownership interest pursuant to this subpart for a period that exceeds 10 years.

(2) *Ownership interests acquired from or transferred to companies held under this subpart.* For purposes of paragraph

(b)(1) of this section, shares, assets or ownership interests—

(i) Acquired by a financial holding company from a company in which the financial holding company held an interest under this subpart will be considered to have been acquired by the financial holding company on the date that the share, asset or ownership interest was acquired by the company; and

(ii) Acquired by a company from a financial holding company will be considered to have been acquired by the company on the date that the share, asset or ownership interest was acquired by the financial holding company if—

(A) The financial holding company held the share, asset, or ownership interest under this subpart; and

(B) The financial holding company holds an interest in the acquiring company under this subpart.

(3) *Interests previously held by a financial holding company under limited authority.* For purposes of paragraph (b)(1) of this section, any shares, assets, or ownership interests previously owned or controlled, directly or indirectly, by a financial holding company under any other provision of the Federal banking laws that imposes a limited holding period will if acquired under this subpart be considered to have been acquired by the financial holding company under this subpart on the date the financial holding company first acquired ownership or control of the shares, assets or ownership interests under such other provision of law. For purposes of this paragraph (b)(3), a financial holding company includes a depository institution controlled by the financial holding company and any subsidiary of such a depository institution.

(4) *Approval required to hold interests held in excess of time limit.* A financial holding company may seek Board approval to own, control or hold shares, assets or ownership interests of a company under this subpart for a period that exceeds the period specified in paragraph (b)(1) of this section. A request for approval must:

(i) Be submitted to the Board at least 90 days prior to the expiration of the applicable time period;

(ii) Provide the reasons for the request, including information that addresses the factors in paragraph (b)(5) of this section; and

(iii) Explain the financial holding company's plan for divesting the shares, assets or ownership interests.

(5) *Factors governing Board determinations.* In reviewing any proposal under paragraph (b)(4) of this section, the Board may consider all the facts and circumstances related to the investment, including:

(i) The cost to the financial holding company of disposing of the investment within the applicable period;

(ii) The total exposure of the financial holding company to the company and the risks that disposing of the investment may pose to the financial holding company;

(iii) Market conditions;

(iv) The nature of the portfolio company's business;

(v) The extent and history of involvement by the financial holding company in the management and operations of the company; and

(vi) The average holding period of the financial holding company's merchant banking investments.

(6) *Restrictions applicable to investments held beyond time period.* A financial holding company that directly or indirectly owns, controls or holds any share, asset or ownership interest of a company under this subpart for a total period that exceeds the period specified in paragraph (b)(1) of this section must—

(i) For purposes of determining the financial holding company's regulatory capital, apply to the financial holding company's adjusted carrying value of such shares, assets, or ownership interests a capital charge determined by the Board that must be:

(A) Higher than the maximum marginal Tier 1 capital charge applicable under the Board's capital adequacy rules or guidelines (*see* 12 CFR 225 Appendix A) to merchant banking investments held by that financial holding company; and

(B) In no event less than 25 percent of the adjusted carrying value of the investment; and

(ii) Abide by any other restrictions that the Board may impose in connection with granting approval under paragraph (b)(4) of this section.

§ 225.173 How are investments in private equity funds treated under this subpart?

(a) *What is a private equity fund?* For purposes of this subpart, a ''private equity fund'' is any company that:

(1) Is formed for the purpose of and is engaged exclusively in the business of investing in shares, assets, and ownership interests of financial and nonfinancial companies for resale or other disposition;

(2) Is not an operating company;

(3) No more than 25 percent of the total equity of which is held, owned or controlled, directly or indirectly, by the financial holding company and its directors, officers, employees and principal shareholders;

(4) Has a maximum term of not more than 15 years; and

(5) Is not formed or operated for the purpose of making investments inconsistent with the authority granted under section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) or evading the limitations governing merchant banking investments contained in this subpart.

(b) *What form may a private equity fund take?* A private equity fund may be a corporation, partnership, limited liability company or other type of company that issues ownership interests in any form.

(c) *What is the holding period permitted for interests in private equity funds?*—(1) *In general.* A financial holding company may own, control or hold any interest in a private equity fund under this subpart and any interest in a portfolio company that is owned or controlled by a private equity fund in which the financial holding company owns or controls any interest under this subpart for the duration of the fund, up to a maximum of 15 years.

