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"Foreign Banks and the Regulation of Financial Holding Companies "

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A. The Framework of the Gramm-Leach-Bliley Act*

It is an established policy in the United States to separate commercial banking (the business of taking deposits and making commercial loans) from other commercial activities.[1] The separation of banking and commercial activities is achieved by federal and state banking laws, which enumerate the powers that banks may exercise, the activities that banks may engage in, and the investments that banks may lawfully make,[2] and expressly exclude banks from certain activities or relationships.[3] Some of these provisions could be circumvented if a nonbank company could carry on banking activities through a banking subsidiary and nonbanking activities either itself or through a nonbanking subsidiary. To prevent such

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* Note on references to Regulation K and Regulation Y.

On October 16, 2001 the Board promulgated a new version of Regulation K, 66 Fed. Reg. 54,374 (Oct. 26, 2001). The accompanying release was published in 66 Fed. Reg. 54,346-98 (Oct. 26, 2001). The new Regulation K will be codified in 12 C.F.R. pt. 211 of 2002. For ease of reference, this paper already cites the revised Regulation K to 12 C.F.R. pt. 211 of 2002, although 12 C.F.R. pt. 211 of 2002 has not been published as of the date hereof.

Some of the revisions of Regulation Y promulgated to carry out the Gramm-Leach-Bliley Act, *infra* note 4, were issued during 2001 and will be codified in 12 C.F.R. pt. 225 of 2002. The Regulation Y amendments that were published in 2001 are the rules on financial holding companies (§§ 225.81–225.94) (Subpart I of Regulation Y), the rules on merchant banking activities (§§ 225.170–225.177) (Subpart J of Regulation Y), 12 C.F.R. § 225.86(d) (final rule) & (e) (interim rule), and the equity investment capital rules (app. A & D to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs)). For ease of reference, this paper already cites all Regulation Y provisions to 12 C.F.R. pt. 225 of 2002, although 12 C.F.R. pt. 225 of 2002 has not been published as of the date hereof.

1 This policy reflects a concern that a bank that controls industrial enterprises would be economically too powerful. There is also a concern that commercial or industrial activities of banks may endanger the safety of deposits: bankers may be bad industrialists; they may extend credit to the bank's commercial affiliates on preferential terms; and, once a commercial affiliate of a bank incurs losses, the bank may be under great pressure to extend unsound credit. The policy of separation also reflects a concern that a bank that engages in a commercial activity may not extend credit to its commercial competitors, and a bank that has subsidiaries engaged in commercial activities may refuse to extend credit to competitors of its subsidiaries. *See* Gruson, *Nonbanking and Financial Activities of Foreign Banks Operating in the United States*, Chapter 10, § 10.01 *in* MICHAEL GRUSON & RALPH REISNER (eds.), REGULATION OF FOREIGN BANKS, UNITED STATES AND INTERNATIONAL, vol. 1 (3d ed. 2000).

2 *See, e.g.*, § 5136, Revised Statutes (National Bank Act of 1864), 12 U.S.C. § 24 (seventh) (1994 & Supp. V 1999) (restricting national banks to "carry[ing] on the business of banking" and prohibiting the ownership of securities) and, as an example of a state law, §§ 96 & 97, N.Y. Banking Law (McKinney 2001).

3 *See, e.g.*, § 20, Banking Act of 1933, 12 U.S.C. § 377 (1994) (prohibiting banks that are members of the Federal Reserve System from affiliating with organizations that are primarily engaged in underwriting or dealing in securities). Section 20 was part of the Glass-Steagall Act and was repealed in 1999. *See infra* note 12. An example of similar state law restrictions was § 103(9), N.Y. Banking Law (*see* McKinney 2001) (prohibiting affiliations between banks and security corporations), which was repealed by the New York State Financial Modernization Act of 1999, 2000 N.Y. Laws ch. 493, § 1.

circumvention, the federal Bank Holding Company Act of 1956[4] [*herein* BHCA] restricts the permissible activities and investments of bank holding companies. A bank holding company [*herein* BHC][5] is a company[6] that has direct or indirect control over any bank[7] organized in the United States or over another BHC. A BHC may only own or control banks, other BHCs[8] and — with the approval of the Board of Governors of the Federal Reserve System [*herein* the Board] — subsidiaries that are engaged in narrowly defined activities "closely related to banking".[9] BHCs may only acquire up to 5 percent of any class of voting shares of companies not engaged in banking activities or activities closely related to banking, and such shareholding must represent passive investments.[10]

The BHCA has also the effect of preventing an entity that is not a bank or a BHC from acquiring more than 24.9 percent of the equity of, or otherwise acquiring control over, a U.S. bank or a BHC because an entity holding 25 percent of the equity of or otherwise controlling a U.S. bank or a BHC, itself becomes a BHC and is subject to all restrictions to

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4 Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841–1850 (1994 & Supp. V 1999). On Nov. 12, 1999, the BHCA was substantially amended by the Gramm-Leach-Bliley Act of 1999 [*herein* GLBA], Pub. L. No. 106-102, 106th Cong., 1st Sess. (Nov. 12, 1999), 113 Stat. 1338–1481 (1999). S*ee* H.R. Conference Report to accompany S. 900 (Nov. 2, 1999), 106th Cong., 1st Sess. (1999) [*herein* Conference Report on S. 900]. The GLBA was signed into law by President Clinton on Nov. 12, 1999.

5 *BHC* is defined in § 2(a)(1), BHCA, 12 U.S.C. § 1841(a)(1) (1994). *See also* 12 C.F.R. § 225.2(c) (2002) (Regulation Y).

6 *Company* is defined in § 2(b), BHCA, 12 U.S.C. § 1841(b) (1994 & Supp. V 1999). *See also* 12 C.F.R. § 225.2(d) (2002) (Regulation Y).

7 *Bank* is defined in § 2(c), BHCA, 12 U.S.C. § 1841(c) (1994 & Supp. V 1999). *See also* 12 C.F.R. § 225.2(b) (2002) (Regulation Y). *Control* is defined in § 2(a)(2), BHCA, 12 U.S.C. § 1841(a)(2) (1994 & Supp. V 1999). *See also* 12 C.F.R. § 225.2(e) (2002) (Regulation Y).

8 Section 4(a)(2)(A), BHCA, 12 U.S.C. § 1843(a)(2)(A) (1994), providing that no BHC shall acquire or retain direct or indirect ownership or control of any voting shares of any company which is not a bank or a BHC. Section 4(a), BHCA, 12 U.S.C. § 1843(a) (1994), further provides that no BHC shall engage in any activities other than banking or managing or controlling banks.

9 Section 4(a)(2)(B), BHCA, 12 U.S.C. § 1843(a)(2)(B) (1994), which permits a BHC to acquire and retain direct or indirect ownership or control of any voting shares of a company engaged in activities permitted by § 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999). *See* 12 C.F.R. § 225.28 (2002) (Regulation Y). Section 4(c)(8), BHCA, as amended by § 102(a), GLBA, 113 Stat. at 1341 (1999), freezes the activities that are closely related to banking: permitted are only those activities that were determined by the Board to be permissible as of Nov. 11, 1999, the day before the date of enactment of the GLBA. No new activities can be added.

10 Section 4(c)(6), BHCA, 12 U.S.C. § 1843(c)(6) (1994). Section 4(c)(6), BHCA permits a domestic or foreign BHC to acquire and own not more than 5 percent of any class of the voting shares of any domestic or foreign company. For a discussion of § 4(c)(6), BHCA, *see* Gruson, *supra* note 1, § 10.09. Section 4(c), BHCA, 12 U.S.C. § 1843(c) (1994 & Supp. V 1999), contains some other narrowly defined exceptions from the general prohibition against investing in equity securities of other companies. *See generally* Gruson, *supra* note 1, § 10.07 *et seq.*

which BHCs are subject.[11] In particular, such equity owner could no longer be engaged in activities other than banking and activities closely related to banking. Furthermore, the Glass-Steagall Act excludes U.S. banks and BHCs from the business of underwriting and dealing in securities, and under that act a holding group could not have a deposit-taking bank and a company engaged in securities underwriting and dealing.[12]

The above rules apply, subject to some exceptions, not only to foreign banks that have a U.S. bank subsidiary[13] but also to foreign banks that maintain a branch, agency or commercial lending company in the United States.[14]

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[11] Under the U.S. banking law, a *subsidiary* is a company in which the parent owns or controls 25 percent or more of any class of voting securities or in which the parent owns or controls between 5 percent and 24.9 percent of any class of voting securities *and* has the power to exercise a controlling influence. *See* § 2(a)(2) (control) and § 2(d) (subsidiary), BHCA, 12 U.S.C. § 1841(a)(2) and (d) (1994); 12 C.F.R. § 211.21(i) (control) and § 211.21(z) (subsidiary) (2002) (Regulation K); 12 C.F.R. § 225.2(e) (control) and § 225.2(o) (subsidiary) (2002) (Regulation Y). An entity owning or controlling less than 5 percent of any class of voting shares of a company is presumed not to control such company. Section 2(a)(3) & (4), BHCA, 12 U.S.C. § 1841(a)(3) & (4) (1994). The terms *subsidiary* and *controlled company* have the same meaning. For a discussion of control, controlling influence and subsidiary, *see* Gruson, *supra* note 1, §§ 10.05 & 10.06.

[12] Sections 16, 20, 21 and 32 of the Banking Act of 1933, *codified in* 12 U.S.C. §§ 24 (seventh), 377, 378 & 78 (1994 & Supp. V 1999), are known as the Glass-Steagall Act. The idea behind the separation of commercial banking and investment banking is that the deposits of the public should not be exposed to the risky securities transactions. Section 16 prohibits banks from acquiring securities and from engaging in underwriting and dealing in securities; § 20 prohibited banks that are members of the Federal Reserve System from affiliating with organizations that are primarily engaged in underwriting or dealing in securities; § 21 prohibits the receipt of deposits by securities companies; § 32 prohibited management interlocks between officers, directors or employees of a bank that is a member of the Federal Reserve System and a securities firm. Sections 20 and 32 were repealed by § 101(b), GLBA, 113 Stat. at 1341 (1999). The prohibitions of §§ 16 and 21 remain in effect, because the GLBA permits the conduct of banking and securities activities in a holding group but not in one enterprise. Although the Glass-Steagall Act has hurt commercial banks, it has furthered or even made possible the development of strong investment banks in the United States. Section 20 is not completely dead. *See* the Board's release of Mar. 10, 2000, 65 Fed. Reg. 14,440 (Mar. 17, 2000), accompanying interim rule 12 C.F.R. § 225.4(g) (2002) (Regulation Y) that imposes two of the eight § 20 operating standards on securities affiliates of FHCs. The Board stated in the release, at 14,441 n.1: "The operating standards would continue to apply to section 20 subsidiaries controlled by [BHCs] that do not qualify as [FHCs]". *See* Wells Fargo & Company, 86 FED. RES. BULL. 341 (2000), and Banque Nationale de Paris and Paribas, 86 FED. RES. BULL. 118 (2000) (applying the rules relating to § 20 subsidiaries that are based on the repealed § 20); Final FHC Release, *infra* note 32, at 405 n.10 (the 25 percent revenue limit applicable to Section 20 subsidiaries of BHCs that are not FHCs remains in effect). *See infra* note 821 (Regulation Y applies two § 20 operating standards to the extension of credit by banks that are part of an FHC group to broker-dealer subsidiaries of such group.)

[13] The BHCA applies directly to such foreign banks.

[14] Section 8(a), International Banking Act of 1978 [*herein* IBA], 12 U.S.C. § 3106(a) (1994), makes the BHCA applicable to foreign banks maintaining a branch or agency or controlling a commercial lending company in the United States. A *branch* is a place of business of a foreign bank in the United States where deposits are received from U.S. citizens or residents. Section l(b)(3), IBA, 12 U.S.C. § 3101(3) (1994); 12 C.F.R. § 211.21(e) (2002) (Regulation K). An *agency* is a place of business of a foreign bank in the United States where credit balances are maintained or checks are paid or money is lent, but where deposits are not accepted from U.S. citizens or residents. Section l(b)(1), IBA, 12 U.S.C. § 3101(1) (1994); 12 C.F.R. §

The system that separates banking from other commercial activities created significant competitive disadvantages for U.S. banks in the international banking market and in the financial services market in general. Furthermore, the strict separation of banking and nonbanking activities has made it impossible for some non-U.S. banks to access the U.S. market. In particular a foreign holding group that had banks and insurance company members could engage in the United States either in the banking business or in the insurance business.[15]

In adopting the Gramm-Leach-Bliley Act[16] [*herein* GLBA] it was, of course, not the intention of Congress to help foreign banks, but to strengthen the competitive position of U.S. banks by permitting a combination in a holding group of banks, insurance companies and securities companies. Enterprises that are not engaged in financial activities are still precluded from acquiring directly or indirectly U.S. banks. Representative Leach, the Chairman of the Committee on Banking and Financial Services of the House of Representatives, has said that this separation between banks and enterprises outside the financial sector was retained because Congress was afraid that otherwise all major banks would be taken over, in particular by companies in the media and technology sectors, and that such takeovers would not be in the best interest of the U.S. economy and the international competitive position of U.S. banks.[17]

The GLBA, which was approved by Congress after 20 years of discussion at the end of 1999,[18] brought about major changes in the U.S. financial system but it does not abolish the policy of separating banking from commercial activities.[19] The GLBA only modifies the separation policy for *some* BHCs and for *some* activities. The GLBA creates a subgroup of BHCs, BHCs whose depository institutions are well capitalized and well managed and have received a satisfactory rating under the Community Reinvestment Act of 1997.[20] A BHC that meets these requirements and files with the Board a declaration of election to be a financial

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211.21(b) (2002) (Regulation K) (definition of agency and of credit balance). A *commercial lending company* is a corporation organized under state law, that maintains credit balances and engages in the business of making commercial loans. Section 1(b)(9), IBA, 12 U.S.C. § 3101(9) (1994); 12 C.F.R. § 211.21(g) (2002) (Regulation K). For details, *see* Gruson, *supra* note 1, § 10.02.

15 This had the consequence that some foreign banks had to close their U.S. branches when they were acquired by a foreign insurance company or the holding company of a foreign insurance company. The most recent example is BHF-Bank, whose acquiror, ING Groep, is engaged in insurance activities in the United States. *See* Gruson, *supra* note 1, Chapter 10, note 628.

16 *See supra* note 4.

17 *See* statement made by Rep. James A. Leach at the Financial Services Symposium held by the American Council of Life Insurers, the American Insurance Association and Northwestern University School of Law, in New York City on Mar. 1, 2000. *See also* James A. Leach, *Modernization of Financial Institutions*, 25 IOWA J. CORP. L. 681, 687 (2000).

18 *See* 145 CONG. REC. H11,513–26 and H11,526–51 (daily ed.) (Nov. 4, 1999) and 145 CONG. REC. S13,871–881 and S13,883–917 (daily ed.) (Nov. 4, 1999).

19 *See* Leach, *supra* note 17, at 682 ("While competition should be opened up in finance, the American model of separating commerce from banking should be maintained."), 687.

20 Section 4(*l*)(1)(A) and (B) & (2), BHCA, 12 U.S.C. § 1843(*l*)(1)(A) and (B) & (2) (1994 & Supp. V 1999). *See infra* note 38 for a discussion of the Community Reinvestment Act.

holding company [*herein* FHC][21] may engage in, and may acquire and retain shares of a company engaged in, certain activities that are prohibited to BHCs that are not FHCs. These activities must be *financial activities* or activities that are *incidental* or *complementary* to financial activities.[22] The most important of the newly authorized financial activities for FHCs are securities underwriting and dealing, insurance underwriting and sales, and merchant/investment banking equity investments. The FHC may own besides its banking subsidiaries, broker-dealers, other financial service providers and insurance companies, and the FHC itself may be a broker-dealer, financial service provider or an insurance company that owns a bank — in other words, any company that is either a mere holding company or is engaged in financial activities can be an FHC. Thus, the GLBA provides a framework for the affiliation of banks, securities firms, insurance companies and other financial service providers[23] in a holding company structure.[24] In addition to the power to invest in companies engaged in financial activities, an FHC may, directly or indirectly and subject to certain limitations, in the exercise of its merchant banking, underwriting, dealing or insurance activities, invest in securities and other assets of companies not engaged in financial activities.

Except for this expansion of the scope of permitted nonbanking activities, the prohibition of nonbanking activities in Section 4(a), BHCA[25] and the exemptions from this prohibition in Section 4(c), BHCA,[26] remain in place for FHCs.

BHCs that do not meet the conditions for an election to become an FHC remain subject to the prohibition of Section 4(a), BHCA, and only the exemptions set forth in Section 4(c), BHCA (other than those relating to FHCs) are available to them. A foreign bank that maintains a branch, agency or commercial lending company in the United States and therefore is subject to the BHCA can elect to be an FHC[27] and then engage directly or indirectly in financial activities. It is important to note, however, that the GLBA does not abrogate for foreign bank FHCs the existing special rules under the BHCA and the IBA in favor of foreign banks which permit under certain conditions foreign banks to engage in the United States in

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21 Section 4(*l*)(1)(C), BHCA, 12 U.S.C. § 1843(*l*)(1)(C) (1994 & Supp. V 1999). An FHC is defined in § 2(p), BHCA, 12 U.S.C. § 1841(p) (1994 & Supp. V 1999), as a BHC that meets the requirements of § 4(*l*)(1), BHCA, *i.e*., that is well capitalized and well managed and has filed a declaration of election with the Board. The condition of a satisfactory Community Reinvestment Act rating is not part of the definition of FHC but a condition for engaging in financial activities. Section 4(*l*)(2), BHCA, 12 U.S.C. § 1843(*l*)(2) (1994 & Supp. V 1999), and § 804(c), Community Reinvestment Act, 12 U.S.C. § 2903(c) (1994 & Supp. V 1999).

22 Section 4(k)(1), BHCA, 12 U.S.C. § 1843(k)(1) (1994 & Supp. V 1999).

23 To accomplish this result, § 101, GLBA, 113 Stat. at 1341 (1999), repealed §§ 20 & 32, Banking Act of 1933 (Glass-Steagall Act), 12 U.S.C. §§ 377 & 78 (1994). *See supra* note 12.

24 *See* 145 CONG. REC. S13,889 (daily ed.) (Nov. 4, 1999) (Sen. Reed); 145 CONG. REC. S13,904 (daily ed.) (Nov. 4, 1999) (Sen. Kerry).

25 12 U.S.C. § 1843(a) (1994).

26 12 U.S.C. § 1843(c) (1994 & Supp. V 1999).

27 *See* § 4(*l*)(3), BHCA, 12 U.S.C. § 1843(*l*)(3) (1994 & Supp. V 1999).

nonbanking activities (that are not classified as financial activities) from which U.S. BHCs are excluded.[28]

As of January 11, 2002, 581 U.S. BHCs (including 5 BHCs from Puerto Rico), 4 holding companies of U.S. banks incorporated outside the United States, but only 23 foreign banks (6 BHCs from Canada, 1 BHC from Australia and 16 BHCs from Europe) maintaining a branch or agency in the United States have effectively elected to be FHCs.[29]

B. Election Procedures by BHCs to Be FHCs

1. Qualification as an FHC – An Overview

After the enactment of the GLBA amendments to the BHCA, a BHC that meets the requirements of, and elects to be, an FHC may engage in, and may acquire and retain shares of a company engaged in, certain activities that are prohibited to BHCs that are not FHCs. The GLBA calls activities permitted to be carried out by FHCs *financial activities*. Foreign banks have the benefit of the new rules if they are or are treated as BHCs under the BHCA. A foreign bank that maintains a branch or agency or owns or controls a commercial lending company in the United States is treated as a BHC,[30] and a foreign bank or other company that controls a bank subsidiary in the United States is a BHC.[31]

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[28] *See* §§ 2(h)(2) & 4(c)(9), BHCA, 12 U.S.C. §§ 1841(h)(2) & 1843(c)(9) (1994). *See* Gruson, *supra* note 1, §§ 10.12–10.14.

[29] *See* Federal Reserve Board, Financial Holding Companies as of Jan. 11, 2002, *available at* http://www.federalreserve.gov/generalinfo/fhc (last visited Jan. 22, 2002).

Australia: Australia and New Zealand Banking Group Limited;
Europe: Banco Santander Central Hispano, S.A. (Spain); Bank of Scotland (UK); HSBC Holdings PLC (UK); Abbey National plc (UK); BNP Paribas (France); Société Générale (France); CERA Stichting VZW (Belgium); Dexia S.A. (Belgium); Credit Suisse Group (Switzerland); UBS AG (Switzerland); Den Danske Bank Aktieselskab (Denmark); Skandinaviska Enskilda Banken AB (Sweden); Deutsche Bank Aktiengesellschaft (Germany); Dresdner Bank Aktiengesellschaft (Germany); Rabobank (The Netherlands); Stichting Prioriteit ABN AMRO Holding (The Netherlands);
Holding companies of U.S. banks incorporated outside the United States: Cayman Investment Company Omega (Cayman Islands); Incus Co. Ltd. (Laredo National Bank, South Texas National Bank); Granvalor Holding, Ltd. (International Bank of Miami) (BVI); SNBNY Holdings Limited (Safra National Bank) (Gibraltar).

The 23 foreign bank FHCs represent a small fraction of the 169 foreign banks maintaining a branch or agency in the United States. *See* Federal Reserve Board, *available at* http://www.federalreserve.gov/releases/iba/current/struca.pdf (last visited Jan. 29, 2002), Structure Data for U.S. Offices of Foreign Banks as of 9/30/2001.

[30] Section 4(*l*)(1)(C), BHCA, 12 U.S.C. § 1843(*l*)(1)(C) (1994 & Supp. V 1999), refers to the election of a BHC to be an FHC. Section 8(a), IBA, 12 U.S.C. § 3106(a) (1994), provides that (1) any foreign bank that maintains a branch or agency in a state, (2) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under state law, and (3) any company of which any foreign bank or company referred to under the first two categories is a subsidiary, is subject to the provisions of the BHCA in the same manner and to the same extent that BHCs are subject to such provisions, *i.e.*, as if the foreign bank or other company were a BHC. In other words, such foreign bank or

A BHC, including a foreign bank, will be or will be treated as an FHC if it meets the following requirements:[32]

- all the depository institution subsidiaries[33] of the BHC and, in the case of a foreign bank that is treated as a BHC, also the foreign bank itself must be and remain well capitalized;[34]

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other company is treated as a BHC or "as if it were" a BHC. *See* Final FHC Release, *infra* note 32, at 408 n.17. Thus, companies covered under § 8(a), IBA are entitled to elect FHC status if they meet the statutory requirements. Section 4(*l*), BHCA, 12 U.S.C. § 1843(*l*) (1994 & Supp. V 1999), however, avoids the interpretation issues arising under § 8(a), IBA (*see* Gruson, *supra* note 1, § 10.02, text accompanying nn. 41 & 45) and introduces its own concept of foreign bank in § 4(*l*)(3), BHCA, 12 U.S.C. § 1843(*l*)(3) (1994 & Supp. V 1999), as a "foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States". 12 C.F.R. § 225.90(a) (2002) (Regulation Y) equally does not refer to companies covered by § 8(a), IBA but provides for the election to be an FHC by a "foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States, and any company that owns or controls such a foreign bank". Section 225.90, Regulation Y correctly does not refer to foreign banking organizations (defined in 12 C.F.R. § 211.21(o) (2002) (Regulation K)) because that term includes foreign banks that control a bank in the United States. Such foreign banks controlling a U.S. bank must elect to be FHCs like U.S. BHCs under 12 C.F.R. § 225.82 (2002) (Regulation Y). *See infra* text accompanying note 48.

It appears that one entity that is covered by § 8(a), IBA is not covered by § 4(*l*), BHCA, namely a foreign company that controls a foreign bank (that does not operate a branch, agency or commercial lending company subsidiary in the United States) and at the same time controls a commercial lending company. *See* Gruson, *supra* note 1, § 10.02, nn. 41 & 45. If such entities are treated as BHCs, they must have the ability to elect FHC status. The issue may be moot because § 7(d), IBA, 12 U.S.C. § 3105(d) (1994 & Supp. V 1999), as amended in 1991, seems to restrict ownership of commercial lending companies to foreign banks engaged directly in the business of banking outside the United States. *See* Gruson, *supra* note 1, § 10.02, nn.40 & 73 *sub* (a)2.

31 The BHCA applies directly to such foreign banks. *See* § 2(a)(1), BHCA, 12 U.S.C. § 1841 (a)(1) (1994). U.S. and foreign banks or other companies that control a bank in the United States are sometimes referred to herein as U.S. BHCs. *See also infra* text accompanying note 48.

32 The provisions of Regulation Y dealing with the election to be an FHC were issued by the Board on an interim basis on Jan. 18, 2000 (Regulation Y, Docket No. R-1057), 65 Fed. Reg. 3791–94 (Jan. 25, 2000), as amended on an interim basis by the Board on Mar. 15, 2000 (Regulation Y, Docket No. R-1057), 65 Fed. Reg. 15,055–57 (Mar. 21, 2000) and issued as a final rule by the Board on Dec. 21, 2000 (Regulation Y, Docket Nos. R-1057 and R-1062), 66 Fed. Reg. 414–22 (Jan. 3, 2001). These rules are codified in 12 C.F.R. §§ 225.81–225.94 (2002) (Subpart I of Regulation Y). These rules were accompanied by releases, 65 Fed. Reg. 3785–94 (Jan. 25, 2000) [*herein* Interim FHC Release]; 65 Fed. Reg. 15,053–57 (Mar. 21, 2000) [*herein* Amended Interim FHC Release]; 66 Fed. Reg. 400–422 (Jan. 3, 2001) [*herein* Final FHC Release]; and the Interim Financial Activities Release, *infra* note 272. *See* Letter, dated Feb. 25, 2000, from Michael Gruson, Bradley K. Sabel and Jonathan M. Weld to the Secretary of the Board commenting on the interim rules.

33 *Depository institution* is defined in § 2(n), BHCA, 12 U.S.C. § 1841(n) (1994 & Supp. V 1999), by reference to § 3, Federal Deposit Insurance Act [*herein* FDIA], 12 U.S.C. § 1813 (1994 & Supp. V 1999). 12 C.F.R. § 225.2(t)(2002) (Regulation Y) defines the term *depository institution* by reference to § 3(c), FDIA. Section 3(c)(1), FDIA, 12 U.S.C. § 1813(c)(1) (1994), defines *depository institution* as "any bank or savings association". Section 3(a)(1), FDIA, 12 U.S.C. § 1813(a)(1) (1994), defines *bank* as "any national bank, State bank, and District bank, and any Federal branch [of a foreign bank] and insured branch

- all depository institution subsidiaries of the BHC and, in the case of a foreign bank that is treated as a BHC, also the foreign bank itself must be and remain well managed;[35]

[of a foreign bank]". *Federal branch* is defined in § 3(s)(2), FDIA, 12 U.S.C. § 1813(s)(2) (1994), by reference to § 1(b)(6), IBA, 12 U.S.C. § 3101(6) (1994). *Insured branch* is defined in § 3(s)(3), FDIA, 12 U.S.C. § 1813(s)(3) (1994), as any branch (as defined in § 1(b)(3), IBA, 12 U.S.C. § 3101(3) (1994)) of a foreign bank, any deposits of which are insured by the FDIC. Thus, the term *depository institution* does not cover uninsured state branches. An uninsured federal branch is a depository institution; however, only depository institution *subsidiaries* must be well capitalized and well managed.

The term *depository institution* under the FDIA is broader than the term *bank* under § 2(c), BHCA, 12 U.S.C. § 1841(c) (1994 & Supp. V 1999). *E.g.*, savings banks, savings associations, industrial banks and nonbank trust companies are *depository institutions* but not *banks*. *Compare* § 2(c)(2)(B), (D) & (J), BHCA, 12 U.S.C. § 1841(c)(2)(B), (D) & (J) (1994), *with* § 3(c)(1) & (b), (a)(1) & (g), FDIA, 12 U.S.C. § 1813(c)(1) & (b), (a)(1) & (g) (1994). Thus, a foreign bank that is a BHC because it controls a U.S. bank must meet the well-capitalized requirements not only with respect to the bank subsidiary but also with respect to its U.S. nonbank depository institution subsidiaries. *See*, *e.g.*, Met Life, Inc., Order of Feb. 12, 2001, 87 FED. RES. BULL. 268, at 269 n.6 & 270 n.15 (2001) (stating that a certain limited-purpose trust company subsidiary of the applicant Met Life is not a bank for purposes of the BHCA but is a depository institution under the FDIA and, therefore, Met Life must certify that the trust company is well capitalized and well managed). A foreign bank to which the BHCA applies because it operates a U.S. branch, agency or commercial lending company must meet the well-capitalized requirements not only with respect to itself (*see infra* B.2.c.) but also with respect to any U.S. nonbank depository institution subsidiaries.

[34] Section 4(*l*)(1)(A) & (3), BHCA, 12 U.S.C. § 1843(*l*)(1) (A) & (3) (1994 & Supp. V 1999). These Sections are carried out by Regulation Y as follows: (i) 12 C.F.R. § 225.81(b)(1) (2002) (Regulation Y) (depository institution subsidiaries of U.S. BHCs, including depository institution subsidiaries of foreign banks that control a U.S. bank and therefore are U.S. BHCs (the U.S. bank subsidiary would be one of such depository institution subsidiaries)); (ii) 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(5) (2002) (Regulation Y) (depository institution subsidiaries of foreign banks maintaining a branch, agency or commercial lending company in the United States or of companies controlling such foreign banks; if such depository institution subsidiaries are U.S. banks, the foreign bank and the company controlling the foreign bank would be U.S. BHCs); and (iii) 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(3) (2002) (Regulation Y) (foreign banks maintaining a branch, agency or commercial lending company in the United States and electing to be FHCs; foreign banks maintaining a branch, agency or commercial lending company in the United States that are controlled by the foreign bank electing to be an FHC; and foreign banks maintaining a branch, agency or commercial lending company in the United States that are controlled by a company controlling a foreign bank electing to be an FHC). *See infra* B.3.

[35] Section 4(*l*)(1)(B) & (3), BHCA, 12 U.S.C. § 1843(*l*)(1)(B) & (3) (1994 & Supp. V 1999). These Sections are carried out by Regulation Y as follows: (i) 12 C.F.R. § 225.81(b)(2) (2002) (Regulation Y) (depository institution subsidiaries of U.S. BHCs, including depository institution subsidiaries of foreign banks that control a U.S. bank and therefore are U.S. BHCs (the U.S. bank subsidiary would be one of such depository institution subsidiaries)); (ii) 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(5) (2002) (Regulation Y) (depository institution subsidiaries of foreign banks maintaining a branch, agency or commercial lending company in the United States or of companies controlling such foreign banks; if such depository institution subsidiaries are U.S. banks, the foreign bank and the company controlling the foreign bank would be U.S. BHCs); and (iii) 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(4)(2002) (Regulation Y) (foreign banks maintaining a branch, agency or commercial lending company in the United States and electing to be FHCs; foreign banks maintaining a branch, agency or commercial lending company in the United States that are controlled by the foreign bank electing to be an FHC; and foreign banks maintaining a branch, agency or commercial lending company in the United States that are controlled by a company controlling a foreign bank electing to be an FHC). *See infra* B.4.

- the foreign bank that elects to be an FHC must be subject in its home country to comprehensive supervision on a consolidated basis;[36]

- the BHC must have filed with the Board a declaration of election to be an FHC and a certification that the BHC's depository institutions and, in the case of a foreign bank that is treated as a BHC, also the foreign bank itself meet the requirements of being well capitalized and well managed;[37]

- all insured depository institution subsidiaries of the BHC must have achieved a rating of at least "satisfactory" under the Community Reinvestment Act of 1977[38] in the most recent examination of such institutions;[39] and

- it is uncertain whether the election by a foreign company that controls a foreign bank together with the controlled foreign bank to be treated as FHCs subjects the foreign controlling company to the usual consolidated capital requirements applicable to BHCs.[40]

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36 *See infra* B.5.

37 Section 4(*l*)(1)(C), BHCA, 12 U.S.C. § 1843(*l*)(1)(C) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.81(b)(3) & 225.82 (2002) (Regulation Y) (U.S. BHCs); 12 C.F.R. §§ 225.90(a)(2), 225.91 & 225.92 (2002) (Regulation Y) (foreign banks maintaining a branch, agency or commercial lending company in the United States and companies controlling such foreign bank). 12 C.F.R. §§ 225.81(b)(3) & 225.90(a)(2) (2002) (Regulation Y) state that the U.S. BHC and the foreign bank together with the company controlling it must have made "an effective election". *See infra* B.2.

The BHC must declare that it elects to be an FHC to engage in activities or acquire and retain shares of a company that were not permissible for a BHC to engage in or acquire before the enactment of the GLBA. Section 4(*l*)(1)(C)(i), BHCA, 12 U.S.C. § 1843(*l*)(1)(C)(i) (1994 & Supp. V 1999). Does this mean that a BHC cannot become an FHC solely for the purpose of engaging in activities or acquiring shares of a company engaged in activities that were *permissible* before the enactment of the GLBA, *i.e.*, in activities under the now frozen § 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999)? *See* Gruson, *supra* note 1, § 10.10 C. A BHC may wish to become an FHC in order to engage in § 4(c)(8), BHCA activities without a notice requirement. Regulation Y does not repeat this apparent statutory limitation regarding the intention of a BHC electing to be an FHC.

Section 4(m)(1), BHCA, 12 U.S.C. § 1843(m)(1) (1994 & Supp. V 1999), seems to anticipate FHCs that are only engaged in activities under the authority of § 4(c)(8), BHCA. *See infra* note 839.

38 The Community Reinvestment Act of 1977 requires banks to help meeting the credit needs of the low and moderate income neighborhoods of the local communities in which such banks are chartered. A bank's record of meeting community credit needs must be rated annually by the appropriate federal financial supervisory agency. The Community Reinvestment Act of 1977 [*herein* CRA] is codified at 12 U.S.C. §§ 2901–2908 (1994 & Supp. V 1999).

39 Section 804(c)(1), CRA, 12 U.S.C. § 2903(c)(1) (1994 & Supp. V 1999); 12 C.F.R. § 225.82(c)(1) (2002) (Regulation Y) (insured depository institution subsidiaries of U.S. BHCs); 12 C.F.R. § 225.92(c)(2) (2002) (Regulation Y) (U.S. insured depository institution subsidiaries of foreign banks maintaining a branch, agency or commercial lending company in the United States or of companies controlling such banks, and insured U.S. branches of foreign banks). *See infra* B.6.

40 *See infra* B.7.

2. Election to Become an FHC

a. Different Rules for U.S. BHCs and for Foreign Banks

The procedure for the election to be an FHC is set forth in Sections 225.81–225.94, Regulation Y.[41] If the foreign bank maintaining a branch, agency or commercial lending company in the United States is controlled within the meaning of the BHCA[42] by another company, this holding company itself is a "foreign bank" and is subject to the BHCA[43] and must be an FHC, if its foreign bank subsidiary intends to engage in the United States in financial activities.[44] The same applies to all holding companies in the case of tiered holding company structures.

Sections 225.81–225.84, Regulation Y[45] deal with U.S. BHCs electing to be FHCs, and Sections 225.90–225.94, Regulation Y[46] deal with foreign banks[47] that maintain a

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41 12 C.F.R. §§ 225.81–225.94 (2002) (Regulation Y). The language in the BHCA and Regulation Y is somewhat inconsistent. Section 4(*l*)(1)(C), BHCA, 12 U.S.C. § 1843(*l*)(1)(C) (1994 & Supp. V 1999), and 12 C.F.R. § 225.81 (2002) (Regulation Y) speak about an election *to be* an FHC; § 4(n)(1), BHCA, 12 U.S.C. § 1843(n)(1) (1994 & Supp. V 1999), and 12 C.F.R. § 225.82(a), (c) & (f) (2002) (Regulation Y) speak about an election to *become* an FHC; and 12 C.F.R. §§ 225.91(a) & 225.91(b) speak about an election *to be treated* as an FHC. These differences in terminology have no legal consequences. It appears that in the terminology of the Board a foreign bank and a company controlling such foreign bank which are *treated as BHCs*, *see supra* note 30, are also *treated as FHCs*. *See, e.g.*, 12 C.F.R. § 225.4(g)(2) (2002) (Regulation Y). A BHC that elects FHC status remains a BHC, it does not change its nature but only expands its authority to engage in additional activities and to make additional investments.

42 *See supra* note 11.

43 Section 8(a), IBA, 12 U.S.C. § 3106(a) (1994), subjects not only foreign banks maintaining a branch, agency or commercial lending company in the United States to the BHCA, but also all companies that control such banks. *See supra* notes 11 (discussing control) & 30 (discussing application of BHCA to foreign banks). *See also* § 1(b)(7), IBA, 12 U.S.C. § 3101(7) (1994): A *foreign bank* is "any company organized under the laws of a foreign country . . . which engages in the business of banking, or any subsidiary or affiliate, organized under such laws, of any such company". A company that controls a bank is an affiliate of such bank and, therefore, a *foreign bank*. Section 1(b)(13), IBA, 12 U.S.C. § 3101(13) (1994), in conjunction with § 2(k), BHCA, 12 U.S.C. § 1841(k) (1994).

44 12 C.F.R. §§ 225.90(a) & 225.91(a) (2002) (Regulation Y) refer not only to a foreign bank maintaining a branch, agency or commercial lending company in the United States, but also to "any company that owns or controls such a foreign bank". *See supra* note 11 for a discussion of *control* and *infra* B.2.c. for a discussion of which entities in a foreign bank holding group have to file a declaration of election to be an FHC.

45 12 C.F.R. §§ 225.81–225.84 (2002) (Regulation Y).

46 12 C.F.R. §§ 225.90–225.94 (2002) (Regulation Y).

47 It is curious that neither the BHCA nor Regulation Y define the term *foreign bank*. The appropriate definition would be 12 C.F.R. § 211.21(n) (2002) (Regulation K) because this definition applies to foreign banks that are permitted to establish a branch, agency or commercial lending company in the United States. *See* 12 C.F.R. § 211.24(a)(1) (2002) (Regulation K). *See also* in this context the inapplicable definition of *foreign bank* in 12 C.F.R. § 211.2(j) (2002) (Regulation K) that limits the term to organizations that receive deposits.

branch, agency or commercial lending company in the United States electing to be FHCs. If a foreign bank has no branch, agency or commercial lending company in the United States but owns or controls a bank subsidiary in the United States, it is a BHC directly under the BHCA (and not by virtue of the IBA) and must make its election to be a BHC pursuant to Sections 225.81–225.82, Regulation Y.[48] If the foreign bank maintains a U.S. branch, agency or commercial lending company and is deemed to be a BHC under the IBA,[49] it must make its FHC election pursuant to Sections 225.90–225.92, Regulation Y.[50] If the foreign bank owns a U.S. banking subsidiary *and* operates a U.S. branch, agency or commercial lending company it must comply with the U.S. BHC requirements of Sections 225.81–225.82, Regulation Y, as well as with the foreign bank requirements of Sections 225.90–225.92, Regulation Y.[51] The same rule applies if a U.S. BHC (*i.e.*, an organization that controls a U.S. bank) owns a foreign bank that maintains a branch, agency or controls a commercial lending company in the United States.[52] If a foreign bank does not own a U.S. bank but owns a U.S. depository institution that is not a bank[53] (such as a thrift or a nonbank trust company) and at the same time operates a U.S. branch, agency or commercial lending company, it is not a BHC under the BHCA and an election by such bank must be made pursuant to Sections 225.90–225.92, Regulation Y.[54] Under which

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48 12 C.F.R. §§ 225.81 & 225.82 (2002) (Regulation Y). *See* Interim FHC Release, *supra* note 32, at 3,788; Final FHC Release, *supra* note 32, at 408.

49 *See supra* note 30.

50 12 C.F.R. §§ 225.90(a), 225.91(a) & 225.92 (2002) (Regulation Y).

51 12 C.F.R. § 225.81(c)(1) (2002) (Regulation Y). The words "a foreign bank that is a [BHC]" in 12 C.F.R. § 225.81(c)(1) (2002) (Regulation Y) must refer to a BHC under the BHCA (*i.e.*, a U.S. or foreign bank or other company that controls a bank in the United States) and not to a BHC by virtue of the IBA (*i.e.*, a foreign bank that operates a branch, agency or commercial lending company in the United States). *See supra* notes 30 & 31. The nonbank depository institution subsidiaries of a foreign bank that is a BHC under the BHCA and by virtue of the IBA and makes an election under 12 C.F.R. §§ 225.81–225.82 and 12 C.F.R. §§ 225.90–225.92 (2002) (Regulation Y) are covered by both sets of provisions (*see infra* note 122), whereas the U.S. bank depository institution subsidiaries of such foreign bank are only covered by 12 C.F.R. § 225.82. After such foreign bank has effectively elected to be an FHC, it will be subject to the provisions of 12 C.F.R. §§ 225.83, 225.84, 225.93 & 225.94. 12 C.F.R. § 225.81(c)(1) (2002) (Regulation Y).

52 12 C.F.R. § 225.81(c)(2) (2002) (Regulation Y). The term *BHC* in 225.81(c)(2), Regulation Y must refer to a BHC under the BHCA (*i.e.*, a U.S. or foreign bank or other company that controls a bank in the United States) and not to a BHC by virtue of the IBA (*i.e.*, a foreign bank that operates a branch, agency or commercial lending company in the United States). *See supra* notes 30 & 31. A BHC that owns not only a U.S. bank but also a foreign bank maintaining a U.S. branch, agency or commercial lending company must comply with the U.S. BHC requirements of 12 C.F.R. §§ 225.81–225.82, as well as with the foreign bank requirements of 12 C.F.R. §§ 225.90–225.92 (2002) (Regulation Y). After such BHC has effectively elected to be an FHC, it will be subject to the provisions of 12 C.F.R. §§ 225.83, 225.84, 225.93 & 225.94 (2002) (Regulation Y). 12 C.F.R. § 225.81(c)(2) (2002) (Regulation Y).

53 *See* § 2(c)(2), BHCA, 12 U.S.C. § 1841(c)(2) (1994 & Supp. V 1999). *See supra* note 33.

54 12 C.F.R. §§ 225.90–225.92 (2002) (Regulation Y). The Amended FHC Release, *supra* note 32, at 15,054 indicates that such foreign bank must make its election to be an FHC under 12 C.F.R. §§ 225.90–225.92 (2002) (Regulation Y). *See infra* note 56 (discussing that the Final FHC Release, *supra* note 32, at 401 n.1 could be read as stating that a foreign bank maintaining a U.S. branch, agency or commercial lending

provision must a foreign bank that owns or controls only a U.S. nonbank depository institution and does not operate a U.S. branch, agency or commercial lending company make its election? The answer is that a U.S. or a foreign bank that only owns or controls a nonbank depository institution is not a BHC[55] and not subject to the BHCA restrictions on nonbank activities and investments and, therefore, does not need to and cannot apply for FHC status.[56] However, if a BHC that also controls a nonbank depository institution elects FHC status, such depository institution must be well capitalized and well managed.[57]

b. The Election Process

The procedure for the election to be treated as an FHC is deceptively simple. The U.S. BHC[58] or the foreign bank maintaining a branch, agency or commercial lending company in the United States and the company owning or controlling such foreign bank[59] must file a written declaration[60] with the appropriate Federal Reserve Bank[61] stating the election,[62] certifying that all the entities that must meet the well-capitalized and well-managed requirements do so,[63] and providing certain capital information.[64] A company that is not a BHC and has applied for the

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company and controlling a nonbank depository institution must elect to be an FHC under 12 C.F.R. § 225.81 (2002) (Regulation Y), but that such reading would not be correct).

55 Section 2(a)(1), BHCA, 12 U.S.C. § 1841(a)(1) (1994).

56 The Final FHC Release, *supra* note 32, causes confusion when it states at 401 n.1, that 12 C.F.R. § 225.81 (2002) (Regulation Y) applies to a foreign bank that controls a depository institution in the United States. It follows from the context and from 12 C.F.R. § 225.81(c) (2002) (Regulation Y) that the release means bank depository institutions. 12 C.F.R. § 225.81 (2002) (Regulation Y) refers to BHCs, and a foreign bank that only controls a U.S. nonbank depository institution and has no branch, agency or commercial lending company in the United States is not a BHC (neither under the BHCA nor by virtue of the IBA). *See supra* note 33 and *infra* note 123.

57 Section 4(*l*)(1), BHCA, 12 U.S.C. § 1843(*l*)(1) (1994 & Supp. 1999); 12 C.F.R. §§ 225.81(b)(1) & (2), 225.82(b)(3) & (5), 225.90(a)(1) and 225.91(b)(5) (2002) (Regulation Y).

58 12 C.F.R. § 225.82(a) (2002) (Regulation Y).

59 12 C.F.R. § 225.91(a) (2002) (Regulation Y).

60 12 C.F.R. §§ 225.82(a) & 225.91(a) (2002) (Regulation Y). Such declaration satisfies the requirement of § 5(a), BHCA, 12 U.S.C. § 1844(a) (1994 & Supp. V 1999), with regard to the registration of a U.S. BHC (but not any requirements to file an application to acquire a bank). Section 5(a), BHCA. *See infra* D.2.i.

61 The appropriate Federal Reserve Bank is determined pursuant to 12 C.F.R. § 225.3(b) (2002) (Regulation Y).

62 12 C.F.R. §§ 225.82(b)(1) & 225.91(b)(1) (2002) (Regulation Y).

63 12 C.F.R. §§ 225.82(b)(3), (5) & 225.91(b)(3), (4), (5) (2002) (Regulation Y).

64 12 C.F.R. §§ 225.82(b)(4) & 225.91(b)(2), (6) (2002) (Regulation Y). The procedure to be followed by U.S. BHCs and foreign banks and by the Federal Reserve Bank and Board staff in connection with an election of FHC status is set forth in the Board's SR Letter No. 00-1 (SUP) (Feb. 8, 2000). It must be kept in mind that the Supervisory Letter is based on the interim regulations and not on the final version of Regulation Y.

Board's approval to be a BHC under Section 3(a)(1), BHCA may as part of that application submit a request to be an FHC on consummation of that transaction.[65] An election to be an FHC is automatically effective on the 31st calendar day after the date that a complete declaration was filed with the appropriate Federal Reserve Bank, unless the Board notifies the applicant prior to that time that the election is ineffective or that the election is effective prior to such 31st day.[66] Other than in the case of an election by a U.S. BHC to be an FHC, in the case of an election by a foreign bank or a company owning or controlling a foreign bank, the 30-day period may be extended by the Board with the consent of such foreign bank or such company.[67] The Board will find an election ineffective if any of the entities that must meet the well-capitalized and well-managed requirements does not meet such requirements[68] or if a U.S.-insured depository institution subsidiary of the U.S. BHC, of the electing foreign bank or of the company owning or controlling such foreign bank or any U.S. insured branch of the electing foreign bank[69] has not achieved at least a rating of "satisfactory" under the CRA.[70] In the case of an election to be an FHC filed by a foreign bank or a company owning or controlling such foreign bank, the Board may also find the election ineffective if the Board does not have sufficient information to determine whether the foreign bank or company making the election meets the well-capitalized and well-managed requirements.[71]

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65 12 U.S.C. § 1842(a)(1) (1994). The procedure for this combined request is set forth in 12 C.F.R. § 225.82(f) (2002) (Regulation Y).

66 12 C.F.R. §§ 225.82(e) and 225.92(a)(1) & (b) (2002) (Regulation Y). The difference in language in 12 C.F.R. § 225.82(e) ("after the date that a complete declaration was filed") and 12 C.F.R. § 225.92(a) ("after the date that an election was received") is curious but without legal consequences. 12 C.F.R. § 225.82(e) is correct because 12 C.F.R. § 225.82(a) as well as § 225.91(a) (2002) (Regulation Y) require the filing of a declaration that makes an election, and *declaration* must mean a complete declaration..

Section 4(*l*)(1), BHCA, 12 U.S.C. § 1843(*l*)(1) (1994 & Supp. V 1999), does not expressly give the Board the power to review and confirm or even to reject a filed declaration of election to be an FHC. However, if an FHC is not in compliance with the well-capitalized and well-managed requirements, the Board may request the BHC to undertake corrective actions and failing correction may require divestiture. *See* § 4(m), BHCA, 12 U.S.C. § 1843(m) (1994 & Supp. V 1999). *See infra* H. It is not surprising that the Board takes the position that it follows from this power that it also has the power to verify the certification of a BHC and to ascertain whether the BHC meets the well-capitalized and well-managed requirements. Note that the Board must find that the certification of the applicant is not effective rather than that it is effective.

67 12 C.F.R. § 225.92(a)(2) (2002) (Regulation Y).

68 12 C.F.R. §§ 225.82(c)(2) & 225.92(c)(1), (3) (2002) (Regulation Y).