(2) *Request to hold interest for longer period.* A financial holding company may seek Board approval to own, control or hold an interest in or held through a private equity fund for a period longer than the duration of the fund in accordance with § 225.172(b) of this subpart.

(3) *Application of rules.* The rules described in § 225.172(b)(2) and (3) governing holding periods of interests acquired, transferred or previously held by a financial holding company apply to interests in, held through, or acquired from a private equity fund.

(d) *How do the restrictions on routine management and operation apply to private equity funds and investments held through a private equity fund?*—(1) *Portfolio companies held through a private equity fund.* A financial holding company may not routinely manage or operate a portfolio company that is owned or controlled by a private equity fund in which the financial holding company owns or controls any interest under this subpart, except as permitted under § 225.171(e).

(2) *Private equity funds controlled by a financial holding company.* A private equity fund that is controlled by a financial holding company may not routinely manage or operate a portfolio company, except as permitted under § 225.171(e).

(3) *Private equity funds that are not controlled by a financial holding company.* A private equity fund may routinely manage or operate a portfolio company so long as no financial holding company controls the private equity fund or as permitted under § 225.171(e).

(4) *When does a financial holding company control a private equity fund?* A financial holding company controls a private equity fund for purposes of this subpart if the financial holding company, including any director, officer, employee or principal shareholder of the financial holding company:

(i) Serves as a general partner, managing member, or trustee of the private equity fund (or serves in a similar role with respect to the private equity fund);

(ii) Owns or controls 25 percent or more of any class of voting shares or similar interests in the private equity fund;

(iii) In any manner selects, controls or constitutes a majority of the directors, trustees or management of the private equity fund; or

(iv) Owns or controls more than 5 percent of any class of voting shares or similar interests in the private equity fund and is the investment adviser to the fund.

§ 225.174 What aggregate thresholds apply to merchant banking investments?

(a) *In general.* A financial holding company may not, without Board approval, directly or indirectly acquire any additional shares, assets or ownership interests under this subpart or make any additional capital contribution to any company the shares, assets or ownership interests of which are held by the financial holding company under this subpart if the aggregate carrying value of all merchant banking investments held by the financial holding company under this subpart exceeds:

(1) 30 percent of the Tier 1 capital of the financial holding company; or

(2) After excluding interests in private equity funds, 20 percent of the Tier 1 capital of the financial holding company.

(b) *How do these thresholds apply to a private equity fund?* Paragraph (a) of this section applies to the interest acquired or controlled by the financial holding company under this subpart in a private equity fund. Paragraph (a) of this section does not apply to any interest in a company held by a private equity fund or to any interest held by a person that is not affiliated with the financial holding company.

(c) *How long do these thresholds remain in effect?* This § 225.174 shall cease to be effective on the date that a final rule issued by the Board that specifically addresses the appropriate regulatory capital treatment of merchant banking investments becomes effective.

§ 225.175 What risk management, record keeping and reporting policies are required to make merchant banking investments?

(a) *What internal controls and records are necessary?*—(1) *General.* A financial holding company, including a private equity fund controlled by a financial holding company, that makes investments under this subpart must establish and maintain policies, procedures, records and systems reasonably designed to conduct, monitor and manage such investment activities and the risks associated with such investment activities in a safe and sound manner, including policies, procedures, records and systems reasonably designed to:

(i) Monitor and assess the carrying value, market value and performance of each investment and the aggregate portfolio;

(ii) Identify and manage the market, credit, concentration and other risks associated with such investments;

(iii) Identify, monitor and assess the terms, amounts and risks arising from transactions and relationships (including contingent fees or contingent interests) with each company in which the financial holding company holds an interest under this subpart;

(iv) Ensure the maintenance of corporate separateness between the financial holding company and each company in which the financial holding company holds an interest under this subpart and protect the financial holding company and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of each such company; and

(v) Ensure compliance with this part and any other provisions of law governing transactions and relationships with companies in which the financial holding company holds an interest under this subpart (*e.g.*, fiduciary principles or sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1), if applicable).

(2) *Availability of records.* A financial holding company must make the policies, procedures and records required by paragraph (a)(1) of this section available to the Board or the appropriate Reserve Bank upon request.

(b) *What periodic reports must be filed?* A financial holding company must provide reports to the appropriate Reserve Bank in such format and at such times as the Board may prescribe.