69 For a discussion of the FDIC insurance of U.S. branches of foreign banks, *see* John C. Dugan, Peter L. Flanagan & E. Jason Albert, *FDIC Insurance and Regulation of U.S. Branches of Foreign Banks*, Chapter 6 *in* MICHAEL GRUSON & RALPH REISNER (eds.), REGULATION OF FOREIGN BANKS, UNITED STATES AND INTERNATIONAL, vol. 1 (3d ed. 2000).

70 12 C.F.R. §§ 225.82(c)(1) & 225.92(c)(2) (2002) (Regulation Y). *See infra* B.6. Special rules apply to the consideration of the CRA performance of recently acquired insured depository institutions. 12 C.F.R. §§ 225.82(d) & 225.92(d) (2002) (Regulation Y).

71 12 C.F.R. § 225.92(c)(4) (2002) (Regulation Y).

c. Election by Foreign Bank Holding Groups

In the case of a U.S. BHC group, the ultimate holding company and all intermediary holding companies must make the election to be FHCs, and as a consequence of such election, all depositary institutions directly or indirectly controlled by the electing BHC must be well capitalized and well managed.[72]

More difficult issues arise in connection with FHC election by foreign bank holding groups. Although Sections 225.90(a) and 225.91(a), Regulation Y do not plainly so state,[73] they intend to say that in the case of a foreign bank maintaining a branch, agency or commercial lending company in the United States that is controlled (directly or indirectly) by one or more tiers of companies, the bank and all controlling companies must at the same time elect to be FHCs. If the foreign bank engages in financial activities in the United States, the controlling companies will be indirectly engaged in such activities. Presumably, all entities would join in one election. Obviously, the company controlling a foreign bank maintaining a U.S. branch, agency or commercial lending company could itself be a foreign bank maintaining a U.S. branch, agency or commercial lending company.

A foreign bank maintaining a branch, agency or commercial lending company in the United States may be controlled by a foreign industrial or commercial company that is not subject to bank regulatory supervision in its home country. If these entities elect FHC status, the Board may require from the foreign industrial or commercial company a commitment as part of the election process to the effect that only the controlled foreign bank and its direct and indirect subsidiaries will engage in the United States in activities permissible for an FHC. The Board is concerned about nonregulated foreign entities engaging in financial activities in the United States.

Section 225.91(a), Regulation Y does not require that each foreign bank maintaining a branch, agency or commercial lending company in the United States that is part of a foreign bank holding group must elect FHC status. In other words, if the holding company controls two foreign banks, each with a branch in the United States, the holding company and one of the banks may elect FHC status, whereas the other bank may choose not to do so. The same applies to a foreign bank maintaining a branch in the United States that controls a second foreign bank also maintaining a U.S. branch. When the controlling bank elects FHC status, the controlled bank may also elect FHC status, but may choose not to do so.[74] However, in both

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[72] 12 C.F.R. §§ 225.81 & 225.82 (2002) (Regulation Y).

[73] 12 C.F.R. §§ 225.90(a) & 225.91(a) (2002) (Regulation Y). The Board reads the words in 12 C.F.R. § 225.91(a) (2002) (Regulation Y), "[a] foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States, *or* a company that owns or controls such a foreign bank, may elect to be treated as [an FHC]" as if *and* were substituted for *or*.

[74] 12 C.F.R. § 225.91(a) (2002) (Regulation Y) provides that "[a] foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States, or [and] a company that owns or controls such a foreign bank" may make an election to be FHCs. The Section does *not* read: "A company that owns or controls one or more foreign banks (that operate branches or agencies or owns or controls commercial lending companies in the United States) and all such foreign banks may jointly elect to be treated as FHCs by filing . . . ." 12 C.F.R. § 225.91(a) (2002) (Regulation Y) refers to *a* foreign bank

examples the non-electing banks must meet the well-capitalized and well-managed requirements.[75] On the other hand, if a foreign bank maintaining a U.S. branch is controlled by another foreign bank maintaining a U.S. branch, and the controlled bank elects FHC status, the controlling bank must also elect FHC status.[76]

Regulation Y makes it clear that the essential part of the election is the election of the foreign bank maintaining a U.S. branch, agency or commercial lending company.[77] The companies controlling such bank must make parallel elections or join the foreign bank's election.[78] All foreign banks maintaining a branch, agency or commercial lending company in the United States that are controlled by a foreign bank electing FHC status or are controlled by a company owning or controlling such foreign bank electing FHC status must meet the capital and management standards comparable to those required of U.S. banks owned by an FHC, even if they do not wish to engage in the expanded FHC activities and themselves do not elect to be an FHC.[79] The Board imposed this requirement because under the BHCA, as amended by the GLBA, all of the depository institution subsidiaries of a BHC must be well capitalized and well managed in order for the BHC to qualify for FHC status, regardless of where in the corporate structure the expanded activities are to be located.[80] The Board was concerned that permitting a foreign bank to evade a similar requirement merely by placing the expanded activities in a particular location in its organization could provide foreign banks with a competitive advantage over U.S. BHCs.[81]

The following diagram clarifies the above. If Foreign Bank X and Foreign Bank X's parents, Foreign Companies A and B (together with Bank X) elect FHC status, Foreign Bank

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and its parent. *See infra* note 75 (12 C.F.R. §§ 225.90(a)(1) and 225.91(b)(3) & (4) (2002) (Regulation Y) use different language than 12 C.F.R. § 225.91(a) (2002) (Regulation Y) to extend the well-capitalized and the well-managed requirements to all controlled foreign banks).

75 *See* 12 C.F.R. § 225.91(b)(3) & (4) (2002) (Regulation Y) requiring that the foreign bank referred to in 12 C.F.R. § 225.91(a) (2002) (Regulation Y) and "each foreign bank that maintains a U.S. branch, agency, or commercial lending company and is controlled by the foreign bank or company" must meet the standards of being well capitalized and well managed. 12 C.F.R. § 225.90(a)(1) (2002) (Regulation Y) uses substantially identical language to address the question of who must meet the well-capitalized and well-managed requirements. This language is not used in 12 C.F.R. § 225.91(a) (2002) (Regulation Y) which addresses the question of who must file an election to be an FHC. *See also* Final FHC Release, *supra* note 32, at 411 (emphasizing that each foreign bank that maintains a U.S. branch and is controlled by a foreign bank or company electing to be treated as an FHC must meet the capital and management standards, but never intimating that such foreign bank must also elect to be treated as an FHC).

76 *See supra* note 73 and accompanying and following text.

77 *See* 12 C.F.R. § 225.90(a)(2) (2002) (Regulation Y).

78 This was not clear under the amended interim rule § 225.90(a)(2), 65 Fed. Reg. 15,053, at 15,055 (Mar. 21, 2000).

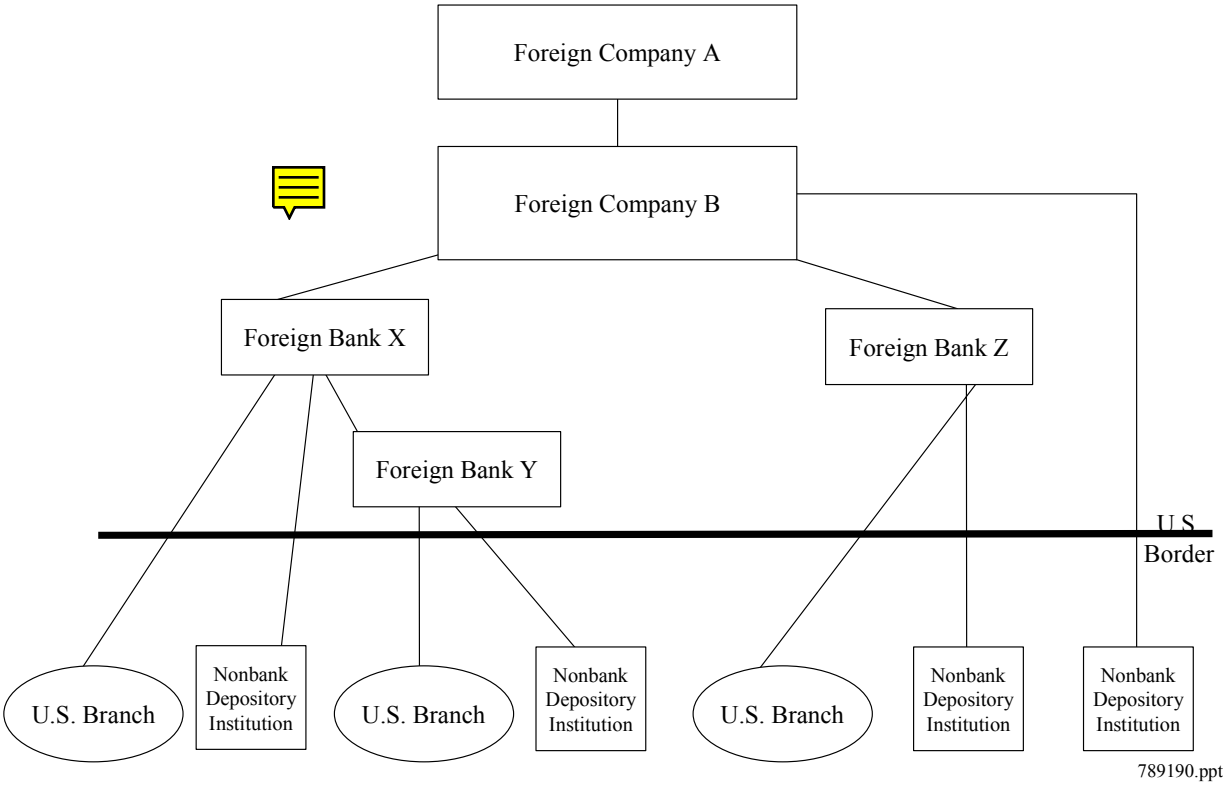
79 12 C.F.R. §§ 225.90(a)(1) and 225.91(b)(3) & (4) (2002) (Regulation Y). *See supra* note 75.

80 *See* Final FHC Release, *supra* note 32, at 411.

81 *Id.*

Y need not join the election. However, the election by Foreign Bank X and Foreign Companies A and B has the consequence that not only Foreign Bank X but also Foreign Bank Y must meet the well-capitalized and well-managed standards. Therefore, there is little reason why Foreign Bank Y would not join the election to be an FHC. The same is true for Foreign Bank Z if the foreign parents, Foreign Companies A and B, that control Foreign Bank X and Foreign Bank Z, each with a branch in the United States, elect (together with Foreign Bank X) to be FHCs, even though Foreign Bank Z does not do so: Foreign Bank Z must meet the well-capitalized and well-managed requirements and might as well join the election to be an FHC. It is irrelevant for the above analysis whether Foreign Banks Y and Z are located in the same country or in different countries than Bank X.

Diagram 1
FHC Election by a Foreign BHC Group



lines indicate control

If Foreign Bank X wishes to elect to be an FHC, Foreign Companies A and B must also make such election. If Foreign Bank Y elects to be an FHC, Foreign Bank X and Foreign Companies A and B must also make such election. If Foreign Bank X and Foreign Bank X's parents, Foreign Companies A and B (together with Foreign Bank X) elect FHC status, the U.S. nonbank depository institution subsidiaries of all electing entities, *i.e.*, of Foreign Bank X, and of Foreign Companies A and B, must meet the well-capitalized and well-managed requirements.[82] As stated above, if Foreign Banks Y and Z do not elect FHC status together with

[82] 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(5) (2002) (Regulation Y).

their respective parents, they still must meet the well-capitalized and well-managed requirements. However, the same rule does not apply to the U.S. nonbank depository institution subsidiaries of nonelecting Foreign Banks Y and Z: under the language of Regulation Y they do not have to comply with the well-capitalized and well-managed requirements.[83]

The broad concept of control[84] and the broad definition of foreign bank[85] can lead to surprising results in the application of the well-capitalized and well-managed requirements to minority-owned banks. For instance, a Foreign Bank D from country D with a branch in the United States owns 25 percent or more but less than 50 percent of the voting shares of a Bank K in a third country K that also has a branch in the United States. If Foreign Bank D elects to be an FHC, Bank K must meet the requirements of being well capitalized and well managed. The foreign bank electing FHC status may not have the corporate ability to direct the other foreign bank to improve its capital and management in order to meet the FHC standards or to close or divest its U.S. offices (to debank). The electing foreign bank would be required to either divest its interest in the other foreign bank or forgo the election to be an FHC.[86] The Board addressed this issue in the Final FHC Release[87] and stated that in limited situations involving strategic minority investments some relief may be justified and a foreign bank seeking FHC status that has a strategic minority investment of 25 percent or more of voting shares in a non-U.S. bank that does not meet the FHC requirements may utilize the pre-clearance process[88] to request a determination that it should not be held accountable for another bank with U.S. offices that does

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83 This result follows from 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(5) (2002) (Regulation Y). 12 C.F.R. § 225.90(a)(1) (2002) (Regulation Y) only refers to "any U.S. depository institution subsidiary that is owned or controlled by the foreign bank [*i.e.*, the foreign bank electing to be an FHC] or company [the company owning or controlling the electing foreign bank]." 12 C.F.R. § 225.91(b)(5) (2002) (Regulation Y) uses nearly identical language. These sections do not refer to a U.S. depository institution owned or controlled by "any other foreign bank" [*i.e.*, a foreign bank that is owned or controlled by the electing foreign bank or a company owning or controlling such electing foreign bank]. The Final FHC Release, *supra* note 32, at 411 refers only to the capital of a U.S. depository institution subsidiary "of the foreign bank or company certificant". It is questionable whether this result is justified by § 4(*l*)(1)(A) & (3), BHCA, 12 U.S.C. § 1843(*l*)(1)(A) & (3) (1994 & Supp. V 1999), because the U.S. depository institution subsidiaries of Banks Y and Z are indirectly depository institution subsidiaries of Foreign Bank X (in the case of the subsidiaries of Foreign Bank Y) and of Foreign Companies A and B (in the case of the subsidiaries of Foreign Banks Y and Z). *See infra* B.3.a. (diagrams 3(b) & (c)). The carefully worded language of 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(5) (2002) (Regulation Y) appears to exclude under a plain language reading (12 U.S.C. § 4809 (1994 & Supp. V 1999)) the argument that a depository institution subsidiary of non-electing Foreign Bank Y or Foreign Bank Z is covered by the well-capitalized requirement as an *indirect* subsidiary of Foreign Bank X and Foreign Companies A and B, respectively.

84 *See supra* note 11. It must be kept in mind that control is presumed in the case of ownership of 25 percent of the voting securities of a bank and control may be found depending on the circumstances in case of ownership of between 5 and 24.9 percent of the voting securities. *See* Gruson, *supra* note 1, §§ 10.05 & 10.06.

85 *See supra* note 43.

86 *See* Final FHC Release, *supra* note 32, at 411.

87 *Id.*

88 12 C.F.R. § 225.91(c) (2002) (Regulation Y). *See infra* B.2.d.

not meet the capital and management standards.[89] The Board warned, however, that it anticipates that relief would be granted only under limited circumstances where the foreign bank "can clearly demonstrate that it has no ability to control the other foreign bank".[90]

If a foreign bank that does not maintain a branch, agency or commercial lending company in the United States but has a U.S. bank subsidiary and the company, if any, that controls such foreign bank elect to be FHCs, the U.S. bank and all nonbank depository institution subsidiaries of the BHCs/FHCs must meet the well-capitalized, well-managed and CRA standards;[91] however, the foreign parent bank need not meet the requirements because it is not covered by Sections 225.90 and 225.91, Regulation Y.[92] Difficult issues arise if a foreign bank holding group combines branches, agencies and commercial lending companies in the United States with U.S. bank subsidiaries as shown by the following diagram.

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89 *See* Final FHC Release, *supra* note 32, at 411.

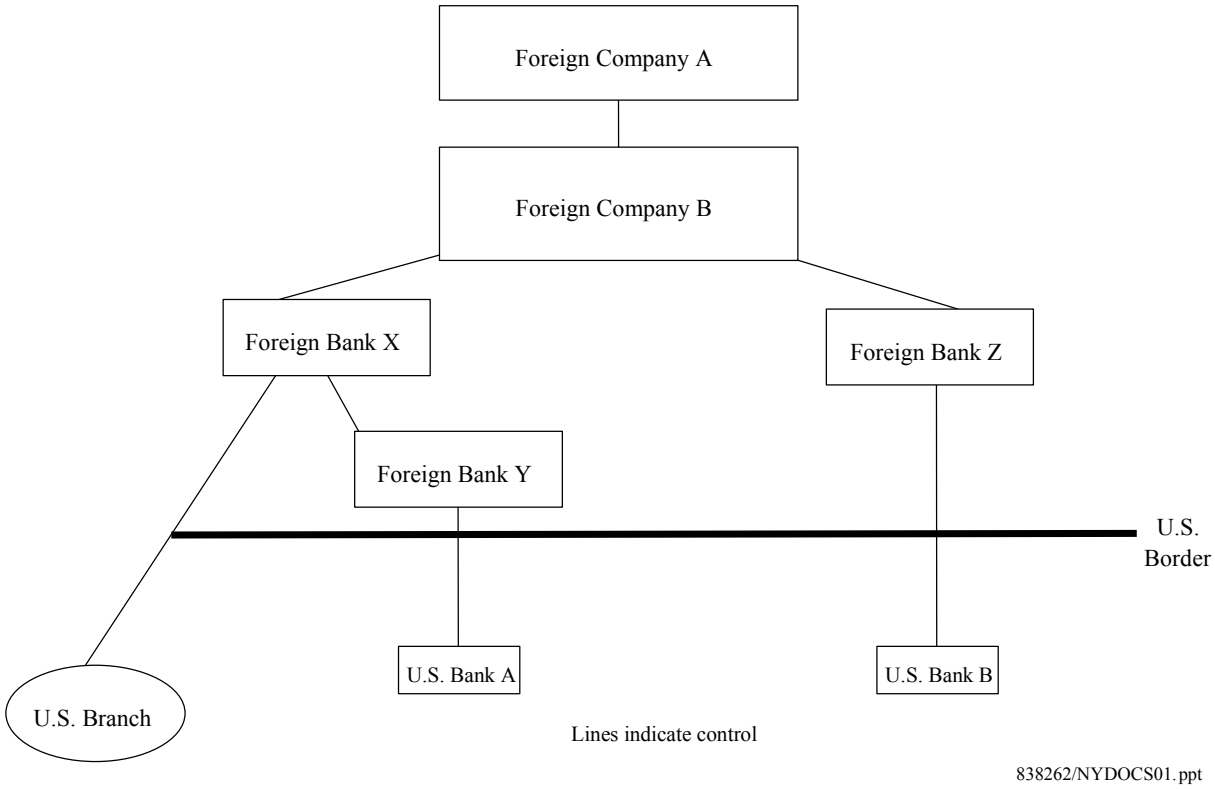
90 *Id.* It is unclear what the Board means when it requires a demonstration that the foreign bank (Bank D in the above example) "has no ability to control the other foreign bank" (Bank K in the above example). *Id.* The issue only arises if Bank D controls Bank K in the meaning of the BHCA. *See* Gruson, *supra* note 1, §§ 10.05 & 10.06. Thus, the demonstration cannot relate to control in the meaning of the BHCA. If *control* refers to control in a corporate sense, it should be fairly easy to demonstrate that ownership of 25 percent of the shares of a corporation does not give corporate control over such corporation. In particular, if Bank K refuses to comply with the well-capitalized requirements in spite of urgent requests by Bank D, Bank D's lack of control is obvious. It is likely that the Board meant that the foreign bank that owns shares in another foreign bank must demonstrate that it has no other indices of control, such as seats on the board of the other foreign bank, agreements, etc.

91 12 C.F.R. §§ 225.81(b) and 225.82 (b) & (c) (2002) (Regulation Y). 12 C.F.R. §§ 225.81(b)(1), (2) & 225.82(b)(3) (2002) (Regulation Y) clearly refer to "all" and "each" depository institutions controlled by the BHC and clearly include directly and indirectly controlled depository institutions.

92 *See* 12 C.F.R. §§ 225.90(a) & 225.91(a) (2002) (Regulation Y).

Diagram 2

FHC Election by a Foreign BHC Group



Foreign Bank X is a U.S. BHC that also operates a U.S. branch. If it wishes to be an FHC, it must, pursuant to Section 225.81(c), Regulation Y,[93] comply with the FHC election requirements for branches and for bank subsidiaries.[94] Foreign Companies A and B are BHCs because they indirectly control two U.S. banks. Section 225.82(a), Regulation Y[95] does not expressly require Foreign Companies A and B to elect FHC status; however, if Foreign Bank X engages in financial activities in the United States, Foreign Companies A and B are indirectly engaged in such activities and must be FHCs to be permitted to do so. Furthermore, pursuant to Section 225.90, Regulation Y,[96] they are required to elect FHC status by virtue of their controlling Foreign Bank X that maintains a U.S. branch and elects FHC status.

If Foreign Bank Z elects FHC status, it must do so pursuant to Sections 225.81–225.82, Regulation Y.[97] That Section does not *require* an election by foreign controlling

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93 12 C.F.R. § 225.81(c) (2002) (Regulation Y).

94 12 C.F.R. §§ 225.81–225.82 (subsidiaries), 12 C.F.R. §§ 225.90–225.92 (branches) (2002) (Regulation Y).

95 12 C.F.R. § 225.82(a) (2002) (Regulation Y).

96 12 C.F.R. § 225.90(a) (2002) (Regulation Y).

97 12 C.F.R. §§ 225.81–225.82 (2002) (Regulation Y).

shareholders of the U.S. BHC; however, such shareholders are BHCs by virtue of their indirect control of a U.S. bank, and the financial activities of Foreign Bank Z and U.S. Bank B are their indirect activities. Thus, Foreign Companies A and B must, together with Foreign Bank Z, elect FHC status. If Foreign Companies A and B are FHCs, their indirect U.S. bank subsidiaries, U.S. Bank A and U.S. Bank B, must be well capitalized and well managed.

If Foreign Companies A and B and Foreign Bank Z elect FHC status, it is unclear how this affects the capital requirements of Foreign Bank X. Section 225.81(c), Regulation K[98] which deals with a foreign bank with a U.S. branch and a U.S. bank subsidiary does not apply because neither Foreign Company A nor Foreign Company B is "a foreign bank that is a [BHC] and that operates a branch . . . in the United States" as required by Section 225.81(c), Regulation Y. By way of analogy, one has to conclude that Foreign Bank X must be well capitalized and well managed if Foreign Companies A and B elect, together with Foreign Bank Z, FHC status.[99] It is less clear whether Foreign Bank X must join the FHC election.[100]

It is a different issue that Foreign Companies A and B could be U.S. BHCs only if the Board found that they are subject to comprehensive supervision or regulation on a consolidated basis in their home country,[101] and this is unlikely if they are industrial or commercial companies. Even if Foreign Companies A and B were able to overcome the hurdle of comprehensive supervision on a consolidated basis when they acquired U.S. Bank A and U.S. Bank B, the Board may not wish Foreign Companies A and B to engage in financial activities in the United States if they are not banks in their home country. In some cases, the Board has required a commitment from foreign nonbank holding companies of a foreign bank with a U.S. branch that these nonbank holding companies will engage in financial activities in the United States only through the foreign bank.[102] The same approach might be applied where the foreign bank has a U.S. bank subsidiary.

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98 12 C.F.R. § 225.81(c) (2002) (Regulation Y).

99 12 C.F.R. § 225.91(a) (2002) (Regulation Y) provides that a company (Foreign Companies A and B) that owns or controls a foreign bank with a U.S. branch (Foreign Bank X) will be treated as an FHC only if the controlled foreign bank is well capitalized and well managed. This language addresses the case where the foreign bank (Foreign Bank X) (together with the company controlling it) elects FHC status under 12 C.F.R. § 225.92(a) (2002) (Regulation Y); it is not intended to cover the hypothetical case under consideration (Foreign Companies A and B electing FHC status as U.S. BHCs together with Foreign Bank Z pursuant to 12 C.F.R. § 225.82 (2002) (Regulation Y)). However, it makes sense to apply that Section by way of analogy to foreign companies electing FHC status under 12 C.F.R. § 225.82 (2002) (Regulation Y) rather than under 12 C.F.R. § 225.92(a) (2002) (Regulation Y). One could also apply 12 C.F.R. § 225.81(c) (2002) (Regulation Y) by way of analogy to BHCs controlling (i) a foreign bank that controls a U.S. bank and (ii) a foreign bank that operates a U.S. branch.

100 *See supra* note 83 and accompanying text.

101 12 C.F.R. § 225.13(a)(4) (2002) (Regulation Y).

102 *See supra* B.2.c. (second paragraph).

d. The Pre-Clearance Process

Because of the difficult issues relating to the well-capitalized and well-managed requirements that a foreign bank's election to be an FHC may raise, a foreign bank or its controlling company, before filing an election to be treated as an FHC, may file a request for a pre-clearance review of its qualifications to be treated as an FHC (well capitalized and well managed).[103] Regulation Y specifies two cases in which a pre-clearance process must be initiated. In addition, a foreign bank or a company controlling a foreign bank may on its own initiate the pre-clearance process to have the Board review the qualifications that it has to meet for an effective election to be an FHC.

- A foreign bank whose home country has not adopted risk-based capital standards consistent with the Basel Capital Standards[104] *must* obtain a determination from the Board in the pre-clearance process that the foreign bank's capital is comparable to the capital that would be required of a U.S. bank owned by an FHC.[105]

- A foreign bank that has not been found, and that is chartered in a country where no bank from that country has been found, by the Board to be subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor *must* use the pre-clearance process for a determination of its comprehensive supervision on a consolidated basis.[106]

- A foreign bank whose home country has adopted risk-based capital standards consistent with the Basel Capital Standards but that does not meet the capital

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103 12 C.F.R. § 225.91(c) (2002) (Regulation Y). The Board will endeavor to make a determination on such request within 30 days of receipt. *Id.* The pre-clearance procedure was originally proposed by Representative Leach, 145 CONG. REC. H11,529 (daily ed.) (Nov. 4, 1999) (assessment of a foreign bank's compliance with comparable capital and management standards could be accomplished through a "pre-clearance evaluation" conducted in connection with the foreign bank's certification as an FHC).

104 Committee on Banking Regulation and Supervisory Practices [now: Basel Committee on Banking Supervision], *International Convergence of Capital Measurement and Capital Standards* (July 1988, as amended), Introduction, no. 7 [*herein* Basel Capital Standards]. The members of the European Union have adopted the Basel Capital Standards as they were implemented by the Council Directive of 17 Apr. 1989 on the Own Funds of Credit Institutions, 89/299/EEC, O.J. Eur. Comm. No. L. 124/16 (1989), as restated in Title V, Chapter 2, Section 1 of the Directive of the European Parliament and the Council of 20 Mar. 2000 relating to the Taking Up and Pursuit of the Business of Credit Institutions, 2000/12/EC, O.J. Eur. Comm. No. L. 126/1 (2000) [*herein* the Banking Directive]; and by the Council Directive of 18 Dec. 1989 on a Solvency Ratio for Credit Institutions, 89/647/EEC, O.J. Eur. Comm. No. L. 386/14 (1989), as restated in Title V, Chapter 2, Section 2 of the Banking Directive. 12 C.F.R. § 225.90(b)(1)(i) (2002) (Regulation Y) requires that the home country supervisor (as defined in 12 C.F.R. § 211.21(q) (2002) (Regulation K)) of the foreign bank must have adopted risk-based capital standards consistent with the Basel Capital Standards.

105 12 C.F.R. § 225.90(b)(2) (2002) (Regulation Y). *See infra* B.3. The factors that have to be taken into account in the capital comparability analysis are listed in 12 C.F.R. § 225.92(e) (2002) (Regulation Y).

106 12 C.F.R. § 225.91(c) (2002) (Regulation Y). *See infra* B.5 for an analysis of this requirement.

standards that would be required of a U.S. bank owned by an FHC (either because it falls short of the required capital adequacy ratios under the Basel Capital Standards[107] or because there is a question about the comparability of the foreign bank's capital to the capital that would be required of a U.S. bank owned by an FHC)[108] *may* obtain a determination from the Board in the pre-clearance process that the foreign bank's capital is otherwise comparable to the capital that would be required of a U.S. bank owned by an FHC.[109]

- The pre-clearance process *may* be used by a foreign bank or company controlling a foreign bank to request the Board to review any other of the qualifications that must be met to make an effective election of the FHC status.[110] In particular, the question of whether the foreign bank is well managed could be subject of the pre-clearance process. For instance, the pre-clearance process *may* be used by a foreign bank that wishes to obtain FHC status but has not been assigned a combined U.S. banking assessment as part of the regular examination cycle and, thus, cannot determine whether it is well managed.[111]

The pre-clearance process helps the Board to comply with the rule that FHC elections become effective on the 31st day after receipt of the election and avoids the need to extend the period with the consent of the electing foreign bank and the company controlling the foreign bank.[112] The pre-clearance process may be advantageous for a foreign bank because the Board does not make a public announcement of the filing of a request for a pre-clearance review, and the records of the Board relating to the pre-clearance process may be accorded confidential treatment.[113]

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107 *See* 12 C.F.R. § 225.90(b)(1)(ii). *See infra* B.3.b. and note 144.

108 12 C.F.R. § 225.90(b)(1)(iii) (2002) (Regulation Y).

109 12 C.F.R. § 225.90(b)(2) (2002) (Regulation Y). *See infra* note 144.

110 12 C.F.R. § 225.91(c) (2002) (Regulation Y).

111 *See* Final FHC Release, *supra* note 32, at 409. *See infra* note 164.

112 12 C.F.R. § 225.92(a)(2) (2002) (Regulation Y). *See supra* B.2.b.

113 The Board's staff takes the position that information relating to a pre-clearance process is a matter contained in or related to examination, operating or condition reports prepared by or for the use of an agency responsible for the regulation or supervision of financial institutions and that therefore such information need not be made available to the public under the Freedom of Information Act, 5 U.S.C. § 552 (2000). Section 552(b), Freedom of Information Act, 5 U.S.C. § 552(b) (2000); 12 C.F.R. § 261.14(a)(8) (2002). It may still be advisable for the foreign bank to request confidential treatment of its submissions in connection with a pre-clearance process pursuant to 12 C.F.R. § 261.15 (2002).

3. The Well-Capitalized Requirement

a. Entities that Must Be Well Capitalized

As noted above, a BHC may elect to be an FHC only if (i) in the case of a U.S. BHC, each of its depository institution subsidiaries,[114] and (ii) in the case of a foreign bank maintaining a U.S. branch, agency or commercial lending company, the electing foreign bank itself,[115] each other foreign bank maintaining a U.S. branch, agency or commercial lending company that is controlled by the electing foreign bank or under common control with the electing foreign bank,[116] and each nonbank depository institution subsidiary of the electing foreign bank or of a company that owns or controls the electing foreign bank[117] is well capitalized. Neither the BHCA nor Regulation Y limits the well-capitalized requirements to foreign banks that are deposit-taking entities in their home country.[118] Diagram 3 shows which entities in a bank holding group of a foreign bank maintaining a branch, agency or commercial lending company must be well capitalized.[119]

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[114] 12 C.F.R. §§ 225.81(b)(1) & 225.82(b)(3) (2002) (Regulation Y). *See supra* text accompanying notes 33, 34, 72 & 91.

[115] 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(3) (2002) (Regulation Y).

[116] 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(3) (2002) (Regulation Y). *See supra* text accompanying notes 74 & 75.

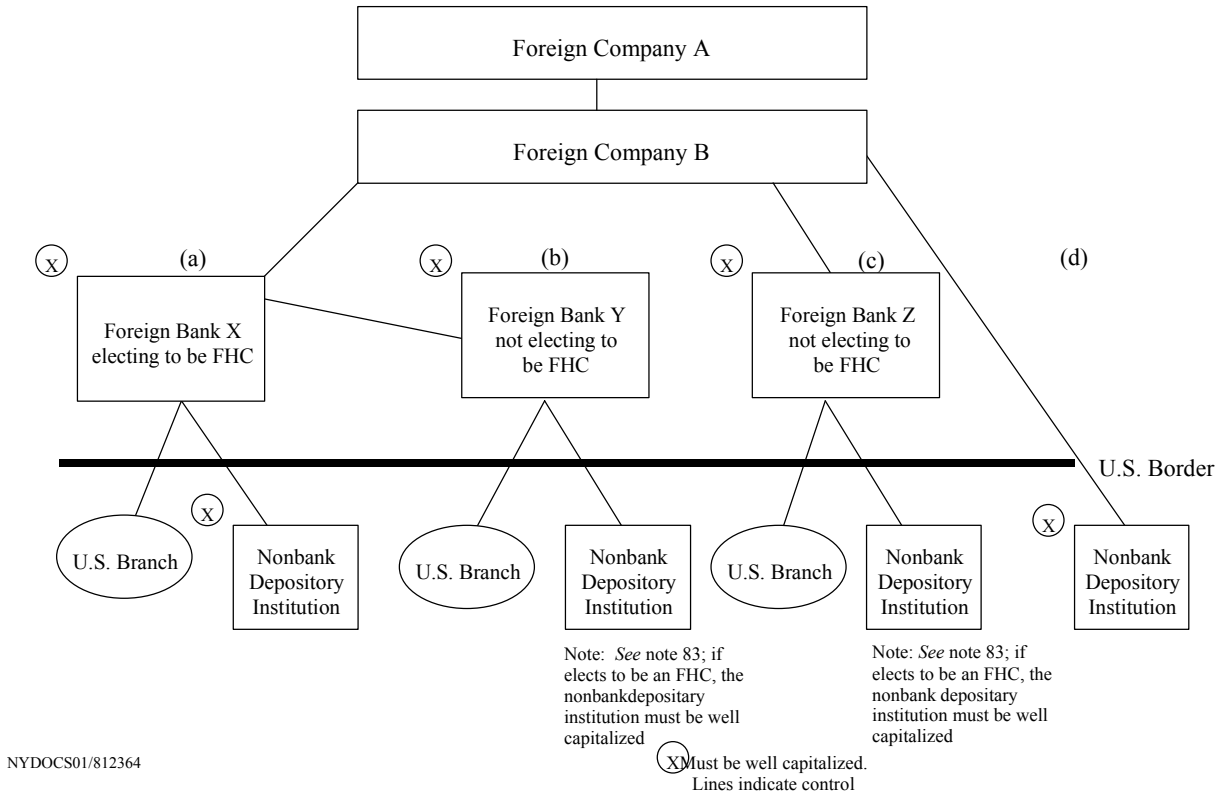
[117] 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(5) (2002) (Regulation Y). Nonbank depository institution subsidiaries of the nonelecting "other foreign bank", *i.e.*, a foreign bank that is controlled by the electing foreign bank or is under common control with the electing foreign bank, need not meet the well-capitalized requirement. *See supra* note 83 and accompanying text and diagrams 3(b) & (c).

If the nonelecting other foreign bank, that is controlled by the electing foreign bank or is under common control with such electing foreign bank, controls a depository institution in the United States that is a bank, the foreign holding company of the electing and of the nonelecting foreign banks is a U.S. BHC, if such U.S. BHC elects to be an FHC, all of its direct or indirect depository institution subsidiaries must be well capitalized and well managed pursuant to 12 C.F.R. §§ 225.81(b)(1), (2) & 225.82(b)(3) (2002) (Regulation Y). (Diagram 4(d)). S*ee supra* note 91.

[118] Since § 4(*l*)(1)(A), BHCA, 12 U.S.C. § 1843(*l*)(1)(A) (1994 & Supp. V 1999), imposes the well-capitalized requirement on U.S. depository institutions, it is arguably in violation of the principles of national treatment and equality of competitive opportunity postulated in § 4(*l*)(3), BHCA, 12 U.S.C. § 1843(*l*)(3) (1994 & Supp. V 1999), for the Board to impose that requirement in the case of foreign banks also on banks that are not deposit-taking entities.

[119] *See supra* B. 2. c., discussing the FHC election by foreign bank holding groups. The question of which entity in a holding group of a foreign bank should join the election is closely related to the capital consequences of the election and therefore the question of which entities in a bank holding group of a foreign bank must be well capitalized has been discussed under B.2. Diagram 3 deals with BHCs that are such by virtue of the IBA. *See supra* note 30.

Diagram 3
Capital Requirements in a Foreign Bank FHC Group



If a foreign bank and a company controlling such foreign bank electing FHC status control a U.S. bank or nonbank depository institution, the capital requirements are as follows:

- A foreign bank that does not operate a branch, agency or commercial lending company in the United States but owns or controls only bank subsidiaries in the United States is not a *foreign bank* within the meaning of the IBA and Regulation Y but is a U.S. BHC.[120] Therefore, the well-capitalized requirement does not apply to such foreign bank but only, separately and on an individual basis, to the U.S. bank subsidiary and any nonbank depository institution subsidiaries.[121] (Diagram 4(a).)

- If a foreign bank that operates a branch, agency or commercial lending company in the United States also has a bank subsidiary in the United States, it is a U.S. BHC and a *foreign bank* in the meaning of the IBA and Regulation Y, and the

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120 *See supra* notes 30, 31, 43, 47 & 48 and accompanying text; 12 C.F.R. § 225.90(a) (2002) (Regulation Y).

121 Section § 4(*l*)(1)(A), BHCA, 12 U.S.C. § 1843(*l*)(1)(A) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.81(b)(1) & 225.82(b)(3) (2002) (Regulation Y).

BHCA and Regulation Y apply the well-capitalized requirement, separately and on an individual basis, to the foreign bank and each of its U.S. depository institution subsidiaries, including the bank subsidiary.[122] (Diagram 4(b).)

- A foreign bank is not a BHC if it has in the United States only depository institution subsidiaries that are not banks within the meaning of the BHCA, for instance a thrift or a nonbank trust company,[123] and the well-capitalized requirements apply neither to the nonbank depository institution nor to the foreign bank. (Diagram 4(c).)

- If a foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States also controls a nonbank depository institution subsidiary in the United States, such as thrift or a nonbank trust company, each such nonbank depository institution subsidiary must also be well capitalized separately and on an individual basis.[124] (Diagram 3(a) and diagram 4(b).)

- If a foreign company that controls a foreign bank maintaining a branch, agency or commercial lending company in the United States also controls a nonbank depository institution in the United States, such nonbank depository institution subsidiary of such company must be well capitalized.[125] (Diagram 3(d).)

- If a foreign bank that elects FHC status controls another foreign bank, or is under common control with another foreign bank, that does not elect FHC status, and the other foreign bank in turn controls a nonbank depository institution, such

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122 Section 4(*l*)(1)(A), BHCA, 12 U.S.C. § 1843(*l*)(1)(A) (1994 & Supp. V 1999), in connection with 12 C.F.R. §§ 225.81(b) & 225.82 (2002) (Regulation Y), applies to the U.S. bank, whereas § 4(*l*)(3), BHCA, 12 U.S.C. § 1843(*l*)(3) (1994 & Supp. V 1999), in connection with 12 C.F.R. §§ 225.90(a), 225.91 & 225.92 (2002) (Regulation Y) applies to the foreign bank. 12 C.F.R. § 225.81(c)(1) (2002) (Regulation Y). A nonbank depository institution subsidiary of the foreign bank controlling a U.S. bank and maintaining a U.S. branch, agency or commercial lending company is covered by both provisions. *See* 12 C.F.R. §§ 225.81(b)(1) & 225.82(b)(3) *and* 12 C.F.R. §§ 225.90(a)(1), 225.91(b)(5), (6) & 225.92(c)(3) (2002) (Regulation Y). The well-capitalized and well-managed requirements under both sets of provisions are identical. *See supra* note 51 and accompanying text.

123 As pointed out, *supra* note 33, *depository institution* is defined in the FDIA more broadly than *bank* is defined in the BHCA. Thus, a foreign bank may own or control nonbank depository institution subsidiaries without being a BHC. *See supra* text accompanying notes 55 & 56.

124 *See* 12 C.F.R. §§ 225.90(a)(1) and 225.91(b)(5) & (6) (2002) (Regulation Y). 12 C.F.R. § 225.90(a)(1) (2002) (Regulation Y) refers to "any U.S. depository institution subsidiary that is owned or controlled by the foreign bank or company [that owns or controls such a foreign bank]". Although 12 C.F.R. § 225.90(a) (2002) (Regulation Y) is not as clear as it could have been, the Amended FHC Release, *supra* note 32, at 15,054, makes it clear that 12 C.F.R. § 225.90(a) (2002) (Regulation Y) applies only to *nonbank* depository institution subsidiaries of foreign banks that maintain a branch, agency or commercial lending company in the United States. *See* 12 C.F.R. § 225.81(c) (2002) (Regulation Y).

125 12 C.F.R. §§ 225.90(a)(1) & 225.91(b)(5) (2002) (Regulation Y).

nonbank depository institution need not meet the well-capitalized requirement.[126] (Diagrams 3(b) & (c)). If the other foreign bank elects FHC status, its depository institution subsidiary must be well capitalized.

- If a foreign company that controls Foreign Bank X maintaining a branch, agency or commercial lending company in the United States also controls (through Foreign Bank Y) a U.S. bank, and Foreign Bank X (together with the foreign company FHC) elects FHC status, the foreign company is a company controlling a *foreign bank* and a U.S. BHC, and Foreign Bank X as well as the direct and indirect U.S. bank subsidiary and all other direct and indirect depository institution subsidiaries of the foreign company BHC/FHC must be well capitalized.[127] (Diagram 4(d).)

- If Foreign Bank Y (together with the foreign company BHC) elects FHC status, the foreign company BHC is not a company controlling a *foreign bank* in the meaning of Section 225.90(a), Regulation Y.[128] It is, however, a U.S. BHC, and all direct and indirect U.S. bank subsidiaries as well as all other direct and indirect depository institution subsidiaries of the foreign company BHC/FHC must be well capitalized.[129] Although not clearly stated in Regulation Y, one has to conclude by way of analogy that Foreign Bank X must also be well capitalized if the company controlling it elects FHC status as a U.S. BHC. [130] (Diagram 4(e).)

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126 *See supra* notes 83 & 117.

127 Section 4(*l*)(1)(A), BHCA, 12 U.S.C. § 1843(*l*)(1)(A) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.90(a)(1) and 225.91(b)(3) & (5) (2002) (Regulation Y); 12 C.F.R. §§ 225.81(b)(1) & 225.82(b)(3) (2002) (Regulation Y). *See supra* notes 91 & 117.

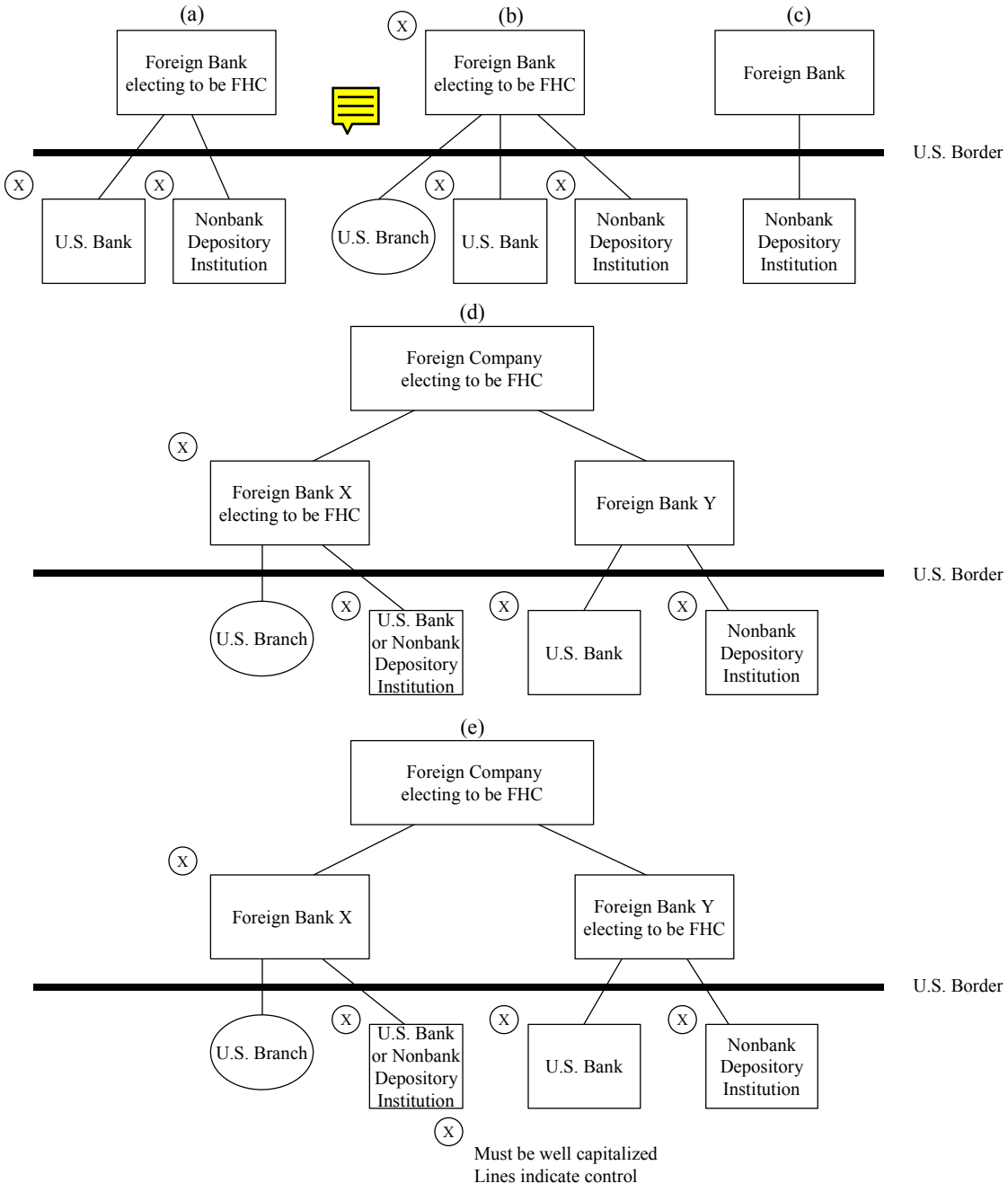
128 12 C.F.R. § 225.90(a) (2002) (Regulation Y). That Section assumes an FHC election by the foreign bank maintaining a U.S. branch, agency or commercial lending company.

129 12 C.F.R. §§ 225.81(b)(1) & 225.82(b)(3) (2002) (Regulation Y). *See supra* notes 91 and 117.

130 *See supra* note 99 for a discussion of this analogy.

Diagram 4 illustrates the above discussion.

Diagram 4
Capital Requirements of U.S. BHCs
that are Foreign Banks or Companies



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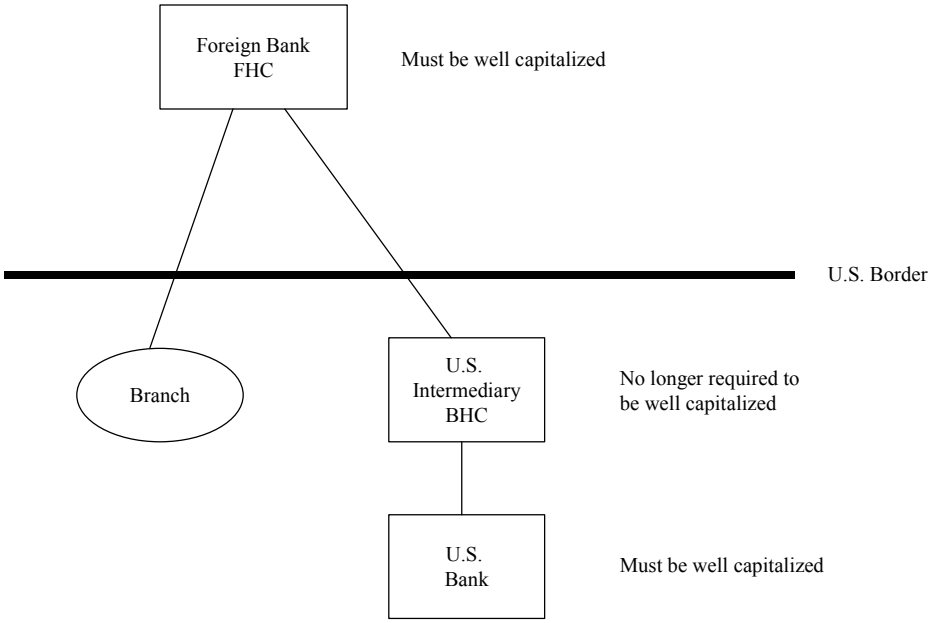
A company that controls a foreign bank that operates a branch or agency or controls a commercial lending company in the United States is treated like a U.S. BHC in that it

does not have to meet the well-capitalized requirement in order to become an FHC (if the other conditions are met).[131] On the other hand, if a foreign bank that operates a branch or agency or controls a commercial lending company in the United States meets the well-capitalized and well-managed requirements, any company that owns or controls such a foreign bank is entitled to be treated as an FHC (if it meets the other requirements for an effective election and makes such election).[132]

Diagram 5
Capitalization of U.S. Intermediary Holding Company



NYDOCS01/812364

131 *See infra* B.7. This follows from a comparison of § 4(*l*), BHCA, 12 U.S.C. § 1843(*l*) (1994 & Supp. V 1999) (requiring that the depository institution subsidiary of a BHC (and in extension of that concept, a foreign bank) is well capitalized) with § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999) (requiring that the BHC and certain of its depository institution subsidiaries are well capitalized). *See infra* note 154.

132 12 C.F.R. § 225.90(a) (2002) (Regulation Y). This Section correctly refers to foreign banks that operate a branch, agency or commercial lending company in the United States and to "any company that owns or controls such a foreign bank". Such company is a company covered by § 8(a), IBA, 12 U.S.C. § 3106(a) (1994), and the BHCA is applicable to such company. *See supra* notes 30 & 43. *See* Gruson, *supra* note 1, § 10.02. As discussed *supra* B.2.c., a company controlling a foreign bank must also elect to be an FHC if the controlled foreign bank makes such election.

The Board has had a longstanding practice of applying its capital adequacy standards to the top tier U.S. BHC owned by a foreign banking organization [FBO] that indirectly owns through the U.S. BHC a U.S. bank. The Board has modified this practice for foreign bank FHCs that at the same time own through a U.S. BHC a U.S. bank and operate a branch, agency or commercial lending company in the United States.[133] In cases in which the Board has determined that a foreign bank operating a U.S. branch, agency or commercial lending company is well capitalized and well managed, the presumption will be that the foreign bank has sufficient financial strength and resources to support its banking activities in the United States. Thus, as a general matter, a U.S. BHC that is owned and controlled by a foreign bank–FHC that the Board has determined to be well capitalized and well managed will not be required to comply with the Board's capital adequacy guidelines.[134] Diagram 5 illustrates the Board's position.

b. The Standard of Being Well Capitalized

A depository institution subsidiary of a BHC is well capitalized if it maintains a total capital to total risk-based assets ratio of at least 10 percent on a consolidated basis and a Tier 1 capital to total risk-based assets ratio of at least 6 percent on a consolidated basis.[135]

Section 4(*l*)(3), BHCA authorizes the Board to develop capital standards for foreign banks maintaining a branch, agency or commercial lending company in the United States that are "comparable" to U.S. standards.[136] By authorizing the Board to make exceptions for foreign banks, the BHCA implies the otherwise unstated rule, namely, that foreign banks maintaining a branch, agency or commercial lending company are subject to the well-capitalized requirement, even though such banks are not depository institutions under U.S. law.[137]

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133 Board, SR Letter 01-1 (SUP) (Jan. 5, 2001). Members of the staff of the Board have indicated that this Supervisory Letter will be clarified in the near future.

134 *Id.* The Supervisory Letter, *supra* note 133, however, qualified its policy by stating that relying on the capital strength of the consolidated banking organization, as well as requiring all subsidiary banks to meet appropriate capital and management standards, is consistent with the Board's supervisory assessment process for domestic BHCs. The Board, therefore, retains its supervisory authority to require any BHC, including a U.S. BHC owned and controlled by a foreign bank that meets the FHC standards, to maintain higher capital levels where such levels are appropriate to ensure that its U.S. activities are operated in a safe and sound manner. This authority may be exercised as part of ongoing supervision or through the application process. *Id*.

135 Section 2(o)(1)(A), BHCA, 12 U.S.C. § 1841(o)(1)(A) (1994 & Supp. V 1999); § 38(b)(1)(A), FDIA, 12 U.S.C. § 1831*o*(b)(1)(A) (1994); 12 C.F.R. § 225.2(r)(2) (2002) (Regulation Y); 12 C.F.R. § 325.103(b)(1) (2001) (rules of the FDIC).

136 Section 4(*l*)(3), BHCA, 12 U.S.C. § 1843(*l*)(3) (1994 & Supp. V 1999). *Comparable* does not mean *identical* but means adjusted to the special circumstances of the foreign bank. Representative Leach said that the purpose of § 4(*l*)(3), BHCA is to ensure that foreign banks continue to be provided national treatment "receiving neither advantages nor disadvantages as compared with U.S. organizations," 145 Cong. Rec. H11,529 (daily ed.) (Nov. 11, 1999).

137 Section 4(*l*)(3), BHCA, 12 U.S.C. § 1843(*l*)(3) (1994 & Supp. V 1999), does not apply to foreign banks that are BHCs by virtue of a U.S. bank subsidiary. Section 4(*l*)(1)(A), BHCA, 12 U.S.C. § 1843(*l*)(1)(A) (1994 & Supp. V 1999), requires well-capitalized status only for all U.S. depository institution subsidiaries of a BHC, not for the BHC itself, even if the BHC is a foreign bank and a depository institution under foreign law. Neither § 4(*l*)(1)(A) nor § 4(*l*)(3), BHCA imposes capital requirements on a foreign bank that

Regulation Y provides that the well-capitalized requirement must be met by the foreign bank as such, and not in addition by its U.S. branch, agency or commercial lending company on an individual basis.[138]

Regulation Y provides two methods for determining whether a foreign bank will be considered "well capitalized".[139]

The first method relies on the Basel Capital Standards. If the home country of the foreign bank applies risk-based capital adequacy standards that are consistent with the Basel Capital Standards, the foreign bank must maintain a Tier 1 capital-to-total risk-based assets ratio of 6 percent and a total capital-to-total risk-based assets ratio of 10 percent, as calculated on the basis of the capital adequacy rules of the home country.[140] However, the Board leaves the door open for modifications in its discretion by requiring that even if the foreign bank's capital adequacy is computed under the Basel Capital Standards, it must be comparable to the capital required for a U.S. bank owned by an FHC.[141] This provision gives the Board wide discretion to increase or lower the 6 and 10 percent ratios even for countries that have adopted the Basel Capital Standards.[142] Presumably, the Board will analyze the differences between the capital adequacy rule of the relevant country with those of the United States and adjust the well-capitalized requirement for differences. Section 225.92(e), Regulation Y enumerates some factors that the Board may take into account in determining whether a foreign bank is well

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owns a U.S. bank (but does not maintain a branch, agency or commercial lending company in the United States).

138 *See* 12 C.F.R. § 225.90(a)(1) (2002) (Regulation Y). The language of the Amended Interim FHC Release, *supra* note 32, at 15,054, caused some confusion on this point when it said that the well-capitalized requirements provided that the foreign bank "and each of its U.S. branches, agencies, and commercial lending subsidiaries be well capitalized and well managed". *See infra* note 154 for a discussion of the different approach with respect to branches taken by § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999).

139 12 C.F.R. § 225.90(b) (2002) (Regulation Y).

140 12 C.F.R. § 225.90(b)(1)(i) & (ii) (2002) (Regulation Y).

141 12 C.F.R. § 225.90(b)(1)(iii) (2002) (Regulation Y). The original interim version of that provision required that the Board determine comparability of capital in each case (65 Fed. Reg. 3793 (Jan. 25, 2000), § 225.90(b)(1)(iv)). The deletion of the requirement of a Board determination in the amendment to that provision (65 Fed. Reg. 15,055 (Mar. 21, 2000), § 225.90(b)(1)(iv)) is mainly a matter of form. It follows from 12 C.F.R. § 225.92(c)(1) & (4) (2002) (Regulation Y) that the Board still has the power to determine whether the foreign bank's capital is comparable to the capital required for a U.S. bank owned by an FHC, 12 C.F.R. § 225.90(b)(1)(iii) (2002) (Regulation Y), when determining whether the election by a foreign bank to be an FHC is effective. For a discussion of the guidelines for converting foreign bank capital data into equivalent U.S. standards, see Capital Equivalency Report (June 19, 1992) submitted by the Board and the Secretary of the Department of the Treasury to the House and Senate Banking Committees pursuant to § 7(j), IBA, 12 U.S.C. § 3105(j) (1994) [*herein* Capital Equivalency Report], at 42–45.

12 C.F.R. § 225.90(b)(1)(iii) (2002) (Regulation Y) is based on § 4(*l*)(3) BHCA, 12 U.S.C. § 1843(*l*)(3) (1994 & Supp. V 1999), requiring the Board to develop "comparable" capital standards for foreign banks operating a branch, agency or commercial lending company in the United States that elect FHC status.

142 12 C.F.R. § 229.92(e) (2002) (Regulation Y) establishes broad standards for the exercise of this discretion.

capitalized in accordance with comparable capital standards: the foreign bank's composition of capital; Tier 1 capital-to-total assets leverage ratio; accounting standards; long-term debt ratings; reliance on government support to meet capital requirements; and other factors that may affect analysis of capital.[143] It remains to be seen under what circumstances the Board will *ex officio* embark on such difficult investigations in cases where the home country of the foreign bank follows the Basel Capital Standards. Initial experience shows that in the case of banks from some countries, the Board's staff has asked searching questions about the capital structure and the capital adequacy computation. The staff's approach will depend on its familiarity with and confidence in the regulatory structure and accounting rules of a particular country.

In a determination in the pre-clearance process that the capital of a major European bank was comparable to that required of a U.S. bank owned by an FHC and that the European bank was well capitalized for purposes of qualifying to be treated as an FHC, the Board relied in particular on the following factors: the European bank's compliance with the 6 percent Tier 1 and 10 percent total risk-based capital ratios; its strong external debt ratings (within the two highest investment grade rating categories); and the Board's strong supervisory assessment of its operations. The European bank was required to provide notice to the Board should the risk-based capital ratios fall below these levels, its external debt ratings weaken, or its leverage ratio fall below the level on a specified prior date.

The second method permits (1) a foreign bank whose home country has not adopted risk-based capital standards consistent with the Basel Capital Standards and (2) a foreign bank whose home country has adopted the Basel Capital Standards but which does not meet or conceivably does not meet the two standards required under the first method (6 percent/10 percent capital adequacy ratios and comparability of the foreign bank's capital to the capital that would be required of a U.S. bank owned by an FHC),[144] to obtain from the Board a determination that their capital is "otherwise comparable" to the capital that would be required of a U.S. bank owned by an FHC.[145] This Board determination will be made in a pre-clearance process.[146] Before filing an election to be treated as an FHC, a foreign bank whose home

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143 12 C.F.R. § 225.92(e) (2002) (Regulation Y). For a discussion of the so-called leverage ratio, *see infra* text accompanying notes 148–152.

144 12 C.F.R. § 225.90(b) (2002) (Regulation Y) gives the foreign bank a choice between relying on the Basel Capital Standards of its home country or using the pre-clearance process. A foreign bank whose home country has adopted risk-based capital standards consistent with the Basel Capital Standards might opt for the pre-clearance process if (1) the bank falls short of the required capital adequacy ratios (6 percent/10 percent) of 12 C.F.R. § 225.90(b)(1)(ii) (2002) (Regulation Y) as computed under the Basel Capital Standards but wishes to argue that its capital still is comparable to the capital that would be required of a U.S. bank owned by an FHC (*see* 12 C.F.R. § 225.90(b)(2) (2002) (Regulation Y)), or (2) the bank meets the required capital adequacy ratios of 12 C.F.R. § 225.90(b)(1)(ii) (2002) (Regulation Y) as computed under the Basel Capital Standards but there is a question about the comparability of the foreign bank's capital to the capital that would be required of a U.S. bank owned by an FHC (12 C.F.R. § 225.90(b)(2) (2002) (Regulation Y)).

145 12 C.F.R. § 225.90(b)(2) (2002) (Regulation Y). Presumably the factors to determine comparability of capital set forth in 12 C.F.R. § 225.92(e) (2002) (Regulation Y) apply to this determination.

146 12 C.F.R. §§ 225.90(b)(2) & 225.91(c) (2002) (Regulation Y). *See supra* B.2.d. for a discussion of the pre-clearance process.

country has not adopted risk-based capital standards consistent with the Basel Capital Standards or a company owning or controlling such foreign bank must file a request for a determination in the pre-clearance process that the foreign bank's capital is comparable to the capital that would be required of a U.S. bank owned by an FHC.[147] If the home country of the foreign bank has adopted the Basel Capital Standards, it is in the discretion of the foreign bank to request a review of its capital qualification in the pre-clearance process.

The well-capitalized standard as contained in Regulation Y omits the requirement of the interim rules that a foreign bank operating a branch, agency or commercial lending company in the United States and electing to be an FHC must meet a leverage ratio of Tier 1 capital to total (non-risk weighted) assets of at least 3 percent in addition to the 6 and 10 percent risk based ratios.[148] A foreign bank's leverage ratio, however, will continue to be considered by the Board as one of the factors that can be taken into account for purposes of the comparability review under Section 225.92(e), Regulation Y[149] which mentions the leverage ratio as one of the factors to be considered. Under this approach, the Board may consider whether the level of a foreign bank's leverage ratio is such that it indicates that additional analysis should be undertaken in assessing comparability.[150] The Board has stated that it will retain any benefits associated with reviewing the leverage ratio as one of the relevant factors to assess the overall capital strength of the foreign bank, but the foreign bank's qualification for FHC status would not depend upon it.[151] Instead, qualification would depend on the overall capital strength of the foreign bank.[152]

By requiring foreign banks maintaining a branch, agency or commercial lending company to be well capitalized and well managed, Congress in effect modified Section 8(a),

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147 12 C.F.R. §§ 225.90(b)(2) & 225.91(c) (2002) (Regulation Y).

148 *See* interim rule, § 225.90(b)(1)(iii), 65 Fed. Reg. 3793 (Jan. 25, 2000), 65 Fed. Reg. 15,055 (Mar. 21, 2000). U.S. depository institutions are always required to meet a leverage ratio of 5 percent, and U.S. BHCs are required to meet a leverage ratio of 4 percent or 3 percent. *See* the discussion of the leverage ratio in the Interim FHC Release, *supra* note 32, at 3,789. The leverage ratio for BHCs is set forth in app. D to 12 C.F.R. pt. 225 (2002) (Capital Adequacy Guidelines for BHCs) and app. B to 12 C.F.R. pt. 225 (2002) (Capital Adequacy Guidelines for BHCs and State Member Banks) and for insured banks in 12 C.F.R. § 325.3 (2002).

149 12 C.F.R. § 225.92(e) (2002) (Regulation Y). *See* Final FHC Release, *supra* note 32, at 408.

150 *See* Final FHC Release, *supra* note 32, at 408. The Final FHC Release states that the financial information necessary for the Board's staff to compute a foreign bank's leverage ratio will be required as part of the certification process and ongoing reporting required of foreign FHCs. *Id.* at n.18. In a determination in the pre-clearance process that the capital of a major European bank was comparable to that required of a U.S. bank owned by an FHC and that the European bank was well capitalized for purposes of qualifying as an FHC, the Board did not rely on the bank's leverage ratio as a factor underlying its decision but required the bank to provide notice to the Board if the leverage ratio falls below the level on a specified prior date (which was then below 3 percent). The Board indicated to the bank that only a truly material change in the leverage ratio would cause it supervisory concern. The bank had informed the Board that it does not manage its leverage ratio.

151 *See* Final FHC Release, *supra* note 32, at 408.

152 *Id.*

IBA,[153] which provides that a company covered by Section 8(a) "shall be subject to the provisions of the [BHCA] . . . in the same manner and to the same extent that [BHCs] are subject to such provisions".

The concept of the well-capitalized requirement for FHCs differs from the well-capitalized requirement used in Section 4(j), BHCA.[154] In Section 4(j), BHCA the level of

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153 12 U.S.C. § 3106(a) (1994).

154 *Compare* the different structures of § 4(*l*), BHCA, 12 U.S.C. § 1843(*l*) (1994 & Supp. V 1999), and § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999). Section 4(j)(3), (4)(A) & (5), BHCA, 12 U.S.C. § 1843(j)(3), (4)(A) & (5) (1994 & Supp. V 1999), and 12 C.F.R. §§ 225.22(a), 225.23(a) & 225.23(c)(1) (2002) (Regulation Y) provide for a waiver of notice or an expedited notice procedure for activities or acquisitions under § 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999), for BHCs that are well capitalized (and well managed) in accordance with § 2(o)(1)(B), BHCA, 12 U.S.C. § 1841(o)(1)(B) (1994 & Supp. V 1999), 12 C.F.R. § 225.2(r) (2002) (Regulation Y). Section 4(j)(4)(A), BHCA requires that (1) the acquiring BHC is well capitalized, (2) the lead insured depository institution of such BHC is well capitalized, (3) well capitalized insured depository institutions control at least 80 percent of the aggregate total risk-weighted assets of insured depository institutions controlled by such BHC, and (4) no insured depository institution controlled by such BHC is under-capitalized.

The well-capitalized requirement of § 4(*l*)(1)(A), BHCA, 12 U.S.C. § 1843(*l*)(1)(A) (1994 & Supp. V 1999), on the other hand, refers to all depository institution subsidiaries of the FHC, whether or not insured by the FDIC, not only to lead insured depository institutions and insured depository institutions controlling 80 percent of risk-weighted assets. Furthermore, § 4(*l*)(1)(A), BHCA does not apply the well-capitalized requirement to the BHC itself.

For foreign banks, § 4(*l*), BHCA and § 4(j), BHCA have the same result, because the foreign banking organization that wishes to engage in an activity or make an acquisition under § 4(c)(8), BHCA without notice or on the basis of the expedited notice procedure must meet the well-capitalized requirement on the level of the foreign bank (12 C.F.R. § 225.2(r)(3) (2002) (Regulation Y)), and a foreign bank that elects to be an FHC must also meet the well-capitalized requirement on the level of the foreign bank (12 C.F.R. § 225.90(a)(1) & (b) (2002) (Regulation Y).

Section 4 (j)(4)(A), BHCA, 12 U.S.C. § 1843(j)(4)(A) (1994 & Supp. V 1999), requires not only that the acquiring BHC must be well capitalized but, in addition, requires that the BHC's lead depository institution must be well capitalized to make the waiver of notice or the expedited notice procedure available to such BHC. The term *lead insured depository institution* is defined in § 2(o)(8)(A), BHCA, 12 U.S.C. § 1841(o)(8)(A) (1994 & Supp. V 1999), and in 12 C.F.R. § 225.2(h) (2002) (Regulation Y). The term *insured depository institution* is defined in § 2(n), BHCA, 12 U.S.C. § 1841(n) (1994), and in 12 C.F.R. § 225.2(g) (2002) (Regulation Y) by reference to § 3, FDIA, 12 U.S.C. § 1813 (1994 & Supp. V 1999). Section 3(c)(2), FDIA, 12 U.S.C. § 1813(c)(2) (1994), defines *insured depository institution* as any insured bank and savings association. Section 3(h), FDIA, 12 U.S.C. § 1813(h) (1994), defines *insured bank* as any bank (including a foreign bank having an insured branch) the deposits of which are insured by the FDIC. Section 2(o)(8)(B), BHCA, 12 U.S.C. § 1841(o)(8)(B) (1994 & Supp. V 1999), adds that in the case of foreign banks the term *insured depository institution* includes any (insured or uninsured) branch or agency operated in the United States by a foreign bank. This seems to indicate that the capitalization of the branch or agency on a stand-alone basis is relevant. Regulation Y, however, shortcuts the branches and agencies by providing that for purposes of determining whether a U.S. branch or agency of a foreign bank is well capitalized, the branch or agency is deemed to have the same capital ratios as the foreign banking organization. 12 C.F.R. § 225.2(r)(3)(ii) (2002) (Regulation Y). *Foreign banking organization* is defined in 12 C.F.R. § 211.21(o) (2002) (Regulation K). For a discussion of the term *foreign banking organization*, *see* Gruson, *supra* note 1, § 10.02.

capitalization is a threshold requirement. It must be present at the time of the acquisition or at the time an activity is commenced in order to make the waiver of notice or expedited notice procedure available.[155] There is no requirement that the BHC maintain the higher level of capitalization in the future. The higher level of capitalization of an FHC, however, must be maintained during the existence of the FHC, and an FHC that fails to continue to meet the required capitalization level loses its FHC status.[156] Thus, the well-capitalized requirement of FHCs is a maintenance requirement.

4. The Well-Managed Requirement

All institutions that must be well capitalized must also be well managed.[157] The discussion about and the diagrams showing the entities in a foreign bank group that must meet the well-capitalized requirements equally applies to the well-managed requirement.[158] A company that controls a foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States is treated like a U.S. BHC in that it does not have to meet the well-managed requirements in order to become an FHC (if it meets the other requirements for an effective election and makes such election).[159]

Section 4(*l*), BHCA does not refer to insured depository institution (*see supra* note 33) but to depository institutions generally.

155 *See* § 4(j)(4)(A), BHCA, 12 U.S.C. § 1843(j)(4)(A) (1994 & Supp. V 1999) ("Both before and immediately after the proposed transaction — (i) the acquiring [BHC] is well capitalized").

156 *See infra* H.

157 Section 4(*l*)(1)(B) & (3), BHCA, 12 U.S.C. § 1843(*l*)(1)(B) & (3) (1994 & Supp. V 1999). 12 C.F.R. §§ 225.81(b)(2) & 225.82(b)(5) (2002) (Regulation Y) (depository institutions controlled by a U.S. BHC); 12 C.F.R. §§ 225.90(a)(1), 225.91(b)(4) & 225.91(b)(5) (2002) (Regulation Y) (foreign bank electing FHC status; foreign bank that maintains a U.S. branch, agency or commercial lending company and is controlled by the electing foreign bank or is under common control with the electing foreign bank; and U.S. nonbank depository institution subsidiary, such as a thrift or a nonbank trust company, owned or controlled by the electing foreign bank or by a company owning or controlling the electing foreign bank). *See supra* B.3.a.

Compare the different approach of § 4(j)(3), (4)(B) & (5), BHCA, 12 U.S.C. § 1843(j)(3), (4)(B) & (5) (1994 & Supp. V 1999), and 12 C.F.R. §§ 225.22(a), 225.23(a) & 225.23(c)(2) (2002) (Regulation Y) dealing with the waiver of notice or expedited notice procedure for activities or acquisitions under § 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999), for BHCs that are (well capitalized) and well managed in accordance with § 2(o)(9), BHCA, 12 U.S.C. § 1841(o)(9) (1994 & Supp. V 1999), 12 C.F.R. §§ 225.2(s), 225.14(c)(2) & 225.23(c)(2) (2002) (Regulation Y). Under 12 C.F.R. § 225.2(s)(3) (2002) (RegulationY) the Board looks only to the U.S. operations of a foreign bank on a stand-alone basis in determining the well-managed requirements. *See supra* note 154. Whereas § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999), requires that (1) the acquiring BHC, (2) its lead insured depository institution and (3) insured depository institutions that control at least 80 percent of the total risk weighted assets of insured depository institutions controlled by the BHC are well managed and have received at least a satisfactory rating for compliance, § 4(*l*), BHCA, 12 U.S.C. § 1843(*l*) (1994 & Supp. V 1999), requires that the depository institution subsidiary of a BHC (and in extension of that concept, a foreign bank) is well managed.

158 *See supra* B.3.a.

159 *See supra* note 131 and accompanying text.

Well managed is generally defined in Section 2(o)(9), BHCA[160] by reference to the examination by federal or state banking agencies,[161] and in case of companies or depository institutions that have not received an examination rating, the term well managed means that "the Board has determined, after a review of the managerial and other resources . . . that the company or institution is well managed".[162] A foreign bank operating a branch, agency or commercial lending company in the United States is subject to different well-managed requirements for FHC purposes. Such foreign bank must meet "comparable" management standards to be developed by the Board.[163] Pursuant to Regulation Y, such foreign bank will be considered well managed if it meets the following test:[164]

(1) the foreign bank has received at least a satisfactory composite rating at its most recent assessment of its U.S. branch, agency and commercial lending company operations;

(2) the home country supervisor of the foreign bank consents to the foreign bank expanding its activities in the United States to include activities permissible for an FHC; and

(3) the management of the foreign bank meets standards comparable to those required of a U.S. bank owned by an FHC.

Regulation Y provides for an evaluation of a foreign bank for FHC purposes on the basis of a composite rating of all of its direct U.S. branches, agencies and commercial lending company subsidiaries. The Federal Reserve's foreign bank examination process has been amended to include assignment of a combined assessment of an FBO's U.S. branch, agency and commercial

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160 12 U.S.C. § 1841(o)(9) (1994 & Supp. V 1999); 12 C.F.R. § 225.2(s) (2002) (Regulation Y). *See* Final FHC Release, *supra* note 32, at 401 (discussing the definitions of well capitalized and well managed).

161 12 U.S.C. § 1841(o)(9)(A) (1994 & Supp. V 1999); 12 C.F.R. § 225.2(s)(1)(i) (2002) (Regulation Y).

162 12 C.F.R. § 225.2(s)(1)(ii) (2002) (Regulation Y). *See* 12 U.S.C. § 1841(o)(9)(B) (1994 & Supp. V 1999).

163 Section 4(*l*)(3) BHCA, 12 U.S.C. § 1843(*l*)(3) (1994 & Supp. V 1999).

164 12 C.F.R. § 225.90(c) (2002) (Regulation Y). The definition of the well-managed requirement for foreign banking organizations in 12 C.F.R. § 225.2(s)(3) (2002) (Regulation Y) applies only "except as otherwise provided". 12 C.F.R. § 225.90(a) (2002) (Regulation Y) contains such other provision. The original interim version of that provision required that the Board determine comparability of management standards in each case (65 Fed. Reg. 3793 (Jan. 25, 2000), § 225.90(c)(3)). The deletion of the reference to a Board determination in the amendment to that provision (65 Fed. Reg. 15,055 (Mar. 21, 2000), § 225.90(c)(3)) is mainly a matter of form. It follows from 12 C.F.R. § 225.92(c)(1) & (4) (2002) (Regulation Y) that the Board still has the power to determine whether the foreign bank meets standards comparable to those required of a U.S. bank owned by an FHC, 12 C.F.R. § 225.90(c)(3) (2002) (Regulation Y), when determining whether the election to be an FHC is effective. *See supra* note 141.

12 C.F.R. § 225.90(c) (2002) (Regulation Y) is based on § 4(*l*)(3), BHCA, 12 U.S.C.§ 1843(*l*)(3) (1994 & Supp. V 1999), requiring the Board to develop "comparable" management standards for foreign banks operating a branch, agency or commercial lending company in the United States.

lending company operations through the regular examination cycle.[165] If a foreign banking group contains more than one foreign bank with U.S. banking offices, each such foreign bank in the group must have a satisfactory combined U.S. banking assessment in order for the foreign banking group or any of its subsidiaries to obtain FHC status.[166] Each U.S. depository institution subsidiary of a foreign bank or company owning or controlling such foreign bank is required to meet the well-managed standard separately on an individual basis for the foreign bank or company to obtain FHC status in the same manner as required for U.S. BHCs.[167]

The interim rules required as a condition for FHC status of a foreign bank that the home country supervisor of the foreign bank considered the overall operations of the foreign bank to be satisfactory or better.[168] The Board dropped this requirement, and Regulation Y now provides that the home country supervisor must consent to the proposed expansion of the foreign bank's U.S. operations to include activities permissible for FHCs.[169] This formulation is based on suggestions of the Basel Committee on Banking Supervision.[170] The consent could be obtained in a formal consent process if such process is available in the home country of the foreign bank or by way of consultation between the Board and the home country supervisor.[171]

It is unclear how the Board will judge whether a foreign bank meets management standards "comparable" to those required of a U.S. bank owned by an FHC.[172] How can the

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165 *See* Board, SR Letter No. 00-14 (SUP) (Oct. 23, 2000). *See also* Final FHC Release, *supra* note 32, at 409, and *id.* at n.19. If a foreign bank that wishes to obtain FHC status has not been assigned a combined U.S. banking assessment as part of the regular examination cycle, the foreign bank should contact its responsible Federal Reserve Bank or utilize the pre-clearance process. 12 C.F.R. § 225.91(c) (2002) (Regulation Y). A combined U.S. banking assessment may be assigned to a foreign bank as part of the FHC pre-clearance process. *See* Final FHC Release, *supra* note 32, at 409. *See supra* text accompanying note 111.

166 *See* Final FHC Release, *supra* note 32, at 409.

167 *Id.* at 409 n.20. The definition for *well managed* applicable for the determination whether a BHC or a depository institution is well managed, is set forth in 12 C.F.R. § 225.2(s) (2002) (Regulation Y).

168 *See* interim rule § 225.90(c)(2), 65 Fed. Reg. 3793 (Jan. 25, 2000); 65 Fed. Reg. 15,055 (Mar. 21, 2000).

169 12 C.F.R. § 225.90(c)(2) (2002) (Regulation Y).

170 *See* Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, at 41–43 (1997); Basel Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments*, § II.2 (1992). *See* Final FHC Release, *supra* note 32, at 409 (discussing the position of the Basel Committee on Bank Supervision).

171 *See* Final FHC Release, *supra* note 32, at 409. The purpose of the consultation is that the Board can assure itself that the home country supervisor considers the consolidated capital and management of the bank to satisfy its home country standards and that the supervisor has no objections to the expansion. *Id.*

172 12 C.F.R. § 225.90(c)(3) (2002) (Regulation Y). The Board's justification in the Final FHC Release, *supra* note 32, at 408–10, of the retention of the requirement of a comparability finding in Regulation Y does not address the issue how the Board will judge comparability of management. The reference to the comparability factors in 12 C.F.R. § 225.92(e) (2002) (Regulation Y) is not very helpful because those factors deal with capital and supervision, not with management. *See* Final FHC Release, *supra*, at 410. The discussion of the management comparability test in the Final FHC Release, *supra*, at 410 and the comparability factors in 12 C.F.R. § 225.92(e) convey the sense that the Board does not really mean

Board reach this conclusion for a foreign bank without examining the foreign bank? How will the Board sensibly review the managerial resources of a foreign bank that operates under a different legal and economic system? The pre-clearance process is also available to a foreign bank that wishes a Board review of its well-managed qualification.[173]

5. Comprehensive Supervision on a Consolidated Basis

Whether a foreign bank that elects the status of an FHC is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor is one of the factors that the Board may take into account when determining whether a foreign bank is well capitalized and well managed in accordance with comparable U.S. capital and management standards.[174] Regulation Y adopts the position that, as a general matter, a foreign bank may not be considered to be well capitalized and well managed if the foreign bank is not subject to comprehensive supervision on a consolidated basis.[175] The GLBA does not require that foreign banks electing FHC status must be subject to comprehensive supervision on a consolidated basis. The comprehensive supervision on a consolidated basis standard has been mandated by Congress only in connection with applications by foreign banks to expand their U.S. *banking* operations,[176] and there is no indication that Congress intended to require foreign banks to meet this standard before being permitted to expand their U.S. *nonbanking* activities as FHCs. Nevertheless, the Board makes it clear that this factor ranks high in its view.[177]

The Board stated that as a general rule, the top tier foreign bank in a foreign banking group should be subject to comprehensive supervision on a consolidated basis by its home country supervisor in order for the foreign bank group to obtain FHC status.[178] If a top tier

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management quality in the sense of the ability of the management of the foreign bank but supervision of the foreign bank by the home country supervisor.

173 12 C.F.R. § 225.91(c) (2002) (Regulation Y). *See supra* B.2.d.

174 12 C.F.R. § 225.92(e)(1) & (2) (2002) (Regulation Y). *See* Joseph J. Norton & Christopher D. Olive, *A By-Product of the Globalization Process: The Rise of Cross-Border Bank Mergers and Acquisitions – The U.S. Regulatory Framework*, 56 BUS. LAW. 591, 604–09 (2001) for a discussion of the comprehensive and consolidated supervision standard.

175 12 C.F.R. § 225.92(e)(2) (2002) (Regulation Y).

176 *See* § 7(d)(2)(A), IBA, 12 U.S.C. § 3105(c)(2)(A) (1994) and 12 C.F.R. § 211.24(c)(1)(i)(A) (2002) (Regulation K) (requiring that a foreign bank that wishes to establish an office in the United States and any foreign parent bank of such bank must be subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor); § 3(c)(3)(B), BHCA, 12 U.S.C. § 1842(c)(3)(B) (1994) and 12 C.F.R. § 225.13(a)(4) (2002) (Regulation Y) (same requirement for foreign banks applying to become BHCs).

177 *See* Final FHC Release, *supra* note 32, at 410. The Board justifies this additional requirement that must be satisfied before a foreign bank can effectively elect FHC status with the observation that only if a foreign bank is subject to comprehensive and consolidated supervision, the Board can have a high level of confidence that the capital and management information being submitted by the applicant is accurate and reliable. *Id.*

178 *Id.*

foreign bank in a foreign banking group is determined to be subject to comprehensive and consolidated supervision, subsidiary foreign banks of the group should be incorporated into the supervisory framework of the home country supervisor of the top tier foreign bank and, thus, should be subject to comprehensive supervision on a consolidated basis even if the subsidiary foreign bank is not subject to comprehensive consolidated supervision by its own home country supervisor.[179]

A foreign bank that has not been previously determined by the Board to be subject to comprehensive and consolidated supervision and that is chartered in a country where no other bank from that country has been determined by the Board to be subject to comprehensive and consolidated supervision is *required* (not merely encouraged) to use the pre-clearance process, even if it otherwise meets the objective FHC criteria.[180] The Board will make a determination about the comprehensive supervision on a consolidated basis in the pre-clearance process.[181]

There may be limited situations in which an exceptionally strong bank from a country that has not yet fully implemented comprehensive and consolidated supervision should be able to be considered for FHC status.[182] Regulation Y provides that the Board may grant after the pre-clearance process FHC status to a foreign bank that is not yet fully subject to comprehensive supervision on a consolidated basis if the home country supervisor has made significant progress in adopting and implementing arrangements for the comprehensive and consolidated supervision of its banks, and if the foreign bank demonstrates significant financial strength, such as through levels of capital that significantly exceed the minimum levels required

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179 *Id.* at 410 n.23.

180 12 C.F.R. § 225.91(c) (2002) (Regulation Y). *See* Final FHC Release, *supra* note 32, at 410. The formulation of 12 C.F.R. § 225.91(c) (2002) (Regulation Y) is curious. This provision refers to a foreign bank that previously has not been determined to be subject to comprehensive supervision on a consolidated basis *or* that is chartered in a country where no bank has been found to be subject to comprehensive supervision on a consolidated basis. If the electing bank is from such country, surely it cannot have been determined to be subject to such supervision. The narrower test (the electing bank has not been found to be subject to comprehensive and consolidated supervision) is included in the wider test (no bank in the home country of the electing bank has been found to be subject to comprehensive and consolidated supervision) and adds nothing. The amended interim rule, § 225.91(c), 65 Fed. Reg. 15,056 (Mar. 21, 2000), made more sense: it encouraged the pre-clearing process for banks chartered in a country where no other bank has been reviewed by the Board for comprehensive supervision on a consolidated basis. (The amended interim rule should have deleted the word "other"). 12 C.F.R. § 225.91(c) (2002) (Regulation Y) probably contains a drafting error in that the *or* should be read as *and*. *See* Final FHC Release, *supra*, at 410, which uses *and* instead of *or* when summarizing 12 C.F.R. § 225.91(c) (2002) (Regulation Y) to connect the absence of an individual finding of comprehensive and consolidated supervision of the electing bank and the absence of such finding for any other bank from the country of charter of the electing bank. This reading makes sense, because requesting the pre-clearing process for an electing bank from a country where numerous other banks previously have been found to be subject to comprehensive consolidated supervision seems to be unnecessary.

181 *See* Final FHC Release, *supra* note 32, at 410–11. For a discussion of the pre-clearance process, *see supra* B.2.d.

182 *See* Final FHC Release, *supra* note 32, at 411.

for a well-capitalized determination or through exceptional asset quality.[183] A foreign bank that is not subject to comprehensive and consolidated supervision may use the pre-clearance process to explain to the Board why it still should be granted FHC status.[184] The Board anticipates granting FHC status to foreign banks that are not subject to comprehensive and consolidated supervision only in rare instances.[185]

6. Community Reinvestment Act Rating

It is not part of the declaration of the FHC election by a U.S. BHC, a foreign bank or a company controlling the electing foreign bank or of the certification required in connection with the election[186] that the insured depository institution subsidiaries of such electing U.S. BHC, foreign bank or company controlling such foreign bank, or any insured U.S. branch of such foreign bank, meet a certain rating requirement under the Community Reinvestment Act of 1977.[187] However, an election to be an FHC will not be effective unless the Board finds that each insured depository institution controlled by the electing U.S. BHC, foreign bank or company controlling such foreign bank and each insured U.S. branch of the electing foreign bank has achieved at least a rating of "satisfactory record of meeting community credit needs"[188] at its most recent examination under the CRA.[189] The Board must use the 30-day period beginning on the date the complete declaration of election to be an FHC is filed[190] to determine whether the CRA rating requirement is met.[191] If any of a U.S. BHC's, foreign bank's or controlling company's insured depository institutions or any of the foreign bank's insured branches has not received in its most recent examination under the CRA at least a rating of "satisfactory", the

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183 12 C.F.R. § 225.92(e)(2) (2002) (Regulation Y). *See* Final FHC Release, *supra* note 32, at 411. *Cf.* 12 C.F.R. § 211.24(c)(1)(iii) (2002) (Regulation K) (it may be sufficient for the approval of an application for the opening of a U.S. office of a foreign bank to show that the home country is actively working to establish arrangements for the consolidated supervision of such bank).

If the election by a foreign bank from country X to be an FHC has been approved because the home country supervisor in country X has made significant progress in establishing arrangements for comprehensive supervision on a consolidated basis, 12 C.F.R. § 225.92(e)(2)(i) (2002) (Regulation Y), another bank from country X thereafter electing FHC status must still use the pre-clearance process, because no foreign bank from country X has been determined by the Board to be subject to comprehensive and consolidated supervision, 12 C.F.R. § 225.91(c) (2002) (Regulation Y).

184 *See* Final FHC Release, *supra* note 32, at 411.

185 *Id.*

186 *See supra* B.2.b.

187 *See* § 4(*l*)(1), BHC, 12 U.S.C. § 1843(*l*)(1) (1994 & Supp. V 1999), and the definition of FHC in § 2(p), BHCA, 12 U.S.C. § 1841(p) (1994 & Supp. V 1999).

188 Section 807(b)(2)(B), CRA, 12 U.S.C. § 2906(b)(2)(B) (1994).

189 Section 804(c)(1), CRA, 12 U.S.C. § 2903(c)(1) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.82(c)(1) & 225.92(c)(2) (2002) (Regulation Y).

190 *See supra* text accompanying note 66.

191 *See* § 804(c)(1)(B), CRA, 12 U.S.C. § 2903(c)(1)(B) (1994 & Supp. V 1999).

election to be an FHC cannot become effective.[192] The CRA rating requirement is relevant for foreign banks or companies controlling such foreign banks electing to be FHCs only if the foreign bank or controlling company maintains an insured depository institution subsidiary or the foreign bank maintains an insured branch in the United States.[193]

7. Capitalization of the FHC

a. No Requirement to Be Well Capitalized

The well-capitalized requirement must be met by the depository institution subsidiaries of an FHC and, in the case of a foreign bank FHC operating a branch, agency or commercial lending company in the United States, by such foreign bank FHC and by other foreign banks operating a branch, agency or commercial lending company in the United States that are controlled by or under common control with the foreign bank FHC.[194] Other than Section 4(j), BHCA,[195] Section 4(*l*), BHCA does not establish a well-capitalized requirement for BHCs, except in the case of foreign banks that are BHCs by virtue of the IBA because they operate a branch, agency or commercial lending company in the United States.[196] Furthermore, the Board is not authorized to prescribe capital or capital adequacy requirements for any functionally regulated subsidiary of a BHC that is not a depository institution and that is in compliance with its own applicable capital requirements imposed by another federal regulatory authority, *e.g.*, the capital standards applied by the SEC to broker-dealers or by a state insurance

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192 Section 804(c)(1), CRA, 12 U.S.C. § 2903(c)(1) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.82(c)(1) & 225.92(c)(2) (2002) (Regulation Y). The CRA contains a limited exception for insured depository institutions that were acquired by the BHC in the year prior to the filing of a declaration to be an FHC, if an affirmative plan to achieve at least a satisfactory CRA rating at the next examination of the institution is submitted to and accepted by the appropriate federal financial supervisory agency (defined in § 803(1), CRA, 12 U.S.C. § 2902(1) (1994)). Section 804(c)(2), CRA, 12 U.S.C. § 2903(c)(2) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.82(d) & 225.92(d) (2002) (Regulation Y).

193 Section 804(a), CRA, 12 U.S.C. § 2903(a) (1994), § 803(2), CRA, 12 U.S.C. § 2902(2) (1994), § 3(a)(1) & (c)(2), FDIA, 12 U.S.C. § 1813(a)(1) & (c)(2) (1994) (insured depository institution covered by CRA). *See* 12 C.F.R. § 225.92(c)(2) (2002) (Regulation Y). Only U.S. insured depository institutions and insured branches of foreign banks are subject to the CRA. Because the GLBA does not instruct the Board to develop comparable standards for foreign banks, the CRA rating requirement does not raise the same issues for foreign banks as does § 4(*l*)(1) & (3), BHCA, 12 U.S.C. § 1843(*l*)(1) & (3) (1994 & Supp. V 1999).

194 *See supra* B.2.c. & B.3.

195 12 U.S.C. § 1843(j) (1994 & Supp. V 1999). *See supra* note 154 for a discussion of § 4(j), BHCA.

196 Section 4(*l*), BHCA, 12 U.S.C. § 1843(4)(*l*) (1994 & Supp. V 1999), does not apply capital requirements to a company controlling a bank maintaining a branch, agency or commercial lending company in the United States. *See supra* notes 131 & 154 and accompanying text.

authority to U.S. insurance companies.[197]

b. General Capital Requirements for BHCs/FHCs

The Board, however, has the authority, based on its general supervisory power over BHCs, to impose capital and capital adequacy requirements on BHCs. This authority does not diminish once the BHC has effectively elected FHC status.[198] Regulation Y imposes on BHCs a minimum ratio of total capital-to-total risk-based assets of at least 8 percent on a consolidated basis and a ratio of Tier 1 capital-to-total risk-based assets of at least 4 percent on a consolidated basis.[199] The risk-based guidelines are used "in the inspection and supervision process as well as in the analysis of applications acted upon by the Federal Reserve".[200] Although Regulation Y does not contain any specific requirement that, as a condition to the effective election of FHC status, a U.S. BHC must meet the capital requirements applicable to all BHCs, there is little doubt that the Board under its general supervisory power over BHCs could deny a BHC from effectively making an FHC election if it is in violation of applicable laws and regulations, including the rules on capital adequacy. The Board may impose capital requirements on a BHC/FHC, not only if it is a mere holding company without its own business activities, but, according to the BHCA, even if the BHC/FHC is a broker-dealer, insurance company, insurance agent or investment company.[201] It is not clear, however, how the

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197 Section 5(c)(3)(A), BHCA, 12 U.S.C. § 1844(c)(3)(A) (1994 & Supp. V 1999). Furthermore, the Board may not prescribe capital or capital adequacy requirements for (1) investment advisers registered under the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1994 & Supp. V 1999), or with any state or (2) insurance agents licensed with a state insurance authority. *Id.* *See* Conference Report on S. 900, *supra* note 4, at 158. The Board, however, may impose capital or capital adequacy requirements on non-investment advisory activities (and activities incidental thereto) of a registered investment adviser and non-insurance agency activities (and activities incidental thereto) of a licensed insurance agent. Section 5(c)(3)(B), 12 U.S.C. § 1844(c)(3)(B) (1994 & Supp. V 1999).

In developing capital adequacy rules for BHCs and in determining the capital adequacy of a BHC, the Board may not take into account the activities, operations or investments of an affiliated investment company registered under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (1994 & Supp. V 1999), unless such investment company itself is a BHC or 25 percent or more of the shares of the investment company are owned by a BHC (and the shares owned by the BHC have a market value of at least $1 million). Section 5(c)(3)(C), BHCA, 12 U.S.C. § 1844(c)(3)(C) (1994 & Supp. V 1999).

198 12 C.F.R. § 225.82(g) (2002) (Regulation Y). *See infra* B.8.

199 A U.S. BHC is subject to the capital requirements set forth in app. A (Capital Adequacy Guidelines for BHCs: Risk-Based Measure) (*see* attachment VI), app. B (Capital Adequacy Guidelines for BHCs and State Member Banks: Leverage Measure), app. D (Capital Adequacy Guidelines for BHCs: Tier 1 Leverage Measure) and app. E (Capital Adequacy Guidelines for BHCs: Market Risk Measure) to 12 C.F.R. pt. 225 (2002). The capital requirements applicable to BHCs obviously continue to apply after a BHC has effectively elected to be an FHC. *See* D.2.m for a discussion of capital requirements for equity investments in nonfinancial companies.

200 App. A (I Overview) to 12 C.F.R. pt. 225 (2002) (Capital Adequacy Guidelines for BHC's).

201 This follows from § 5(c)(3), BHCA, 12 U.S.C. § 1844(c)(3) (1994 & Supp. V 1999), which prohibits the Board from prescribing capital requirements on functionally regulated *subsidiaries* of a BHC (not: functionally regulated BHCs).

capitalization of a company engaged in financial activities other than banking, *e.g.*, a broker-dealer or an insurance company, can be computed in accordance to the Basel Capital Standards.[202] On the other hand, the Board may not impose on FHCs the requirement of being well-capitalized (except that, as stated above, in the case of a foreign bank–FHC maintaining a branch, agency or commercial lending company in the United States, the well-capitalized requirement applies to the FHC[203]).

In several orders approving the acquisition by a securities company of a bank under Section 3, BHCA[204] and the election of the new BHC to be an FHC,[205] the Board has stated that the new BHC would be well capitalized on a pro forma basis on consummation of the acquisition of the bank.[206] These orders apparently do not require the securities companies that acquired a depository institution to be well capitalized but simply stated as a fact that the new FHC will be well capitalized. In an order approving the acquisition of a depository institution by Met Life, the Board did not address the capitalization of the acquiring company but found that "all the subsidiaries of Met Life that are subject to regulatory capital requirements currently exceed those relevant minimum regulatory capital requirements".[207]

c. Capital Requirements for Foreign BHCs/FHCs

A more difficult question is whether the Board may impose capital requirements on a foreign company that owns or controls a foreign bank maintaining a branch, agency or commercial lending company in the United States, if the foreign company and the foreign bank elect to be FHCs. Section 7(d)(3)(B), IBA[208] provides that in acting upon an application of a foreign bank to establish a branch or an agency or to acquire control or ownership of a commercial lending company, the Board may take into consideration, among other factors, the financial resources of the foreign bank. Section 7, IBA,[209] however, does not refer to the capital resources of a company controlling the applicant foreign bank. The provisions of Regulation K

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202 *See supra* note 104.

203 *See supra* note 115 and accompanying text.

204 12 U.S.C. § 1842 (1994 & Supp. V 1999).

205 *See* 12 C.F.R. § 225.82(f) (2002) (Regulation Y).

206 *See* The Charles Schwab Corporation, 86 FED. RES. BULL. 494 (2000) ("Schwab also would be well capitalized on a pro forma basis on consummation of the proposal". *Id.* at 495); Friedmann, Billings, Ramsey Group, Inc., Order of Mar. 13, 2001, 87 FED. RES. BULL. 346 (2001). The Board did not explain how and on what basis it reached those conclusions. Pursuant to § 3(c)(2), BHCA, 12 U.S.C. § 1842(c)(2) (1994), and 12 C.F.R. § 225.13(b)(1) (2002) (Regulation Y) the Board in deciding an application under § 3, BHCA, 12 U.S.C. § 1842 (1994 & Supp. V 1999), may consider the financial condition and prospects, including current and projected capital positions, of the applicant.

207 *See* Met Life, Inc., Order of Feb. 12, 2001, 87 FED. RES. BULL. 268 (2001). *See also* The Charles Schwab Corporation, *supra* note 206, at 495 ("[A]ll subsidiaries of . . . Schwab that are subject to regulatory capital requirements currently exceed the relevant requirements.").

208 12 U.S.C. § 3105(d)(3)(B) (1994).

209 12 U.S.C. § 3105 (1994 & Supp. V 1999).

dealing with such applications[210] refer as a standard for approval to the financial resources, including capital position, only of the applicant foreign bank and not of companies controlling the applicant foreign bank.[211]

It can be argued that because a company controlling a bank establishing a branch, agency or commercial lending company is not subject to specific capital requirements, there is no basis for the imposition of capital requirements on the controlling company if the foreign bank (together with the controlling company) elects to be an FHC. On the other hand, the Board might take the position that a controlling company that is a foreign bank and is subject in its home country to risk-based capital standards consistent with the Basel Capital Standards must comply with such standards, and that a nonbank controlling company that is subject to specific capital rules in its home country as, *e.g.*, a foreign insurance company or a foreign securities company, must comply with those requirements. It must be emphasized, however, that the requirements and procedures in Regulation Y dealing with the election by foreign banks to be treated as FHCs[212] do not establish any capital or capital adequacy requirements regarding the companies controlling the electing foreign bank.