(c) *Is notice required for the acquisition of companies?*—(1) *Fulfillment of statutory notice requirement.* Except as required in paragraph (c)(2) of this section, no post-acquisition notice under section 4(k)(6) of the Bank Holding Company Act (12 U.S.C. 1843(k)(6)) is required by a financial holding company in connection with an investment

made under this subpart if the financial holding company has previously filed a notice under § 225.87 indicating that it had commenced merchant banking investment activities under this subpart.

(2) *Notice of large individual investments.* A financial holding company must provide written notice to the Board on the appropriate form within 30 days after acquiring more than 5 percent of the voting shares, assets or ownership interests of any company under this subpart, including an interest in a private equity fund, at a total cost to the financial holding company that exceeds the lesser of 5 percent of the Tier 1 capital of the financial holding company or $200 million.

§ 225.176 How do the statutory cross marketing and sections 23A and B limitations apply to merchant banking investments?

(a) *Are cross marketing activities prohibited?*—(1) *In general.* A depository institution, including a subsidiary of a depository institution, controlled by a financial holding company may not:

(i) Offer or market, directly or through any arrangement, any product or service of any company if more than 5 percent of the company's voting shares, assets or ownership interests are owned or controlled by the financial holding company pursuant to this subpart; or

(ii) Allow any product or service of the depository institution, including any product or service of a subsidiary of the depository institution, to be offered or marketed, directly or through any arrangement, by or through any company described in paragraph (a)(1)(i) of this section.

(2) *How are certain subsidiaries treated?* For purposes of paragraph (a)(1) of this section, a subsidiary of a depository institution does not include a financial subsidiary held in accordance with section 5136A of the Revised Statutes (12 U.S.C. 24a) or section 46 of the Federal Deposit Insurance Act. (12 U.S.C. 1831w), any company held by a company owned in accordance with section 25 or 25A of the Federal Reserve Act (12 U.S.C. 601 *et seq.*; 12 U.S.C. 611 *et seq.*), or any company held by a small business investment company owned in accordance with the Small Business Investment Act of 1958 (15 U.S.C. 661 *et seq.*).

(3) *How do the cross marketing restrictions apply to private equity funds?* The restriction contained in paragraph (a)(1) of this section does not apply to:

(i) Portfolio companies held by a private equity fund that the financial holding company does not control; or

(ii) The sale, offer or marketing of any interest in a private equity fund, whether or not controlled by the financial holding company.

(b) *When are companies held under section 4(k)(4)(H) affiliates under sections 23A and B?*—(1) *Rebuttable presumption of control.* The following rebuttable presumption of control shall apply for purposes of sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c-1): if a financial holding company directly or indirectly owns or controls more than 15 percent of the total equity of a company pursuant to this subpart, the company shall be presumed to be an affiliate of any member bank that is affiliated with the financial holding company.

(2) *Request to rebut presumption.* A financial holding company may rebut this presumption by providing information acceptable to the Board demonstrating that the financial holding company does not control the company.

(3) *Presumptions that control does not exist.* Absent evidence to the contrary, the presumption in paragraph (b)(1) of this section will be considered to have been rebutted without Board approval under paragraph (b)(2) of this section if any one of the following requirements are met:

(i) No officer, director or employee of the financial holding company serves as a director, trustee, or general partner (or individual exercising similar functions) of the company;

(ii) A person that is not affiliated or associated with the financial holding company owns or controls a greater percentage of the equity capital of the portfolio company than the amount owned or controlled by the financial holding company, and no more than one officer or employee of the holding company serves as a director or trustee

(or individual exercising similar functions) of the company; or

(iii) A person that is not affiliated or associated with the financial holding company owns or controls more than 50 percent of the voting shares of the portfolio company, and officers and employees of the holding company do not constitute a majority of the directors or trustees (or individuals exercising similar functions) of the company.

(4) *Convertible instruments.* For purposes of paragraph (b)(1) of this section, equity capital includes options, warrants and any other instrument convertible into equity capital.

(5) *Application of presumption to private equity funds.* A financial holding company will not be presumed to own or control the equity capital of a company for purposes of paragraph (b)(1) of this section solely by virtue of an investment made by the financial holding company in a private equity fund that owns or controls the equity capital of the company unless the financial holding company controls the private equity fund as described in § 225.173(d)(4).