In cases where a foreign bank acquired control of a U.S. bank, the Board, in its orders under Section 3, BHCA[213] approving the acquisition, has emphasized that not only the direct foreign BHC but also foreign companies controlling such BHC (indirect BHCs) met the foreign capital adequacy requirements based on the Basel Capital Standards.[214] This is justified

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210 12 C.F.R. § 211.24 (2002) (Regulation K).

211 12 C.F.R. § 211.24(c)(2)(ii) (2002) (Regulation K). Note that in contrast to this Section, 12 C.F.R. § 211.24(c)(2)(iii) (2002) (Regulation K) refers to the managerial resources of the principal shareholders of the foreign bank. The Capital Equivalency Report, *supra* note 141, does not at all mention capital requirements for companies controlling foreign banks seeking to establish branches or agencies in the United States. *See also* Report by the Board to the Senate Banking Committee submitted to the Chairman of the Senate Committee on Banking, Housing and Urban Affairs, Alfonse M. D'Amato under a cover letter, dated Jan. 20, 1995, entitled *Report on Applications Under the Foreign Bank Supervision Enhancement Act*. The Board has not applied the source of strength doctrine, *infra* text accompanying notes 748-751, to foreign companies controlling foreign banks operating branches, agencies or commercial lending companies in the United States. Obviously, there is nothing in 12 C.F.R. § 211.24 (2002) (Regulation K) that prevents the Board from making the capital of a company controlling the applicant foreign bank an issue in the application procedure.

212 12 C.F.R. §§ 225.90 & 225.91 (2002) (Regulation Y).

213 12 U.S.C. § 1842 (1994 & Supp. V 1999).

214 *See, e.g.*, Caisse Nationale de Crédit Agricole, 86 FED. RES. BULL. 412 (2000). Banco Espírito Santo, Portugal, had applied under § 3, BHCA, 12 U.S.C. § 1842 (1994 & Supp. V 1999), to the Board to acquire all of the voting shares of Espírito Santo Bank, Miami, Fla. Caisse Nationale de Crédit Agricole ("CNCA") controlled more than 25 percent of the voting shares of Banco Espírito Santo and was also required to seek Board approval under § 3, BHCA to own indirectly the shares of Espírito Santo Bank. The Board approving the CNCA application stated "CNCA's capital levels exceed the levels required under French capital guidelines. The capital levels of CNCA also exceed the capital levels under the Basel Capital Accord, and are considered equivalent to the capital levels that would be required of a U.S. banking organization under similar circumstances". *Id.* at 413. Note that the Board used the same language in the order approving the application of Banco Espírito Santo, 86 FED. RES. BULL. 418, at 419 (2000), substituting "Portuguese" for "French". *See also* HSBC Holdings Plc, HSBC Finance Netherlands, HSBC

because Regulation Y expressly makes the financial condition and the capital of the applicant factors in deciding on an application under Section 3, BHCA,[215] and companies that would become indirect BHCs of the target U.S. bank are necessarily applicants under Section 3, BHCA. It can be expected that the Board will take a similar approach if a foreign company applies for the acquisition of a U.S. bank and simultaneously elects to be an FHC.[216]

d. Structure of FHC Group

Because the Board may impose capital requirements only on FHCs but not on any functionally regulated subsidiary of the FHC, it can be expected that in the United States operating nonbank companies, such as insurance companies and securities companies, will not be direct or indirect owners of banks. All U.S. FHCs will be mere holding companies without their own business activities which hold their bank, their insurance company, or their securities company as direct subsidiaries or as indirect subsidiaries through intermediary holding companies without their own business activities. Such structure prevents the securities company and the insurance company from becoming BHCs and FHCs; they become functionally regulated subsidiaries of an FHC.[217]

If a foreign bank that operates a branch, agency or commercial lending company in the United States is controlled by a foreign operating nonbank company, *e.g.*, an insurance company, it also might be advantageous to restructure this relationship and to subordinate both the bank and the insurance company to a holding company without its own business activities as subsidiaries on the same level. This will avoid the treatment of the insurance company as a BHC. The insurance company would no longer have to join the FHC election of the bank and would not be subject to whatever capital requirements the Board may impose on foreign BHCs. The creation of a non-operating holding company above an insurance company controlling a bank is of no particular advantage from a BHCA point of view because the insurance company and the new holding company would be companies controlling the bank, would have to join the election to become FHCs and would be subject to whatever capital requirement the Board may impose on foreign BHCs.

Holdings BV, Republic New York Corporation and Republic National Bank of New York, 86 FED. RES. BULL. 140 (2000) (the Board said, *id*. at 142, that HSBC Holding's capital ratios exceeded the minimum levels that would be required under the Basel Capital Standards and are considered equivalent to the capital that would be required of a U.S. banking organization; that the proposed transaction would not materially affect the capital position of HSBC Holding and Republic New York Corporation; and that it was not expected to have a significant adverse effect on the financial resources of HSBC Holding); Canadian Imperial Bank of Commerce, The CIBC World Markets Corporation, CIBC World Markets Inc. and CIBC Delaware Holdings Inc., 85 FED. RES. BULL. 733 (1999). *See also* Piraeus Bank S.A., 85 FED. RES. BULL. 579 (1999) ("Piraeus's capital levels exceed the levels required under Greek capital guidelines and under the Basel Capital Accord, and are considered equivalent to the capital levels that would be required of a U.S. banking organization under similar circumstances". *Id.* at 581).

215 12 C.F.R. § 225.13(b)(1) (2002) (Regulation Y).

216 12 C.F.R. § 225.82(f) (2002) (Regulation Y).

217 *See infra* G.1. *See also infra* D.2.m. for a discussion of capital requirements for equity investments in nonfinancial companies, in particular *see* text accompanying notes 589-591.

Even in the case of an FHC that is a mere holding company without its own business activities, the capital requirements imposed by the Board on BHCs affect indirectly the capital requirements of operating subsidiaries of the FHC that are functionally regulated by other regulatory authorities.[218] There is a tension between the authority of the Board to impose capital requirements on an FHC and the prohibition to impose such requirement on functionally regulated subsidiaries of the FHC. Take, for instance, an FHC that has 50 percent of its (risk weighted?) assets in a depository institution subsidiary and 50 percent in a broker-dealer or an insurance company: if the Board imposes the regular 4/8 percent capital adequacy requirement on a consolidated basis[219] on the FHC, it indirectly impacts the capital requirements of the broker-dealer or insurance subsidiary. Although Congress was aware of this problem, the GLBA does not provide a solution. The Conference Report on S. 900 states that the Board is expected to be flexible in the application of its capital requirements and to be able to harmonize them with the capital standards applied by the SEC to the broker-dealer.[220] In the above example the assets of the broker-dealer and insurance business should be eliminated from the balance sheet of the FHC before the capital adequacy for the FHC is computed.

8. Limited FHC Status

The Board expressly retains the authority to take supervisory actions against a BHC[221] even if that BHC has effectively elected to be an FHC.[222] These supervisory actions include, for example, imposing supervisory limitations, restrictions or prohibitions on the activities and acquisitions of an FHC.[223] The Final FHC Release states that the Board may take appropriate supervisory action against an FHC if the Board believes that the FHC "does not have the appropriate financial and managerial resources to commence or conduct an activity, make an

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218 *See* § 5(c)(3), BHCA, 12 U.S.C. § 1844(c)(3) (2002) (Regulation Y).

219 App. A (attachment VI) to 12 C.F.R. pt. 225 (2002) (Capital Adequacy Guidelines for BHCs).

220 The Conference Report on S. 900, *supra* note 4, at 159 states:

> The Conferees intend that the Board be flexible in its application of holding company consolidated capital standards for the leverage requirement and the timing of the asset calculations to FHCs of which the predominant regulated subsidiary is a broker-dealer. The Conferees intend that, to the extent the Board deems feasible and consistent with the overall financial condition and activities of the holding company, the capital requirements for such holding companies be consistent with the capital standards applied by the SEC to the broker-dealer, which accounts for the predominant amount of assets and activities of the holding company.

221 The statutory bases for such supervisory action are § 8, BHCA, 12 U.S.C. § 1847 (1994), and § 8, FDIA, 12 U.S.C. § 1818 (1994 & Supp. V 1999).

222 12 C.F.R. § 225.82(g) (2002) (Regulation Y). *See* Final FHC Release, *supra* note 32, at 403 (the GLBA "did not limit the general applicability of the Board's supervisory power over [BHCs] that become [FHCs]").

223 12 C.F.R. § 225.82(g) (2002) (Regulation Y). *See* Final FHC Release, *supra* note 32, at 402–03.

acquisition, or retain ownership of a company".[224] This provision seems to give the Board the power to grant a U.S. BHC or a foreign bank a status of a limited FHC. A BHC or foreign bank that, as required by the BHCA, at the time of the election is and thereafter remains in compliance with the well-capitalized and well-managed requirements, meets the requirements of the BHCA and can not be found to "not have the appropriate financial and managerial resources" to engage in activities permitted to FHCs. The BHCA allows an FHC, as long as it meets the legal requirements to be an FHC, to engage in all activities permitted to FHCs and gives no discretion to the Board to limit these activities. If an existing FHC fails to comply with the well-capitalized and well-managed standards, the BHCA and Regulation Y provide detailed rules as to how the Board must deal with this situation.[225] There is no statutory basis for a finding by the Board that a well-capitalized and well-managed FHC lacks financial or managerial resources. The position taken by the Board in Regulation Y reflects a very aggressive use of the Board's general supervisory power under the BHCA.[226]

C. Financial Activities – General

7. Authority to Engage in Financial Activities

Pursuant to Section 4(k)(1), BHCA, a BHC that has effectively elected to be an FHC may itself (directly) engage in financial activities and may acquire and retain shares of a company engaged in financial activities.[227] This means that an FHC may directly or indirectly

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[224] Final FHC Release, *supra* note 32, at 403. The Board's SR Letter No. 00-1 (SUP) (Feb. 8, 2000) expresses a similar concern under the caption "Supervisory Concerns". The Supervisory Letter states:

> There may be instances where a U.S. [BHC] or a foreign bank meets the statutory requirements to be [an FHC], but its capital strength and managerial resources are less than satisfactory on a consolidated basis. In such a situation, the Federal Reserve may have supervisory concerns about the consolidated entity although it technically qualifies as [an FHC]. The Federal Reserve may, in the exercise of its supervisory authority, restrict or limit the conduct of new activities or future acquisitions of [an FHC], or take other appropriate action, if the Board finds that the [FHC] does not have the financial or managerial resources to conduct the activity or make the acquisition.

See also the Interim FHC Release, supra note 32, at 3,787, for a discussion of the Board's concern that there may be instances in which a BHC meets the statutory requirements to be an FHC but on a consolidated basis is not *well capitalized* and *well managed*. The Board goes beyond its statutory authority because the BHCA clearly imposes the well-capitalized and the well-managed requirements only on depository institution subsidiaries of a BHC and on foreign banks maintaining a U.S. branch, agency or commercial lending company, but does not impose these requirements on a nonbank BHC. *See supra* B.3. The use of the terms *well capitalized* and *well managed* in the Interim Rule Release must be a drafting error.

[225] *See infra* H.

[226] *See supra* note 221 and *infra* G.1.

[227] Section 4(k)(1), BHCA, 12 U.S.C. § 1843(k)(1) (1994 & Supp. V 1999). Financial activities are the activities listed in 12 C.F.R. § 225.86 (2002) (Regulation Y). As discussed *infra* C.3., the Board treats financial activities and activities incidental to financial activities synonymously. Complementary activities are not financial activities. *See infra* C.7.

through a subsidiary engage in financial activities or may make minority investments in companies engaged in financial activities or make indirectly through a subsidiary such investments in a subsidiary or a minority-owned company engaged in financial activities.[228]

The above general statement must be qualified in two respects.

(1) *Certain financial activities may only be engaged in directly or through a subsidiary*. The first qualification to the above general statement is that, in order to engage in certain financial activities, *i.e.*, merchant banking activities, underwriting activities and insurance company portfolio investments, the FHC must act directly or through a subsidiary; it may not make a minority investment in a company engaged in such activities.[229] Of course, the FHC may make, directly or indirectly, merchant banking investments as such in minority-owned portfolio companies subject to the merchant banking conditions,[230] and the FHC may make, directly or indirectly, insurance company portfolio investments as such in minority-owned companies,[231] and the FHC may underwrite, directly or indirectly, noncontrolling blocks of equity securities of issuers.[232]

(2) *Exclusivity requirement*. The second qualification to the above general statement is that the FHC-controlled or minority-owned company engaged in financial activities must be *exclusively* engaged in financial activities[233] or in activities

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228 Section 4(k)(1), BHCA, 12 U.S.C. § 1843(k)(1) (1994 & Supp. V 1999); 12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y).

229 *See* § 4(k)(4)(H) & (I), BHCA, 12 U.S.C. § 1843(k)(4)(H) & (I) (1994 & Supp. V 1999) (permitting an FHC to acquire or control "directly or indirectly" shares of another company in the exercise of the merchant banking investment authority, underwriting authority or insurance portfolio investment authority). *See infra* notes 444, 601 & 624 (discussing the *directly or indirectly* requirement in connection with the merchant banking investment authority, the underwriting authority and the insurance company portfolio investment authority, respectively).

230 *See* § 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). *See infra* D.2. An FHC, however, may not make a merchant banking investment in a bank or BHC. *See infra* D.2.i.

231 *See* § 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 § Supp. V 1999). *See infra* D.4.

232 *See* § 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(4)(H) (1994 & Supp. V 1999). *See infra* D.3.

233 12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y). For a discussion of financial activities, *see infra* C.3. & 4. No prior notice to or prior approval from the Board is generally required to acquire shares or control of a company exclusively engaged in financial activities. *See infra* F. for a further discussion of the notice requirements.

It is curious that the rule (that the exclusivity requirement of 12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y) is not violated if the acquired company is also engaged in FHC § 4(c) permissible activities) is only set forth in the exception permitting the acquisition of *mixed* activities companies, 12 C.F.R. § 225.85(a)(3)(i) (2002) (Regulation Y) and is not repeated in 12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y) which establishes the exclusivity requirement. A portfolio company engaged in financial activities and in FHC § 4(c) permissible activities is not a mixed activity company but satisfied the exclusivity requirement. *See infra* note 265.

"otherwise permissible for the [FHC] under [Section 4(c), BHCA]"[234] [*herein* FHC § 4(c) permissible activities] or in a combination of financial activities and FHC § 4(c) permissible activities. There are two exceptions to the exclusivity requirement:

(i) *Companies engaged in mixed activities*. If the controlled or minority-owned company engaged in financial activities is not exclusively but *substantially* engaged in financial activities, the FHC may make the acquisition subject to certain conditions.[235] A company that is not *exclusively* but merely *substantially* engaged in

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234 12 U.S.C. § 1843(c) (1994 & Supp. V 1999).

235 12 C.F.R. § 225.85(a)(3)(i) (2002) (Regulation Y). A company is "substantially engaged" in activities permissible for an FHC for purposes of 12 C.F.R. § 225.85(a)(3)(i)(A) (2002) (Regulation Y) if at least 85 percent of the company's consolidated total annual gross revenues is derived from, and at least 85 percent of the company's consolidated total assets is attributable to, the conduct of activities that are financial in nature, incidental to a financial activity, or FHC § 4(c) permissible activities. 12 C.F.R. § 225.85(a)(3)(ii) (2002) (Regulation Y). As discussed *infra* C.3., the Board treats financial activities and activities incidental to financial activities synonymously.

Obviously, an FHC may acquire up to 5 percent of any class of voting shares of a company that is not substantially engaged in financial activities. *See* § 4(c)(6), BHCA, 12 U.S.C. § 1843(c)(6) (1994), and 12 C.F.R. § 225.85(a)(3)(i) (2002) (Regulation Y), which clarifies this point.

If the company in which an FHC invests is a company that is only substantially engaged in financial activities, the FHC must comply with the post-transaction notice requirements of 12 C.F.R. § 225.87 (2002) (Regulation Y). 12 C.F.R. § 225.85(a)(3)(i)(B) (2002) (Regulation Y). It is unclear why this notice requirement of 12 C.F.R. 225.87 (2002) (Regulation Y) is repeated in 12 C.F.R. § 225.85(a)(3)(i)(B) (2002) (Regulation Y). It is not referred to in 12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y), although the post-transaction notice provisions also apply to the acquisition of companies exclusively engaged in financial activities. (Only *prior* notice or approval is dispensed with in case of an acquisition of a company exclusively engaged in financial activities.) 12 C.F.R. § 225.85(a)(3)(i)(B) (2002) (Regulation Y) does not create a new notice provision; it only refers to the applicable notice provisions. Although an FHC may acquire any percentage of shares or control of a company that is only substantially engaged in financial activities, the FHC must give a post-transaction notice under 12 C.F.R. § 225.87 (2002) (Regulation Y) only in case such acquisition results in control of the company. *See* Final FHC Release, *supra* note 32, at 404.

It is also curious that the dispensation from prior notice to or approval of the Board is only mentioned in 12 C.F.R. § 225.85(a)(1)(2002) (Regulation Y) in connection with the acquisition of a company exclusively engaged in financial activities and not repeated in 12 C.F.R. § 225.85(a)(3)(i)(2002) (Regulation Y) in connection with the acquisition of a company engaged in limited nonfinancial activities. Even in the latter case, no prior notice to or approval of the Board is necessary, except in the case in which the acquired company is engaged in FHC § 4(c) permissible activities and notice is required in connection with the § 4(c), BHCA, 12 U.S.C. § 1843(c)(1994 & Supp. V 1999) authority. The absence of an express requirement of prior notice in case of the acquisition of a company engaged in limited nonfinancial activities and the express reference in 12 C.F.R. § 225.85(a)(3)(i)(B)(2002) (Regulation Y) to post-transaction notices indicate that no prior notice is required in the case of the acquisition of a company only substantially engaged in financial activities. On the other hand, a § 4(c), BHCA notice may also be required if the company is "exclusively" engaged in financial activities pursuant to 12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y) and is also engaged in FHC § 4(c) permissible activities. *See supra* note 233.

12 C.F.R. § 225.85(a) (2002) (Regulation Y) is not a masterpiece of clear drafting because it tries to cover two related but different concepts: the exclusivity requirement and its exceptions and the exceptions from

financial activities (a company with mixed activities) must conform, terminate or divest within two years of the date of acquisition by the FHC all activities that are not financial activities.[236] Thus, an FHC may acquire a company that is engaged in limited nonfinancial activities, but the FHC must within two years cause the company to be exclusively engaged in financial activities.[237] The same exception applies if the controlled or minority-owned company is not exclusively but substantially engaged in a combination of financial activities and FHC § 4(c) permissible activities. The FHC must within two years cause the company to be exclusively engaged in financial and in FHC § 4(c) permitted activities.[238] Obviously, the FHC need not terminate or divest the FHC § 4(c) permitted activities. The FHC may make the acquisition if the company with mixed activities conforms, terminates or divests within two years of the date of acquisition by the FHC all activities that are not financial activities or FHC § 4(c) permissible activities.[239] An acquisition of a company engaged in limited nonfinancial activities or non-FHC § 4(c) permissible activities would be unauthorized if the activities of the company are not conformed to Regulation Y within two years of the acquisition.[240] An FHC may not utilize the authority to engage in financial activities to make an investment in a company that is less than substantially engaged in financial activities or in a combination of financial activities and FHC § 4(c) permissible activities.[241]

(ii) *Companies engaged in FHC otherwise permissible Regulation Y activities.* The FHC may make an investment in a subsidiary or a minority-owned company that is not exclusively engaged in financial activities and FHC § 4(c) permissible activities if such subsidiary or company is "engaged in activities otherwise permissible for [an

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the no-notice requirement. It would have been clearer if all issues relating to notice had been consolidated in 12 C.F.R. § 225.87 (2002) (Regulation Y).

236 12 C.F.R. § 225.85(a)(3)(i)(C) (2002) (Regulation Y).

237 *See* Final FHC Release, *supra* note 32, at 404–05.

238 12 C.F.R. § 225.85(a)(3)(i)(A) (2002) (Regulation Y). Under the definition of *substantially engaged* in 12 C.F.R. § 225.85(a)(3)(ii) (2002) (Regulation Y), FHC § 4(c) permissible activities are counted towards the 85 percent test. *See supra* note 235.

The post transaction notice provisions of 12 C.F.R. § 225.87 (2002) (Regulation Y) apply to the acquisition of a company exclusively or substantially engaged in FHC § 4(c) permissible activities or a combination of financial activities and FHC § 4(c) permissible activities. *See supra* note 235. If an FHC invests in a company that is only engaged in FHC § 4(c) permissible activities, *e.g.*, in activities set forth on the laundry list of 12 C.F.R. § 225.28 (2002) (Regulation Y) and makes the acquisition under Section 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999), 12 C.F.R. § 225.85 (2002) (Regulation Y) does not apply. The acquired company cannot be engaged in any activities that are not closely related to banking. *See* Gruson, *supra* note 1, § 10.10.

239 12 C.F.R. § 225.85(a)(3)(i)(C) (2002) (Regulation Y).

240 *See* Final FHC Release, *supra* note 32, at 405. The Final FHC Release, *id.*, states that therefore a commitment to terminate impermissible activities is unnecessary.

241 *But see* the exception under 12 C.F.R. § 225.85(a)(2) (2002) (Regulation Y) described below *sub* (ii).

FHC] under [Regulation Y]" [*herein* FHC otherwise permissible Regulation Y activities] and if such investment is made in accordance with any applicable notice, approval or other requirements.[242] Thus, investments in companies engaged in FHC otherwise permissible Regulation Y activities are generally permitted; however, any notice must be given, any approval must be obtained or any requirement must be met, to the extent such notices, approvals and requirements apply.

Regulation Y does not explain the differences between the categories of *financial activities*, activities that are "otherwise permissible for the [FHC] under section 4(c) [BHCA]",[243] *i.e.*, *FHC § 4(c) permissible activities*, and activities "otherwise permissible for [an FHC] under [Regulation Y]",[244] *i.e.*, *FHC otherwise permissible Regulation Y activities*. The three groups of activities overlap in their scope and in their legal significance.

What activities are encompassed by FHC otherwise permissible Regulation Y activities? Regulation Y permits BHCs to engage in financial activities,[245] the nonbanking activities permitted by Section 4(c), BHCA,[246] complementary activities,[247] and the acquisition of banks and BHCs and savings banks.[248] Section 225.85(a)(2), Regulation Y, however, limits

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242 12 C.F.R § 225.85(a)(2) (2002) (Regulation Y). 12 C.F.R. § 225.85(a)(3) (2002) (Regulation Y) only qualifies 12 C.F.R. § 225.85(a)(1) and not § 225.85(a)(2) (2002) (Regulation Y). Thus, the permission of 12 C.F.R. § 225.85(a)(3) (2002) (Regulation Y) to acquire companies that are only substantially engaged in financial activities does not apply to companies that are only substantially engaged in FHC otherwise permissible Regulation Y activities.

FHC otherwise permissible Regulation Y activities (other than FHC § 4(c) permissible activities) do not contribute to the 85 percent portion of the "substantially engaged" test of 12 C.F.R. § 225.85(a)(3)(ii) (2002) (Regulation Y), *see supra* note 235, for determining whether a company is substantially engaged in permissible activities. It would seem, although 12 C.F.R. § 225.85(a)(3)(ii) (2002) (Regulation Y) is not clear on this point, that FHC otherwise permissible Regulation Y activities that are not FHC § 4(c) permissible activities also do not count as part of the 15 percent portion of the "substantially engaged" test, *see supra* note 235. If applicable notice, approval or other requirements have been met for the acquisition of a company engaged in FHC otherwise permissible Regulation Y activities (other than FHC § 4(c) permissible activities), the restriction against non-permitted activities does not apply with respect to such FHC otherwise permissible Regulation Y activities, and they remain outside the "substantially engaged" test. *See* 12 C.F.R. § 225.85(a)(2) (2002) (Regulation Y). *See infra* text accompanying notes 245–250 for a discussion of the scope of FHC otherwise permissible Regulation Y activities.

243 12 C.F.R. § 225.85(a)(3) (2002) (Regulation Y).

244 *See* 12 C.F.R. § 225.85(a)(2) (2002) (Regulation Y).

245 *See* Subparts I & J of Regulation Y, 12 C.F.R. pt. 225 (2002).

246 Subpart C of Regulation Y, 12 C.F.R. pt. 225 (2002). *See* 12 U.S.C. § 1843(c) (1994 & Supp. V 1999).

247 *See* 12 C.F.R. § 225.89 (2002) (Regulation Y). *See infra* C.7. Such activities are subject to approval. The Board takes the position that a company engaged in complementary activities "generally" could not be acquired under 12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y) using the post-transaction notice procedure, because complementary activities are subject to prior approval on a case-by-case basis under § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999). Final FHC Release, *supra* note 32, at 404 n.9.

248 *See* for banks and BHCs Subpart B of Regulation Y, 12 C.F.R. pt. 225 (2002), and for savings banks 12 C.F.R. § 225.85(c) (2002) (Regulation Y). An FHC may also engage in certain grandfathered activities.

the range of FHC otherwise permissible Regulation Y activities by stating that they must be "in addition to the activities listed in § 225.86".[249] Thus, it follows that financial activities are not included in the category of *FHC otherwise permissible Regulation Y activities*. Consequently, companies engaged in FHC otherwise permissible Regulation Y activities that may be acquired pursuant to Section 225.85(a)(2), Regulation Y are companies engaged in FHC § 4(c) permissible activities or complementary activities, and U.S. banks, BHCs and savings banks.[250]

As stated above,[251] the FHC controlled or minority-owned company may be engaged, in addition to financial activities, FHC § 4(c) permissible activities and 15% FHC non-permissible activities, in FHC otherwise permissible Regulation Y activities in accordance with notice, approval or other requirements. These acquisitions constitute no danger for the FHC because the Board is involved in such acquisitions. Section 225.85(a)(2), Regulation Y[252] does not establish an investment authority but simply refers to investment authorities contained in other provisions of the BHCA or Regulation Y. Therefore, the omission from Section 225.85(a)(2), Regulation Y of a reference to the Regulation K investment[253] authorities is of no consequence. For the same reason, it is consistent that FHC § 4(c) permissible activities are covered as a subgroup of FHC otherwise permissible Regulation Y activities by Section 225.85(a)(2), Regulation Y. Section 225.85(a)(2), Regulation Y simply provides that if notice under Regulation Y is required before engaging in an FHC § 4(c) permissible activity, such notice must be obtained and thereafter an FHC may engage in or acquire shares of a company engaged in such activities. Section 225.85(a)(2), Regulation Y is intended to say that if an FHC engages in activities not on the basis of the FHC authority set forth in Section 4(k), BHCA[254] but on the basis of authorities that are also available to BHCs that are not FHCs, notice and approval provisions relating to such authorities remain in effect.[255] Bluntly stated, Section 225.85(a)(2), Regulation Y is a superfluous provision.

Section 4(n), BHCA, 12 U.S.C. § 1843(n) (1994 & Supp. V 1999). However, grandfathered activities are not covered by Regulation Y and a grandfathered company cannot be acquired by an FHC. *See infra* E.2.

249 12 C.F.R. § 225.85(a)(2) (2002) (Regulation Y). *See* 12 C.F.R. § 225.86 (2002) (Regulation Y).

250 Complementary activities are permitted by § 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999), and the acquisition of banks and BHCs is governed by § 3, BHCA, 12 U.S.C. § 1842 (1994 & Supp. V 1999).

251 *See supra* C.1. *sub* (2)(ii).

252 12 C.F.R. § 225.85(a)(2) (2002) (Regulation Y).

253 It is curious that investments by BHCs outside the United States, which are covered by 12 C.F.R. §§ 211.8 & 211.10 (2002) (Regulation K), are not included in the FHC otherwise permissible activities of 12 C.F.R. § 225.85(a)(2) (2002) (Regulation Y).

254 12 U.S.C. § 1843(k) (1994 & Supp. V 1999).

255 12 C.F.R. § 225.85(a)(2) (2002) (Regulation Y) has the function of a cross-reference, but it is an incomplete cross-reference.

What activities are encompassed by FHC § 4(c) permissible activities? As stated above, such activities are all activities permissible for an FHC under Section 4(c), BHCA.[256] The relationship between the categories of financial activities and FHC § 4(c) permissible activities requires further analysis. The Board has stated that the various sections of the BHCA that authorize activities for BHCs and FHCs, most notably Sections 4(c)(8), 4(c)(9), 4(c)(13) and 4(k), BHCA,[257] remain separate sources of authority under which an FHC may engage in various activities.[258] If an FHC gives notice to the appropriate Federal Reserve Bank that it wishes to engage in an activity permitted under Section 4(c)(8), BHCA and set forth on the laundry list of Section 225.28, Regulation Y,[259] the question arises whether this Section 225.28, Regulation Y activity is an "activity listed in § 225.86"[260] (a financial activity) or an FHC § 4(c) permissible activity.

The Section 225.28, Regulation Y activities are referred to in Section 225.86(a), Regulation Y.[261] Since the Board thinks in terms of authorities rather than in terms of actual activities,[262] it can be expected that the Board will not consider activities that are set forth on the laundry list of Section 225.28, Regulation Y and are applied for under the authority of Section 4(c)(8), BHCA (and not exercised under the authority of Section 4(k), BHCA) as financial activities, *i.e.*, "activities listed in § 225.86",[263] even though such activities are also referred to in Section 225.86, Regulation Y. This interpretation also makes substantive sense, because an FHC may engage in Section 225.86, Regulation Y activities without prior notice or approval, but it may engage in Section 225.28, Regulation Y activities, at least in most cases, only upon notice[264] if those activities are exercised under the authority of Section 4(c)(8), BHCA.

The Section 225.28, Regulation Y activities that are exercised under the authority of Section 4(c)(8), BHCA rather than the authority of Section 4(k), BHCA are FHC § 4(c) permissible activities and are counted together with financial activities in the determination of whether or not a company acquired by an FHC is exclusively or substantially engaged in

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256 12 U.S.C. § 1843(c) (1994 & Supp. V 1999). Complementary activities and the acquisition of banks and BHCs are not permitted by § 4(c), BHCA, 12 U.S.C. § 1843(c) (1994 & Supp. V 1999) and therefore are not FHC § 4(c) permissible activities. Financial activities are permitted by § 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999), and are not FHC § 4(c) permissible activities.

257 12 U.S.C. § 1483(c)(8), (c)(9), (c)(13) & (k) (1994 & Supp. V 1999).

258 *See infra* C.8.

259 12 C.F.R. § 225.28 (2002) (Regulation Y). *See* Gruson, *supra* note 1, § 10.10 D for a discussion of the notice procedures under § 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999).

260 12 C.F.R. § 225.85(a)(1) & (2) (2002) (Regulation Y).

261 12 C.F.R. § 225.86(a) (2002) (Regulation Y).

262 *See infra* C.8.

263 12 C.F.R. § 225.85(a)(1) & (2) (2002) (Regulation Y).

264 *See* Gruson, *supra* note 1, § 10.10 D.

financial activities and FHC § 4(c) permissible activities.[265] The Section 225.28, Regulation Y activities that are exercised under the authority of Section 4(c)(8), BHCA rather than under the authority of Section 4(k), BHCA are also FHC otherwise permissible Regulation Y activities because, as stated above, the category *FHC otherwise permissible Regulation Y activities* includes *FHC § 4(c) permissible activities*. Section 225.28, Regulation Y activities that are exercised under the authority of Section 4(c)(8), BHC are permissible under Regulation Y and are not "activities listed in § 225.86". The admonition of Section 225.85(a)(2), Regulation Y[266] that such activities can only be exercised in accordance with applicable notice requirements applies to such Section 225.28, Regulation Y activities.

The discussion relating to Section 225.28, Regulation Y activities that are exercised under the authority of Section 4(c)(8), BHCA equally applies to Section 211.10, Regulation K[267] activities that are exercised by BHCs under the authority of Section 4(c)(13), BHCA[268] and not under the authority of Section 4(k), BHCA.[269] Such activities are FHC § 4(c) permissible activities. Shares acquired in satisfaction of debt previously contracted pursuant to Section 4(c)(2), BHCA may serve as a further example for an FHC § 4(c) permissible activity.[270]

An FHC may make an investment in a company that is not only engaged in financial activities but also in FHC § 4(c) permissible activities without violating the exclusivity requirement.[271]

The above discussion is illustrated by the following diagrams:

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265 *See* 12 C.F.R. § 225.85(a)(3) (2002) (Regulation Y). It is curious that 12 C.F.R. § 225.85(a) is drafted as if FHC § 4(c) permissible activities can only contribute to a company that is substantially engaged in financial activities (12 C.F.R. § 225.85(a)(3)(i)(A) (2002) (Regulation Y)) but not to a company that is exclusively engaged in financial activities (12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y)). The case of a company, all of whose activities are either financial activities or FHC § 4(c) permissible activities, is not specifically addressed in 12 C.F.R. § 225.85(a) (2002) (Regulation Y), but this does not create problems. An FHC may invest in such company if applicable notice requirements have been complied with (12 C.F.R. § 225.85(a)(2) (2002) (Regulation Y)); no divestiture is required (12 C.F.R. § 225.85(a)(3)(i)(A) & (C) (2002) (Regulation Y)). *See supra* note 233.

266 12 C.F.R. § 225.85(a)(2) (2002) (Regulation Y)

267 12 C.F.R. §§ 211.8 & 211.10 (2002) (Regulation K). A BHC is an investor in the meaning of 12 C.F.R. § 211.8(c) (2002) (Regulation K). 12 C.F.R. § 211.2(o) (2002) (Regulation K).

268 12 U.S.C. § 1843(c)(13) (1994).

269 12 U.S.C. § 1843(k) (1994 & Supp. V 1999).

270 12 U.S.C. § 1843(c)(2) (1994 & Supp. V 1999).

271 *See supra* note 265.

Diagram 6

Categories Used in Section 225.85, Regulation Y

Financial activities:	FHC otherwise permissible Regulation Y activities:
Set forth on the laundry list of 12 C.F.R. § 225.86	FHC § 4(c) permissible activities
	Complementary activities
	U.S. bank and BHC acquisitions and savings bank acquisitions

Diagram 7

Acquisition of Company Exclusively or Substantially Engaged in Financial Activities

(a) Companies Exclusively Engaged in Financial Activities

financial activities	financial activities
	FHC § 4(c) permissible activities

(b) Companies Substantially Engaged in Financial Activities

financial activities	financial activities
	FHC § 4(c) permissible activities
15% FHC non-permissible activities	15% FHC non-permissible activities

The rules applicable to FHCs are not limited to activities in the United States. An FHC may conduct any financial activities at any location in the United States or at any location outside the United States, subject, of course, to the laws of the jurisdiction in which the activity is conducted.[272]

8. Acquiring Banks, Insurance Companies and Securities Firms

The BHCA permits an FHC to own an insurance company or insurance broker or agent subsidiary, a bank, a broker-dealer or an investment adviser. The BHCA, however, does not modify the provisions of various statutes that subject the acquisition of control of such companies to regulatory approvals or other requirements. Thus, the acquisition of a U.S. bank or BHC requires Board approval under Section 3, BHCA[273] and the acquisition of a foreign bank requires compliance with Sections 211.8 & 211.9, Regulation K.[274]

If an FHC acquires a licensed broker-dealer, the broker-dealer is required to obtain approval for the acquisition from the self-regulatory organization that is its designated examining authority, for example, the New York Stock Exchange ("NYSE") or the National Association of Securities Dealers, Inc. ("NASD").[275] If an FHC acquires an investment adviser,

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272 12 C.F.R. § 225.85(b) (2002) (Regulation Y); Board release accompanying interim rules §§ 225.85–225.89, 65 Fed. Reg. 14,433–40, at 14,434 (Mar. 17, 2000) (Regulation Y, Docket No. R-1062) [*herein* Interim Financial Activities Release]. (The Board release accompanying the final rules 12 C.F.R. §§ 225.85–225.89 (2002) (Regulation Y) is the Final FHC Release, *supra* note 32.) The territorial limitations of 12 C.F.R. §§ 211.8 & 211.10 (2002) (Regulation K) relating to investments by BHC outside the United States do not apply to FHCs. *See* Final FHC Release, *supra* note 32, at 406 n.14. The territorial restrictions of 12 C.F.R. § 211.8(a) (2002) (Regulation K), however, continue to apply to BHCs that have not elected to be FHCs. Section 4(k)(4)(G) BHCA, 12 U.S.C. 1843(k)(4)(G) (1994 & Supp. V 1999), is confusing because it permits engaging in 12 C.F.R. §§ 211.8 & 211.10 (2002) (Regulation K) (previously 12 C.F.R. § 211.5) activities "in the United States". None of the other financial activities pre-approved by § 4(k)(4), BHCA, 12 U.S.C. § 1843(k)(4) (1994 & Supp. V 1999), has the "in the United States" reference, and the Board has not read it as a limitation. Final FHC Release, *supra* note 32, at 406 n.14. The authority to engage in insurance activities, § 4(k)(4)(B), BHCA, 12 U.S.C. § 1843(k)(4)(B) (1994 & Supp. V 1999), permits the activity "in any state" and the insurance portfolio investment authority, § 4(k)(4)(I)(iii), BHCA, 12 U.S.C. § 1843(k)(4)(I)(iii) (1994 & Supp. V 1999), refers to state law. Again, these references must not be read, and the Board did not read such references, as limiting the authority to the United States. In all the above cases, the references to the United States or the states indicated that Congress intended to overcome the territorial restrictions of prior law rather than to establish new territorial limitations.

273 12 U.S.C. § 1842 (1994 & Supp. V 1999). *See supra* note 250. *See* Final FHC Release, *supra* note 32, at 405.

274 12 C.F.R. §§ 211.8 & 211.9 (2002) (Regulation K). *See* Final FHC Release, *supra* note 32, at 405. *See also infra* D.2.i (discussing whether an FHC in the exercise of its merchant banking investment authority may invest in a bank or BHC).

275 *See* NYSE Manual, Rule 312(e) in connection with Rule 311(b)(2); NASD Manual, Rule 1017(a). Self-regulatory organizations are empowered by § 15, Securities and Exchange Act of 1934, 15 U.S.C. § 78*o*-3 (1994), to issue rules within their assigned fields which are subject to SEC approval. Section 19, Securities and Exchange Act of 1934, 15 U.S.C. § 78s (1994).

the FHC must be registered as investment adviser. In addition, in connection with the acquisition of an investment adviser it is necessary to obtain its customers' consents.[276]

When entering into the insurance business in a state of the United States, a person must comply with the applicable state insurance law. Any person that desires to engage in the business of insurance in a state, whether as principal or agent, must obtain a license and is subject to regulation under applicable state law.[277] Equally, "any proposed acquisition of, or a change or continuation of control of, an insurer" domiciled in a state is subject to approval or disapproval by the state in which the insurer is domiciled.[278] This approval power also applies to affiliations between depository institutions, or any affiliate thereof (which includes an FHC of a depository institution), and any insurer.[279] However, in the case of such affiliations the ability of the insurance commissioner of the state of domicile to approve or disapprove an acquisition of control is limited to a 60-day window preceding the effective date of the acquisition or change or continuation of control.[280] During that 60-day period the insurance commissioner of the state of domicile of the insurer may require the acquiror to maintain or restore the insurer's capital up to the amount required by the state's capital regulations.[281]

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276 Section 203(g), Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(g) (1994), provides that a successor to the business of a registered investment adviser must file an application for registration within 30 days of the acquisition. This applies also to the acquisition of a registered investment adviser. Furthermore, an investment adviser may only enter into investment advisory contracts that provide that no assignment of the contract may be made by the investment adviser without the consent of the customer. Section 205(a)(2), Investment Advisers Act of 1940, 15 U.S.C. § 80b-5(a)(2) (1994). *Assignment* is defined in Section 202(a)(1), Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(1) (1994), to include the "transfer of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor".

277 15 U.S.C. § 6701(b) (1994 & Supp. V 1999). The McCarran-Ferguson Act, 15 U.S.C. § 1011 *et seq*. (1994 & Supp. V 1999), which requires federal deference in most cases to state regulation of insurance activities, remains in force. 15 U.S.C. § 6701(a) & (d)(3)(A) (1994 & Supp. V 1999). The McCarran-Ferguson Act provides that "no Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any state for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance". 15 U.S.C. § 1012(b) (1994).

Generally speaking, an FHC that wishes to acquire an insurance underwriter, known under most state laws as an insurance company, will be required to file change in control forms in the state of domicile of the target and obtain approval by the superintendent. *See, e.g.*, § 1506(a), N.Y. Ins. Law (McKinney 2000). A party who will sell insurance and receive commissions must obtain an insurance agent's license. *See, e.g*., § 2102, N.Y. Ins. Law (McKinney 2000). Thus, the sale of insurance typically requires corporate licensing and individual agent licensing both in the resident state and in all nonresident states. The GLBA preserves state insurance licensing schemes for insurance agents, but includes provisions requiring uniform and reciprocal licensing procedures in the states. 15 U.S.C. §§ 6751–6766 (1994 & Supp. V 1999).

278 15 U.S.C. § 6701(c)(2)(A)(i) (1994 & Supp. V 1999).

279 15 U.S.C. § 6701(c)(2)(A)(1994 & Supp. V 1999).

280 15 U.S.C. § 6701(c)(2)(A) (1994 & Supp. V 1999). Furthermore, the insurance commissioner of any state where the insurer is engaged in the business of insurance and regulated as an insurer may collect information during the 60-day period. 15 U.S.C. § 6701(c)(2)(A)(ii) (1994 & Supp. V 1999).

281 15 U.S.C. § 6701(c)(2)(B) (1994 & Supp. V 1999).

The state power over licensing and approval of acquisitions of insurance companies or insurance agents is limited, in that, generally speaking, a state may not restrict or discriminate against a depository institution or an affiliate thereof (which includes an FHC of a depository institution). No state may prevent or restrict a depository institution, or an affiliate thereof, from being affiliated, directly or indirectly, or associated with any person, as authorized or permitted by the GLBA or any other provision of federal law.[282]

The actions by a state in connection with the approval or disapproval and the collection of information in connection with an acquisition of, or change or continuation of control of, an insurer must not have the effect of discriminating, intentionally or unintentionally, against a depository institution or an affiliate thereof, or against any other person based upon an association of any such person with a depository institution.[283] Thus, state anti-affiliation laws are federally preempted. Another provision protects depository institutions and FHCs controlling depository institutions against state actions that may prevent or restrict depository institutions or their affiliates from engaging, directly or indirectly, either by themselves or in conjunction with an affiliate or any other person, in any activity authorized or permitted under the GLBA.[284] Finally, a state may not regulate insurance activities authorized by the GLBA or other federal law of a depository institution or affiliate thereof in a manner that discriminates against the depository institution or affiliate.[285]

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282 15 U.S.C. § 6701(c)(1) (1994 & Supp. V 1999). The prohibited state action may be a statute, a regulation, an order, an interpretation or any other action. *Id.* The term *associated* as used in 15 U.S.C. § 6701(c)(1) is not defined. In its context the term would seem to cover joint ventures, contractual and other relationships between individuals, companies and other persons engaged in financial or other activities allowed under the GLBA or other federal law. *See* Neal R. Pandozzi, *Beware of Banks Bearing Gifts: Gramm-Leach-Bliley and the Constitutionality of Federal Financial Privacy Legislation*, 55 U. MIAMI L. REV. 163, 178.

283 15 U.S.C. § 6701(c)(2)(A) & (C) (1994 & Supp. V 1999).

284 15 U.S.C. § 6701(d)(1) (1994 & Supp. V 1999). The state action may be a statute, a regulation, an order, an interpretation or any other action.

Special rules apply to state action dealing with insurance sales, solicitation and cross-marketing [*herein* state insurance sales laws]. State insurance sales laws may not prevent or *significantly* interfere with insurance sales, solicitation or cross-marketing activities of depository institutions and their affiliates. Such preventing or significantly interfering state insurance sales laws are preempted. 15 U.S.C. § 6701(d)(2)(A) (1994 & Supp. V 1999) (expressly incorporating the legal standards for preemption set forth in Barnett Bank of Marion County N.A. v. Nelson, 517 U.S. 25 (1996)). State insurance sales laws are also preempted if they are discriminatory under the four-pronged test of 15 U.S.C. § 6701(e) (1994 & Supp. V 1999). However, the § 6701(e) discrimination test does not apply to any state insurance sales law enacted before Sept. 3, 1998 or to state insurance sales laws falling within one of the 13 safe harbors of 15 U.S.C. § 6701(d)(2)(B). 15 U.S.C. § 6701(d)(2)(C). *See* Pandozzi, *supra* note 282, at 179–81.

15 U.S.C. § 6701(d)(2)(A) is a federal act that "specifically relates to the business of insurance". 15 U.S.C. § 1012(b) (1994). Thus, in accordance with *Barnett Bank*, *supra*, and the McCarran-Ferguson Act, *supra* note 277, state law cannot override, restrict or significantly interfere with 15 U.S.C. § 6701(d)(2). *See* Pandozzi, *supra* note 282, at 179.

285 15 U.S.C. § 6701(e) (1994 & Supp. V 1999). Discrimination must be determined under a four-pronged test. The State action may be a statute, or regulation, an order, an interpretation or any other action.

The antidiscrimination provisions discussed above,[286] protecting depository institutions engaging or desiring to engage directly, indirectly or through affiliates in insurance activities, also protect foreign banks maintaining a U.S. branch, agency or commercial lending company and companies controlling such banks. *Depository institution*, for purposes of the antidiscrimination provisions, includes not only depository institutions under Section 3, FDIA[287] but also foreign banks that maintain a branch, agency or commercial lending company in the United States.[288] Since the provisions protecting the insurance business of depository institutions against state action generally also refer to affiliates of the depository institutions, [289] affiliates of such foreign banks are also protected.

The provisions discussed above have the purpose of preventing the states from using their regulatory power over insurance companies in a discriminatory manner against FHCs that wish to acquire or establish insurance companies. The reverse is also true: the states may not, by law, regulation, order, interpretation or otherwise, prevent or significantly interfere with the ability of any insurer or any affiliate of an insurer to become an FHC or to acquire control of a depository institution[290] or limit the amount of an insurer's assets that may be invested in the voting securities of a depository institution or any company which controls such institution.[291] The state of an insurer's domicile may, however, by law limit the amount of the insurer's assets that may be invested in the voting securities of a depository institution or a company controlling such depository institution to an amount that is not less than 5 percent of the insurer's admitted assets.[292]

Mutual insurance companies can affiliate with banks only by buying a bank.[293]

See also 12 U.S.C. § 6701(d)(3) (1994 & Supp. V 1999) (to avoid federal preemption, state laws that govern insurance activities (other than state insurance sales laws) must meet a four-part test, one part being that they must be non-discriminatory under 15 U.S.C. § 6701(e)).

286 15 U.S.C. § 6701 (1994 & Supp. V 1999). *See supra* text accompanying notes 282–285.

287 12 U.S.C. § 1813 (1994 & Supp. V 1999).

288 15 U.S.C. § 6701(g)(3) (1994 & Supp. V 1999).

289 *Affiliate* is defined for purposes of 15 U.S.C. § 6701 (1994 & Supp. V 1999) in 15 U.S.C. § 6701(g)(1) as "any company that controls, is controlled by, or is under common control with, another company."

290 15 U.S.C. § 6715(1) (1994 & Supp. V 1999).

291 15 U.S.C. § 6715(2) (1994 & Supp. V 1999).

292 15 U.S.C. § 6715(2) (1994 & Supp. V 1999). *See, e.g.*, § 1301, N.Y. Ins. Law (McKinney 2000) for definitions of admitted assets.

293 15 U.S.C. § 6715(2) (1994 & Supp. V 1999). 15 U.S.C. § 6715(3) prohibits the states from preventing or significantly interfering with the demutualization of mutual insurers except for the state of domicile of the insurer. *See* Wolcott B. Dunham, Jr., Ivan E. Mattei & Thomas M. Kelly, *Financial Services Reform: The New Business of Banking and Insurance under Gramm-Leach-Bliley*, 1232 PLI/Corp. 121, at 148–50 for a discussion of affiliations with mutual insurers. *See* 15 U.S.C. § 6701(c)(2)(C) (1994 & Supp. V 1999) (a state may not restrict a change in the ownership of stock of a holding company formed to control an insurer

9. Types of Financial Activities – Overview

The BHCA distinguishes between financial activities predetermined by and set forth in the BHCA,[294] additional financial activities determined by the Board in conjunction with the Secretary of the Treasury,[295] pre-approved additional financial activities enumerated in the BHCA but still requiring action by the Board (in conjunction with the Secretary of the Treasury),[296]activities incidental to financial activities as determined by the Board in conjunction with the Secretary of the Treasury,[297] and activities determined by the Board to be complementary to financial activities.[298] Complementary activities are nonfinancial activities that may be engaged in by FHCs. The Board in Regulation Y uses the term *financial activities* to include financial activities predetermined by and set forth in the BHCA, additional financial activities, and pre-approved additional financial activities.[299] All financial activities are listed or referred to in Section 225.86, Regulation Y.[300] Complementary activities are subject to different

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after conversion of a mutual to a stock form in a manner discriminating against depository institutions or their affiliates).