(6) *Application of sections 23A and B to U.S. branches and agencies of foreign banks.* Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1) shall apply to all covered transactions between each U.S. branch and agency of a foreign bank that acquires or controls, or that is affiliated with a company that acquires or controls, merchant banking investments and—

(i) Any portfolio company that the foreign bank or affiliated company controls or is presumed to control under paragraph (b)(1) of this section; and

(ii) Any company that the foreign bank or affiliated company controls or is presumed to control under paragraph (b)(1) of this section if the company is engaged in acquiring or controlling merchant banking investments and the proceeds of the covered transaction are used for the purpose of funding the company's merchant banking investment activities.

§ 225.177 Definitions.

(a) *What do references to a financial holding company include?*—(1) Except as otherwise expressly provided, the term ''financial holding company'' as used in this subpart means the financial holding company and all of its subsidiaries, including a private equity fund or other fund controlled by the financial holding company.

(2) Except as otherwise expressly provided, the term ''financial holding company'' does not include a depository institution or subsidiary of a depository institution or any portfolio company controlled directly or indirectly by the financial holding company.

(b) *What do references to a depository institution include?* For purposes of this subpart, the term ''depository institution'' includes a U.S. branch or agency of a foreign bank.

(c) *What is a portfolio company?* A portfolio company is any company or entity:

(1) That is engaged in any activity not authorized for the financial holding company under section 4 of the Bank Holding Company Act (12 U.S.C. 1843); and

(2) Any shares, assets or ownership interests of which are held, owned or controlled directly or indirectly by the financial holding company pursuant to this subpart, including through a private equity fund that the financial holding company controls.

(d) *Who are the executive officers of a company?*—(1) An executive officer of a company is any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of the company, whether or not the officer has an official title, the title designates the officer as an assistant, or the officer serves without salary or other compensation.

(2) The term ''executive officer'' does not include—

(i) Any person, including a person with an official title, who may exercise a certain measure of discretion in the performance of his duties, including the discretion to make decisions in the ordinary course of the company's business, but who does not participate in the determination of major policies of the company and whose decisions are limited by policy standards fixed by senior management of the company; or

(ii) Any person who is excluded from participating (other than in the capacity of a director) in major policymaking functions of the company by resolution of the board of directors or by the bylaws of the company and who does not in fact participate in such policymaking functions.

CONDITIONS TO ORDERS

§ 225.200 Conditions to Board's section 20 orders.

(a) *Introduction.* Under section 20 of the Glass-Steagall Act (12 U.S.C. 377) and section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)), a nonbank subsidiary of a bank holding company may to a limited extent underwrite and deal in securities for which underwriting and dealing by a member bank is prohibited. Pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, these so-called section 20 subsidiaries are required to register with the SEC as broker-dealers and are subject to all the financial reporting, anti-fraud and financial responsibility rules applicable to broker-dealers. In addition, transactions between insured depository institutions and their section 20 affiliates are restricted by sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and 371c–1). The Board expects a section 20 subsidiary, like any other subsidiary of a bank holding company, to be operated prudently. Doing so would include observing corporate formalities (such as the maintenance of separate accounting and corporate records), and instituting appropriate risk management, including independent trading and exposure limits consistent with parent company guidelines.

(b) *Conditions.* As a condition of each order approving establishment of a section 20 subsidiary, a bank holding company shall comply with the following conditions.

(1) *Capital.* (i) A bank holding company shall maintain adequate capital on a fully consolidated basis. If operating a section 20 authorized to underwrite and deal in all types of debt and equity securities, a bank holding company shall maintain strong capital on a fully consolidated basis.

(ii) In the event that a bank or thrift affiliate of a section 20 subsidiary shall become less than well capitalized (as defined in section 38 of the Federal Deposit Insurance Act, 12 U.S.C. 1831o), and the bank holding company shall fail to restore it promptly to the well capitalized level, the Board may, in its discretion, reimpose the funding, credit extension and credit enhancement firewalls contained in its 1989 order allowing underwriting and dealing in bank-ineligible securities,[1] or order the bank holding company to divest the section 20 subsidiary.

(iii) A foreign bank that operates a branch or agency in the United States shall maintain strong capital on a fully consolidated basis at levels above the minimum levels required by the Basle Capital Accord. In the event that the Board determines that the foreign bank's capital has fallen below these levels and the foreign bank fails to restore its capital position promptly, the Board may, in its discretion, reimpose the funding, credit extension and credit enhancement firewalls contained in its 1990 order allowing foreign banks to underwrite and deal in bank-ineligible securities,[2] or order the foreign bank to divest the section 20 subsidiary.