294 Section 4(k)(4), BHCA, 12 U.S.C. § 1843(k)(4) (1994 & Supp. V 1999), contains a list of statutorily predetermined financial activities. Since the activities listed in § 4(k)(4), BHCA "shall be considered to be financial in nature", the Board has no discretion with respect to the predetermined listed activities. It cannot decrease, limit or restrict such powers. The congressional intent, as expressed in a colloquy between Senator Dodd and Senator Gramm, is that the financial activities of § 4(k)(4), BHCA are permissible upon the effective date of the GLBA without further action by the regulators. 145 CONG. REC. S13,901 (daily ed.) (Nov. 4, 1999). The conferees have recognized, however, that "refinements in rulemaking may be necessary and desirable going forward." *Id.* An identical statement was made by Representative Leach, 145 CONG. REC. H11,529 (daily ed.) (Nov. 4, 1999).

295 Section 4(k)(1)(A) & (2), BHCA, 12 U.S.C. § 1843(k)(1)(A) & (2) (1994 & Supp. V 1999). *See infra* C.5. for a discussion of additional financial activities.

296 Section 4(k)(5), BHCA, 12 U.S.C. § 1843(k)(5) (1994 Supp. V 1999). *See infra* C.6. for a discussion of pre-approved additional financial activities.

297 Section 4(k)(1)(A) & (2), BHCA, 12 U.S.C. § 1843(k)(1)(A) & (2) (1994 & Supp. V 1999).

298 Section 4(k)(1)(B), BHCA, 12 U.S.C. § 1843(k)(1)(B) (1994 & Supp. V 1999). *See infra* C.7. for a discussion of complementary activities.

299 Financial activities predetermined by and set forth in the BHCA: 12 C.F.R. § 225.86(a), (b) & (c) (2002) (Regulation Y); additional financial activities: 12 C.F.R. § 225.88 (2002) (Regulation Y) (procedure for determination of an activity as additional financial activity), 12 C.F.R. § 225.86(d)(1) (2002) (Regulation Y) (acting as finder), *see infra* note 323, and proposed § 225.86(d)(2) & (3), Regulation Y (to be codified as 12 C.F.R § 225.86(d)(2) & (3) (2002) (Regulation Y)) (real estate brokerage and real estate management determined to be additional financial activities), *see infra* notes 324 & 325; pre-approved additional financial activities: interim rule 12 C.F.R. § 225.86(e) (2002) (Regulation Y) (procedure for determination of a pre-approved financial activity as additional financial activity). *See* Final FHC Release, *supra* note 32, at 404 n.7.

300 12 C.F.R. § 225.86 (2002) (Regulation Y).

rules than financial activities and, not being financial activities, are not listed in Section 225.86, Regulation Y.[301]

Although Section 4(k)(1)(A), BHCA[302] clearly makes a distinction between financial activities and activities incidental to financial activities and although the term *incidental* has a distinct meaning in U.S. banking law,[303] the Board in Regulation Y disregards any distinction between the two categories of activities and labels all financial activities as "financial in nature or incidental to a financial activity".[304] Thus, the Board treats both terms as synonymous. Since plain English indicates that an activity can be incidental to another activity of a certain type without belonging to that type, the Board's interpretation of Section 4(k)(1)(A), BHCA limits the range of activities permitted to be engaged in by FHCs.[305]

An FHC or other interested party may request an advisory opinion from the Board about whether a specific proposed activity falls within the scope of an activity listed in Section 225.86, Regulation Y[306] as financial in nature or incidental to a financial activity.[307]

10. Laundry List of Financial Activities – Section 225.86, Regulation Y

In Section 225.86, Regulation Y,[308] the Board sets forth or refers to (1) all financial activities that are predetermined as financial activities by and set forth in the BHCA[309] and (2) all additional financial activities that the Board and the Secretary of the Treasury have

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301 Section 4(k)(1)(B), BHCA, 12 U.S.C. § 1843(k)(1)(B) (1994 & Supp. V 1999); 12 C.F.R. § 225.89 (2002) (Regulation Y). *See infra* C.7. for a discussion of complementary activities.

302 12 U.S.C. § 1843(k)(1)(A) (1994 & Supp. V 1999).

303 *See* Gruson, *supra* note 1, § 10.13 B.3., at 834–43 (discussing the use of the term *incidental* in various U.S. banking laws and regulations).

304 *See, e.g.*, 12 C.F.R. §§ 225.86 (introductory clause), 225.88(a) (2002) (Regulation Y). For example, in the Board release accompanying 12 C.F.R. § 225.86(d)(1), 65 Fed. Reg. 80,735–41 (Dec. 22, 2000), the Board did not distinguish whether the activity of acting as a finder that the Board added to the laundry list in 12 C.F.R. § 225.86(d)(1) (2002) (Regulation Y) as additional financial activity is a financial activity or an incidental activity. *See also* Board release accompanying proposed 12 C.F.R. § 225.86(d)(1), 65 Fed. Reg. 47,696–701 (Aug. 3, 2000).

305 Incidental to an activity means dependent on, or appertaining to, another thing (the activity); directly and immediately pertinent to, or involved in, something else, though not an essential part of it. WEBSTER'S NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE (1933).

306 12 C.F.R. § 225.86 (2002) (Regulation Y).

307 12 C.F.R. § 225.88(e) (2002) (Regulation Y). The Board will provide an advisory opinion within 45 calendar days from receiving a complete written request for an advisory opinion. 12 C.F.R. § 225.88(e)(2) (2002) (Regulation Y). As to the required contents of the written request, *see* 12 C.F.R. § 225.88(e)(1) (2002) (Regulation Y).

308 12 C.F.R. § 225.86 (2002) (Regulation Y).

309 Section 4(k)(4), BHCA, 12 U.S.C. § 1843(k)(4) (1994 & Supp. V 1999).

determined to be financial in nature.[310] The Board will add to Section 225.86, Regulation Y all pre-approved additional financial activities that the Board and the Secretary of the Treasury will in the future determine to be financial activities.[311] The following is a summary of the financial activities laundry list:

Financial Activities Predetermined by the BHCA

- lending business: (i) lending, exchanging, transferring or safeguarding money, (ii) lending, exchanging, transferring or safeguarding securities and (iii) investing monies for others;[312]

- insurance: insurance business as principal, broker or agent, in connection with life, accident and health, property and casualty, liability, disability insurance and issuing annuities;[313]

- advisory services: providing financial, investment or economic advisory services, including advising investment companies, as defined in Section 3, Investment Company Act of 1940;[314]

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310 *See supra* C.3. and *infra* C.5.

311 *See supra* C. 3. and *infra* C.6.

312 Section 4(k)(4)(A), BHCA, 12 U.S.C. § 1843(k)(4)(A) (1994 & Supp. V 1999); 12 C.F.R. § 225.86(c) (2002) (Regulation Y). Money lending is also permitted by 12 C.F.R. § 225.28(b)(1) (2002) (Regulation Y); safeguarding money is also permitted to some extent by 12 C.F.R. § 225.28(c) (2002) (Regulation Y) (safe deposit business).

313 Section 4(k)(4)(B), BHCA, 12 U.S.C. § 1843(k)(4)(B) (1994 & Supp. V 1999) ("insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities"); 12 C.F.R. § 225.86(c) (2002) (Regulation Y). *Insurance* includes reinsurance. *See* Final FHC Release, *supra* note 32, at 405; Interim Financial Activities Release, *supra* note 272, at 14,435. *See infra* D.1. for a discussion of the authority to engage in insurance activities and the investment authority related thereto and D.4. for a discussion of the investment authority related thereto.

Before the adoption of the GLBA, a BHC could, and it may continue to, (i) underwrite or sell as agent accident, health, life and unemployment insurance, that is related to credit extended by the BHC or its subsidiaries, 12 C.F.R. § 225.28(b)(11)(i) (2002) (Regulation Y), (ii) sell as agent property insurance that is related to small credits issued by the BHC's finance company subsidiary, 12 C.F.R. § 225.28(c)(11)(ii) (2002) (Regulation Y), and (iii) perform insurance agency activities from a place with a population of 5,000 or less (or which has otherwise inadequate insurance facilities, as determined by the Board) if the BHC or any of its subsidiaries has a lending office in such small town (insurance can be sold to customers nationwide from such location, regardless of the customer's location), 12 C.F.R. § 225.28(b)(11)(iii) (2002) (Regulation Y). *See* 12 U.S.C. § 92 (1994).

314 Section 4(k)(4)(C), BHCA, 12 U.S.C. § 1843(k)(4)(C) (1994 & Supp. V 1999); 12 C.F.R. § 225.86(c) (2002) (Regulation Y). These activities are also already permitted in a somewhat more limited form by 12 C.F.R. § 225.28(b)(6) (2002) (Regulation Y). *See* § 3, Investment Company Act of 1940, 15 U.S.C. §§ 80a-3 (1994 & Supp. V 1999).

- securitization: issuing and selling instruments representing interests in pools of assets permissible for a bank to hold directly;[315]

- securities activities: securities underwriting, dealing or market making;[316]

- activities closely related to banking: Section 4(c)(8), BHCA activities, *i.e.*, the same activities that are "closely related to banking" in which a BHCA that has not elected FHC status may engage in after the adoption of the GLBA;[317]

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315 Section 4(k)(4)(D), BHCA, 12 U.S.C. § 1843(k)(4)(D) (1994 & Supp. V 1999); 12 C.F.R. § 225.86(c) (2002) (Regulation Y). For pre-GLBA law, *see* Securities Industry Association v. Security Pacific N.A., 885 F.2d 1034, 1047 (2d Cir. 1989) (national bank's sale of mortgage pass-through certificates is within the business of banking).

316 Section 4(k)(4)(E) & (H), BHCA, 12 U.S.C. § 1843(k)(4)(E) & (H) (1994 & Supp. V 1999); 12 C.F.R. § 225.86(c) (2002) (Regulation Y). *Dealer* is defined in § 3(a)(5)(A), Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(5)(A) (1994 & Supp. V 1999). *See infra* D.1. for a discussion of the authority to engage in the activities of underwriting and dealing and the investment authority related thereto and D.3. for a discussion of the investment authority related thereto.

317 Section 4(k)(4)(F), BHCA, 12 U.S.C. § 1843(k)(4)(F) (1994 & Supp. V 1999), referring to § 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999); 12 C.F.R. § 225.86(a) (2002) (Regulation Y). Section 4(k)(4)(F), BHCA refers to activities that the Board has determined, by order or regulation that is in effect on the date of enactment of the GLBA (Nov. 12, 1999) [§ 4(c)(8), BHCA refers to Nov. 11, 1999], to be closely related to banking. Thus, the § 4(c)(8), BHCA activities are frozen. *See* Gruson, *supra* note 1, § 10.10 C.

The § 4(c)(8), BHCA activities determined by Board regulation to be closely relating to banking are listed on the laundry list of 12 C.F.R. § 225.28 (2002) (Regulation Y) that is referred to in 12 C.F.R. § 225.86(a)(1) (2002) (Regulation Y).

Activities that the Board had determined by an order that was in effect on Nov. 12, 1999 to be closely related to banking and that therefore may be engaged in by FHCs are set forth in 12 C.F.R. § 225.86(a)(2) (2002) (Regulation Y). They are: (i) providing administrative and other services to mutual funds; (ii) owning shares of a securities exchange; (iii) acting as a certification authority for digital signatures and authenticating the identity of persons conducting financial and nonfinancial transactions; (iv) providing employment histories to third parties for use in making credit decisions and to depository institutions and their affiliates for use in the ordinary course of business; (v) check cashing and wire transmission services; (vi) in connection with the offering of banking services, providing notary public services, selling postage stamps and postage-paid envelopes, providing vehicle registration services, and selling public transportation tickets and tokens; and (vii) real estate title abstracting.

FHCs that engage in any activity pursuant to 12 C.F.R. § 225.86(a)(1) (2002) (Regulation Y) must conduct the activity in accordance with the terms of and conditions contained in 12 C.F.R. § 225.28 (2002) (Regulation Y), and FHCs that engage in any activity pursuant to 12 C.F.R. § 225.86(a)(2) (2002) (Regulation Y) must conduct the activity in accordance with the Board orders authorizing the activity which are referenced in 12 C.F.R. § 225.28(a)(2) (2002) (Regulation Y). Sections 4(c)(8) & 4(k)(4)(F), BHCA, 12 U.S.C. §§ 1843(c)(8) & 1843(k)(4)(F) (1994 & Supp. V 1999). The Board may modify such terms and conditions. *See* §§ 4(c)(8) & 4(k)(4)(F), BHCA and 12 C.F.R. § 225.86(a)(1) (2002) (Regulation Y) (each containing the clause "unless modified by the Board"). *See generally* Final FHC Release, *supra* note 32, at 405. For example, the Board has proposed to modify 12 C.F.R. § 225.28(b)(14) (data processing) by increasing from 30 to 49 percent the amount of revenues that may be derived from

- management consulting: providing management consulting services, including to any person with respect to nonfinancial matters, as long as the management consulting services are advisory and do not allow the FHC to control the person to which the services are provided;[318]

- travel agency business: operating a travel agency in connection with financial services offered by the FHC to others;[319]

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nonfinancial data processing. The Board proposes this change as a change of the conditions that govern the conduct of financial data processing activities. Complementary Activities Release, *infra* note 362, at 80,385; proposed § 225.28(b)(14), Regulation Y, 65 Fed. Reg. 80,387–88 (Dec. 21, 2000).

318 Section 4(k)(4)(G), BHCA, 12 U.S.C. § 1843(k)(4)(G) (1994 & Supp. V 1999), permits FHCs to engage in activities (inside or outside the United States) in which a BHC may engage in outside the United States pursuant to 12 C.F.R. § 211.5 (2001) (Regulation K), as in effect on Nov. 11, 1999 (the day before the enactment of the GLBA). Thus, the 12 C.F.R. § 211.5 (2001) (Regulation K) activities are frozen. 12 C.F.R. § 211.5 (2001) (Regulation K) was promulgated under Section 4(c)(13), BHCA, 12 U.S.C. § 1843(c)(13) (1994). The GLBA does not give the Board the power to modify the terms and conditions of the § 211.5, Regulation K laundry list activities as it does with respect to the laundry list activities of 12 C.F.R. § 225.28 (2002) (Regulation Y). *See* §§ 4(c)(8) & 4(k)(4)(F), BHCA, 12 U.S.C. §§ 1843(c)(8) & 1843(k)(4)(F) (1994 & Supp. V 1999). *See* Gruson, *supra* note 1, § 10.10 C. 12 C.F.R. § 225.86(b) (2002) (Regulation Y) states that the 12 C.F.R. § 211.5 (2001) (Regulation K) activities are financial activities "subject to the terms and conditions in part 211 [Regulation K] and Board interpretations in effect on [Nov. 11, 1999] regarding the scope and conduct of the activity". However, the notice procedures of Regulation K do not apply to activities that are conducted under § 4(k)(4), BHCA, 12 U.S.C. § 1843(k)(4) (1994 & Supp. V 1999). Final FHC Release, *supra* note 32, at 405 n.12.

Most activities set forth in the 12 C.F.R. § 211.5 (2001) (Regulation K) laundry list have been either authorized for FHCs in a broader form by the BHCA or are also contained in the laundry list of 12 C.F.R. § 225.28 (2002) (Regulation Y) that is based on Section 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999). The remaining activities of the § 211.5, Regulation K laundry list are enumerated in 12 C.F.R. § 225.86(b) (2002) (Regulation Y), and are set forth in this and the following two bullet points. *See* Interim Financial Activities Release, *supra* note 272, at 14,435. Because 12 C.F.R. § 225.86(b) (2002) (Regulation Y) sets forth the relevant activities that were contained on November 11, 1999 in § 211.5, Regulation K (12 C.F.R. § 211.5 (2001) (Regulation K)), it does not matter that the 2002 version of Regulation K modifies the activities in which a BHC may engage outside the United States. *See* 12 C.F.R § 211.10 (2002) (Regulation K).

The Board interprets § 4(k)(4)(G), BHCA, 12 U.S.C. § 1843(k)(4)(G) (1994 & Supp. V 1999), as permitting FHCs to engage in the activities that are listed in 12 C.F.R. § 211.5(d) (2001) (Regulation K) as interpreted by the Board, but not in activities that the Board has approved in individual orders under § 4(c)(13), BHCA, 12 U.S.C. § 1843(c)(13) (1994). Final FHC Release, *supra* note 32, at 405 n.11; Interim Financial Activities Release, *supra* note 272, at 14,435.

The management consulting services referred to in this bullet point are permitted by 12 C.F.R. § 225.86(b)(1) (2002) (Regulation Y) and were already permitted to be engaged in outside the United States by 12 C.F.R. § 211.5(d)(12) (2001) (Regulation K).

319 *See supra* note 318. Travel agency activities are permitted by 12 C.F.R. § 225.86(b)(2) (2002) (Regulation Y) and were already permitted to be engaged in outside the United States by 12 C.F.R. § 211.5(d)(15) (2001) (Regulation K). The Board's legal staff has indicated that the "in connection with financial services" requirement has a low threshold. Travel agency business is effectively prohibited to foreign banks that operate a U.S. branch, agency or commercial lending company in the United States but are not FHCs. *See* 12 C.F.R. § 211.23(f)(5)(iii)(B)(2) (2002) (Regulation K).

- mutual funds: organizing, sponsoring and managing a mutual fund, so long as (i) the fund does not exercise managerial control over the entities in which the fund invests, and (ii) the FHC reduces its ownership in the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund or such additional period as the Board permits;[320]

- owning securities as part of merchant banking investments: owning securities as part of bona fide underwriting or merchant or investment banking activities;[321] and

- owning securities as part of insurance company portfolio investments: owning securities in connection with investments made in the ordinary course of insurance business.[322]

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- acting as finder, *i.e.*, bringing together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate;[323]

- real estate brokerage (proposed);[324] and

- real estate management (proposed).[325]

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320 *See supra* note 318. Fund activities are permitted by 12 C.F.R. § 225.86(b)(3) (2002) (Regulation Y) and were already permitted to be engaged in outside the United States by 12 C.F.R. § 211.5(d)(11) (2001) (Regulation K).

321 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999); 12 C.F.R. § 225.86(c) (2002) (Regulation Y). *See infra* D.1. & 2. for a discussion of this authority.

322 Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999); 12 C.F.R. § 225.86(c) (2002) (Regulation Y). *See infra* D.1. & 4. for a discussion of this authority.

323 12 C.F.R. § 225.86(d)(1) (2002) (Regulation Y). *See* Board releases accompanying the proposed rule § 225.86(d)(1), 65 Fed. Reg. 47,696–701 (Aug. 3, 2000) (Regulation Y, Docket No. R-1078) and the final rule, 65 Fed. Reg. 80,735–41 (Dec. 22, 2000) (Regulation Y, Docket No. R-1078). *See also* the technical amendments to 12 C.F.R. § 225.86(d) & (e) (Regulation Y), 66 Fed. Reg. 19,081–82 (Apr. 13, 2001) (Regulation Y, Docket Nos. R-1078 and R-1094). *See* Julie L. Williams & James F.E. Gillespie, Jr., *The Impact of Technology on Banking: The Effect and Implications of "Deconstruction" of Banking Functions*, 5 N.C. BANKING INST. 135, 150–56 (2001), for a discussion of the activity of banks acting as finders.

324 Proposed § 225.86(d)(2), Regulation Y, 66 Fed. Reg. 313 (Jan. 3, 2001) (to be codified as 12 C.F.R. § 225.86(d)(2) (Regulation Y)). *See* Board release accompanying the proposed rule § 225.86(d)(2), 66 Fed. Reg. 307–14, at 308-11 (Jan. 3, 2001) (Regulation Y, Docket No. R-1091). The final rule has not been issued as of the date hereof.

Pre-approved Additional Financial Activities Determined by the Board and the Secretary of the Treasury

- None so far.

It must be emphasized that the authorities to engage in financial activities of (i) making merchant banking investments, (ii) making insurance company portfolio investments and (iii) underwriting, dealing and market-making differ from all other financial activities in that these three authorities permit the acquisition and ownership of companies that are *not* engaged in financial activities.

11. Determination of Activities as Additional Financial Activities

Although the BHCA may well have intended a distinction between an additional activity that is financial in nature and an activity that is incidental to a financial activity, the Board treats both terms as being synonymous[326] and refers in the procedure for the determination of additional financial activities to activities that are "financial in nature or incidental to a financial activity". [327] The procedure apparently does not permit a request to the Board for a determination of an additional activity as either only financial in nature or as only incidental to a financial activity.

An FHC or other interested party may request a determination from the Board that an activity not set forth in the BHCA and not previously determined by the Board to be a financial activity, in short, an activity not set forth in § 225.86, Regulation Y,[328] is "financial in nature or incidental to a financial activity".[329] It appears that a favorable determination by the Board will always result in an addition to the list of the financial activities set forth in Section 225.86, Regulation Y and not only in an order permitting the applicant to engage in the requested activity.[330]

Upon receipt of such request, the Board must notify the Secretary of the Treasury of, and consult with the Secretary about, such request.[331] The Secretary of the Treasury may

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325 Proposed § 225.86(d)(3), Regulation Y, 66 Fed. Reg. 313 (Jan. 3, 2001) (to be codified as 12 C.F.R. § 225.86(d)(3) (Regulation Y)). *See* Board release, *supra* note 324, at 311–13. The final rule has not been issued as of the date hereof.

326 *See supra* text accompanying notes 302–305.

327 12 C.F.R. § 225.88 (2002) (Regulation Y).

328 12 C.F.R. § 225.86 (2002) (Regulation Y).

329 12 C.F.R. § 225.88(a) (2002) (Regulation Y). This right to file a request with the Board is implied in § 4(k)(2)(A), BHCA, 12 U.S.C. § 1843(k)(2)(A) (1994 & Supp. V 1999). The information required to be submitted with such request is set forth in 12 C.F.R. § 225.88(b) (2002) (Regulation Y).

330 *See* Final FHC Release, *supra* note 32, at 407.

331 Section 4(k)(2)(A)(i), BHCA, 12 U.S.C. § 1843(k)(2)(A)(i) (1994 & Supp. V 1999); 12 C.F.R. § 225.88(c) (2002) (Regulation Y).

reject the request.[332] The BHCA also permits the Board to propose *ex officio* an activity as an additional financial activity or an activity incidental to a financial activity.[333] A proposal for an additional or incidental financial activity may also be originated by the Secretary of the Treasury and be recommended to the Board.[334] The Board may reject the proposal.[335] If the Board does not reject the Treasury proposal, the Board must initiate a public rule-making proposing that the recommended activity be found financial in nature or incidental to a financial activity.[336]

The determination of whether or not an activity is a financial activity or an activity incidental to a financial activity for an FHC is always made jointly by the Board and the Secretary of the Treasury. A BHC or an FHC, however, cannot submit a request to the Secretary of the Treasury to have an activity designated financial or incidental; they can submit such request only to the Board.

Factors that the Board must take into account when determining whether an activity is financial in nature or incidental to a financial activity are set forth in Section 4(k)(3), BHCA.[337] The Board has provided an interesting comparison between the test under Section 4(c)(8), BHCA[338] which requires an activity to be "closely related to banking" and the test under Section 4(k)(1)(A), BHCA[339] which requires that an activity is "financial in nature or incidental to a financial activity". The Board said that the financial activity test was specifically designed to create a test that is broader than the "closely related to banking" test of Section 4(c)(8), BHCA.[340] The "closely related to banking" test allows BHCs to conduct activities that are permissible for banks to conduct, are operationally similar to activities conducted by banks, or are activities that BHCs are particularly well equipped to conduct because of their other activities.[341] The new "financial in nature" test is intended to allow activities to be authorized in

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332 Section 4(k)(2)(A)(ii), BHCA, 12 U.S.C. § 1843(k)(2)(A)(ii) (1994 & Supp. V 1999). The Secretary of the Treasury must respond within 30 days to the request, § 4(k)(2)(A)(ii), BHCA, and the Board will endeavor to make a decision on the request within 60 calendar days following the completion of the consultative process with the Secretary of the Treasury and the public comment period, if any, pursuant to 12 C.F.R. § 225.88(c)(2) (2002) (Regulation Y). 12 C.F.R. § 225.88(d) (2002) (Regulation Y).

333 Section 4(k)(2)(A)(i), BHCA, 12 U.S.C. § 1843(k)(2)(A)(i) (1994 & Supp. V 1999).

334 Section 4(k)(2)(B)(i), BHCA, 12 U.S.C. § 1843(k)(2)(B)(i) (1994 & Supp. V 1999).

335 Section 4(k)(2)(B)(ii), BHCA, 12 U.S.C. § 1843(k)(2)(B)(ii) (1994 & Supp. V 1999).

336 *Id.*

337 12 U.S.C. § 1843(k)(3) (1994 & Supp. V 1999).

338 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999).

339 12 U.S.C. § 1843(k)(1)(A) (1994 & Supp. V 1999).

340 *See* Complementary Activities Release, *infra* note 362, at 80,385.

341 *Id.*

response to technological and other developments that more broadly affect the market for financial products and services.[342]

The Board has so far approved one additional financial activity (acting as finder) and proposed two additional financial activities (real estate brokerage and real estate management).[343]

12. Determination of Pre-approved Financial Activities as Additional Financial Activities

Section 4(k)(5), BHCA[344] contains a list of three activities[345] that are not designated by law as financial activities but that the BHCA mandates the Board to define as being financial in nature.[346] Thus, Congress has determined that these three activities are in concept financial in nature. The Board has the power to determine by regulation or order the extent to which such activities are financial in nature or incidental to a financial activity.[347]

Because these three activities encompass a wide range of activities, including some activities in which FHCs and national banks and their financial subsidiaries are already permitted to be engaged,[348] the Board and the Secretary of the Treasury have solicited comments

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342 *Id.*

343 *See supra* text accompanying notes 323–325.

344 12 U.S.C. § 1843(k)(5) (1994 & Supp. V 1999).

345 These activities are:

(1) lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities;

(2) providing any device or other instrumentality for transferring money or other financial assets; and

(3) arranging, effecting, or facilitating financial transactions for the account of third parties.

346 Section 4(k)(5)(A), BHCA, 12 U.S.C. § 1843(k)(5)(A) (1994 & Supp. V 1999).

347 12 U.S.C. § 1843(k)(5) (1994 & Supp. V 1999).

348 *See* release of the Board and the Secretary of the Treasury accompanying the interim rule 12 C.F.R. § 225.86(e) (2002) (Regulation Y), 66 Fed. Reg. 257–261, at 258 (Jan. 3, 2001) [*herein* Section 4(k)(5) Release]. *See also* technical amendments to 12 C.F.R. § 225.86(e), 66 Fed. Reg. 19,081–82 (Apr. 13, 2001). The Section 4(k)(5) Release states at 258:

> For example, these categories [Section 4(k)(5), BHCA] include providing safe deposit services, electronic funds transfer activities, credit and stored-value card activities, securities brokerage activities, as well as finders activities. These categories [Section 4(k)(5), BHCA] were intended, however, to allow [FHCs] . . . to engage in activities that were not otherwise permitted for these companies.

on the question of what activities should be defined by rule as financial in nature or incidental to a financial activity for purposes of Section 4(k)(5), BHCA.[349]

In addition, the Board and the Secretary issued an interim rule that creates a procedure by which FHCs or others may request Board determinations that specific proposed activities fall within one of the three categories of Section 4(k)(5), BHCA.[350] The Board believes that requiring FHCs that seek to engage in particular activities pursuant to Section 4(k)(5), BHCA to file requests with the Board for approval of those activities is necessary because of "the broad scope of the statutory language".[351] Although Section 4(k)(5), BHCA could be interpreted as giving the Board the power to issue regulations or orders with respect to the three named activities without cooperation with the Department of the Treasury,[352] the Board and the Treasury apply the consultative procedure of Section 4(k)(2)(A), BHCA[353] to Board determinations under Section 4(k)(5), BHCA.[354] In evaluating a request made under Section 4(k)(5), BHCA, the Board will take into account the factors listed in Section 4(k)(3), BHCA[355] that it must consider when determining whether an additional activity is financial in nature or incidental to a financial activity.[356] By using the factors of Section 4(k)(3), BHCA for purposes of Section 4(k)(5), BHCA, the Board ignores that the BHCA has already determined in Section 4(k)(5), BHCA that the three activities or categories of activities are financial in nature and that only the scope of such activities or the specific description of activities within the scope of such categories is subject to Board discretion.[357]

See also interim rule 12 C.F.R. § 225.86(e)(2)(i) (2002) (Regulation Y) (permitting a request for determination that an activity "that is not otherwise permissible for [an FHC]" is permitted under interim rule 12 C.F.R. § 225.86(e)(1) (2002) (Regulation Y)).

349 *See* Section 4(k)(5) Release, *supra* note 348, at 258. The Section 4(k)(5) Release and the interim rule treat the terms *financial in nature* and *incidental to a financial activity* as being synonymous. *See supra* text accompanying notes 302–305.

350 12 U.S.C. § 1843(k)(5) (1994 & Supp. V 1999). *See* interim rule 12 C.F.R. § 225.86(e) (2002) (Regulation Y).

351 *See* Section 4(k)(5) Release, *supra* note 348, at 258.

352 Different from § 4(k)(1), BHCA, 12 U.S.C. § 1843(k)(1) (1994 & Supp. V 1999), § 4(k)(5), BHCA, 12 U.S.C. § 1843(k)(5) (1994 & Supp. V 1999), does not refer to the coordination between Board and the Secretary of the Treasury covered in § 4(k)(2), BHCA, 12 U.S.C. § 1843(k)(2) (1994 & Supp. V 1999).

353 12 U.S.C. § 1843(k)(2)(A) (1994 & Supp. V 1999).

354 12 U.S.C. § 1843(k)(5) (1994 & Supp. V 1999). Interim rule 12 C.F.R. § 225.86(e)(2) (2002) (Regulation Y). The procedure set forth in interim rule 12 C.F.R. § 225.86(e)(2) (2002) (Regulation Y) is similar to but not identical with the procedure for the determination of an activity as additional financial or incidental activity set forth in 12 C.F.R. § 225.88 (2002) (Regulation Y).

355 12 U.S.C. § 1843(k)(3) (1994 & Supp. V 1999).

356 Interim rule 12 C.F.R. § 225.86(e)(3) (2002) (Regulation Y).

357 Section 4(k)(5), BHCA, 12 U.S.C. § 1843(k)(5) (1994 & Supp. V 1999), provides that "the Board shall . . . define, consistent with the purposes of [the BHCA] the [three] activities . . . as financial in nature, and the extent to which such activities are financial in nature or incidental to a financial activity". If the

Once the Board has determined that a particular activity is financial in nature or incidental to a financial activity under Section 4(k)(5), BHCA, either by rule or by order, other FHCs are eligible to engage in the activity if applicable requirements are met.[358] The post-transaction notice requirements apply to additional financial activities under Section 4(k)(5), BHCA.[359]

13. Complementary Activities

An FHC may, in addition to financial activities, engage in any activity, and may acquire and retain shares of any company engaged in any activity, that the Board determines is complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.[360] An FHC that seeks to engage in or acquire more than 5 percent of the outstanding shares of any class of voting securities of a company engaged in an activity that the FHC believes is complementary to a financial activity must obtain prior approval from the Board.[361] Complementary activities must be approved on a case-by-case basis by the Board under the notice procedures of Section 4(j), BHCA.[362] The Board apparently does not have the power to declare *ex officio* by regulation

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requirement that a Board determination must be consistent with the BHCA is interpreted to mean that the factors of § 4(k)(3), BHCA, 12 U.S.C. § 1843(k)(3) (1994 & Supp. V 1999), must be met, there would be no difference between additional financial activities in general and pre-approved additional financial activities. A statutory interpretation that gives meaning to a provision is always preferred over an interpretation that renders a provision meaningless. *See* NORMAN J. SINGER, 2 A STATUTES AND STATUTORY CONSTRUCTION 81-85 (6th ed. 2000).

358 *See* Section 4(k)(5) Release, *supra* note 348, at 258.

359 12 C.F.R. § 225.87 (2002) (Regulation Y). *See* Section 4(k)(5) Release, *supra* note 348, at 258.

360 Section 4(k)(1)(B), BHCA, 12 U.S.C. § 1843(k)(1)(B) (1994 & Supp. V 1999).

361 12 C.F.R. § 225.89(a) (2002) (Regulation Y).

362 The approval must be obtained in accordance with § 4(j)(1)(A), BHCA, 12 U.S.C. § 1843(j)(1)(A) (1994 & Supp. V 1999). *See* 12 C.F.R. § 225.89(a) (2002) (Regulation Y). The issues that must be addressed in the notice and the factors for consideration by the Board in evaluating a notice are set forth in 12 C.F.R. § 225.89(a) & (b) (2002) (Regulation Y). The waiver of notice and the expedited notice provisions for § 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999), activities do not apply. *See* § 4(j)(3), BHCA, 12 U.S.C. § 1843(j)(3) (1994 & Supp. V 1999). *See* Conference Report on S. 900, *supra* note 4, at 155.

In addition, the Board release accompanying a proposed rule approving engaging in and making investments in companies engaged in expanded data processing and e-commerce activities as complementary activities, 65 Fed. Reg. 80,384–88, at 80,386 (Dec. 21, 2000) [*herein* Complementary Activities Release], proposed that each investment under any of the complementary activities discussed in the Complementary Activities Release (data storage, general data processing and electronic information portal services) would be subject to review by the Board on a case-by-case method under § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999). The Board further stated, *id.* at 80,386, that it would revisit the case-by-case notice requirement once experience with complementary activities investments has been gained and decide whether a more streamlined process (*e.g.*, a one-time approval to make investments in companies engaged in the listed activities) is appropriate.

certain activities as being complementary. No notice to, and no consultation with, the Secretary of the Treasury are required from the Board with respect to complementary activities.[363]

Activities complementary to financial activities are not financial activities.[364] The term *complementary* has no precedent in the banking law terminology. The complementary activity must be complementary *to* a financial activity.[365] That is, the activity must in some way complement or enhance a financial activity or there must be a relationship or connection between the complementary activity and the financial activity.[366] The Board said:

> The authority to engage in complementary activities was included as a mechanism for allowing some amount of commercial or nonfinancial activities as long as there is a connection between the complementary activity and a financial activity conducted by the FHC and the activity does not pose unacceptable risks to the safety and soundness of the FHC, its banks or the banking system.[367]

It would seem that the necessary relationship of a new activity to financial activities also exists when the skills and resources created and developed by an FHC in connection with financial activities can be utilized without substantial investments or substantial additional risk. The Board, however, has not yet accepted this view.

The relationship between merchant banking investments and investments in companies involved in complementary activities is of interest. In a proposed rule that would permit an FHC to engage in and to invest in companies engaged in data storage, general data processing and electronic information portal services activities,[368] the Board observed that such investments would be permissible under the merchant banking investments authority but that a permission of the investments under the complementary activities authority would be advantageous for the FHC because it would not place the investments under the prohibition of cross-marketing between the depository institution owned by the FHC and the company engaged in the complementary activities.[369] The Board noted that it is precisely the cross-marketing opportunity that motivated the requested investments in companies involved in these expanded

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363 *See* § 4(k)(2)(A), BHCA, 12 U.S.C. § 1843(k)(2)(A) (1994 & Supp. V 1999).

364 *See* 145 CONG. REC. H11,529 (daily ed.) (Nov. 4, 1999) (Rep. Leach).

365 Section 4(k)(1)(B), BHCA, 12 U.S.C. § 1843(k)(1)(B) (1994 & Supp. V 1999).

366 *See* Complementary Activities Release, *supra* note 362, at 80,385. *See also* the application for a determination that the activities discussed in the Complementary Activities Release are permissible, submitted by the New York Clearing House (Apr. 24, 2000).

367 Complementary Activities Release, *supra* note 362, at 80,385.

368 *See* Complementary Activities Release, *supra* note 362, at 80,386 and proposed § 225.89(d), Regulation Y, 65 Fed. Reg. 80,388 (Dec. 21, 2000) (to be codified as 12 C.F.R. § 225.89(d) (Regulation Y).

369 *See* Complementary Activities Release, *supra* note 362, at 80,385 & 80,386.

data processing services.[370] Companies engaged in complementary activities would not be under the restrictions on managing companies that are applicable to companies acquired under the merchant banking investment authority.[371] The FHCs that requested the Board to permit investments in data processing and e-commerce activities argued that they must be in a position to make equity investments in companies that have found innovative methods of reaching the same customers that the banking organizations seek to reach for their own financial products and services, that they must be able to participate in and influence the development of new technologies that in the future may be useful in delivering financial products and services, and that they must be permitted to own delivery systems in order to assure that these technologies for the delivery of products and services remain available to them.[372]

For these reasons the Board does not propose that any restrictions be placed on the FHC's ability to be involved in the management of these companies or cross-marketing or delivery of financial products and services through these companies.[373] The Board noted that in each case it is expected that financial products and services, such as storing and processing financial data or providing access to financial advice or home banking services, would be provided as an integral part of the activities of the FHC.[374] In order to limit the potential risk of these investments and activities to the safety and soundness of the FHC, its depository institutions and the financial system as required by Section 4(k)(1)(B), BHCA,[375] the Board proposed to limit the total carrying value of all investments permitted under the three categories to an aggregate of 5 percent of the FHC's Tier 1 capital.[376]

14. Interplay Between the Various Authorities

The various sections of the BHCA that authorize activities for BHCs and FHCs, most notably Sections 4(c)(8), 4(c)(13) and 4(k), BHCA,[377] remain separate sources of authority under which an FHC may engage in various activities.[378] If an activity is listed in more than one provision of Section 4, BHCA,[379] the FHC may choose to conduct the activity under any

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370 *Id.* at 80,385 & 80,386. The Board does not propose that any restrictions be placed on the FHC's ability to cross-market financial products and services through these companies. *Id*. at 80,386.

371 *See infra* D.2.j. The Board does not propose that any restrictions be placed on the FHC's ability to be involved in managing these companies. Complementary Activities Release, *supra* note 362, at 80,386.

372 *Id.* at 80,384–85.

373 *Id.* at 80,386.

374 *Id.*

375 12 U.S.C. § 1843(k)(1)(B) (1994 & Supp. V 1999).

376 *See* Complementary Activities Release, *supra* note 362, at 80,386; proposed § 225.89(d)(1)(ii), Regulation Y, 65 Fed. Reg. 80,388 (Dec. 21, 2000) (to be codified as 12 C.F.R. § 225.89(d)(1)(ii) (Regulation Y).

377 12 U.S.C. § 1843(c)(8), (c)(13) & (k) (1994 & Supp. V 1999).

378 *See* Final FHC Release, *supra* note 32, at 406; Final Merchant Banking Release, *infra* note 418, at 8,469.

379 12 U.S.C. § 1843 (1994 & Supp. V 1999).

applicable provision, subject only to the procedures and limitations that the chosen source of authority imposes on the activity.[380] For example, an FHC could engage in securities underwriting under Section 4(c)(8), BHCA, in which case it must comply with the applicable notice provisions and the restrictions set forth on the laundry list of Section 225.28, Regulation Y,[381] or it could engage in securities underwriting under Section 4(k)(4)(E), BHCA,[382] in which case only post-transaction notice would be required.[383] If an FHC engages in travel agency business pursuant to Regulation K,[384] all the procedures and investment limitations of Section 211.8 & 9, Regulation K apply;[385] however, if the FHC relies on Section 4(k)(4)(G), BHCA, the Regulation K limitations do not apply.[386]

An FHC may use a combination of authorities to invest through the same subsidiary or fund in ownership interests of both nonfinancial companies and financial companies.[387] The decision whether to base new activities on, or classify acquired activities under, the merchant banking investment authority or under any other authority depends on issues such as whether the FHC intends to dispose of the investment after the permitted holding

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380 *See* Final FHC Release, *supra* note 32, at 406; Final Merchant Banking Release, *infra* note 418, at 8,469 ("The authority granted by [§ 4(k)(4)(H), BHCA] to [FHCs] to make merchant banking investments is also an alternative to any other authority that [an FHC] may have to make investments in nonfinancial companies under other provisions of the [BHCA]").

381 12 C.F.R. §§ 225.28(b)(8) (limited underwriting power), 225.23 (expedited notice for well-run BHCs) (2002) (Regulation Y). *See* Gruson, *supra* note 1, § 10.10 D (discussion of notice procedures).

382 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999).

383 12 C.F.R. § 225.87 (2002) (Regulation Y). *See infra* F.2.

384 12 C.F.R § 211.10(a)(16) (2002) (Regulation K). *See* former 12 C.F.R. § 211.5(d)(15) (2001) (Regulation K).

385 12 C.F.R. § 211.8 & 9 (2002) (Regulation K). *See* Gruson, *supra* note 1, § 10.17 E.

386 *See* Final FHC Release, *supra* note 32, at 406.

387 *See* Final Merchant Banking Release, *infra* note 418, at 8,469. This does not mean, however, that an FHC is permitted to avoid investment size limitations or investment restrictions by using a combination of investment authorities for the investments in one target company. For purposes of determining whether an investment qualifies under § 4(c)(6) & (7), BHCA, 12 U.S.C. § 1843(c)(6) & (7) (1994), an FHC must aggregate all investments held by the FHC in a single company. Sections 4(c)(6) & (7), BHCA are only available if the FHC's aggregate investment in the target company under a combination of authorities is within the 5 percent investment limitation. An FHC may not own any shares of a company in reliance of § 4(c)(6) or (7), BHCA where the FHC owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company. *See* Interim Merchant Banking Release, *infra* note 418, at 16,463 n.1; Final Merchant Banking Release, *infra* note 418, at 8,469 n.10 & 8,481 n.29; Proposed Regulation W Release, *infra* note 793, at 24,204 n.95.

The same is true for investments held under Regulation K, 12 C.F.R. pt. 211 (2002), in particular 12 C.F.R. § 211.8 (2002) (Regulation K). The Regulation K authority is only available if the FHC's aggregate investment in the target company under a combination of authorities is within the applicable investment limitations and restrictions set forth in Regulation K. *See* Final Merchant Banking Release, *infra* note 418, at 8,469 n.10.

period[388] and whether the FHC can live with the applicable management restrictions.[389] Capital adequacy requirements are no longer a relevant factor because the capital requirements are identical for all equity investments in nonfinancial companies.[390]

D. Investment Activities: Merchant Banking Investments, Underwriting, Insurance Company Portfolio Investments

7. Distinction Between Activities and the Investment Powers Inherent in Such Activities

The principal purpose of the GLBA was to provide a framework for the affiliation of banks, securities firms, insurance companies and other financial service providers in a holding company structure.[391] Therefore, the most important powers for a BHC that has effectively elected the status of an FHC are the authorities to engage in underwriting, dealing and market making activities,[392] merchant banking[393] and insurance activities.[394] All these activities involve the investment in securities of companies engaged in *any kind* of activities, *i.e.,* activities that are not financial activities. Merchant banks and insurance companies also invest in assets other than securities. Consequently, it was important that the GLBA amendments to the BHCA not only authorized FHCs to invest in companies that are engaged in securities, insurance, merchant banking or other *financial activities*, but also permitted the FHC, directly or indirectly, in the exercise of those authorities to engage in financial activities to make investments in securities or assets of companies engaged in *nonfinancial activities*.

The BHCA distinguishes between permitted financial activities and the investments in securities made in carrying out such financial activities. Section 4(k)(4)(B), BHCA[395] permits insurance activities and Section 4(k)(4)(I), BHCA[396] permits investments by

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388 *See infra* D.2.k.

389 *See infra* D.2.j; Gruson, *supra* note 1, § 10.09B (discussing the passivity requirement for § 4(c)(6), BHCA, 12 U.S.C. § 1843(c)(6) (1994), investments).

390 *See infra* D.2.m.

391 *See* 145 CONG. REC. S13,888-89 (daily ed.) (Nov. 4, 1999) (Sen. Reed); 145 CONG. REC. S13,904 (daily ed.) (Nov. 4, 1999) (Sen. Kerry).

392 *See supra* text accompanying notes 316 & 321.

393 *See supra* text accompanying note 321.

394 *See supra* text accompanying notes 313 & 322.

395 12 U.S.C. § 1843(k)(4)(B) (1994 & Supp. V 1999).

396 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999).

insurance companies; Section 4(k)(4)(E), BHCA[397] permits underwriting and Section 4(k)(4)(H), BHCA[398] permits the acquisition of shares as part of an underwriting.

This legislative approach - the distinction between the financial activities in which an FHC may engage and the authorization to make investments in carrying out such financial activities - was not followed in connection with investment banking and merchant banking. Although Section 4(k)(4)(H), BHCA[399] permits investments in companies engaged in any activities *as part of* the merchant or investment banking activities of an FHC, there is no explicit authority for FHCs to engage generally in merchant/investment banking activities. Thus, merchant/investment banking is treated differently from underwriting or insurance. However, since the authority to invest in securities as part of merchant/investment banking activities logically presupposes the authority to engage in merchant/investment banking activities, such authority arguably is implied. Neither the BHCA nor Regulation Y defines the activity of merchant banking or investment banking, and the legislative history of the GLBA is not helpful either.[400] Merchant and investment banking have been defined in the literature as including counseling, negotiating in merger and acquisition transactions, securities portfolio management for customers, dealing in bullion, arranging credit financing without holding the loan to maturity, investing own capital in leveraged buyouts, corporate acquisitions and structured finance transactions, acting as underwriter or agent for the issuer of securities and acting as dealer in securities.[401] The definitions of merchant or investment banking are generally descriptive and inclusive, not limiting, in nature.

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397 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999).

398 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

399 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

400 *See* Conference Report on S. 900, *supra* note 4, at 154; Report 106-44 of the Senate Committee on Banking, Housing, and Urban Affairs to accompany S. 900, 106th Cong., 1st Sess. (1999) [*herein* Senate Report on S. 900], at 9, 64, 72–73. *See infra* note 414.

401 A *merchant bank* has been defined in the literature as a financial institution that "engages in investment banking, counseling, and negotiating in mergers and acquisitions, and a variety of other services including securities portfolio management for customers, insurance, the acceptance of foreign bills of exchange, dealing in bullion, and participating in commercial ventures." JOHN DOWNES & JORDAN E. GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS (5th ed. 1998), at 357. *Merchant banking* has been defined as a "form of banking where the bank arranges credit financing, but does not hold the loans in its investment portfolio to maturity. A merchant bank invests its own capital in leveraged buyouts, corporate acquisitions, and other structured finance transactions." THOMAS P. FITCH, DICTIONARY OF BANKING TERMS (1990), at 383. *See* JERRY M. ROSENBERG, DICTIONARY OF BANKING AND FINANCIAL SERVICES (2d ed. 1985), at 433 (the term merchant bank is "used in Great Britain for an organization that underwrites securities for corporations, advises such clients on mergers, and is involved in the ownership of commercial ventures"). *Investment banker* has been defined as a firm, acting as underwriter or agent, that serves as intermediary between an issuer of securities and the investing public. Downes & Goodman, *supra*, at 296–97. Downes & Goodman continue:

> Where a client relationship exists, the investment banker's role begins with preunderwriting counseling and continues after the distribution of securities is completed, in the form of ongoing expert advice and guidance, often including a seat on the board of directors . . . . In addition to new securities offerings, investment

The Board in Regulation Y apparently takes the position that FHCs do not have a general authority to engage in all merchant/investment banking activities. Most, if not all, of the activities that fall under the general description of merchant banking activities, such as investment advisory services, asset management services, acting as underwriter or dealer, arranging credit financing and credit financing, are already permitted financial activities for FHCs under various provisions of the BHCA and Regulation Y.[402] The GLBA amendments to the BHCA add to these authorities the authority to make merchant banking investments, *i.e.*, controlling or noncontrolling investments in companies engaged in any kind of business for the purpose of appreciation and ultimate resale.[403] Subpart J of Regulation Y (Merchant Banking Investments)[404] deals only with the authority to make merchant banking investments, and Regulation Y does not generally deal with merchant or investment banking activities. When Regulation Y refers to merchant banking activities or engaging in merchant banking activities, it means merchant banking investment activities and engaging in investments under the merchant banking investment authority. Although Section 4(k)(4)(H), BHCA[405] refers to merchant banking and to investment banking, the Board in Regulation Y never mentions investment banking. Presumably it takes the position that merchant banking and investment banking are synonymous terms.

> bankers handle the distribution of blocks of previously issued securities, either through secondary offerings or through negotiations; maintain markets for securities already distributed; and act as finders in the private placement of securities.