(2) *Internal controls.* (i) Each bank holding company or foreign bank shall cause its subsidiary banks, thrifts, branches or agencies[3] to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in transactions underwritten or arranged by a section 20 affiliate.

(ii) Each bank holding company or foreign bank shall ensure that an independent and thorough credit evaluation has been undertaken in connection with participation by a bank, thrift, or branch or agency in such transactions, and that adequate documentation of

[1] Firewalls 5–8, 19, 21 and 22 of *J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp.*, 75 Federal Reserve Bulletin 192, 214–16 (1989).

[2] Firewalls 5–8, 19, 21 and 22 of *Canadian Imperial Bank of Commerce, The Royal Bank of Canada, Barclays PLC and Barclays Bank PLC*, 76 Federal Reserve Bulletin 158, (1990).

[3] The terms ''branch'' and ''agency'' refer to a U.S. branch and agency of a foreign bank.

that evaluation is maintained for review by examiners of the appropriate federal banking agency and the Federal Reserve.

(3) *Interlocks restriction.* (i) Directors, officers or employees of a bank or thrift subsidiary of a bank holding company, or a bank or thrift subsidiary or branch or agency of a foreign bank, shall not serve as a majority of the board of directors or the chief executive officer of an affiliated section 20 subsidiary.

(ii) Directors, officers or employees of a section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer of an affiliated bank or thrift subsidiary or branch or agency, except that the manager of a branch or agency may act as a director of the underwriting subsidiary.

(iii) For purposes of this standard, the manager of a branch or agency of a foreign bank generally will be considered to be the chief executive officer of the branch or agency.

(4) *Customer disclosure*—(i) *Disclosure to section 20 customers.* A section 20 subsidiary shall provide, in writing, to each of its retail customers,[4] at the time an investment account is opened, the same minimum disclosures, and obtain the same customer acknowledgment, described in the Interagency Statement on Retail Sales of Nondeposit Investment Products (Statement) as applicable in such situations. These disclosures must be provided regardless of whether the section 20 subsidiary is itself engaged in activities through arrangements with a bank that is covered by the Statement.

(ii) *Disclosures accompanying investment advice.* A director, officer, or employee of a bank, thrift, branch or agency may not express an opinion on the value or the advisability of the purchase or the sale of a bank-ineligible security that he or she knows is being underwritten or dealt in by a section 20 affiliate unless he or she notifies the customer of the affiliate's role.

[4] For purposes of this operating standard, a retail customer is any customer that is not an ''accredited investor'' as defined in 17 CFR 230.501(a).

(5) *Intra-day credit.* Any intra-day extension of credit to a section 20 subsidiary by an affiliated bank, thrift, branch or agency shall be on market terms consistent with section 23B of the Federal Reserve Act.

(6) *Restriction on funding purchases of securities during underwriting period.* No bank, thrift, branch or agency shall knowingly extend credit to a customer secured by, or for the purpose of purchasing, any bank-ineligible security that a section 20 affiliate is underwriting or has underwritten within the past 30 days, unless:

(i) The extension of credit is made pursuant to, and consistent with any conditions imposed in a preexisting line of credit that was not established in contemplation of the underwriting; or

(ii) The extension of credit is made in connection with clearing transactions for the section 20 affiliate.

(7) *Reporting requirement.* (i) Each bank holding company or foreign bank shall submit quarterly to the appropriate Federal Reserve Bank any FOCUS report filed with the NASD or other self-regulatory organizations, and any information required by the Board to monitor compliance with these operating standards and section 20 of the Glass-Steagall Act, on forms provided by the Board.

(ii) In the event that a section 20 subsidiary is required to furnish notice concerning its capitalization to the Securities and Exchange Commission pursuant to 17 CFR 240.17a–11, a copy of the notice shall be filed concurrently with the appropriate Federal Reserve Bank.

(8) *Foreign banks.* A foreign bank shall ensure that any extension of credit by its branch or agency to a section 20 affiliate, and any purchase by such branch or agency, as principal or fiduciary, of securities for which a section 20 affiliate is a principal underwriter, conforms to sections 23A and 23B of the Federal Reserve Act, and that its branches and agencies not advertise or suggest that they are responsible for the obligations of a section 20 affiliate, consistent with section 23B(c) of the Federal Reserve Act.

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