Id. *See also* Fitch, *supra*, at 329, entry "investment banking" and BLACK'S LAW DICTIONARY (7th ed. 1999), at 831, entries "Investment banker" and "Investment banking," defining investment banking as underwriting. However, others define investment banking broader, as long-term financing or the financing of capital requirements. *See* Rosenberg, *supra*, at 375, who defines investment banking more broadly as the "financing of the capital requirements of an enterprise rather than the current 'working capital' requirements of a business." GLENN G. MUNN, F.L. GARCIA & CHARLES J.WOELFEL, ENCYCLOPEDIA OF BANKING FINANCE (9th ed. 1991), at 585, defines "Investment Banks" as banking institutions "that supply long-term and intermediate credit to borrowers."

402 Investment advisory services: *see* § 4(k)(4)(C), BHCA, 12 U.S.C. § 1843(k)(4)(C) (1994 & Supp. V 1999); § 4(k)(4)(F), BHCA, 12 U.S.C. § 1843(k)(4)(F) (1994 & Supp. V 1999), in connection with 12 C.F.R. § 225.28(b)(6) (2002) (Regulation Y) (*see supra* note 314); underwriting and dealing: *see* § 4(k)(4)(E), BHCA, 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999) (*see supra* note 316); lending: *see* § 4(k)(4)(A), BHCA, 12 U.S.C. § 1843(k)(4)(A) (1994 & Supp. V 1999); § 4(k)(4)(F), BHCA in connection with 12 C.F.R. § 225.28(b)(1) (2002) (Regulation Y) (*see supra* note 312); and buying and selling bullion: *see* § 4(k)(4)(F), BHCA in connection with 12 C.F.R. § 225.28(b)(8)(iii) (2002) (Regulation Y) (*see supra* note 317).

403 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). Section 4(k)(4)(H), BHCA is curiously drafted in that the requirement that investment activities must be engaged in for the purpose of appreciation and ultimate resale is introduced by the word "including", leaving room for the argument that investments for other purposes are also permissible. Regulation Y does not accept this argument and limits all merchant banking investments to investments for the purpose of appreciation and ultimate resale. *See* 12 C.F.R. § 225.172 (2002) (Regulation Y).

404 *See* Subpart J (Merchant Banking Investments) of Regulation Y, 12 C.F.R. §§ 225.170–225.177 (2002) (Regulation Y).

405 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

A similar interpretation issue arises in connection with the financial activity of dealing and market making in securities. Section 4(k)(4)(E), BHCA[406] permits an FHC to engage in underwriting, dealing in, or making a market in securities. Although Section 4(k)(4)(H), BHCA[407] permits the acquisition of securities as part of underwriting, it does not expressly permit the acquisition of securities as part of dealing or market making. Dealing and market making, however, necessarily imply the acquisition and ownership of securities; these activities are not conceivable without such acquisition and ownership.[408] The same is true for underwriting: the activity of underwriting essentially consists of the acquisition and sale of securities and the grant of a specific investment power for underwriting in Section 4(k)(4)(H), BHCA seems to be superfluous.[409] One could argue that the reference to underwriting in Section 4(k)(4)(H), BHCA is unnecessary and superfluous and erroneous or one could argue that the references to dealing and market making were erroneously omitted from Section 4(k)(4)(H), BHCA.[410]

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406 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999).

407 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

408 Without a specific investment authorization for the dealing and market-making activities, equity investments in connection with such activities could be limited to 5 percent under § 4(c)(6), BHCA, 12 U.S.C. § 1843(c)(6) (1994). Rep. Leach has made it clear, however, that the 5 percent limitation does not apply to dealing and market-making activities. ("I would like to make clear that by permitting [FHCs] to engage in underwriting, dealing and market making, Congress intends that the five-percent limitation no longer applies to bona fide securities underwriting, dealing and market-making activities.") 145 CONG. REC. H11,529 (daily ed.) (Nov. 4, 1999). Furthermore, such limitation to 5 percent would be inconsistent with the intent of the GLBA to tear down the wall between commercial banking and securities activities.

409 *See infra* note D.3. for a discussion of the investment authority of the underwriting activity.

410 Dealing is generally recognized as part of the investment or merchant banking activity. In Securities Industries Association v. Board of Governors, 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988), the court accepted the position taken by the Board that dealing is part of merchant banking. The court said that "[t]he Board notes that NatWest engages in extensive merchant banking activities outside the United States, including acting as a dealer of securities". *Id.* at 819 n.9. *See also* MUNN, GARCIA & WOELFEL, ENCYCLOPEDIA OF BANKING FINANCE, *supra* note 401, at 657, entry "Merchant Bank", stating that "merchant banks frequently . . . underwrite [and] deal in securities".

2. Merchant Banking Investments

a. General

Section 4(k)(4)(H), BHCA[411] permits an FHC, directly or indirectly, to invest in securities, assets or other ownership interests as part of merchant/investment banking activities, subject to certain conditions:

- the investment is made as part of a "bona fide" merchant or investment banking activity;
- the investment is made by a securities affiliate or by a registered investment adviser that is affiliated with an insurance company and provides investment advice to an insurance company, or by an affiliate of such securities affiliate or such investment adviser;
- the investment is not made by a depository institution of the FHC, or by a subsidiary of a depository institution;
- the investment is "held for a period of time to enable the sale or disposition thereof on a reasonable basis" consistent with the financial viability of the merchant/investment banking activity; and
- the FHC does not routinely manage or operate the entity in which the investment is made except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.

b. The Nature of Merchant Banking Investments

The authority of Section 4(k)(4)(H), BHCA[412] to make investments as part of merchant/investment banking activities permits an FHC or a subsidiary of an FHC to make controlling or noncontrolling equity or other investments in companies engaged in any kind of nonfinancial activities (businesses).[413]

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411 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

412 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

413 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999) (introductory paragraph) ("whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to [§ 4, BHCA]"). *See* 12 C.F.R. § 225.170(a) (2002) (Regulation Y) ("any amount of shares" of a company or other entity "that is engaged in any activity not otherwise authorized" for FHCs under § 4, BHCA). *See* § 4, BHCA, 12 U.S.C. § 1843 (1994 & Supp. V 1999). An FHC must make merchant banking investments directly or indirectly through a subsidiary. *See supra* text accompanying note 229 and *infra* 444.

Section 4(k)(4)(H), BHCA does not define *merchant banking* or *investment banking* and the legislative history is not helpful.[414] Section 4(k)(4)(H), BHCA states that merchant/investment banking investments *include* "investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment".[415] The Board in Regulation Y limits the authority to make merchant banking investments to the authority to make investments for the purpose of appreciation and ultimate resale. Regulation Y contains a not very helpful definition of *merchant banking investments*. It defines[416] *merchant banking investments* as "shares, assets or ownership interests" acquired or controlled under Section 4(k)(4)(H), BHCA[417] and Sections 225.170–225.177, Regulation Y.[418] This "definition" mixes the activity and the results of the activity. The subsequent provision[419] that an FHC may not make a merchant banking investment except in compliance with Sections 225.170–225.177, Regulation Y makes little sense because under the above definition, such investments would not be merchant banking investments. Regulation Y should have defined *merchant banking investments* as a "direct or indirect acquisition, control or ownership of shares, assets or

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414 *See* Conference Report on S. 900, *supra* note 4, at 154; Senate Report on S. 900, *supra* note 400, at 9, 64, 72–73. Certain Senators gave the following definition in an Additional View in the Senate Report on S. 900:

> Merchant banking refers to the practice whereby an investment bank takes a passive equity stake in a company in connection with the provision of financial services, such as underwriting the company's securities, with a view towards appreciation and eventual sale.

Id. at 64. This definition is narrower than § 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999), would require.

415 Section 4(k)(4)(H)(ii), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii) (1994 & Supp. V 1999).

416 12 C.F.R. § 225.170(a) (2002) (Regulation Y).

417 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

418 12 C.F.R. §§ 225.170–225.177 (2002) (Regulation Y).

On Mar. 17, 2000, the Board issued an interim rule governing merchant banking investments of FHCs (Regulation Y, Docket No. R-1065), 65 Fed. Reg. 16,472–76 (Mar. 28, 2000) and adopted final rules on Jan. 10, 2001 (Regulation Y, Docket No. R-1065), 66 Fed. Reg. 8,484–89 (Jan. 31, 2001). The final rules are codified in 12 C.F.R. §§ 225.170–225.177 (2002) (Subpart J of Regulation Y). The Secretary of the Treasury also issued on Mar. 17, 2000 regulations governing merchant banking investments of FHCs, 65 Fed. Reg. 16,476–79 (Mar. 28, 2000) and issued final regulations on Jan. 10, 2001, 66 Fed. Reg. 8,489–93 (Jan. 31, 2001). The final rules are codified in 12 C.F.R. §§ 1500.1–1500.8 (2002). These rules were accompanied by joint release, 65 Fed. Reg. 16,460–79 (Mar. 28, 2000) [*herein* Interim Merchant Banking Release] and 66 Fed. Reg. 8,466–93 (Jan. 31, 2001) [*herein* Final Merchant Banking Release]. *See* Letter, dated May 15, 2000, from Michael Gruson, Bradley K. Sabel and Jonathan M. Weld to the Secretary of the Board commenting on the interim rules. The merchant banking rules issued by the Secretary of the Treasury and by the Board are identical and therefore the rules issued by the Secretary of the Treasury are not specifically referred to herein. The authority to issue the rules relating to merchant banking investments is derived from § 4(k)(7)(A), BHCA, 12 U.S.C. § 1843(k)(7)(A) (1994 & Supp. V 1999).

419 12 C.F.R. § 225.170(a), last sentence (2002) (Regulation Y).

ownership interests of a company or other entity [*herein* the portfolio company][420] that is engaged in any activity not otherwise authorized for an FHC under Section 4, BHCA, provided such investment is made in accordance with Subpart J [Sections 225.170–225.177, Regulation Y]".[421] In summary, the investment in a company that is not engaged in financial activities[422] qualifies as a permitted merchant banking investment if the FHC does not routinely manage the portfolio company[423] and if the investment is disposed of during the holding period.[424]

Pursuant to Regulation Y, a portfolio company may not be engaged in any activity authorized for FHCs under Section 4, BHCA.[425] The meaning of this prohibition is not completely clear. An FHC may make investments in any company of up to 5 percent of the outstanding voting shares of any class,[426] it may engage in complementary activities[427] and may retain investments in grandfathered activities.[428] Does the characterization of an activity as complementary result in a prohibition of merchant banking investments in companies engaged in such activities? The answer must be no. The Board has indicated that an FHC has a choice of whether to invest in a company engaged in complementary activities under the merchant banking investment authority subject to the limitations inherent in that authority or to invest under the authority to invest in companies engaged in complementary activities.[429]

It is likely that the Board meant that the portfolio company acquired under the merchant banking investment authority should not be engaged in financial activities.[430] This is in contrast to the requirement that an FHC may engage in financial activities either directly or

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420 12 C.F.R. § 225.177(c) (2002) (Regulation Y) defines *portfolio company* as a company that is engaged in any activity not authorized for an FHC under § 4, BHCA, 12 U.S.C. § 1843 (1994 & Supp. V 1999) in which an FHC has invested pursuant to Subpart J [12 C.F.R. §§ 225.170–225.177 (2002) (Regulation Y)].

421 12 C.F.R. §§ 225.170–225.177 (2002) (Regulation Y).

422 The company must not be engaged in any activity authorized for an FHC under § 4, BHCA, 12 U.S.C. § 1843 (1994 & Supp. V 1999). *See* 12 C.F.R. § 225.177(c) (2002) (Regulation Y).

423 12 C.F.R. § 225.171 (2002) (Regulation Y). *See infra* D. 2. j.

424 12 C.F.R. § 225.172 (2002) (Regulation Y). *See infra* D. 2. k.

425 12 C.F.R. § 225.177(c)(1) (2002) (Regulation Y). *See supra* note 420. *See also* 12 U.S.C. § 1843 (1994 & Supp. V 1999).

426 Section 4(c)(6), BHCA, 12 U.S.C. § 1843(c)(6) (1994).

427 Section 4(k)(1)(B), BHCA, 12 U.S.C. § 1843(k)(1)(B) (1994 & Supp. V 1999). *See supra* C.7.

428 *See infra* E.2.

429 *See supra* text accompanying notes 368–372.

430 The Board seems to agree with this interpretation in the Final Merchant Banking Release, *supra* note 418, at 8,469 ("Because section 4(k)(4)(H) does not authorize investments in financial companies . . . ."). However, *see infra* text accompanying notes 488 and 489 (FHC's interest in a nonqualifying fund is treated as an investment in a portfolio company even though the fund is engaged in investment activities).

through controlled or minority-owned companies that are exclusively (or at least substantially) engaged in financial activities.[431]

Does the requirement that portfolio companies cannot engage in financial activities prevent an investment under the merchant banking investment authority in a minority interest in an insurance company, or a broker-dealer or a merchant bank? As stated above,[432] an insurance company in which an FHC invests must be a subsidiary of the FHC in order that the FHC can utilize the insurance company investment authority under Section 4(k)(4)(I), BHCA.[433] Thus, a minority investment in an insurance company is in effect not permitted under the Section 4(k), BHCA investment authorities, and therefore a minority investment in an insurance company must be permissible under the merchant banking authority. The definition of *portfolio company* must be read to the effect that a portfolio company is a company that is not engaged in a financial activity and also a company that may be engaged in a financial activity if the investment in such company by an FHC is not otherwise authorized under Section 4(k), BHCA. There is no legislative purpose in prohibiting a less-than-controlling merchant banking investment in an insurance company subject to the restrictions applicable to merchant banking investments. On the other hand, the investment in a controlling interest in an insurance company is authorized by Section 4(k)(1)(A) & (4)(B), BHCA,[434] and the activities of the insurance company constitute the indirect activities of the FHC. Thus, an FHC cannot invest under the merchant banking authority in a controlling interest of an insurance company. A similar analysis applies to minority investments under the merchant banking investment authority in broker-dealers and merchant banks.[435]

A U.S. bank, a BHC, a savings association or a company that controls a savings association, on the other hand, can never be a portfolio company under the merchant banking authority.[436]

The Board has stated that an FHC may retain a portfolio company acquired under the merchant banking investment authority that at the time of acquisition was a nonfinancial company but subsequently commenced a financial activity.[437]

c. Bona Fide Requirement

Investments made as part of a merchant banking investment must be bona fide.[438] The Board has stated that the bona fide requirement addresses the motive of an investment made

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431 *See supra* C.1.

432 *See* text accompanying *supra* note 229 & *infra* note 624.

433 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999).

434 12 U.S.C. § 1843(k)(1)(A) & (4)(B) (1994 & Supp. V 1999).

435 *See* text accompanying *supra* note 229 & *infra* note 601.

436 *See infra* D. 2. i.

437 *See* Final Merchant Banking Release, *supra* note 418, at 8,469.

by an FHC. The requirement is, in the Board's view, intended to distinguish between merchant banking investments that are made for the purpose of resale or other disposition, and investments that are made for the purpose of allowing the FHC to engage in the nonfinancial activities conducted by the portfolio company.[439] The Board intends to monitor the merchant banking activities of FHCs to ensure that all merchant banking investments are made in compliance with the BHCA's bona fide requirement and that FHCs do not use the merchant banking authority as a means of becoming impermissibly involved in nonfinancial activities.[440] Since all merchant banking investments must be disposed of within a certain period of time, it is difficult to see why the motive of the FHC should make a difference. An indication of the Board's real concern can be gleaned from a statement of the Board that it expects all FHCs to establish policies governing portfolio diversification.[441] If, for instance, an FHC makes merchant banking investments only in real estate development companies, it might be seen as being engaged in real estate development.[442]

d. Entity in the FHC Group that May Make Merchant Banking Investments

An FHC may directly or through a subsidiary engage in merchant banking investment activities. Whereas Section 4(k)(1), BHCA[443] generally permits an FHC to engage in financial activities through a controlled or a noncontrolled company, the financial activities of making merchant/investment banking investments must be carried out by the FHC itself (directly) or indirectly through a subsidiary (a controlled company).[444] The FHC or the

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438 Section 4(k)(4)(H)(ii), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii) (1994 & Supp. V 1999); 12 C.F.R. § 225.170(b) (2002) (Regulation Y).

439 *See* Final Merchant Banking Release, *supra* note 418, at 8,469.

440 *Id*.

441 *Id*. at n.12.

442 *Id*. at 8,469. *See also* Interim Merchant Banking Release, *supra* note 418, at 16,463. The Board seems to be particularly concerned about investments in real estate investment or development companies. Final Merchant Banking Release, *supra* note 418, at 8,469; Interim Merchant Banking Release, *supra*, at 16,462–63. The Final Merchant Banking Release, *supra*, at 8,469 dispelled a concern created by the Interim Merchant Banking Release, *supra*, at 16,463 that the first merchant banking investment of an FHC may not be made in a company engaged in real estate investment or development. The Final Merchant Banking Release, *supra*, at 8,469, also clarified that the bona fide requirement does not prohibit an FHC from specializing in making merchant banking investments in particular industries. Concentration in particular industries or in individual investments may cause supervisory concerns. *See* Board SR Letter No. 00-9 (SPE) (June 22, 2000), *sub* III B, at 5–6, Policy and Limits (requiring portfolio diversification).

443 12 U.S.C. § 1843(k)(1) (1994 & Supp. V 1999). *See supra* text accompanying note 228.

444 This follows from § 4(k)(4)(H) (introductory paragraph), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999), which permits an FHC only directly or indirectly (*i.e*., through a subsidiary) to acquire securities or make investments as part of the merchant banking business ("[d]irectly or indirectly acquiring or controlling . . . shares . . . as part of a . . . merchant or investment banking activity"). *See* 12 C.F.R. § 225.170(a) (2002) (Regulation Y). *See supra* note 229. *See also infra* text accompanying note 601 (discussing the *directly or indirectly* requirement in connection with the underwriting authority) and *infra*

merchant/investment banking subsidiary of such FHC, however, may invest in the exercise of its merchant banking investment authority in minority or majority positions of portfolio companies.[445]

Although Section 4(k)(4)(H), BHCA[446] permits an FHC to make merchant banking investments "directly or indirectly", this is modified in several respects by the subsequent language of paragraph (H).

First, the investment may not be made by a depository institution (or a subsidiary thereof). This restriction does not affect FHCs that are foreign banks, because foreign banks are not depository institutions.[447]

Furthermore, Section 4(k)(4)(H), BHCA provides that the merchant banking investments must be made and held by a securities affiliate,[448] or by a registered investment adviser that is affiliated with an insurance company in the FHC group and provides investment advice to an insurance company,[449] or by an affiliate of such securities affiliate or such investment adviser.[450] This language is very ambiguous and leaves room for various

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text accompanying note 624 (discussing the *directly or indirectly* requirement in connection with the insurance company portfolio investment authority).

445 Section 4(k)(4)(H) (introductory paragraph), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999) (permitting the acquisition of shares or other ownership interests of another company or entity "whether or not constituting control of such company or entity").

446 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

447 The restriction applies to the U.S. bank and nonbank depository institution subsidiaries that the foreign bank may have. Section 4(k)(4)(H)(i), BHCA, 12 U.S.C. § 1843(k)(4)(H)(i) (1994 & Supp. V 1999); 12 C.F.R. § 225.170(d) (2002) (Regulation Y). For purposes of the merchant banking rules [Subpart J of Regulation Y], the term *depository institution* includes a U.S. branch or agency of a foreign bank. 12 C.F.R. § 225.177(b) (2002) (Regulation Y). The distinction between a branch of a foreign bank or the foreign bank acquiring assets is not meaningful as a matter of law. If a branch acquires or owns assets, the bank that has established the branch acquires or owns the assets; since a branch is not a legal entity separate from the bank it cannot have a separate ownership interest in assets. *See* Committee on Banking Regulations and Supervisory Practices, *Principles for the Supervision of Bank's Foreign Establishments* (Basle Concordat) at 2 (May 1983) (defining branches as operating entities that do not have separate legal status and are thus integral parts of the foreign parent bank).

448 Section 4(k)(4)(H)(ii)(I), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii)(I) (1994 & Supp. V 1999) (merchant banking investments are permitted if "such shares, assets, or ownership interests are acquired and held by – (I) a securities affiliate or an affiliate thereof").

449 Section 4(k)(4)(H)(ii)(II), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii)(II) (1994 & Supp. V 1999) (merchant banking investments are permissible if "such shares, assets, or ownership interests are acquired and held by . . . (II) an affiliate of an insurance company described in [12 U.S.C. § 1843(k)(4)(I)(ii) (1994 & Supp. V 1999)] that provides investment advice to an insurance company and is registered pursuant to the Investment Advisers Act of 1940 [15 U.S.C. § 80b-1 *et seq*.], or an affiliate of such investment adviser.").

450 Section 4(k)(4)(H)(ii)(I) & (II), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii)(I) & (II) (1994 & Supp. V 1999).

interpretations.[451] The Board in Regulation Y provides that an FHC may, directly or indirectly through a subsidiary, acquire or control merchant banking investments *if the FHC is or has an affiliate that is* a company that is registered with the Securities and Exchange Commission as a broker-dealer under the Securities Exchange Act of 1934.[452] Regulation Y does not require that

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451 An *affiliate* is defined in Section 2(k), BHCA, 12 U.S.C. § 1841(k) (1994), as a company that controls, is controlled by, or is under common control with, another company. The BHCA does not say with whom the securities company must be affiliated. If *affiliate* means affiliate of the FHC in the meaning of Section 2(k), BHCA, it would include not only subsidiaries of the FHC but also a securities company controlling the FHC and securities companies controlled by a securities company controlling the FHC. Any person controlling a BHC is also a BHC and would have to qualify as an FHC in order to engage in underwriting and merchant/investment banking activities. Thus, the *securities affiliate* of one FHC that controls the FHC would itself be an FHC and would also require a securities affiliate to engage in underwriting and merchant/investment banking activities. If *securities affiliate* means a securities subsidiary of an FHC, this would contradict the introductory language of § 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999), which permits FHCs to directly engage in underwriting and merchant/investment banking activities. *Affiliate* could also mean an affiliate of the depository institution — other than a subsidiary of the depository institution. In that case, the securities company that engages in merchant/investment banking activities could be a sister company of the depository institution or the parent of the depository institution, *i.e.*, the FHC itself, if such FHC is a securities company.

Section 4(k)(4)(H)(ii)(I), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii)(I) (1994 & Supp. V 1999), permits not only a securities affiliate of an FHC to make and hold investments in connection with underwriting or merchant/investment banking activities, but also an affiliate of a securities affiliate. Even if *securities affiliate* is interpreted to mean a *securities subsidiary* of the FHC, the FHC as parent of the subsidiary is an affiliate of the securities subsidiary. If *securities affiliate* is interpreted to mean an affiliate of the depository institution, the FHC as parent of the depository institution clearly is an affiliate of the depository institution.

The conclusion that the FHC itself may engage in merchant/investment banking activities permits a consistent interpretation of § 4(k)(4)(H), BHCA and it makes sense. When Congress used the term *securities affiliate*, it arguably meant to designate a broker-dealer in the FHC group.

The legislative history of the GLBA indicates a third interpretation. The Conference Report on S. 900, *supra* note 4, at 154 states that § 4(k)(4)(H), BHCA permits an FHC, "that has a securities affiliate or an affiliate of an insurance company . . . to conduct such activities. Under this provision, *the FHC may directly or indirectly* acquire or control any kind of ownership interest . . . in an entity engaged in any kind of trade or business whatsoever. The FHC may make such acquisition . . .". (emphasis added). Representative Leach made a similar statement:

> [T]he Act would permit [an FHC] to engage in merchant banking only if the company has a securities affiliate, or a registered investment adviser that performs these functions for an affiliate insurance company.

145 CONG. REC. H11,529 (daily ed.) (Nov. 4, 1999). Thus, the Conference Report on S. 900 clearly says that an FHC may directly acquire securities in connection with merchant/investment banking activities, *as long as it has a securities affiliate*. The securities affiliate need not make the investments.

452 12 C.F.R. § 225.170(d) & (f) (2002) (Regulation Y). An FHC may only acquire or control merchant banking investments if the FHC is, or has an affiliate that is, registered under §§3, 15 & 15B, Securities Exchange Act of 1934 (15 U.S.C. §§ 78c, 78*o*, 78*o*-4 (1994 & Supp. V 1999)) as a broker-dealer or as a municipal securities dealer. 12 C.F.R. § 225.170(f)(1)(i) & (ii) (2002) (Regulation Y). It suffices if a bank has a separate and identifiable department or division that is registered as a municipal securities dealer. 12 C.F.R. § 225.170(f)(1)(ii) (2002) (Regulation Y).

the broker-dealer be the investor. The legislative history of the GLBA supports this interpretation of Section 4(k)(4)(H), BHCA.[453]

Regulation Y further permits an FHC to acquire or control merchant banking investments *if* the FHC controls (1) an insurance company[454] and (2) a registered investment adviser[455] that provides investment advice to an insurance company.[456] Again, Regulation Y does not require that the investment adviser be involved in the merchant banking investments.

e. Investments Through Private Equity Funds

Securities firms typically make significant percentages of their merchant banking investments through funds that are limited partnerships or other investment vehicles that pool the firm's capital with capital provided by third-party investors.[457] These investors typically are

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453 *See* 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999); Conference Report on S. 900, *supra* note 4, at 154; Rep. Leach, 145 CONG. REC. H11,529 (daily ed.) (Nov. 4, 1999). *See supra* note 451 (penultimate paragraph).

454 The insurance company must be predominantly engaged in underwriting life, accident and health or property and casualty insurance (other than credit-related insurance), or providing and issuing annuities. 12 C.F.R. § 225.170(f)(2)(i) (2002) (Regulation Y). *See* § 4(k)(4)(H)(ii)(II), BHCA in connection with § 4(k)(4)(I)(ii), BHCA, 12 U.S.C. §§ 1843(k)(4)(H)(ii)(II) & 4(k)(4)(I)(ii) (1994 & Supp. V 1999); it is curious that Regulation Y does not cover the case where the FHC itself is an insurance company. Such FHC should be permitted to make merchant banking investments even if it does not control a second insurance company. *See* 12 C.F.R. § 225.170(f)(1) (2002) (Regulation Y) (the FHC itself may be the broker dealer or municipal securities dealer). The interim rule, § 225.170(f)(1), 65 Fed. Reg. 16,473 (Mar. 28, 2000) did not permit the FHC itself to be the broker-dealer, but the final version of 12 C.F.R. § 225.170(f)(1) (2002) (Regulation Y) corrected this oversight. *See* Final Merchant Banking Release, *supra* note 418, at 8,468. A corresponding change was (probably erroneously) not made in 12 C.F.R. § 225.170(f)(2) (2002) (Regulation Y) with respect to insurance companies.

455 12 C.F.R. § 225.170(f)(2)(ii) (2002) (Regulation Y). *See* § 4(k)(4)(H)(ii)(II), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii)(II) (1994 & Supp. V 1999). The investment adviser must be registered under § 203(a), Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(a) (1994 & Supp. V 1999), or be an affiliate thereof. Since the license as an investment adviser does not permit an entity to act as underwriter, subclause (ii)(II) relates only to merchant/investment banking activities. Regulation Y correctly does not require the investment adviser to acquire and hold the investments as the language of § 4(k)(4)(H)(ii)(II) might indicate. Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999), as in the case of a securities affiliate, requires that the investment adviser is an affiliate of an insurance company or an affiliate thereof. *See* § 2(k), BHCA, 12 U.S.C. § 1841(k) (1994) (definition of *affiliate).* The affiliate of an insurance company could be a subsidiary thereof, a sister company or a parent company of the insurance company. It includes the FHC parent of the insurance company, although 12 C.F.R. § 225.170(f)(2)(ii) (2002) (Regulation Y) does not seem to expressly cover this case. The investments may also be made by an affiliate of such investment adviser affiliate. Section 4(k)(4)(H)(ii)(II), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii)(II) (1994 & Supp. V 1999). This last provision is odd, because an affiliate of an affiliate of a company is an affiliate of such company.

456 12 C.F.R. § 225.170(f)(2)(ii)(B) (2002) (Regulation Y). Note that § 4(k)(4)(H)(ii)(II), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii)(II) (1994 & Supp. V 1999), and 12 C.F.R. § 225.170(f)(2)(ii)(B) only require that the affiliate give advice to *an* insurance company; the provisions do not require advice to the affiliated insurance company.

457 *See* Final Merchant Banking Release, *supra* note 418, at 8,475.

institutional investors, such as other investment companies, pension funds, endowments, financial institutions or corporations, and sophisticated individual investors with high net worth.[458] In most instances, the securities firm is the sponsor or advisor to the fund and has a general partnership or similar interest in the fund.[459] Securities firms also make noncontrolling investments in funds that are sponsored and advised by unaffiliated companies.[460] Under Regulation Y,[461] a private equity fund qualifies for the special provisions of Regulation Y if the fund has a fixed duration of not more than 15 years including all potential extensions, and the FHC (including its officers, directors, employees and principal shareholders) does not own more than 25 percent of the total equity of the fund.[462] Regulation Y does not impose any limits on advisory fees or on the various types of incentive compensation that the FHC may receive for services rendered to the fund, provided that such fees do not increase the FHC's equity stake in the fund above the 25 percent threshold.[463]

Regulation Y requires that the fund not be an operating company,[464] engage exclusively in the business of investing in financial and nonfinancial companies for resale or other disposition,[465] and not be established or operated for the purpose of making investments that are inconsistent with Section 4(k)(4)(H), BHCA[466] or evading the limitations on merchant banking investments.[467] As discussed below, the fund must have policies and systems for monitoring and addressing the various risks associated with merchant banking activities.[468] The private equity fund may be organized in any legal form.[469] In addition, the fund may be, but need not be, registered as an investment company under the Investment Company Act.[470]

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458 *Id*.

459 *Id*.

460 *Id*.

461 12 C.F.R. § 225.173(a) (2002) (Regulation Y).

462 12 C.F.R. § 225.173(a)(3) & (4) (2002) (Regulation Y).

463 *See* Final Merchant Banking Release, *supra* note 418, at 8,475.

464 12 C.F.R. § 225.173(a)(2) (2002) (Regulation Y).

465 12 C.F.R. § 225.173(a)(1) (2002) (Regulation Y).

466 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). It seems that the blanket authority granted by 12 C.F.R. § 225.173(a)(1) (2002) (Regulation Y) to funds to invest in companies engaged in financial or nonfinancial activities is inconsistent with § 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). *See supra* text accompanying note 465. *See* the discussion *supra* text accompanying 425-435.

467 12 C.F.R. § 225.173(a)(5) (2002) (Regulation Y).

468 *See infra* D.2.*l*.

469 12 C.F.R. § 225.173(b) (2002) (Regulation Y).

470 *See* Final Merchant Banking Release, *supra* note 418, at 8,476. *See* 15 U.S.C. §§ 80a-1 to 80a-65 (1994 & Supp. V 1999).

Regulation Y permits an FHC, without Board approval, to own or control an investment in a private equity fund that makes merchant banking investments for the duration of the fund, which may be up to 15 years.[471] Regulation Y contemplates that a qualifying private investment fund may hold investments in portfolio companies for the duration of the fund.[472] Accordingly, a private equity fund that conducts merchant banking investment activities is not required to dispose of its investments within the 10-year period applicable to other types of merchant banking investments.[473] An FHC may seek the Board's approval to retain an investment in a qualifying private equity fund or to extend the duration of a private equity fund for a period longer than 15 years in special circumstances.[474]

The BHCA and Regulation Y prohibit an FHC from routinely managing or operating any portfolio company.[475] This prohibition also applies to any portfolio company that is owned or controlled by a private equity fund in which the FHC owns or controls any interest.[476] Likewise, a private equity fund that is controlled by an FHC may not routinely manage or operate a portfolio company.[477] Regulation Y does *not* prohibit an FHC from routinely managing or operating a private equity fund.[478]

Regulation Y defines situations in which an FHC is considered to control a private equity fund.[479] An FHC is considered to control a private equity fund if the FHC,

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471 12 C.F.R. § 225.173(c)(1) (2002) (Regulation Y). The 15-year limitation relates to any interest in the private equity fund and any interest in a portfolio company that is owned or controlled by a private equity fund in which the FHC owns or controls any interest. *Id.*

472 *Id*. *See* Final Merchant Banking Release, *supra* note 418, at 8,476.

473 *See* Final Merchant Banking Release, *supra* note 418, at 8,476.

474 12 C.F.R. § 225.173(c)(2) (2002) (Regulation Y). The holding period tacking rules set forth in 12 C.F.R. § 225.172(b)(2) & (3) (2002) (Regulation Y) must be applied in determining whether a private equity fund investment has been held longer than the period permitted by Regulation Y. 12 C.F.R. § 225.172(c)(3) (2002) (Regulation Y). *See* Final Merchant Banking Release, *supra* note 418, at 8,476 n.19. *See also infra* note 531. Any request for extension must be filed at least 90 days prior to the expiration of the holding period and include the information described in 12 C.F.R. § 225.172(b)(4) (2002) (Regulation Y). If the Board grants the extension request, the FHC must apply the capital charge described in 12 C.F.R. § 225.172(b)(6) (2002) (Regulation Y) to the FHC's investment in the fund and must comply with other restrictions imposed by the Board. *See* Final Merchant Banking Release, *supra* note 418, at 8,476. *See also infra* text accompanying notes 533 & 534.

475 Section 4(k)(4)(H)(iv), BHCA, 12 U.S.C. § 1843(k)(4)(H)(iv) (1994 & Supp. V 1999); 12 C.F.R. § 225.171(a) (2002) (Regulation Y).

476 12 C.F.R. § 225.173(d)(1) (2002) (Regulation Y).

477 12 C.F.R. § 225.173(d)(2) (2002) (Regulation Y). *See* the discussion of 12 C.F.R. § 225.173(d)(2) (2002) (Regulation Y) in Final Merchant Banking Release, *supra* note 418, at 8,476. A private equity fund may routinely manage or operate a portfolio company so long as no FHC controls the private equity fund. 12 C.F.R. § 225.173(d)(3) (2002) (Regulation Y).

478 *See* Final Merchant Banking Release, *supra* note 418, at 8,476.

479 12 C.F.R. § 225.173(d)(4) (2002) (Regulation Y).

including any director, officer, employee or principal shareholder of the FHC (1) serves as general partner, managing member or trustee of the private equity fund; (2) owns or controls in the aggregate 25 percent or more of any class of voting shares or similar interests in the fund or (3) selects, controls or constitutes a majority of the directors, trustees or management of the fund.[480] The adviser of the fund typically establishes the policies that govern the fund's investments and operations, makes investment and disposition decisions on behalf of the fund, and otherwise controls the fund and its operations.[481] For this reason, Regulation Y provides that an FHC is deemed to control a private equity fund if the FHC owns more than 5 percent of any class of voting shares or similar ownership interests in the fund *and* serves as the fund's investment adviser.[482]

It appears that the rules determining control over a private equity fund[483] are exclusive, *i.e.*, they exclude the rules on control and controlling influence that have developed under the BHCA.[484] The specific rules on control over a private equity fund apply only to equity funds that meet the definition of private equity fund,[485] one of the elements of the definition being that the FHC has an investment in the private equity fund.[486] The situation could arise that an FHC that has no investment in a private equity fund is found to control that fund under application of the general control rules but would not control the fund if it made a small investment in the fund.

An FHC may routinely manage or operate a portfolio company that is owned or controlled by a private equity fund, and a private equity fund that is controlled by an FHC may routinely manage or operate a portfolio company when the intervention is necessary or required to obtain a reasonable return on the FHC's investment upon resale or other disposition of the investment, such as to avoid or address a significant operating loss or in connection with the loss of senior management of the portfolio company.[487]

f. Investment Through Funds that Are Not Private Equity Funds

Although Regulation Y permits certain advantages to funds that meet the definition of a private equity fund, Regulation Y also permits FHCs to invest in and control a fund that does not meet the definition of a private equity fund. If the FHC *controls* the non-qualifying fund, then the provisions of Regulation Y, including the provisions governing the

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480 12 C.F.R. § 225.173(d)(4) (2002) (Regulation Y).

481 *See* Final Merchant Banking Release, *supra* note 418, at 8,476.

482 12 C.F.R. § 225.173(d)(4)(iv) (2002) (Regulation Y).

483 12 C.F.R. § 225.173(d)(2) (2002) (Regulation Y).

484 *Supra* note 11.

485 12 C.F.R. § 225.173(a) (2002) (Regulation Y).

486 12 C.F.R. § 225.173(a)(3) (2002) (Regulation Y).

487 12 C.F.R. § 225.171(e)(1), in connection with § 225.173(d)(1) & (2) (2002) (Regulation Y).

holding periods for portfolio companies, the routine management restrictions, the risk-management and recordkeeping requirements, the cross-marketing provisions, and Sections 23A and 23B, FRA, apply to investments made by the non-qualifying fund in the same manner as those provisions would apply if the investment in the portfolio company were held directly by the FHC.[488] If the FHC owns a *noncontrolling* interest in the fund, then the fund is itself considered to be a portfolio company and provisions of Regulation Y apply to that investment in the same way as they apply to any other investment in a portfolio company.[489]

Thus, under Regulation Y, an FHC may own more than 25 percent of the equity of a fund that has an unlimited life (and, consequently, is not a qualifying private equity fund), so long as the fund does not hold investments in portfolio companies for more than the 10-year holding period that would apply if the FHC held the investment in the portfolio company directly and the fund complies with the routine management and other restrictions in Regulation Y. Similarly, an FHC may invest in a fund that, in addition to making merchant banking investments, engages in other businesses (and, consequently, is not a qualifying private equity fund), so long as the FHC does not control the fund, divest its interest in the fund within the 10-year holding period, and complies with the other provisions of Regulation Y that apply to other investments in a portfolio company.[490]

g. Acting as Agent

FHCs and their subsidiaries may invest as principal under the merchant banking investment authority. Section 4(k)(4)(H), BHCA[491] makes it clear that an FHC and its subsidiaries may also make such investments on behalf of others. The others may be controlled companies (but not a depository institution or their subsidiaries) or third parties. Thus, *e.g.*, an FHC may act as investment adviser to a fund, regardless of whether the FHC is also an investor in the fund.[492]

h. Permitted Types of Investments

The BHCA is very inclusive in its description of the types of permitted merchant/investment banking. Such investments may be acquired or controlled by the FHC directly or indirectly by any subsidiary[493] (other than a depository institution or a subsidiary thereof), whether as principal, on behalf of one or more entities (including entities controlled by

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488 *See* Final Merchant Banking Release, *supra* note 418, at 8,477. *See* holding period: *infra* D.2.k.; routine management restrictions: *infra* D.2.*l*.; risk-management and recordkeeping requirements: *infra* D.2.j.; cross-marketing provisions: *infra* G.3.; application of prudential safeguards and application of §§ 23A and 23B, FRA: *infra* G.4.

489 *See* Final Merchant Banking Release, *supra* note 418, at 8,477.

490 *Id*.

491 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). *See* 12 C.F.R. § 225.170(a) (2002) (Regulation Y).

492 *See* Conference Report on S. 900, *supra* note 4, at 154.

493 *See* the discussions *supra* note D.2.d.

the FHC other than a depository institution or subsidiary thereof), or otherwise, and may consist of shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership) of a company or other entity, whether or not the FHC or the subsidiary has control over such company or entity, and such company or entity may be engaged in any activity.[494]

i. Investment in a Bank or Savings Association

The question arises whether an FHC may under the authority of Section 4(k)(4)(H), BHCA[495] acquire a bank or a BHC. The language of Section 4(k)(4)(H), BHCA permits the target company or entity (the portfolio company) to be "engaged in any activity not authorized pursuant to this section [4, BHCA]".[496] Thus, if the activities of a bank are authorized by Section 4, BHCA, a portfolio company could not engage in such activities, *i.e.*, a bank could not be a portfolio company. By clear implication, Section 4, BHCA permits the acquisition of a controlling or noncontrolling equity interest in a U.S. bank or BHC[497] and, therefore, a bank cannot be a portfolio company. At any rate, the requirements of Section 3, BHCA are not overruled by Section 4(k)(4)(H), BHCA and any acquisition of a bank or BHC must comply with Section 3, BHCA.[498] This conclusion is supported by Section 5(a), BHCA that provides that a declaration to become an FHC does not satisfy any requirements to file an application to acquire a bank pursuant to Section 3, BHCA.[499] The Board took a clear position on the relation between Sections 3 and 4(k)(4)(H), BHCA, stating that the merchant banking investment authority does

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494 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). *See* 12 C.F.R. § 225.170(c) (2002) (Regulation Y) enumerating the types of ownership interests that may be acquired under the merchant banking investment authority. An FHC may only acquire and hold shares and other ownership interests; other assets must be held or promptly transferred to a portfolio company in which the FHC has an ownership interest that maintains a corporate separateness from the FHC, has a management separate from the FHC and has policies that ensure the limitation of legal liability of the FHC. 12 C.F.R. § 225.170(e) (2002) (Regulation Y). *See* 12 C.F.R. § 225.175(a)(iv) (2002) (Regulation Y). It is the purpose of the separateness provision to avoid a situation in which the corporate veil between the FHC and the portfolio company could be pierced. *See infra* note 546 (discussing the doctrine of piercing the corporate veil).

495 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

496 Section 4(k)(4)(H) (introductory paragraph), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). The parenthetical exclusion of depository institutions in § 4(k)(4)(H), BHCA refers only to the principal for whom the FHC may act as agent. The Conference Report on S. 900, *supra* note 4, at 154, goes further than § 4(k)(4)(H), BHCA, when it states that the target company may be "engaged in any kind of trade or business whatsoever".

497 Section 4(a)(1), BHCA, 12 U.S.C. § 1843(a)(1) (1994 & Supp. V 1999), provides that no BHC shall "acquire direct or indirect ownership or control of the voting shares of any company which is not a bank". Thus, the acquisition of shares of a bank is permitted. One could also argue that a bank is engaged in some of the activities in which an FHC is authorized to engage under § 4, BHCA, 12 U.S.C. § 1843 (1994 & Supp. V 1999), such as § 4(k)(4)(A), 12 U.S.C. § 1843(k)(4)(A) (1994 & Supp. V 1999) (lending).

498 12 U.S.C. § 1842 (1994).

499 Section 5(a), BHCA, 12 U.S.C. § 1844(a) (1994 & Supp. V 1999). *See* § 3, BHCA, 12 U.S.C. § 1842 (1994).

not override the prior approval requirements of Section 3, BHCA that govern the acquisition of shares of a U.S. bank or BHC, the provisions of Sections 211.8–211.10, Regulation K to the extent they apply to the acquisition of a foreign bank,[500] or the provisions of Sections 4(k)(6)(B) and 4(j),[501] BHCA that govern the acquisition of shares of a savings association.[502] On the other hand, Section 4(k)(4)(H), BHCA does not incorporate the approach of Section 2(h)(3), BHCA.[503]

j. Management of Portfolio Companies

The merchant banking investments permitted by Section 4(k)(4)(H), BHCA[504] need not be noncontrolling in the meaning of the Board's Policy Statement[505] or the Board's Guidelines[506] and need not be passive in the meaning of Section 4(c)(6), BHCA investments.[507] Section 4(k)(4)(H)(iv), BHCA provides that during the period when such shares in a portfolio company, assets or ownership interests are held by an FHC or a subsidiary of an FHC, the FHC may not "routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition".[508] One might

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500 12 C.F.R. §§ 211.8–211.10 (2002) (Regulation K).

501 12 U.S.C. § 1843(k)(6)(B) (1994 & Supp. V 1999); 12 U.S.C. § 1843(j) (1994 & Supp. V 1999).

502 *See* Final Merchant Banking Release, *supra* note 418, at 8,469 n.8; Interim Merchant Banking Release, *supra* note 418, at 16,463 n.4. *See also* Interim FHC Release, *supra* note 32, at 3,787 (a company may file an application to become a BHC by virtue of the acquisition of a depository institution and an election to become an FHC at the same time).

503 Section 2(h)(3), BHCA, 12 U.S.C. § 1841(h)(3) (1994), and 12 C.F.R. § 211.23(f)(5)(iii)(B) (2002) (Regulation K) require Board approval before a foreign company controlled by a qualifying foreign banking organization can acquire a company engaged in the United States in any banking, securities, insurance or other financial activities. *See* Gruson, *supra* note 1, § 10.14 D.

504 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

505 12 C.F.R. § 225.143 (2002) (Regulation Y, Board Interpretations), 2 FED. RES. REG. SERV. 4-172.1, 68 FED. RES. BULL. 413 (1982), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 13-843). *See* Gruson, *supra* note 1, § 10.06 C.

506 Staff Op. of Nov. 5, 1984, 2 FED. RES. REG. SERV. 4-305.1, *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 60-055. *See* Gruson, *supra* note 1, § 10.06 D.

507 12 U.S.C. § 1843(c)(6) (1994). *See* Gruson, *supra* note 1, § 10.09 B.

508 Sections 4(k)(4)(H)(iv), BHCA, 12 U.S.C. § 1843(k)(4)(H)(iv) (1994 & Supp. V 1999). *See* 12 C.F.R. § 225.171(a). However, in the case of a controlling and actively managed investment there is a risk that loans granted to the target company are subject to equitable subordination. The doctrine of equitable subordination gives courts the power to change the relative priorities of claims in bankruptcy cases, in effect treating debt claims as equity. Developed by the United States Supreme Court in the 1930s (*see* Pepper v. Litton, 308 U.S. 295, 308 (1939); Taylor v. Standard Gas & Electric, 306 U.S. 307 (1939)) the doctrine was adopted by the Bankruptcy Code of 1978 (11 U.S.C. § 510(c)).

As a general matter, courts have been more likely to subordinate claims by "insiders". The term insider includes any party that has a sufficiently close relationship with the debtor that his conduct is made subject to greater scrutiny than those dealing at arm's length with the debtor. A lender can be attacked as an insider on the basis that he has exercised excessive control over the debtor. The fact that the lender is the dominant creditor is not alone enough to show that the creditor controls the debtor. There must be evidence

think that this provision refers to the management of the portfolio company by its board of directors.[509] The language of Section 4(k)(4)(H)(iv), BHCA which refers to "routine" management and operation of the portfolio company and the legislative history indicate, however, that the restriction does not refer to the typical policy setting function of the board of directors but to day-to-day management and routine business decisions that typically the officers or employees of the corporation are engaged in.[510] An FHC routinely manages or operates a portfolio company, for example, if (1) any director, officer or employee of the FHC or a subsidiary of the FHC serves as or has the responsibility of an executive officer of the portfolio company;[511] (2) any executive officer of the parent FHC or of certain of its major subsidiaries serves as or has the responsibility of an officer or employee of the portfolio company;[512] or

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of managerial or economic interference before a lender is found to be in control (*see* National Westminster Bank USA v. Century Healthcare Corp., 885 F. Supp. 601, 603 (S.D.N.Y. 1995)). However, control is likely to be found when the board of directors of the debtor is not capable of making independent decisions concerning the steps which the debtor will take in relation to the repayment of its debts. *See* GERALD BLANCHARD, 1 LENDER LIABILITY – LAW, PRACTICE AND PREVENTION § 9.08 (1999 & Supp. 2001). This will often be the case if the lender holds or acquires a controlling interest in the debtor's stock (*see* In re American Lumber Co., 5 B.R. 470 (Bankr. D. Minn. 1980)).

The doctrine of equitable subordination might well apply where a FHC is a controlling shareholder of a company that borrowed from the bank subsidiary of the FHC.

509 *See, e.g*., § 141(a) of the Delaware Corporation Law, 4 Del. Code Ann. (1991 Replacement Vol. & 1998 Supp.) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

510 *See* 12 C.F.R. § 225.171(b) (2002) (Regulation Y). *See* Conference Report on S. 900, *supra* note 4, at 155.

511 12 C.F.R. § 225.171(b)(1)(i) (2002) (Regulation Y). For a discussion of the subsidiaries of an FHC that are included in the term *FHC* for purposes of the presumptions of 12 C.F.R. § 225.171(b)(1)(i) (2002) (Regulation Y) (officer of FHC serves as executive officer of portfolio company), *see infra* note 512 (second paragraph).

512 12 C.F.R. § 225.171(b)(1)(ii)(A) (2002) (Regulation Y). For purposes of § 225.171(b)(1)(ii)(A) (2002) (Regulation Y) (executive officer of FHC serves as officer of portfolio company), *FHC* means the FHC itself and only certain subsidiaries of the FHC, namely: securities broker-dealers; depository institutions (and subsidiaries of such depository institutions, 12 C.F.R. § 225.171(f)(2) (2002) (Regulation Y)); affiliates of the FHC engaged in merchant banking activities under Subpart J of Regulation Y (2002); affiliates of the FHC engaged in insurance company portfolio investments (§ 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999)); small business investment companies (§ 302(b), Small Business Investment Act of 1958, 15 U.S.C. § 682(b) (1994 & Supp. V 1999)) controlled by the FHC or by a depository institution controlled by the FHC (the term depository institution includes a branch or agency of a foreign bank, 12 C.F.R. § 225.177(b) (2002) (Regulation Y)); any other affiliates engaged in significant equity investment activities that are subject to a special capital charge under the capital adequacy rules of the Board. 12 C.F.R. § 225.171(b)(1)(ii)(B) (2002) (Regulation Y). Thus, if an executive officer of any of such subsidiaries serves as an officer or employee of the portfolio company, the FHC is presumed to routinely manage the portfolio company. The definition of *FHC* set forth in 12 C.F.R. § 225.171(b)(1)(ii)(B) supersedes the general FHC definition of 12 C.F.R. § 225.177(a) (2002) (Regulation Y) because that general definition only applies "except as otherwise expressly provided". *Executive officer* is defined in 12 C.F.R. § 225.177(d) (2002) (Regulation Y). *See* Final Merchant Banking Release, *supra* note 418, at 8,471. *See also* 12 C.F.R. § 215.2(e)(1) (2002) (Regulation O).

The definition of *FHC* contained in 12 C.F.R. § 225.171(b)(1)(ii)(B) (2002) (Regulation Y) does not apply to the situation where a director, officer or employee of the FHC serves as executive officer of the portfolio

(3) any contractual arrangement exists between the FHC 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.[513] These presumptions are irrebuttable.

In addition, Regulation Y contains a rebuttable presumption of routine management or operation if any director, officer or employee of the FHC serves as or has the responsibility of an officer (other than an executive officer) or employee of the portfolio company,[514] or if any officer or employee of the portfolio company is supervised by any director,

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company. *See* 12 C.F.R. § 225.171(b)(1)(i) (2002) (Regulation Y). The definition of *FHC* generally applicable to Subpart J of Regulation Y (Merchant Banking Investments) applies with one exception to 12 C.F.R. § 225.171(b)(1)(i) (2002) (Regulation Y). *See* 12 C.F.R. § 225.177(a)(1) & (2) (2002) (Regulation Y). Pursuant to this general definition, *FHC* means the FHC and all of its subsidiaries, including private equity funds and other funds controlled by the FHC, but does not include a depository institution or subsidiaries thereof or any portfolio company controlled, directly or indirectly, by the FHC. However, for purposes of 12 C.F.R. § 225.171(a)–(d) (and of § 225.173(d)) (2002) (Regulation Y), depository institutions controlled by an FHC and subsidiaries of such depository institutions are treated as FHCs (the term *depository institution* includes a branch or agency of a foreign bank, 12 C.F.R. § 225.177(b) (2002) (Regulation Y)). Thus, the exception for depository institutions in the general FHC definition does not apply. 12 C.F.R. § 225.171(f)(2) (2002) (Regulation Y). Consequently, a director, officer or employee of an FHC or of any *subsidiary* of the FHC may not serve as an executive officer of a portfolio company of the FHC; and, as stated above, *subsidiary* includes depository institutions controlled by the FHC and subsidiaries of such depository institutions (including branches and agencies of foreign banks), as well as private equity funds or other funds controlled by the FHC. Directors, officers or employees of such entities may not serve as executive officers of a portfolio company. The term *subsidiary* does not include portfolio companies controlled by the FHC and directors, officers or employees of one portfolio company of any FHC may serve as executive officers of another portfolio company of such FHC. 12 C.F.R. § 225.177(a)(2) (2002) (Regulation Y).

The use of different definitions of FHCs for purposes of 12 C.F.R. § 225.171(b)(1)(i) and (ii)(A) (2002) (Regulation Y) and the resulting difference in the groups of subsidiaries whose officers could violate the prohibition on routine management is curious. The Final Merchant Banking Release, *supra* note 418, at 8,471 seems to imply that the FHC definition of 12 C.F.R. 225.171(b)(1)(ii)(B) (2002) (Regulation Y) is necessary to enlarge the scope of affected officers. In fact, however, it limits the scope. *See* the words "only the following subsidiaries" in 12 C.F.R. § 225.171(b)(1)(ii)(B) (2002) (Regulation Y). The definitional maze built around the term *FHC* does not appear to meet the plain language requirement of 12 U.S.C. § 4809 (1999 & Supp. V 1999).

513 12 C.F.R. § 225.171(b)(1)(iii) (2002) (Regulation Y). It is noteworthy that 12 C.F.R. § 225.171(b)(1)(iii) (2002) (Regulation Y) only refers to covenants and agreements, not to charter or by-law restrictions. *FHC* for purposes of this presumption is the FHC and its subsidiaries as determined for purposes of 12 C.F.R. § 225.171(b)(1)(i) (2002) (Regulation Y). *See supra* note 512 (second paragraph).

514 12 C.F.R. § 225.171(b)(2)(i) (2002) (Regulation Y). The method by which the presumption may be rebutted is set forth in 12 C.F.R. § 225.171(c) (2002) (Regulation Y). *FHC* for purposes of this presumption is the FHC and its subsidiaries as determined for purposes of 12 C.F.R. § 225.171(b)(1)(i) (2002) (Regulation Y). *See supra* note 512 (second paragraph).

officer or employee of the FHC (other than in that individual's capacity as a director of the portfolio company).[515]

Directors, officers and employees of the FHC may constitute a majority of the board of the portfolio company.[516] However, where an FHC controls the board of directors of a portfolio company, the board must refrain from engaging in day-to-day management functions, although the board has the right to do so under corporate law.[517]

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[515] 12 C.F.R. § 225.171(b)(2)(ii) (2002) (Regulation Y). The method by which the presumption may be rebutted is set forth in 12 C.F.R. § 225.171(c) (2002) (Regulation Y). *FHC* for purposes of this presumption is the FHC and its subsidiaries as determined for purposes of 12 C.F.R. § 225.171(b)(1)(i) (2002) (Regulation Y). *See supra* note 512 (second paragraph).

The rebuttable presumption of 12 C.F.R. § 225.171(b)(2) (2002) (Regulation Y) is supported by the legislative history of the GLBA. The Conference Report on S. 990, *supra* note 4, at 155 indicates that the service of FHC officers and employees as officers and employees of the portfolio company might be permissible when it states that the prohibition on routine management is "irrespective of any overlap between board members and officers of the FHC and the portfolio company". *See also* the colloquy between Senator Bennett and Senator Gramm, *infra* note 517. Personnel overlap might be advisable, for instance, if a staff member of the finance department of the FHC is sent for a period of time to the portfolio company. It does not necessarily indicate involvement in routine management; it is rather unlikely that the delegated staff member will get day-to-day instructions from the FHC.

[516] The Conference Report on S. 900 *supra* note 4, at 155 states that the prohibition on routine management is "irrespective of any overlap between board members and officers of the FHC and the portfolio company" and thereby seems to envision any overlap, even an overlap that gives directors and employees of the FHC a majority on the board of the portfolio company. 12 C.F.R. § 225.171(d)(1) (2002) (Regulation Y) provides that an FHC 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 the portfolio company, if the portfolio company employs officers and employees responsible for routinely managing and operating the portfolio company and the FHC does not routinely manage or operate the portfolio company. The selection of partners (including the general partners) of a partnership is considered to be the equivalent of selecting the directors of a company. *See* Final Merchant Banking Release, *supra* note 418, at 8,472. A representative of an FHC that serves as a director of a portfolio company may participate fully in those matters that are typically presented to directors, except that the director may not participate in the day-to-day operations of the portfolio company or in management decisions that are made in the ordinary course of business and not customarily presented to the directors of a company. *See id.* at 8,472.

A director, officer or employee of a depository institution (or a subsidiary thereof) or a U.S. branch or agency of a foreign bank may serve as director of a portfolio company to the same extent as would be permitted for a director of an FHC. *See* Final Merchant Banking Release, *supra*, at 8,473. This follows from 12 C.F.R. § 225.171(a) in connection with § 225.171(f)(2) (2002) (Regulation Y) which defines *FHC* for purposes of 12 C.F.R. § 225.171 (2002) (Regulation Y) to include a depository institution controlled by the FHC (and a subsidiary of such depository institution) and thereby modifies the *FHC* definition contained in 12 C.F.R. § 225.177(a)(2) (2002) (Regulation Y). Branches and agencies of foreign banks are depository institutions for purposes of 12 C.F.R. § 225.171 (2002) (Regulation Y). 12 C.F.R. § 225.177(b) (2002) (Regulation Y). A director, officer or employee of any subsidiary of an FHC (including a private equity fund or other fund controlled by the FHC) may serve as director of a portfolio company to the same extent as would be permitted for a director of an FHC. *See* 12 C.F.R. § 225.177(a) (2002) (Regulation Y) (defining FHC for purposes of Subpart J of Regulation Y to include subsidiaries of the FHC).

[517] A colloquy between Senator Bennett and Senator Gramm supports this interpretation:

If the FHC or its affiliates only elect a minority of the board of directors, neither the FHC nor its affiliates have the power to manage or operate the portfolio company. However, on the basis of provisions in the charter or bylaws of the portfolio company or on the basis of a shareholder agreement, the FHC could make the decisions of the portfolio company dependent on its or its affiliate's consent. Regulation Y sets forth examples of permissible covenants and agreements between an FHC and a portfolio company that restrict the ability of the portfolio company to take actions outside of its ordinary course of business or require the portfolio company to consult with or obtain the approval of the FHC with respect to such actions.[518] Such restrictions and consultation rights are not limited by Regulation Y to FHCs that only own a minority interest in a portfolio company, but, as a practical matter, an FHC that owns a majority interest in a portfolio company does not need such rights. The approach of Regulation Y to provide a list of examples of permissible restrictions and consultation rights but not to provide a list of impermissible restrictions gives the FHC certain safe harbors. Regulation Y further permits FHCs to provide financial, investment and management consulting advice to a portfolio company, to provide underwriting and private placement services to a portfolio company in connection with the portfolio company's securities, and have consultations with officers and

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> Mr. BENNETT. Mr. President, I rise to engage the distinguished chairman of the Banking Committee in a colloquy on the ability of insurance companies to make investments that are treated as "financial in nature" under this legislation even though the investments are made in companies that are not engaged in financial activities.
>
> Am I correct that overlap between board members and officers of a financial holding company and a portfolio company in which an insurance company has an investment is not intended to result necessarily in a determination that the holding company routinely manages or operates the portfolio company? Or to state this intention another way, the existence of routine holding company management or operation is to be based upon an assessment of actual holding company involvement in day-to-day management and operations of the portfolio company, rather than board member or officer overlaps.
>
> Mr. GRAMM. Mr. President, the understanding of the Senator from Utah is correct.

145 CONG. REC. S13,902 (daily ed.) (Nov. 4, 1999). *See* 12 C.F.R. § 225.171(d)(1)(ii) (2002) (Regulation Y).

[518] 12 C.F.R. § 225.171(d)(2) (2002) (Regulation Y). It is noteworthy that § 225.171(d)(2) (2002) (Regulation Y) only refers to (written) covenants and agreements, not to charter or by-law restrictions. The Section does not prohibit agreements among shareholders of a portfolio company, it only prohibits agreements with the portfolio company. The FHC's consulting advice must not lead to a responsibility for decision-making or for day-to-day management or operations of the portfolio company, and the meetings with officers and employees of the portfolio company must not lead to such management or operation. *See* Final Merchant Banking Release, *supra* note 418, at 8,472. The Final Merchant Banking Release, *id*., refers only to "regular or periodic" meetings with officers and employees of the portfolio company. However, nothing in 12 C.F.R. § 25.171(d)(2) (2002) (Regulation Y) excludes ad hoc meetings.

employees of the portfolio company to monitor or provide advice with respect to the portfolio company's performance or activities.[519]

The approach of Section 225.171, Regulation Y[520] to set forth acts that are irrebuttably or rebuttably presumed to constitute routine management and control and acts that do not constitute routine management and control leaves, of course, a wide range of unallocated acts. These acts are permissible for FHCs if they do not constitute routine management and control. Regulation Y does not provide a presumption for such unallocated acts.

A more active role on the part of the FHC and its subsidiaries[521] is permitted when intervention by the FHC is necessary or required to obtain a reasonable return on the FHC's investment in the portfolio company upon resale or other disposition. [522] Section 225.171(e)(1), Regulation Y[523] adds to the permission of the FHC to intervene in the management of the portfolio company in order to obtain a reasonable return, the following

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519 12 C.F.R. § 225.171(d)(3)(i)–(iii) (2002) (Regulation Y). The consulting advice must be consistant with and subject to any restrictions on such activities contained in 12 C.F.R. § 225.28(b)(6) or in 12 C.F.R. § 225.86(b)(1) (2002) (Regulation Y). 12 C.F.R. § 225.171(d)(3)(i) (2002) (Regulation Y).

520 12 C.F.R. § 225.171 (2002) (Regulation Y).

521 *See* 12 C.F.R. § 225.177(a) (2002) (Regulation Y) (defining *FHC* as including all of its subsidiaries, including private equity funds and other funds controlled by the FHC, but as excluding any depository institution or subsidiary thereof); 12 C.F.R. § 225.171(f)(2) & (3) (2002) (Regulation Y) (for purposes of 12 C.F.R. § 225.171(e) (2002) (Regulation Y) the term *FHC* does not include a depository institution controlled by the FHC and a subsidiary of such depository institution; however, there is an exception for certain subsidiaries of depository institutions); and 12 C.F.R. § 225.171(f)(1) (2002) (Regulation Y) (a depository institution and a subsidiary of a depository institution may not routinely manage and operate a portfolio company in which an affiliated FHC owns or controls an interest). This prohibition also applies to branches and agencies of foreign banks. 12 C.F.R. § 225.177(b) (2002) (Regulation Y).

12 C.F.R. § 225.171(f)(3) (2002) (Regulation Y) lists certain subsidiaries of FHC-controlled depository institutions as being included in the definition of FHC for purposes of 12 C.F.R. § 225.171(e) (2002) (Regulation Y) and states that such subsidiaries may routinely manage or operate a portfolio company in which the FHC has an investment in accordance with 12 C.F.R. § 225.171(e) (2002) (Regulation Y). The provision on its face contradicts 12 C.F.R. § 225.171(f)(1) (2002) (Regulation Y) that prohibits depository institutions and all subsidiaries of depository institutions from routinely managing or operating portfolio companies pursuant to 12 C.F.R. § 225.171(e) (2002) (Regulation Y). 12 C.F.R. § 225.171(f)(3) (2002) (Regulation Y) is intended to be an exception to the prohibition of 12 C.F.R. § 225.171(f)(1) (2002) (Regulation Y) as if that Section read "A depository institution and a subsidiary of a depository institution, other than a subsidiary referred to in § 225.171(f)(3), may not routinely manage or operate a portfolio company …". The purpose of 12 C.F.R. § 225.171(f)(1) (2002) (Regulation Y) is not clear in any event. If an FHC may routinely manage a portfolio company, and if pursuant to 12 C.F.R. §§ 225.177(a)(2) and 225.171(f)(2) (2002) (Regulation Y) a depository institution subsidiary of an FHC (and the subsidiaries of such depository institution) is not included in the term *FHC* for purposes of 12 C.F.R. § 225.171(e) (2002) (Regulation Y), the provisions of 12 C.F.R. § 225.171(f)(1) (2002) (Regulation Y) that depository institutions and their subsidiaries may not routinely manage or operate is superfluous and only adds to the definitional confusion.

522 12 C.F.R. § 225.171(e)(1) (2002) (Regulation Y). This Section of Regulation Y is based on § 4(k)(4)(H)(iv), BHCA, 12 U.S.C. § 1843(k)(4)(H)(iv) (1994 & Supp. V 1999).

523 12 C.F.R. § 225.171(e)(1) (2002) (Regulation Y).

words: "such as to avoid or address a significant operating loss or in connection with the loss of senior management at the portfolio company". If the language is read as an exclusive description of the situations in which intervention by the FHC in the portfolio company's management is necessary to obtain a reasonable return, Regulation Y would be substantially narrower than the statutory language of Section 4(k)(4)(H)(iv), BHCA.[524] However, the Board has stated that the situations mentioned in Section 225.171(e)(1), Regulation Y are examples and do not represent an exclusive list of situations when an FHC may permissibly intervene in the routine management of a portfolio company.[525] Still, there is a certain contradiction in Section 225.171(e)(1), Regulation Y when it permits routine management by the FHC of the portfolio company if necessary "to obtain a reasonable return" but the triggering event for such routine management is a "significant operating loss". An FHC should be concerned about a reasonable return upon resale if the portfolio company generates a below average rate of return.[526]

An FHC may routinely manage or operate a portfolio company only for the period of time as may be necessary to address the cause of the FHC's involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return upon the resale or other disposition of the investment.[527] However, an FHC may not routinely manage or operate a portfolio company for a period greater than 9 months without prior written notice to the Board.[528] An FHC must maintain and make available to the Board upon request a written record describing its involvement in routinely managing or operating a portfolio company.[529]

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524 12 U.S.C. § 1843(k)(4)(H)(iv) (1994 & Supp. V 1999). That Section permits routine management or operation "as may be necessary or required to obtain a reasonable return on investment upon resale or disposition".

525 *See* Final Merchant Banking Release, *supra* note 418, at 8,473.

526 A colloquy between Senator Bennett and Senator Gramm supports this interpretation.

> Mr. BENNETT. Mr. President, I also inquire of the distinguished chairman of the Banking Committee whether I am also correct that the exception under which a holding company may routinely manage or operate a portfolio company when necessary or required to obtain a reasonable return on investment is intended to apply to an investment in a company that has been generating a below average rate of return on investment either at the time the holding company becomes a bank holding company or that generates a below average rate of return at a subsequent time?
>
> Mr. GRAMM. Mr. President, the understanding of the Senator from Utah is also correct.

145 CONG. REC. S13,902 (daily ed.) (Nov. 4, 1999). Whereas the colloquy refers to a below-average return, 12 C.F.R. § 225.171(e)(1) (2002) (Regulation Y) requires a significant operating loss.

527 12 C.F.R. § 225.171(e)(2) (2002) (Regulation Y).

528 12 C.F.R. § 225.171(e)(3) (2002) (Regulation Y). As to the form and content of the notice, *see* Final Merchant Banking Release, *supra* note 418, at 8,473.

529 12 C.F.R. § 225.171(e)(4) (2002) (Regulation Y).

k. Holding Period

The Board interprets the requirement that the merchant banking investment must be held "for a period of time to enable the sale or disposition thereof on a reasonable basis"[530] as meaning that an FHC may hold a merchant banking investment for up to 10 years, except that a merchant banking investment in or held through a private equity fund may be held for the duration of the fund (which may not exceed 15 years).[531] In unusual circumstances an FHC may seek Board approval to hold an interest in a portfolio company in excess of 10 years (respectively, 15 years).[532] However, an FHC that holds a merchant banking investment in excess of 10 years or in excess of the duration of the private equity fund must, for purposes of determining the FHC's regulatory capital, apply to the FHC's adjusted carrying value of the shares, assets, or ownership interests held in excess of the holding period, a capital charge determined by the Board[533] and abide by any other restrictions that the Board may impose in connection with granting approval of the extension of the holding period.[534]

l. Risk Management, Record Keeping and Reporting

An FHC, including a private equity fund[535] controlled by an FHC, that makes merchant banking investments must establish and maintain policies, procedures, records, and systems reasonably designed to conduct such investments in a safe and sound manner, to manage the risk associated with such investments in a safe and sound manner and to monitor compliance with the statutory and regulatory provisions governing such investments.[536] The requirements of risk management, record keeping, and reporting policies with which an FHC has to comply when making merchant banking investments are set forth in Section 225.175, Regulation Y.[537] In

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530 Section 4(k)(4)(H)(iii), BHCA, 12 U.S.C. § 1843(k)(4)(H)(iii) (1994 & Supp. V 1999). *See* 12 C.F.R. § 225.172(a) (2002) (Regulation Y).

531 12 C.F.R. §§ 225.172(b)(1) & 225.173(c)(1) (2002) (Regulation Y). *Private Equity Fund* is defined in 12 C.F.R. § 225.173(a) (2002) (Regulation Y) and discussed *supra* D.2.e. 12 C.F.R. § 225.172(b)(2) (2002) (Regulation Y) contains provisions determining when an interest in a portfolio company was acquired if it was acquired by the FHC from, or transferred by the FHC to, a company in which the FHC held an interest. 12 C.F.R. § 225.172(b)(3) (2002) (Regulation Y) addresses the issue of interests previously held by an FHC under a limited authority. 12 C.F.R. § 225.172(b)(2) & (3) (2002) (Regulation Y) also applies to interests in, held through or acquired from a private equity fund. 12 C.F.R. § 225.173(c)(3) (2002) (Regulation Y).

532 12 C.F.R. §§ 225.172(b)(4) & (5) and 225.173(c)(2) (2002) (Regulation Y).

533 12 C.F.R. § 225.172(b)(6)(i) (2002) (Regulation Y). The capital charge must not be less than 25 percent of the adjusted carrying value of the investment 12 C.F.R. § 225.172(b)(6)(i)(B) (2002) (Regulation Y)

534 12 C.F.R. § 225.172(b)(6)(ii) (2002) (Regulation Y). *See* 12 C.F.R. § 225.172(b)(4) (2002) (Regulation Y) (approval required to hold interest in excess of time limit).

535 *See* 12 C.F.R. § 225.173(a) (2002) (Regulation Y). *See supra* D. 2. e.

536 12 C.F.R. § 225.175(a)(1) (2002) (Regulation Y). *See* Final Merchant Banking Release, *supra* note 418, at 8,478.

537 12 C.F.R. § 225.175 (2002) (Regulation Y).

addition, the Division of Banking Supervision and Regulation of the Board has issued a Supervisory Guidance on Equity Investment and Merchant Banking Activities [*herein* the Guidance Letter].[538] Although the Guidance Letter applies to equity investments made under any authority in nonfinancial companies,[539] it is particularly relevant for equity investments under the merchant banking investment authority. The Guidance Letter "discusses basic safety and soundness issues regarding the management of equity investments, and identifies sound investment and risk management practices that merit the attention of both management and supervisors"[540] and describes in detail the internal controls and risk management policies, procedures and systems that the Board expects BHCs engaged in equity investment activities to have and to maintain in order to conduct such activities in a safe and sound manner. The Guidance Letter notes that foreign banks should incorporate the basic principles set forth in the Guidance Letter into their U.S. operations with appropriate adaptation to reflect the fact that those operations are an integral part of a foreign bank, which should be managing its risks on a consolidated basis and that the bank is subject to overall supervision by its home country authorities.[541]

The risk management, record keeping and reporting requirements of Regulation Y and the Guidance Letter can be summarized as follows:

Internal Risk Management Requirements

Regulation Y[542] requires FHCs engaged in merchant banking investment activities to establish policies, procedures and systems and maintain records reasonably designed to:

- Monitor and assess the carrying value, market value and performance of each investment and such values of the FHC's aggregate merchant banking investment portfolio;[543]

- Identify and manage the market, credit, concentration and other risks associated with merchant banking investments;[544]

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538 Board, SR Letter No. 00-9 (SPE) (June 22, 2000).

539 Guidance Letter, *supra* note 538, *sub* II, at 2, 3.

540 Cover Letter to Guidance Letter, *supra* note 538, at 2.

541 Guidance Letter, *supra* note 538, *sub* II, at 3.

542 12 C.F.R. § 225.175(a)(1) (2002) (Regulation Y). The Final Merchant Banking Release, *supra* note 418, at 8,479 states that the list of policies, procedures, records and systems set forth in 12 C.F.R. § 225.175(a)(1) (2002) (Regulation Y) is only intended to identify some of the most important elements of a sound approach to monitoring merchant banking investment activities.

543 12 C.F.R. § 225.175(a)(1)(i) (2002) (Regulation Y).

544 12 C.F.R. § 225.175(a)(1)(ii) (2002) (Regulation Y).

- Identify, monitor and assess the terms, amounts and risks arising from transactions and relationships (including contingent fees or contingent interests) between the FHC and the portfolio companies;[545]

- Ensure the maintenance of corporate separateness between the FHC and the portfolio companies in order to protect the FHC and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of any of the portfolio companies;[546] and

- Ensure compliance with Subpart J (Merchant Banking Investments) of Regulation Y and other provisions of law governing transactions and relationships between the FHC and portfolio companies.[547]

In addition, the Guidance Letter recommends that FHCs should implement "sound management practices".[548] These practices include:

- *Oversight*: Active oversight by the FHC's board of directors and senior management. The board should approve portfolio objectives and investment

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545 12 C.F.R. § 225.175(a)(1)(iii) (2002) (Regulation Y).

546 12 C.F.R. § 225.175(a)(1)(iv) (2002) (Regulation Y). Clause (iv) connects the requirement to maintain corporate separateness and the protection against piercing the corporate veil with an "and". The meaning seems to be that corporate separateness must be maintained *in order* to prevent piercing the corporate veil. Generally, the principle that shareholders are not personally liable for corporate debts is fundamental to the concept of the corporation as a separate legal entity. Due to the importance of the concept of limited liability, courts will not lightly disregard the corporate entity (*see* Laya v. Erin Homes Inc., 352 S.E.2d 93 (W. Va. 1986)). In exceptional circumstances, however, they may do so and "pierce the corporate veil." Although the different states may have somewhat different standards about the doctrine of piercing the corporate veil, there is a common understanding as to the basic rules. Courts have disregarded the corporate separateness of a subsidiary in cases where a combination of factors indicates that the relationship between the parent and the subsidiary is too close or that the parent corporation dominates the activities of the subsidiary in a certain way. This occurs typically, when fraud is involved or the legal fiction serves as a barrier to righting illegal acts (*see* United States v. Del Campo Baking Mfg. Co., 345 F. Supp. 1377–1378 (D. Del. 1972)) and when the corporation is the mere instrumentality, alter ego or agent of the parent corporation (*see* Equitable Trust Co. v. Gallagher, 99 A.2d 490, 493 (Del. 1953)); *see also* Advocat v. Nexus Indus., 497 F. Supp. 328, 334–335 (D. Del. 1980). For a detailed list of factors that are relevant in the decision whether a corporate entity will be held liable for the actions of a subsidiary, *see Laya*, 352 S.E.2d, at 98-99. *See generally* EDWARD P. WELCH, ANDREW J. TUREZYN, FOLK ON THE DELAWARE GENERAL CORPORATE LAW: FUNDAMENTALS at 797 (2000 ed.). Although the separate corporate entity will be ignored when the controlling stockholder treats the corporation as if it were a facet of his own personality or when the corporate formalities have been disregarded, mere control, even the total ownership of a corporation is not in itself sufficient for ignoring the separate entity. *See* Buechner v. Farbenfabriken Bayer Aktiengesellschaft, 154 A.2d 684 (Del. 1959). Additionally, common management between affiliated corporations is not a basis for disregarding the corporate entity absent some showing that fraud is involved or that the subsidiary is the alter ego of the parent. *See* Advocat v. Nexus Indus., 497 F. Supp. at 335 (D. Del. 1980).

547 12 C.F.R. § 225.175(a)(1)(v) (2002) (Regulation Y). Clause (v) specifically refers to fiduciary principles and to §§ 23A & 23B, FRA, 12 U.S.C. §§ 371c & 371c-1 (1994 & Supp. V 1999). *See infra* G.4.

548 *See* Guidance Letter, *supra* note 538, *sub* III, at 3.

strategies and policies, limits on aggregate investment and exposure amounts, types of investments and diversification-related aspects of equity investments. The board should actively monitor the performance and risk profile of the equity investment business in light of its established objectives, strategies and policies. The board should ensure that there is an effective management structure for conducting the institution's equity activities, including adequate systems for measuring, monitoring, controlling and reporting on the risks of equity investments, and should specify lines of authority and responsibility for acquisition and sales of investments.[549]

Senior management must ensure that there are adequate policies, procedures and management information systems for managing equity investment activities on a day-to-day and longer-term basis and that there is competent staff.[550]

- *Management of the Investment Process:*

  – *Policies and Limits*: The FHC must have effective policies that (i) govern the types and amounts of investments that may be made; (ii) provide guidelines on appropriate holding periods for different types of investments; (iii) establish parameters for portfolio diversification;[551] (iv) govern compensation arrangements, including co-investment structures and sale of portfolio company interests by employees of the FHC;[552] (v) govern the terms and conditions of employee loans and sales of participants' interests prior to the release of the lien securing such loans in connection with key employees' co-investments;[553] and (vi) limit the legal liability of the FHC and its affiliates for the financial obligations and liabilities of the portfolio companies.[554]

  – *Procedures*: The FHC must have procedures for assessing, approving and reviewing investments based upon the size, nature and risk profile of an investment. This includes (i) analytical assessments of investment opportunities and formal approval process; (ii) internal risk rating for equity investments; (iii) periodic and timely review of the FHC's equity investments; (iv) valuation accounting policies and procedures; (v) exit strategies; (vi) policies and procedures to govern the sale, exchange or

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549 *Id. sub* III A, at 4–5.

550 *Id. sub* III A, at 5.

551 *Id. sub* III B, at 5.

552 *Id. sub* III B, at 6.

553 *Id*. *sub* III C, at 12.

554 *See* Guidance Letter, *supra* note 538, *sub* V, at 14. *See supra* note 546 (discussing the doctrine of piercing the corporate veil) and note 508 (discussing the doctrine of equitable subordination).

other disposition of the FHC's investments; (vii) internal methods for allocating economic capital based on the risk inherent in the investment activities; and (viii) terms and conditions of employee loans and sales of participants' interests prior to the release of the liens securing such loans in connection with key employees' co-investments.[555]

- *Control System*: An adequate system of internal controls, with appropriate checks and balances and clear audit trails, that focuses on all of the elements of the investment management process including: (i) the appropriateness of existing policies and procedures; (ii) the adherence to policies and procedures; (iii) the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting; (iv) departures from policies and procedure; and (v) compliance with all federal laws and regulations applicable to an FHC's investment activities (in particular compliance with prohibition on impermissible control over equity investments[556] and compliance with restrictions on cross-marketing between depository institution and portfolio companies of FHCs.)[557]

It seems clear that the policies and procedures described above are expected to be at the top-tier FHC level and applied by it on a consolidated basis to its subsidiaries. Accordingly, any subsidiary of an FHC should be informed of the policies and procedures that it would be expected to follow when engaged in merchant banking investments, including reporting requirements to the parent FHC.

Record Keeping Requirements

Regulation Y requires FHCs to keep records designed to conduct, monitor and manage the investment activities and the risks associated with such investments in a safe and sound manner.[558]

The Guidance Letter recommends the following record keeping measures:[559]

- documentation of key elements of the investment process, including initial due diligence, approval reviews, valuation and disposition;

- documentation of board-approved objectives, strategies, policies and procedures;[560]

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555 *Id*. *sub* III B, at 6–10.

556 *See, e.g*., *supra* D.2.j. (impermissible control over portfolio companies); Gruson, *supra* note 1, § 10.09 B (impermissible control over § 4(c)(6), BHCA, 12 U.S.C. § 1843(c)(6) (1994), investments).

557 *See* Guidance Letter, *supra* note 538, *sub* III C, at 10–11. *See infra* G.3. (limitations on cross-marketing).

558 12 C.F.R. § 225.175(a)(1) (2002) (Regulation Y).

559 *See* Guidance Letter, *supra* note 538, *sub* III C, at 11.

- records of transactions between an FHC and companies held under the merchant banking investment authority, specifically documentation transactions that are not on market terms;

- documentation of incentive arrangements in connection with controlling or advising a fund, including the carrying value and market value of the arrangement and amounts that may be payable based on future asset performance; and

- documentation of the legal separation between the FHC and the portfolio company.[561]

Regulation Y does not require an FHC to maintain the records at a central location. Instead, an FHC must be able to identify and promptly make the records – wherever located – available to the Board upon request.[562]

Reporting Requirements

Upon request by the Board or the appropriate Federal Reserve Bank, an FHC must make the policies, procedures and records maintained with respect to its merchant banking investments available to the Board or the Federal Reserve Bank.[563] Furthermore, an FHC must provide reports to the appropriate Federal Reserve Bank in such format and at such times as the Board may prescribe.[564]

FHCs must file both annual and quarterly reports with the appropriate Federal Reserve Bank in such format as shall be prescribed by the Board.[565]

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560 *Id. sub* III A, at 4 & *sub* III C, at 11.

561 *Id*. *sub* III C, at 11. It appear that this documentation requirement would apply to a controlled investment and that the Board expects that the FHC will maintain the usual corporate forms necessary to avoid "piercing the corporate veil." *See supra* note 546.

562 *See* Final Merchant Banking Release, *supra* note 418, at 8,479.

563 12 C.F.R. § 225.175(a)(2) (2002) (Regulation Y).

564 12 C.F.R. § 225.175(b) (2002) (Regulation Y).

565 12 C.F.R. § 225.175(b) (2002) (Regulation Y). For foreign banking organizations (including FBOs that have elected FHC status), *see* Board Form FR Y-10F, OMB Number 7100-0297 (expires Dec. 31, 2003) (Report of Changes in FBO Organizational Structure) containing the Investments and Activities Schedule that collects information on acquisitions and sales of reportable entities. The reportable events include the acquisition of control of nonbanking companies and certain large merchant banking investments. *See* Report of Changes in FBO Organizational Structure (FR Y-10F) – Specific Instructions for the Investments and Activities Schedule, and – General Instructions, Reportable Entities. Form FR Y-10F must be filed by FBOs, *i.e.*, foreign banks that operate a branch, agency or commercial lending company in the United States or that control a bank in the United States and any company of which the foreign bank is a subsidiary. See FR Y-10 and Y-10F Glossary and 12 C.F.R. § 211.21(o) (2002) (Regulation K). See *infra* note 696 discussing that compliance with Form FR Y-10F can be very onerous. Reports on Form FR Y-10F must be received within 30 calendar days of the occurrence of the reportable transaction. For U.S. BHCs (including BHCs that have elected FHC status but not FBOs controlling a U.S. bank) and U.S.

Notice Requirements for Acquisitions of Interests in Portfolio Companies

The notice requirements are discussed elsewhere.[566]

Disclosure of Merchant Banking Investment Activities

The Guidance Letter recommends that FHCs adequately disclose to the public relevant information that is necessary for the markets to assess the risk profiles and performance of the FHCs' merchant banking investment activities. FHCs are encouraged to disclose information relating to:[567]

- The size of their merchant banking investment portfolios;
- The types and nature of their merchant banking investments, such as direct/indirect, domestic/international, public/private and equity/debt with conversion rights;
- The initial cost, carrying value, and fair value of investments, and where applicable, comparisons to publicly quoted share values of portfolio companies;
- The accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices;
- The realized gains and losses arising from sales and unrealized gains and losses; and
- Any insights regarding the potential performance of equity investments under alternative market conditions.

The Guidance Letter recognizes that disclosure regarding each of the above issues might not be appropriate, relevant or sufficient in every case.[568]

Institutions Lending to or Engaging in Other Transactions with Portfolio Companies

Additional risk management issues may arise when a banking institution subsidiary of an FHC or an affiliate lends to or has other business relationships with: (i) a company in which the FHC or an affiliate has invested (*i.e.*, a portfolio company); (ii) the general partner or manager of a private equity fund that has also invested in a portfolio company;

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banks, *see* Board Form FR Y-10, OMB Number 7100-0297 (expires Dec. 31, 2003) (Report of Changes in Organizational Structure).

566 *See infra* F.

567 *See* Guidance Letter, *supra* note 538, at 14–15.

568 *See id.* at 12.

or (iii) a private equity-financed company in which the FHC does not hold a direct or indirect ownership interest but which is an investment or portfolio company of a general partner or fund manager with which the FHC has other investments. Given their potentially higher than normal risk attributes, FHCs should devote special attention to ensuring that the terms and conditions of such lending relationships are at arm's length and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivatives transactions with or guaranteed by portfolio companies and general partners.[569]

Where a banking institution subsidiary of an FHC lends to a private equity-financed company in which it has no equity interest but where the borrowing company is a portfolio investment of private equity fund managers or general partners with which the institution may have other private-equity related relationships, care must be taken to ensure that the extension of credit is conducted on reasonable terms.[570]

Private Equity and Other Funds

If an FHC controls a private equity fund or other fund that makes merchant banking investments, the FHC must ensure that the fund has established the types of policies, procedures and systems and maintains the types of records described in Regulation Y for making and monitoring the fund's merchant banking investments or, alternatively, the FHC may ensure that the fund is subject to the FHC's merchant banking policies, procedures and systems.[571] These requirements do not apply if the FHC does not control the fund.[572] Nevertheless, an FHC must apply its merchant banking policies, procedures and systems to any investment made by the FHC in any fund that is controlled by an unaffiliated entity.[573]

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569 *Id.* at 13. Lending and other business transactions between an insured depository institution and a portfolio company that meets the definition of an affiliate must be negotiated on an arm's-length basis, in accordance with § 23B, FRA, 12 U.S.C. § 371c-1 (1994 & Supp. V 1999). *See infra* G.4. The FHC should have systems and policies in place to monitor transactions between the FHC, or a nondepository institution subsidiary of the FHC, and a portfolio company. (These transactions are not typically governed by § 23B, FRA.) An FHC should assure that the risks of these transactions, including exposures of the FHC on a consolidated basis to a single portfolio company, are reasonably limited and that all transactions are on reasonable terms, with special attention paid to transactions that are not on market terms. *See id.* at 13.

570 *Id.* at 13. Reliance on implicit guarantees or comfort letters should not substitute for reliance on a sound borrower that is expected to service its debt with its own resources. As with any type of credit extension, absent a written contractual guarantee, the credit quality of a private equity fund manager, general partner, or other third party should not be used to upgrade the internal credit risk rating of the borrower company or prevent the classification or special mention of a loan. *Id.*

571 12 C.F.R. § 225.175(a)(1) (2002) (Regulation Y) applies to private equity funds controlled by an FHC. *See* Final Merchant Banking Release, *supra* note 418, at 8,479.

572 *Id*.

573 *Id*.

Board Review of Risk Management Policies

The Board has announced that it generally will conduct a review of the investment and risk management policies, procedures and systems of an FHC that makes merchant banking investments within a short period after the FHC commences the activity. The review may be conducted off-site or on-site, depending on the expected level and complexity of the FHC's merchant banking investments and the FHC's previous experience in making equity investments under other legal authorities.[574]

m. Capital Requirements for Equity Investments in Nonfinancial Companies

Although it is the basic concept of the GLBA amendments to the BHCA that an FHC should be permitted to engage in financial activities because the depository institution subsidiary of the FHC is in large part immunized from financial difficulties of the FHC by the higher capital requirements imposed on it, and that banks, securities firms and insurance companies should be permitted to join in a holding company system without any requirements other than those set forth in the BHCA, the Board has not resisted the temptation to make the formation of FHCs less attractive by imposing special capital requirements on FHCs that engage in merchant banking investments. This action is questionable because the GLBA amendments to the BHCA enumerate in great detail all conditions for the formation of an FHC, and the statute leaves no room for additional substantial regulatory entry barriers. The Board's rule imposing special capital requirements on FHCs that engage in merchant banking investments undermine the basic concept of the GLBA. The Board's staff has indicated that the Board will not apply this capital surcharge to foreign banks maintaining a branch, agency or commercial lending company in the United States that elect to be FHCs.

The Board initially proposed to impose a 50 percent capital surcharge on FHCs for merchant banking investments.[575] Thereafter, the Board imposed until April 1, 2002 on

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574 *Id.* at 8,479.

575 Under that proposed rule, a BHC would have been required to deduct from its Tier 1 capital an amount equal to 50 percent of the total carrying value, as reflected on the consolidated financial statements of the BHC, of all consolidated merchant banking investments made pursuant to § 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999), by the BHC or by its direct or indirect subsidiaries. The total carrying value of any merchant banking investment subject to this capital deduction would be excluded from the BHC's assets for purposes of calculating the asset denominator of the risk-based and leverage ratios. In the case of nonconsolidated merchant banking investments, the total carrying value of any merchant banking investment subject to this capital deduction would be excluded from the BHC's assets for purposes of calculating the asset denominator of the risk-based and leverage capital ratios. The capital charges would also have applied, subject to certain exceptions, to all debt extended by a BHC to a nonfinancial company in which the FHC owns 15 percent or more of the total equity. *See* proposed Board rule of Mar. 17, 2000 (Regulation Y, Docket No. R-1067), 65 Fed. Reg. 16,482 (Mar. 28, 2000), amending app. A (II. *B.*) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs). *See also* Board release accompanying this rule, 65 Fed. Reg. 16,480–83 (Mar. 28, 2000); Letter, dated May 19, 2000, from Michael Gruson, Bradley K. Sabel and Jonathan M. Weld to the Secretary of the Board commenting on the proposed Board rule of March 17, 2000. The proposed rule would have applied the same capital treatment to investments made directly or indirectly by a BHC in a nonfinancial company under any investment authority.

FHCs the requirement to obtain Board approval before making additional merchant banking investments if the aggregate carrying value of all merchant banking investments held by the FHC exceeded (1) 30 percent of the Tier 1 capital of the FHC or (2) after excluding investments in private equity funds, 20 percent of the Tier 1 capital of the FHC.[576]

Finally, the Board adopted a rule that establishes for FHCs special minimum capital requirements for equity investments made on or after March 13, 2000 in nonfinancial companies and applies symmetrically to equity investments by banks and BHCs (including FHCs).[577] The rule is based on the following principles:

- equity investment activities in nonfinancial companies generally involve greater risks than traditional bank and financial activities;
- the risk of loss associated with a particular equity investment is likely to be the same regardless of the legal authority used to make the investment or whether the investment is held by a BHC or a bank; and
- the financial risks to an organization engaged in equity investment activities increases as the level of the organization's investments accounts for a larger portion of its capital, earnings and activities.[578]

In light of these principles, the rule provides for a progression of Tier 1 marginal capital charges on covered equity investments that increases with the size of the aggregate equity

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576 12 C.F.R. § 225.174(a) (2002) (Regulation Y). This Section speaks about the acquisition of additional shares, assets or ownership interests under Subpart J (Merchant Banking Investments) of Regulation Y and the making of any additional capital contributions to any company, the shares, assets or ownership interests of which are held by the FHC under Subpart J of Regulation Y. 12 C.F.R. § 225.174(a) (2002) (Regulation Y) applies to the acquisition by the FHC of interests in a private equity fund, but it does not apply to any interest in a company held by a private equity fund or to any interest in the fund held by a person that is not affiliated with the FHC. 12 C.F.R. § 225.174(b) (2002) (Regulation Y). 12 C.F.R. § 225.174(b) (2002) (Regulation Y) only refers to *any interest* held by a [nonaffiliated] person. The Final Merchant Banking Release, *supra* note 418, at 8,478 makes it clear that this Section is meant to refer to any interest *in a private equity fund*.

12 C.F.R. § 225.174 remains in effect until the effective date of a final rule issued by the Board that specifically addresses the regulatory capital treatment of merchant banking investments. 12 C.F.R. § 225.174(c) (2002) (Regulation Y). A final rule concerning regulatory capital treatment of nonfinancial equity investments, *see infra* note 577, becomes effective on Apr. 1, 2002.

577 *See* app. A (II. *B*. 5.) (Capital Adequacy Guidelines for BHCs: Risk-Based Measure) and app. D (Capital Adequacy Guidelines for BHCs: Tier 1 Leverage Measure) to 12 C.F.R. pt. 225, 67 Fed. Reg. 3,800 (Jan. 25, 2002) (to be codified in 2003). These amendments were accompanied by a joint release by the Board, the OCC and the FDIC, 67 Fed. Reg. 3,784 – 3,807 (Jan. 25, 2002) (Docket No. R-1097) [*herein* Capital Release]. *See* proposed Board rule of Feb. 1, 2001, amending app. A & D to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs), 66 Fed. Reg. 10,222–24 (Feb. 14, 2001). *See also* release from the Board, the OCC and the FDIC accompanying this proposed rule, 66 Fed. Reg. 10,212–26 (Feb. 14, 2001) [*herein* Capital Proposal Release]. *See* Ashley D. Fluhme, *Capital Requirements for Merchant Banking*, 5 N.C. BANKING INST. 265 (2001).

578 *See* Capital Release, *supra* note 577, at 3,784.

investment portfolio for the BHC relative to its Tier 1 capital.[579] Furthermore, the rule applies these higher capital charges symmetrically to all equity investments held by banks and BHCs (including FHCs) in nonfinancial companies,[580] except for investments made prior to March 13,

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[579] *See* Capital Release, *supra* note 577, at 3,784.

[580] *See* Capital Release, *supra* note 577, at 3,786-87. The rule applies the same capital treatment to all equity investments by BHCs (including FHCs) in nonfinancial companies regardless of the authority under which they are held, (i) by FHCs under the merchant banking investment authority, § 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999); (ii) by BHCs (including FHCs) in less than 5 percent of the voting shares of a nonfinancial company or in a company that makes investments in nonfinancial companies under the authority of § 4(c)(6) or § 4(c)(7), BHCA, 12 U.S.C. § 1843(c)(6) or (c)(7) (1994); (iii) by BHCs (including FHCs) in nonfinancial companies through SBICs, § 302(b) of the Small Business Investment Act of 1958, 15 U.S.C. § 682(b) (1994); (iv) by BHCs (including FHCs) in nonfinancial companies under Regulation K, 12 C.F.R. § 211.8(c)(3) (2002) (Regulation K), including the authority to make portfolio investments through Edge Act Corporations and Agreement Corporations (portfolio investments); or (v) by banking organizations in nonfinancial companies under § 24, FDIA, 12 U.S.C. § 1831a (1994 & Supp. V 1999) (other than § 24(f), 12 U.S.C. § 1831a(f) (1994 & Supp. V 1999)). App. A (II. *B*. 5. b.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs). A nonfinancial company is an entity engaged in any activity that has not been determined to be financial in nature under § 4(k)(4), BHCA, 12 U.S.C. § 1843(k)(4) (1994 & Supp. V 1999). *See* Capital Release, *supra*, at 3,787. For a definition of *equity investments*, *see* app. A (*B*. 5. g.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs); Capital Release, *supra*, at 3,787.

SBIC investments of BHCs are exempt from the higher capital charges of the rule to the extent the aggregate adjusted carrying value of all such investments does not exceed 15 percent of the aggregate of the BHC's pro rata interest in the Tier 1 capital of its subsidiary banks, *see* app. A (II. *B*. 5. d.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs), Capital Release, *supra*, at 3,784-85, 3,787, 3,790-91]. For a discussion of the capital treatment of investments under § 24, FDIA, *see* Capital Release, *supra*, at 3,787-88.

The rule does not apply to equity investments by insurance company affiliates of an FHC under § 4 (k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999), because investments made by insurance underwriting affiliates of an FHC generally are already subject to higher capital charges under state insurance laws. *See* Capital Release, *supra*, at 3,788. The Board expects to monitor FHCs with insurance underwriting affiliates to ensure that they do not arbitrage any differences in the capital requirements applicable to equity investments made by insurance companies and other FHC affiliates. *See* Capital Release, *supra*, at 3,788.

The rule does not apply to equity securities that are acquired by satisfaction of a debt previously contracted pursuant to § 4(c)(2), BHCA, 12 U.S.C. § 1843(c)(2) (1999), *see* Capital Release, *supra*, at 3,788, or to investments by qualifying foreign banking organizations pursuant to 12 C.F.R. § 211.23(f) (2002) (Regulation K).

Finally, the rule does not apply to investments made by an FHC in a company engaged in *complementary* activities under § 4(k)(1)(B), BHCA, 12 U.SC. § 1843(k)(1)(B) (1994 & Supp. V 1999). The Board intends to review and consider the appropriate capital treatment of investments in companies engaged in complementary activities in connection with its review of any notice filed by an FHC to acquire a company engaged in complementary activities or in connection with its determination that a particular activity is complementary to a financial activity. *See* 12 C.F.R. § 225.89 (2002) (Regulation Y); Complementary Activities Release, *supra* note 362 (requesting comments on a proposal to determine that certain data processing and data transmission activities are complementary to financial activities and on the appropriate capital treatment for such investments). *See* Capital Release, *supra*, at 3,788.

2000 or investments made on or after such date pursuant to a binding written commitment entered into prior to March 13, 2000.[581]

The rule requires a parent BHC to deduct from its Tier 1 capital the sum of the appropriate percentages (as shown in the following diagram) of the adjusted carrying value of all equity investments in nonfinancial companies[582] held by it or by its direct or indirect subsidiaries.[583] For purposes of the capital charge, investments held by a BHC include all investments held directly or indirectly by the BHC or any of its subsidiaries.[584] The structure of the rule applies a higher capital charge to equity investments as the aggregate amount of the organization's nonfinancial equity investments increases in relation to its capital.

Diagram 7
Deduction for
Nonfinancial Equity Investments[585]

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the BHC (as a percentage of the Tier 1 capital of the BHC)	**Deduction from Tier 1 capital (as a percentage of the adjusted carrying value of the investment)**
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

Each tier of charges applies, on a marginal basis, to the portions of the adjusted carrying value of the BHC's nonfinancial equity investments that fall within the specified ranges of the BHC's

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581 *See* Capital Release, *supra* note 577, at 3,789.

582 App. A (II. *B*. 5. c. i. & f.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs). *See* Capital Release, *supra* note 577, at 3,790. The *adjusted carrying value* is the value at which the relevant investment is recorded on the balance sheet, reduced by (i) net unrealized gains that are included in carrying value but that have not been included in Tier 1 capital and (ii) associated deferred tax liabilities. *Id*.

583 App. A (II. *B*. 5. a.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs).

584 *Id*.

585 App. A (II. *B*. 5. c.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs); Capital Release, *supra* note 577, at 3,790.

Tier 1 capital.[586] The total adjusted carrying value of a nonfinancial equity investment that is subject to a deduction under the rule is excluded from the BHC's risk-weighted assets for purposes of computing the denominator of the BHC's risk-based capital ratio.[587]

For all covered equity investments, an 8 percent Tier 1 capital charge would be applied so long as the adjusted carrying value of all such investments represent less than 15 percent of Tier 1 capital. In the case of a portfolio of covered equity investments that, in the aggregate, exceeds 15 percent of the BHC's Tier 1 capital, a 12 percent Tier 1 capital charge would apply to the portion of the portfolio above the 15 percent threshold. The 12 percent marginal charge would apply to the adjusted carrying value of covered equity investments up to 25 percent of Tier 1 capital. In the case of a portfolio of covered equity investments that, in the aggregate, exceeds 25 percent of the BHC's Tier 1 capital, a 25 percent marginal Tier 1 capital charge would apply to the portion of the portfolio above the 25 percent threshold.[588]

The rule applies the higher capital charge to equity instruments held in the trading account of a BHC as part of an underwriting, market-making or dealing activity.[589] The Board points out that BHCs have the authority to underwrite, deal in, and make a market in equity securities through a securities broker-dealer subsidiary that is subject to special capital and accounting requirements, and securities lawfully acquired under these statutory provisions are not covered by the rule.[590] The implication is that the FHC should use its broker-dealer subsidiaries in the FHC group for underwriting, dealing and market-making activities. This analysis, however, does not address the situation, clearly permitted by the GLBA, of a broker-dealer that is a holding company in an FHC group. The capital rule makes it virtually impossible for a broker-dealer to be the top-tier FHC of an FHC group and therefore contradicts the intention of the GLBA. The capital rule, however, does not apply the higher capital charges to

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586 App. A (II. *B*. 5. c. ii.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs); Capital Release, *supra* note 577, at 3,790.

587 App. A (II. *B*. 5. c. iii.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs). *See* Capital Release, *supra* note 577, at 3,790.

588 App. A (II. *B*. 5. c.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs). *See* Capital Proposed Release, *supra* note 577, at 10,216. For example, if the adjusted carrying value of all nonfinancial equity investments held by a BHC equals 20 percent of the Tier 1 capital of the BHC, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the company's Tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the company's Tier 1 capital. App. A (II. *B*. 5. c. ii.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs). See Capital Release, *supra*, at 3,791. The deductions to Tier 1 capital apply not only for risk-based capital purposes but also for leverage capital purposes. *See* app. D to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs); Capital Release, *supra*, at 3,791-92.

589 *See* Capital Release, *supra* note 577, at 3,788.

590 *See* Capital Release, *supra* note 577, at 3,788. *See also* § 4(k)(4)(E), BHCA, 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999) (FHCs); § 4(c)(8), BHCA, 12 U.S.C. 1843(c)(8) (1994 & Supp. V 1999); and J.P. Morgan & Co., Inc. 75 FED. RES. BULL. 192 (1989), *aff'd sub. nom*. Securities Industry Ass'n v. Board of Governors, 900 F.2d 360 (D.C. Cir. 1990). *See supra* C. 1. *sub* (1).

equity securities acquired and held by a BHC as a bona fide hedge of an equity derivative transaction lawfully entered into by a BHC.[591]

The Board proposes to apply heightened supervision to the equity investment activities of BHCs. The Board may in any case impose a higher minimum capital charge on a BHC as appropriate in light of the nature, concentration or performance of a particular BHC's equity investments, or the sufficiency of the BHC's policies, procedures and systems used to monitor and control the risks associated with the BHC's equity investments.[592]

In the case of equity investments held through equity investment funds, the capital charge would apply only to the holding company's proportionate share of the fund's investments.[593]

3. Securities Acquired Through Underwriting or Dealing

Section 4(k)(4)(H), BHCA[594] not only permits FHCs, directly or indirectly, to invest in securities as part of merchant or investment banking but also as part of underwriting activities. The conditions are the same:

- the investment must be made as part of a "bona fide" underwriting activity;[595]
- the investment must be made by a securities affiliate;[596]
- the investment must not be made by a depository institution of the FHC, or by a subsidiary of a depository institution;[597]

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591 *See* Capital Release, *supra* note 577, at 3,788.

592 *See* Capital Release, *supra* note 577, at 3,792; app. A (II. *B*. 5. c. iv.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs).

593 *See* Capital Proposal Release, *supra* note 577, at 10,217; app. A (II *B*. f. ii. & II. *B*. d. i. n.27) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs). Such treatment would apply even if the fund partnership is consolidated in the BHC's financial reporting statements. Similarly, the rule provides that minority interests resulting from any such consolidation would not be included in the Tier 1 capital of the holding company. *See* Capital Proposal Release, *supra*, at 10, 217.

Similar treatment applies for minority interests with respect to investments in nonfinancial companies under the equity investment authorities covered by the rule. *See supra* note 580. Generally, it would not be expected that any nonfinancial company whose shares are acquired pursuant to those authorities would be consolidated, either because the investment is temporary as in the case of merchant banking investments, or limited to a minority interest. However, if consolidation does occur, any resulting minority interests must be excluded from Tier 1 capital because the minority interest is not available to support the general financial business of the banking organization. *See* Capital Proposal Release, *supra* note 577, at 10,217; app. A (II. *B*. f. ii & II. *B*. d. i. n.27) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs).

594 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

595 Section 4(k)(4)(H)(ii), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii) (1994 & Supp. V 1999).

596 Section 4(k)(4)(H)(ii)(I), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii)(I) (1994 & Supp. V 1999).

- the investment is "held for a period of time to enable the sale or disposition thereof on a reasonable basis", consistent with the financial viability of the underwriting activity;[598] and

- the FHC does not routinely manage or operate the entity in which the investment is made except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.[599]

Whereas Section 4(k)(1), BHCA[600] generally permits an FHC to engage in financial activities through a noncontrolled company, the financial activity of securities underwriting (like merchant banking investments) must be carried out by the FHC itself (directly) or indirectly through a subsidiary (a controlled company).[601] The requirement that investments be made through a securities affiliate that causes interpretative difficulties in connection with merchant banking investments,[602] does not create any questions of interpretation in connection with the underwriting power. It is obvious that only a registered broker-dealer, either the FHC or a subsidiary of the FHC, has the power to engage in underwriting.[603] The FHC or the underwriting subsidiary of the FHC may acquire in the exercise of the underwriting power minority or majority positions in other companies.[604] The restriction that depository institutions of the FHC (or a subsidiary of a depositary institution) may not engage in underwriting does not affect FHCs that are foreign banks, because foreign banks are not depository institutions.[605]

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597 Section 4(k)(4)(H)(i), BHCA, 12 U.S.C. § 1843(k)(4)(H)(i) (1994 & Supp. V 1999).

598 Section 4(k)(4)(H)(iii), BHCA, 12 U.S.C. § 1843(k)(4)(H)(iii) (1994 & Supp. V 1999).

599 Section 4(k)(4)(H)(iv), BHCA, 12 U.S.C. § 1843(k)(4)(H)(iv) (1994 & Supp. V 1999).

600 12 U.S.C. § 1843(k)(1) (1994 & Supp. V 1999).

601 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999) ("[d]irectly or indirectly acquiring or controlling . . . shares . . . as part of a[n] . . . underwriting activity"). *See supra* text accompanying note 229. *See also supra* text accompanying note 444 (discussing the *directly or indirectly* requirement in connection with the merchant banking investment authority) and *infra* text accompanying note 624 (discussing the *directly or indirectly* requirement in connection with the insurance company portfolio investment authority).

602 *See supra* D. 2. d.

603 Section 15, Securities Exchange Act of 1934, 15 U.S.C. § 78j (1994 & Supp. V 1999).

604 Section 4(k)(4)(H), 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999) (permitting the acquisition of shares or other ownership interests of another company or entity "whether or not constituting control of such company or entity").

605 *See supra* note 33 for the definition of *depository institution*.

Voting securities held by an FHC in an underwriting, dealing or market-making capacity need not be aggregated with any shares held by the FHC or other affiliates of the FHC on the basis of another authority.[606]

The underwriting activity may relate to shares and other ownership interests (including debt or equity securities, partnership interests, trust certificates or other instruments representing ownership) of a company or other entity, and such company or entity may be engaged in any activity.[607] The underwriter may act as principal (firm commitment underwriting) or as agent (best efforts underwriting).[608]

The underwriting must be bona fide.[609] For instance, the purchase of shares of an issuer for the purpose of reselling such shares in a public offering in the distant future subject to market conditions is probably not a bona fide underwriting and must meet the conditions of a merchant banking investment in order to be authorized.

The provisions of Section 4(k)(4)(H), BHCA requiring a holding of the securities for the purpose of resale on a reasonable basis[610] applies to shares acquired for the purpose of underwriting, but it is not very relevant to securities underwritings because the intent to resell is inherent in the concept of underwriting. The prohibition against routine management of the issuer is usually not an issue in connection with companies whose securities an FHC underwrites.[611]

Are shares acquired by way of underwriting or dealing covered by Subpart J, Section 225.170 *et seq*., of Regulation Y?[612] Section 225.170, Regulation Y defines merchant banking investments as "shares . . . acquired or controlled under section 4(k)(4)(H) and this subpart". Since Section 4(k)(4)(H), BHCA refers to merchant banking investments *and* to

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606 *See* Representative Leach, 145 CONG. REC. H11,529 (daily ed.) (Nov. 4, 1999). Representative Leach added that this is necessary to allow bank-affiliated securities firms to conduct securities activities in the same manner and to the same extent as their nonbank affiliated competitors, which is one of the principal objectives of the GLBA. *Id*. *But see supra* note 387.

607 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). That Section states that the company whose securities are acquired in connection with an underwriting may be engaged in any activity not authorized pursuant to Section 4, BHCA, 12 U.S.C. § 1843 (1994 & Supp. V 1999). This limitation makes no sense: why should an FHC not underwrite shares of another FHC, a bank or an insurance company? The limitation is surely only meant to restrict the activities of merchant banking investments in portfolio companies. *See supra D*.2.b. for a discussion of this requirement in the context of the merchant banking investment authority.

608 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999), permits acting as principal or agent. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 66-75 (4th ed. 2001).

609 Section 4(k)(4)(H)(ii), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii) (1994 & Supp. V 1999).

610 Section 4(k)(4)(H)(iii), BHCA, 12 U.S.C. § 1843(k)(4)(H)(iii) (1994 & Supp. V 1999).

611 Section 4(k)(4)(H)(iv), BHCA, 12 U.S.C. § 1843(k)(4)(H)(iv) (1994 & Supp. V 1999).

612 12 C.F.R. §§ 225.170–225.77 (2002) (Regulation Y).

underwriting, shares acquired for the purpose of underwriting are arguably *merchant banking investments*. On the other hand, the provisions of Sections 225.170–225.177, Regulation Y are not written in a way that seems to be relevant to shares held by virtue of underwriting or dealing activities.[613] Subpart J of Regulation Y is entitled "Merchant Banking Investments" and the BHCA distinguishes clearly between merchant banking activities and underwriting activities, therefore it is unlikely that the Board intended to use the term merchant banking with an intent to include underwriting without clearly stating so.

The term *portfolio company* is very broadly defined in Subpart J of Regulation Y as any company any shares of which are held by an FHC that is engaged in any activity not authorized for the FHC under Section 4, BHCA.[614] This would include most companies whose securities are underwritten by an FHC or its broker-dealer subsidiary, and the limitations of Section 225.171, Regulation Y[615] on management and operation of portfolio companies might apply to companies whose shares are owned by an FHC or its subsidiary by virtue of the underwriting authority. However, the caption of Section 225.171, Regulation Y[616] expressly limits the application of the Section to portfolio companies held under the merchant banking investment authority.

Only one provision of Subpart J of Regulation Y expressly refers to underwriting, namely, the Section requiring that the acquisition or control of ownership interests "under this subpart" is not permitted "unless it is a part of a bona fide underwriting or merchant or investment banking activity".[617] The Final Merchant Banking Release states that the rule permitting merchant banking investments "does not address or apply to investments acquired as part of securities underwriting, dealing or market making activities conducted under Section 4(k)(4)(E) [BHCA]".[618]

For the reasons stated above, merchant banking authority cannot be read as including the underwriting authority, although underwriting is mentioned in Section 4(k)(4)(H), BHCA. Finally, regulations by the Board dealing with the relation of an underwriter to the company whose securities are being underwritten would interfere with the authority of the Securities and Exchange Commission and violate the principle of functional regulation.[619]

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613 *See* 12 U.S.C. § 4809 (1994 & Supp. V 1999) (plain language requirement).

614 12 C.F.R. § 225.177(c) (2002) (Regulation Y). *See* 12 U.S.C. § 1843 (1994 & Supp. V 1999).

615 12 C.F.R. § 225.171 (2002) (Regulation Y).

616 *Id*.

617 12 C.F.R. § 225.170(b) (2002) (Regulation Y) restating § 4(k)(4)(H)(ii), BHCA, 12 U.S.C. § 1843(k)(4)(H)(ii) (1994 & Supp. V 1999). The Interim Merchant Banking Release, *supra* note 418, and the Final Merchant Banking Release, *supra* note 418, which in great detail discuss the bona fide requirement, 65 Fed. Reg. at 16,463 and 66 Fed. Reg. at 8,469, do not address this requirement in connection with underwriting.

618 *Supra* note 418, at 8,469. *Accord*, Interim Merchant Banking Release, *supra* note 418, at 16,460.

619 *See infra* G. 1.

Investments in equity securities of nonfinancial companies acquired by an FHC itself in exercise of the underwriting, dealing or market-making authority are subject to the capital charge applicable to equity investments in nonfinancial companies.[620] These investments are not subject to such capital charge, however, if they are acquired through a broker-dealer subsidiary of the FHC.[621]

4. Portfolio Investments by Insurance Affiliates

Section 4(k)(4)(I), BHCA[622] permits portfolio investments in securities, assets and other ownership interests by insurance companies. Insurance companies typically make such investments to invest the funds received from policyholders. The investment of funds, in particular funds received from policyholders and funds generated by investments, is an essential and inherent part of the insurance business. The Board has recognized in the Travelers Order that, as an integral part of their insurance business, the insurance underwriting companies invest insurance premiums that they collect in a variety of investments.[623]

The authority of Section 4(k)(4)(I), BHCA permits an insurance company that is an FHC or a subsidiary of an FHC[624] to make controlling or noncontrolling equity or other investments in a company engaged in any kind of business,[625] subject to certain conditions:

- the investments must be made by an insurance company that is predominately engaged in underwriting life, accident and health, or property and casualty

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620 *See supra* D.2.m and in particular text accompanying notes 589-591.

621 *See* Capital Release, *supra* note 577, at 3,788 and *supra* text accompanying note 590.

622 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999). *Insurance* as referred to in § 4(k)(4)(I), BHCA includes reinsurance. *See* Final FHC Release, *supra* note 32, at 405 and Interim Financial Activities Release, *supra* note 272, at 14,435 (insurance for purposes of § 4(k)(4)(B), BHCA, 12 U.S.C. § 1843(k)(4)(B) (1994 & Supp. V 1999) includes reinsurance). Since the group of insurance companies which may be FHCs or in which an FHC is permitted to invest (*see* § 4(k)(4)(B), BHCA, 12 U.S.C. § 1843(k)(4)(B) (1994 & Supp. V 1999) (insurance as financial activity) must be equal to the group of insurance companies that may make insurance portfolio investments (*see* § 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999)), reinsurance companies must be covered by § 4(k)(4)(B), BHCA and by § 4(k)(4)(I), BHCA.

623 Travelers Group Inc., Citicorp Order, 84 FED. RES. BULL. 985, at 988 n.18 ("As an integral part of their insurance business, the Travelers insurance underwriting subsidiaries invest insurance premiums they collect in a variety of investments".).

624 An FHC may *directly or indirectly* make investments, if such investments are held by an insurance company. Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999). *See supra* text accompanying note 229. *See also supra* text accompanying note 444 (discussing the *directly or indirectly* requirement in connection with the merchant banking investment authority) and *supra* text accompanying note 601 (discussing the *directly or indirectly* requirement in connection with the underwriting authority).

625 Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999) ("whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to [§ 4, BHCA]"). *See* § 4, BHCA, 12 U.S.C. § 1843 (1994 & Supp. V 1999).

insurance (other than credit-related insurance), or in providing and issuing annuities;[626]

- the investment must be made in the ordinary course of business of the insurance company in accordance with relevant state law;[627]

- the investment is not made by a depository institution of the FHC or a subsidiary of a depository institution;[628] and

- the FHC does not routinely manage or operate the entity in which the investment is made except as may be necessary or required to obtain a reasonable return on investment.[629]

Section 4(k)(4)(I), BHCA provides that investments made in the ordinary course of the business of insurance must not be made or held by a depository institution or subsidiary thereof but must be made and held by an insurance company. Because the BHCA permits an FHC directly or indirectly to make investments in the ordinary course of business of an insurance company,[630] it follows that the insurance company could be the FHC or a subsidiary of the FHC. The GLBA does not establish a requirement that insurance company investments must be disposed of after a certain period of time.

Whereas Section 4(k)(1), BHCA[631] generally permits an FHC to engage in financial activities through a controlled or noncontrolled company,[632] the financial activity of making insurance portfolio investments under Section 4(k)(4)(I), BHCA must be carried out by an insurance company FHC itself (directly) or indirectly through an insurance company subsidiary (a controlled company) of an FHC.[633] Section 4(k)(4)(I), BHCA has the effect of prohibiting noncontrolling investments by FHCs under Section 4(k)(1), BHCA in insurance companies. Section 4(k)(1), BHCA is limited to investments in insurance company subsidiaries because an FHC could not make insurance company portfolio investments through a noncontrolled insurance company. On the other hand, an FHC would presumably always

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626 Section 4(k)(4)(I)(ii), BHCA, 12 U.S.C. § 1843(k)(4)(I)(ii) (1994 & Supp. V 1999). The types of insurance that are financial activities (§ 4(k)(4)(B), BHCA, 12 U.S.C. § 1843(k)(4)(B) (1994 & Supp. V 1999)) and the insurance companies that may make investments in other companies (§ 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999)) are described in different words. Both sections must be interpreted to cover the same lines of insurance business.

627 Section 4(k)(4)(I)(iii), BHCA, 12 U.S.C. § 1843(k)(4)(I)(ii) (1994 & Supp. V 1999).

628 Section 4(k)(4)(I)(i), BHCA, 12 U.S.C. § 1843(k)(4)(I)(i) (1994 & Supp. V 1999).

629 Section 4(k)(4)(I)(iv), BHCA, 12 U.S.C. § 1843(K)(4)(I)(iv) (1994 & Supp. V 1999).

630 Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999).

631 12 U.S.C. § 1843(k)(1) (1994 & Supp. V 1999).

632 *See supra* C.1.

633 *See supra* note 624.

acquire insurance company subsidiaries under the authority of Sections 4(k)(1), and 4(k)(4)(B), BHCA[634] and not under the insurance company portfolio investment authority.

An FHC that is an insurance company or an insurance company subsidiary of an FHC may invest in the exercise of the insurance company portfolio investment authority in minority or majority positions of other companies.[635] The question arises whether an FHC that is an insurance company or an insurance company subsidiary of an FHC is permitted under the insurance company portfolio investment authority to invest in minority interests of other insurance companies. Section 4(k)(4)(I), BHCA provides that the company in which an investment is made under the insurance company portfolio investment authority must not be engaged in an activity authorized by Section 4, BHCA.[636] Because minority investments in insurance corporations are not authorized by Section 4, BHCA, as discussed above, an insurance company in an FHC group must be permitted to make a minority investment in an insurance company under the insurance company portfolio investment authority.[637] There is no legislative purpose why a less than controlling investment in another insurance company should not be permitted under the insurance company portfolio investment authority, subject to the conditions set forth in Section 4(k)(4)(I), BHCA. As a matter of fact, insurance companies and reinsurance companies frequently make such investments in other insurance companies. Furthermore, the BHCA should not be interpreted as restricting by implication the power of the states to regulate investments by insurance companies.[638] As previously discussed, an FHC could invest in noncontrolling interests of insurance companies under the merchant banking investment authority of Section 4(k)(4)(H), BHCA.[639] The above considerations also apply to insurance

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634 12 U.S.C. § 1843(k)(1) & (k)(4)(B) (1994 & Supp. V 1999).

635 Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999) (permitting the acquisition of shares or other ownership interests of a company or entity "whether or not constituting control of such company or entity").

636 Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999) (permitting the acquisition of shares or other ownership interests of a company or entity "engaged in any activity not authorized pursuant to [§ 4, BHCA]"). *See* 12 U.S.C. § 1843 (1994 & Supp. V 1999).

637 *See supra* text accompanying notes 432-435 discussing noncontrolling investments in insurance companies under the merchant banking investment authority. The prohibition in § 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999), of investments in companies engaged in activities authorized by § 4, BHCA, 12 U.S.C. § 1843 (1994 & Supp. V 1999), is in fact a prohibition against using the insurance company portfolio investment authority to make investments that are otherwise authorized by § 4, BHCA. The qualification that the company, in which an investment is made under the insurance company portfolio investment authority, must not be engaged in an activity authorized by § 4, BHCA has the effect that an insurance company in an FHC group cannot make a controlling investment in another insurance company under the insurance company portfolio investment authority. Such investments must be made pursuant to § 4(k)(1)(A), BHCA in connection with § 4(k)(4)(B), BHCA, 12 U.S.C. § 1843(4)(k)(1)(A) & (4)(B) (1994 & Supp. V 1999).

638 *See supra* note 277 (referring to the federal deference to state insurance laws). *See, e.g.*, § 1408, N.Y. Ins. Law (McKinney 2000), permitting, subject to certain limitations, insurance companies to invest in securities of other insurance companies.

639 For a discussion of this issue, *see supra* text accompanying notes 432–435. *See* 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

company portfolio investments in noncontrolling interests of broker-dealers, investment advisers, etc.

The BHCA is very inclusive in its description of the types of permitted insurance portfolio investments. Such investments may be acquired or controlled by the FHC directly if it is an insurance company, or indirectly by an insurance company subsidiary of an FHC, and may consist of shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership) of a company or other entity and such company or entity may be engaged in any activity.[640]

The insurance company portfolio investments must be made "in the ordinary course of business" of the insurance company.[641] Although the Board has emphasized in the Travelers Order that the investment of insurance premiums is an integral part of the insurance business,[642] neither the language of Section 4(k)(4)(I), BHCA nor the history of the GLBA amendments to the BHCA require that insurance company portfolio investments be made with funds generated from insurance premium rather than with other funds of the insurance company. It is a part of the insurance business that insurance companies invest funds in order to be able to pay claims. The source of the funds is not relevant although the principal source of funds is insurance premiums. Another major source of funds is investment income. A tracing of funds that may be used for insurance company portfolio investments would be completely unworkable.

FHCs and their insurance subsidiaries may invest as principals under the insurance investment portfolio authority. Section 4(k)(4)(I), BHCA makes it clear that the FHC and such subsidiary may also make such investment on behalf of other entities. The others may be entities controlled by the FHC or third parties, but may not be depository institutions controlled by the FHC or subsidiaries of such depository institutions.

The insurance company portfolio investments permitted by Section 4(k)(4)(I), BHCA need not be passive in the meaning of Section 4(c)(6), BHCA investments.[643] Section 4(k)(4)(I)(iv),[644] BHCA provides that during the period such shares, assets or ownership interests are held by the insurance company FHC or an insurance company subsidiary of an FHC, the FHC may not "routinely manage or operate such company except as may be necessary or required to obtain a reasonable return on investment".[645] The BHCA prohibits only the FHC to routinely manage or operate the companies in which an insurance portfolio investment has been made. The prohibition does not apply to an insurance company subsidiary of an FHC but it does apply to an FHC if it is the insurance company. Regulation Y does not contain rules carrying out

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640 Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999).

641 Section 4(k)(4)(I)(iii), BHCA, 12 U.S.C. § 1843(k)(4)(I)(iii) (1994 & Supp. V 1999).

642 *See* Travelers Group Inc., Citicorp Board Order of Sept. 23, 1998, 84 FED. RES. BULL. at 988 n.18.

643 12 U.S.C. § 1843(c)(6) (1994). *See* Gruson, *supra* note 1, § 10.09 B.

644 12 U.S.C. § 1843(k)(4)(1)(iv) (1994 & Supp. V 1999).

645 Section 4(k)(4)(I)(iv), BHCA, 12 U.S.C. § 1843(k)(4)(I)(iv) (1994 & Supp. V 1999). Section 4(k)(4)(I)(iv) should have had added "or entity" after "company".

the prohibition on routine management and operation of insurance company portfolio investments.[646] If FHCs that are insurance companies make insurance company portfolio investments, the provisions of Regulation Y dealing with routine management and operations probably provide some guidance.[647] At any rate, the language of Section 4(k)(4)(I)(iv), BHCA which refers to "routine" management and operation of the portfolio company and the legislative history indicate that the restriction does not refer to the policy-setting function of the board of directors but to the day-to-day management and routine business decisions that the officers or employees of the company are typically engaged in.[648]

Directors, officers and employees of the FHC may constitute a majority of the board of the portfolio company.[649] However, where an FHC controls the board of directors of a portfolio company, the board must refrain from engaging in day-to-day management functions, although the board has the right to do so under corporate law.[650] The Conference Report on S. 900 expresses a presumption that participation by the FHC in the management of a portfolio company in which an insurance affiliate of the FHC has invested "would ordinarily be for the purpose of safeguarding the investment of the insurance company in accordance with the applicable requirements of state insurance law".[651] If the portfolio company generates a below-average rate of return or even runs into financial difficulties, a more active role of the FHC or its affiliates may be necessary to "obtain a reasonable return on investment upon resale or disposition".[652]

The insurance company portfolio investments are not subject to limitations on the permitted holding period.[653]

The principal limitations on insurance company portfolio investments will be state insurance legal investment laws, which vary from state to state. An insurer must comply with

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646 The definition of *portfolio company*, 12 C.F.R. § 225.177(c) (2002) (Regulation Y), is broad enough to apply to a company in which an insurance company has made an investment under the insurance company portfolio investment authority and the limitations on managing or operating portfolio companies, 12 C.F.R. § 225.171 (2002) (Regulation Y), would then apply. However, Subpart J of Regulation Y states in its caption that it only applies to merchant banking investments. *See also* 12 C.F.R. § 225.170(a) (2002) (Regulation Y).

647 12 C.F.R. § 225.171 (2002) (Regulation Y).

648 *See supra* D. 2. j.

649 *See supra* text accompanying note 516.

650 *See supra* text accompanying note 517.

651 *See* Conference Report on S. 900, *supra* note 4, at 155.

652 Section 4(k)(4)(I)(iv), BHCA, 12 U.S.C. § 1843(k)(4)(1)(iv) (1994 & Supp. V 1999). The colloquy between Senator Bennett and Senator Gramm, *supra* note 526, supports this interpretation. *See supra* text accompanying notes 521–526 discussing the right of an FHC to more actively manage a portfolio company if required to obtain a reasonable return.

653 *Cf.* Section 4(k)(4)(H)(iii), 12 U.S.C. § 1843(k)(4)(H)(iii) (1994 & Supp. V 1999); 12 C.F.R. § 225.171 (2002) (Regulation Y).

the legal investment laws of its state of domicile[654] and, if it is licensed in New York, must comply substantially with the New York law that would apply to a comparable insurer domiciled in New York.[655] Such laws generally impose limits, as a percentage of total admitted assets, on the amount an insurer may invest in a single issuer, the amount the insurer may invest in equities and the amount the insurer may invest in subsidiaries.[656] Investments in excess of the limits do not count as admitted assets (for purposes of financial regulation of the insurer),[657] and the domestic regulator often has the power to order divestiture of investments that exceed the limit.[658]

E. Exceptions from Restriction to Financial Activities

As a rule, an FHC may only engage in financial activities. There are two exceptions to that rule.

1. Permitted Investments by QFBOs

A foreign bank with a branch, agency or commercial lending company or a bank subsidiary in the United States that is a *Qualified Foreign Banking Organization*[659] is permitted even after it has elected to be an FHC to make investments in non-U.S. commercial and other nonfinancial companies (even if such companies have U.S. activities or investments) to the same extent as it was permitted to do before it elected to be an FHC. The GLBA does not abrogate investment authority of QFBOs granted by the BHCA and Regulation K.[660] This is most important because investments in nonfinancial non-U.S. companies made under the investment authority for QFBOs under Section 211.23(f), Regulation K[661] are not subject to the merchant banking investment rules of Section 4(k), BHCA on holding periods, management involvement,

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654 *See, e.g.*, § 1301(a)(2) of the N.Y. Ins. Law (McKinney 2000) (investments in accordance with art. 14, N.Y. Ins. Law (McKinney 2000) count as admitted assets for purposes of determining the financial condition of an insurer), and art. 14, N.Y. Ins. Law (enumerating the investments an insurer may make to cover its minimum capital or minimum surplus to policyholders, § 1402, N.Y. Ins. Law, and enumerating permitted reserve and other investments, §§ 1403–1407, N.Y. Ins. Law).

655 *See* § 1413, N.Y. Ins. Law (McKinney 2000).

656 *See* §§ 1409(a), 1404(a)(8), 1404(a)(9) N.Y. Ins. Law (McKinney 2000).

657 *See* § 1412(b), N.Y. Ins. Law (McKinney 2000).

658 *See* § 1412(a), N.Y. Ins. Law (McKinney 2000).

659 The term *Qualified Foreign Banking Organization* [*herein* QFBO] is defined as a foreign bank more than half of whose worldwide business is banking and more than half of whose banking business is outside the United States. 12 C.F.R. §§ 211.21(o) & 211.23(a) & (b) (2002) (Regulation K). *See* Gruson, *supra* note 1, § 10.12.

660 *See supra* C.8. For a discussion of QFBOs and of the special investment authorities of QFBOs, *see* Gruson, *supra* note 1, §§ 10.12–10.18.

661 12 C.F.R. § 211.23(f) (2002) (Regulation K).

notice, etc.[662] On the other hand, investments made under the QFBO investment authority are subject to other restrictions that do not apply to merchant banking investments.[663]

If a foreign company acquires control of a foreign bank that maintains a branch, agency or commercial lending company in the United States and that qualifies as a QFBO, the acquiror foreign company must also qualify as a QFBO because the investments made by the foreign bank under the investment authority of Section 211.23(f), Regulation K for QFBOs are indirect investments of the acquiror foreign company. If the company that acquires control of a foreign bank maintaining a branch, agency or commercial banking company in the United States meets the full QFBO test[664] (typically this will be the case when the acquiring company also is a foreign bank), then the acquiring company also may make use of the full QFBO investment authority.[665] If the acquiring company only meets the modified QFBO test[666] (typically this will be the case when the acquiring company is a life insurance company), then the acquiring company may make use of the QFBO investment authority other than the authority under Section 211.23(f)(5)(iii), Regulation K.[667] The acquired foreign bank, however, may continue to make use of the Section 211.23(f)(5)(iii), Regulation K investment authority.[668] This remains true even if the acquiror foreign company and the acquired foreign bank effectively elect the status of FHCs.

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662 *See* D.2.

663 Gruson, *supra* note 1, §§ 10.12–10.18.

664 12 C.F.R. § 211.23(a) (2002) (Regulation K). *See* Gruson, *supra* note 1, § 10.12.

665 12 C.F.R. § 211.23(f) (2002) (Regulation K).

666 12 C.F.R. § 211.23(c) (2002) (Regulation K).

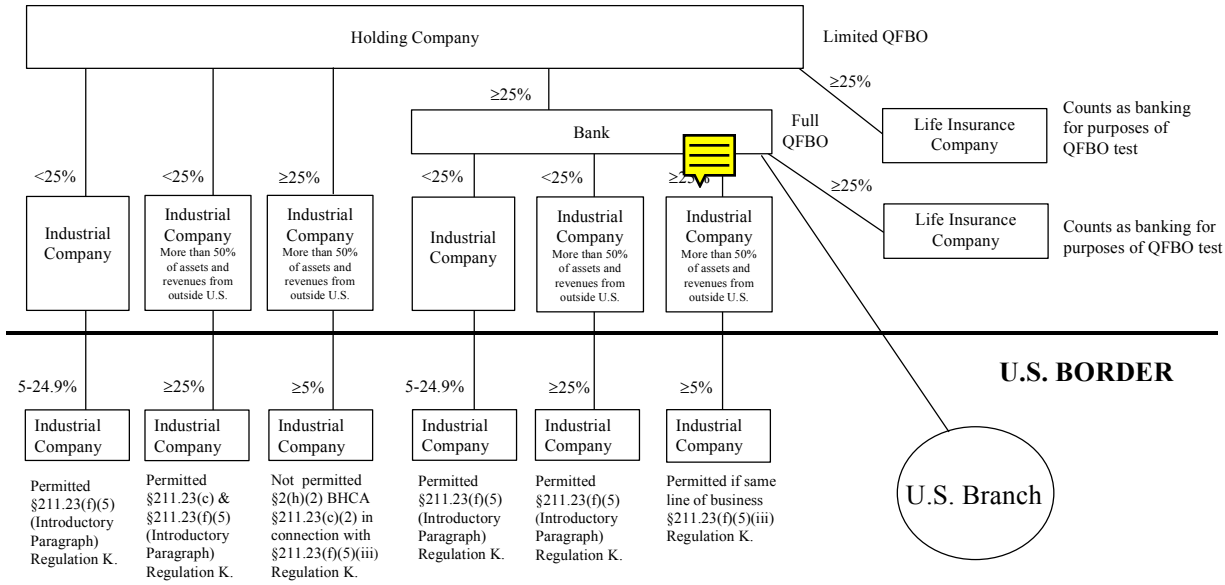
667 12 C.F.R. § 211.23(f)(5)(iii) (2002) (Regulation K). *See* Gruson, *supra* note 1, § 10.14. This investment authority is based on Section 2(h)(2), BHCA, 12 U.S.C. § 1841(h)(2) (1994).

668 *See* Board Release accompanying Regulation K, 66 Fed. Reg. 54,346, at 54,367–70 (Oct. 26, 2001). This is the case even though the foreign bank QFBO's investments are indirectly the investments of the company controlling it, and this controlling company only meets the modified QFBO test and could not itself make the 12 C.F.R. § 211.23(f)(5)(iii) (2002) (Regulation K) investment.

The following diagram summarizes the investment authorities of a QFBO under Regulation K. If the holding company meets the requirements of a full QFBO, the investment authorities of the bank and of the holding company are identical.

Diagram 8

QFBO Investments Under Regulation K
Nonbank as Ultimate Parent



It might be advantageous for a foreign bank and the company controlling it to use the Section 211.23(f) authority for equity investments because equity investments under such authority are not subject to a holding period, to restrictions on management involvement or to U.S. capital requirements for equity investments.[669]

2. Grandfather Rights Under the GLBA

The GLBA creates certain grandfather rights for FHCs that were not previously BHCs. A company that is not a BHC or a *foreign bank*[670] and that after November 12, 1999, the date of the enactment of the GLBA, becomes an FHC (through the acquisition of a banking subsidiary and the election to be an FHC) may continue to be engaged in, or retain direct or indirect investments in companies engaged in, nonfinancial activities until November 12, 2009.[671] This provision covers, *e.g.*, the case where an insurance company or a broker-dealer or

669 *See supra* D.2.j., k. & m.

670 *See* § 1(b)(7), IBA, 12 U.S.C. § 3101(7) (1994).

671 Section 4(n)(1), BHCA, 12 U.S.C. § 1843(n)(1) (1994 & Supp. V 1999). The FHC must terminate any activity engaged in pursuant to § 4(n), BHCA and divest ownership or control of any shares held pursuant to § 4(n), BHCA before the end of a 10-year period beginning on Nov. 12, 1999; however, the Board may

a holding company of an insurance company or a broker-dealer acquires after November 12, 1999 a U.S. bank or a foreign bank with a branch, agency, commercial lending company or bank subsidiary in the United States. If the acquiror is engaged in, or has direct or indirect ownership in or controls a company engaged in, nonfinancial activities, the acquiror could not qualify as an FHC because an FHC may only engage in financial activities.[672] For this case, Section 4(n), BHCA[673] grants limited relief. The FHC may continue to engage in a nonfinancial activity and retain investments in a company engaged in a nonfinancial activity for such ten-year period subject to the following conditions:

- the FHC was lawfully engaged in such activity, or held the shares of a company engaged in such activity, on September 30, 1999;[674]
- the FHC is predominantly engaged in financial activities, which requires that at least 85 percent of the consolidated annual gross revenues of the FHC must be derived from financial activities of the FHC and its subsidiaries (excluding revenues from subsidiary depository institutions);[675] and
- the FHC or the company that is minority-owned or controlled by the FHC engages in only those specific activities that are grandfathered and in activities that are otherwise permissible under the BHCA.[676]

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extend this 10-year period for an additional 5 years. Section 4(n)(7), BHCA, 12 U.S.C. § 1843(n)(7) (1994 & Supp. V 1999). Section 4(n)(1), BHCA permits an FHC to "retain direct or indirect ownership or control of shares" of a company engaged in grandfathered activities. This permits minority and controlling investments.

672 *See supra* C.1. *See also* 12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y)

673 12 U.S.C. § 1843(n) (1994 & Supp. V 1999).

674 Section 4(n)(1)(A), BHCA 12 U.S.C. § 1843(n)(1)(A) (1994 & Supp. V 1999). This condition implies that the minority-owned or controlled company was engaged in such activity on Sept. 30, 1999.

675 Section 4(n)(1)(B) & (2), BHCA, 12 U.S.C. § 1843(n)(1)(B) & (2) (1994 & Supp. V 1999). Financial activities are the activities under § 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999). These activities are set forth in 12 C.F.R. § 225.86 (2002) (Regulation Y). Complementary activities are not financial activities. *See supra* C.7. FHC § 4(c) permissible activities (*see supra* text accompanying notes 234, 251–265, *i.e.*, activities otherwise permissible for the FHC under § 4(c), BHCA) apparently may not be counted towards the 85 percent test, although this result does not appear justified. *See supra* C.1. Revenues from financial activities include revenues from investments made by an insurance company that is the FHC or a subsidiary of the FHC under the insurance company portfolio investment authority and investments made by the FHC or its subsidiaries under the merchant banking investment authority in companies engaged in nonfinancial activities permitted pursuant to Section 4(k)(4)(H) and (I), BHCA, 12 U.S.C. § 1843(k)(4)(H) & (I) (1994 & Supp. V 1999).

676 Section 4(n)(1)(C), BHCA, 12 U.S.C. § 1843(n)(1)(C) (1994 & Supp. V 1999). The company must continue to engage only in the same activities that such company conducted on Sept. 30, 1999 and other activities permissible under the BHCA. *Id*. Thus, the company is not restricted from engaging in financial activities.

Aggregate annual gross revenues from grandfathered activities may continue to grow, but may never exceed 15 percent of the consolidated annual gross revenues of the FHC (excluding revenues from subsidiary depository institutions).[677] Furthermore, the grandfathered FHC may not directly or indirectly acquire, by merger or other type of business combination, assets of any other company not engaged in financial activities, with a very limited exception involving control of broadcasting stations.[678]

Section 4(n)(1), BHCA provides that an FHC may take advantage of the grandfather provisions only if it is not a foreign bank or a BHC and becomes an FHC after November 12, 1999.[679] Section 4(n)(1), BHCA does not give grandfather rights to a company that was not a BHC or foreign bank on November 12, 1999, becomes a BHC or foreign bank after November 12, 1999 and thereafter elects FHC status. Such step transaction is not permissible because a mere BHC or foreign bank (that is not an FHC) does not have the benefit of the grandfather provision of Section 4(n), BHCA and its investment in companies engaged in activities not permissible under the BHCA is prohibited under Section 4(a), BHCA.[680] Thus, the grandfather rights are only available to companies that were at no time BHCs or foreign banks before they elected FHC status, and a company that after November 12, 1999 acquires a bank must at the same time apply FHC status,[681] otherwise the acquiror company becomes a BHC and the grandfather provisions are lost.

Foreign banks[682] are excluded from the grandfather privilege of Section 4(n), BHCA even if they were not treated as BHCs on the date of the enactment of the GLBA, because they did not have a branch, agency or commercial lending company in the United States. A foreign bank that on November 12, 1999 does not have a branch, agency or commercial lending company in the United States but has a U.S. subsidiary engaged in a commercial or industrial activity and that after November 12, 1999 opens a U.S. branch, agency or commercial lending company or acquires a subsidiary bank in the United States and elects to be an FHC does not have the grandfather privileges for that industrial or commercial subsidiary. Section 4(n), BHCA should benefit, however, a foreign insurance company with U.S. subsidiaries engaged in nonfinancial activities (that are not part of the ordinary course of business portfolio investment of the insurance company) that after November 12, 1999 acquires a foreign bank with a U.S.

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677 Section 4(n)(4), BHCA, 12 U.S.C. § 1843(n)(4) (1994 & Supp. V 1999).

678 Section 4(n)(3), BHCA, 12 U.S.C. § 1843(n)(3) (1994 & Supp. V 1999). Section 4(n)(3), BHCA prohibits an FHC and a subsidiary of an FHC from making acquisitions of companies that are not engaged in financial activities. This Section does not prohibit such acquisitions by minority-owned companies with grandfathered activities. This makes sense because the FHC could not prevent a noncontrolled company from making acquisitions.

679 12 U.S.C. § 1843(n)(1) (1994 & Supp.V 1999). The Section does not provide that the company was not a BHC or foreign bank on Nov. 12, 1999; it provides that the company is not a BHC or foreign bank.

680 12 U.S.C. § 1843(a) (1994).

681 12 C.F.R. § 225.82(f) (2002) (Regulation Y).

682 As to the definition of *foreign bank*, *see supra* note 43. It must be remembered that a company that controls a foreign bank is also a foreign bank.

branch, agency or commercial lending company or a bank subsidiary and at the same time elects to become an FHC. Such insurance company was not a foreign bank before it elected FHC status.

The cross-marketing restrictions and prudential safeguards that apply between nonfinancial companies acquired pursuant to the authority to make merchant investment banking investments or insurance company portfolio investments, discussed below, also apply to the relationship between companies engaged in grandfathered activities and depository institution subsidiaries of FHCs.[683]

F. Notice Requirements in Connection with Financial Activities

1. No Prior Application or Notice Required

An FHC need not file an application for prior approval by the Board or give prior notice to the Board to engage, directly or indirectly, in a financial activity[684] or to make a controlling or noncontrolling investment in a company that is exclusively or substantially engaged in financial activities or to make in the exercise of a financial activity (*i.e.,* the underwriting, dealing and market-making authority, the merchant banking investment authority, or the insurance company portfolio investment authority) an investment in a company not engaged in a financial activity.[685] There are four exceptions to the general rule that no prior approval or notice is required:

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683 Section 4(n)(5) & (6), BHCA, 12 U.S.C. § 1843(n)(5) & (6) (1994 & Supp. V 1999). For a discussion of these provisions, *see infra* G.3. & 4.

Section 4(o), BHCA, 12 U.S.C. § 1843(o) (1994 & Supp. V 1999), contains a second limited, but permanent, grandfathering provision: a company that on Nov. 12, 1999 was not a BHC or a foreign bank and that effectively elects to be an FHC thereafter may continue to be engaged in, or directly or indirectly own shares in a company engaged in, activities relating to the trading, sale, or investment in commodities and underlying physical properties that were not permissible for BHCs to conduct in the United States as of Sept. 30, 1997, if (1) the FHC or any subsidiary of the FHC was engaged in such activity as of Sept. 30, 1997 in the United States, (2) the assets relating to such activity do not exceed 5 percent of the total consolidated assets of the FHC, and (3) there is no cross-marketing between any company engaged in such activity and affiliated depository institutions.

684 *I.e.*, an activity enumerated in 12 C.F.R § 225.86 (2002) (Regulation Y). *See supra* C.3.

685 Section 4(k)(6)(B), BHCA, 12 U.S.C. § 1843(k)(6)(B) (1994 & Supp. V 1999); 12 C.F.R. § 225.85(a)(1) (2002) (Regulation Y). *See* Final FHC Release, *supra* note 32, at 404. *See also supra* note 235 (discussing whether the absence of a prior notice requirement applies only to the acquisition of a company exclusively engaged in financial activities or also to the acquisition of a company merely substantially engaged in financial activities). Engaging in financial activities or acquiring shares or control of a company engaged in financial activities by a depository institution subsidiary of an FHC or a subsidiary of such subsidiary are not covered by 12 C.F.R. § 225.85(a).

Section 4(k)(6)(B), BHCA provides that no prior approval of the Board is required to commence any activity pursuant to § 4(k)(4), BHCA, 12 U.S.C. § 1843(k)(4) (1994 & Supp. V 1999), or to acquire any company pursuant to § 4(k)(4), BHCA. Note that the clause relating to acquisitions does not refer to the acquisition of a company engaged in an activity pursuant to § 4(k)(4), BHCA but to the acquisition authorized by § 4(k)(4), BHCA. Thus, § 4(k)(6)(B), BHCA relates not only to the acquisition of companies

- An FHC must obtain Board approval prior to acquiring control or more than 5 percent of the shares of any class of voting securities of a savings association or a holding company of a savings association;[686]

- The Board, in exercise of its supervisory authority, may require an FHC to provide notice to or obtain approval from the Board prior to engaging in any activity or acquiring shares or control of any company engaged in a financial or nonfinancial activity;[687]

- The GLBA amendments to the BHCA did not change in any way the requirements that a BHC/FHC must receive prior approval of the Board under § 3, BHCA before acquiring 5 percent of shares of any class of voting securities of a bank or U.S. BHC/FHC with a U.S. bank subsidiary;[688] and

- The GLBA amendments to the BHCA did not change in any way the requirements that a company must give prior notice to the Board under 4(j), BHCA[689] before engaging in activities on the basis of the authority of Section

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engaged in financial activities but also to the acquisition in exercise of the financial activities investment authorities of companies engaged in nonfinancial activities. This covers the acquisition of nonfinancial companies through the underwriting, dealing and market making authority, the merchant banking investment authority and the insurance company portfolio investment authority. Section 4(k)(4)(E), (H) & (I), BHCA, 12 U.S.C. § 1843(k)(4)(E), (H) & (I) (1994 & Supp. V 1999).

Complementary activities permitted by § 4(k)(1)(B), BHCA, 12. U.S.C. § 1893(k)(1)(B) (1994 & Supp. V 1999), are not financial activities and require prior Board approval. *See supra* C.7.

686 Section 4(k)(6)(B), BHCA, 12 U.S.C. § 1843(k)(6)(B) (1994 & Supp. V 1999); 12 C.F.R. § 225.85(c)(1) (2002) (Regulation Y). Board approval must be obtained in accordance with § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999), and either 12 C.F.R. § 225.14 or § 225.24 (2002) (Regulation Y), as appropriate.

687 12 C.F.R. § 225.85(c)(2) (2002) (Regulation Y). The Board may impose such requirement in accordance with its authority pursuant to 12 C.F.R. § 225.82(g) (2002) (Regulation Y) (residual supervisory authority over FHCs; *see supra* note 221) or 12 C.F.R. § 225.83(d) (2002) (Regulation Y) (limitations during period of noncompliance; *see infra* H.1.) or any other relevant authority. *See* Final FHC Release, *supra* note 32, at 404; Interim Financial Activities Release, *supra* note 272, at 14,434–35. 12 C.F.R. § 225.85(c)(2) speaks about "acquiring shares or control of any company". This covers the acquisition of companies engaged in financial activities, 12 C.F.R. § 225.86 (2002) (Regulation Y), and of companies that are acquired in exercise of the financial activities investment authorities and are engaged in nonfinancial activities, *i.e.*, companies acquired through the underwriting, dealing and market making authority, the merchant banking investment authority or the insurance company portfolio investment authority. Section 4(k)(4)(E), (H) & (I), BHCA, 12 U.S.C. § 1843(k)(4)(E), (H) & (I) (1994 & Supp. V 1999). The Final FHC Release, *supra* note 32, at 404 is incorrect when it summarizes 12 C.F.R. § 225.85(c)(2) as permitting prior Board approval to "acquire a company engaged in a financial activity".

688 Section 3(a)(3), BHCA, 12 U.S.C. § 1842(a)(3) (1994); 12 C.F.R. § 225.11(c)(1) & (f) (2002) (Regulation Y). *See* Final Merchant Banking Release, *supra* note 418, at 8,469 n.8; Interim Financial Activities Release, *supra* note 272, at 14,434 n.1.

689 12 U.S.C. § 1843(j) (1994 & Supp. V 1999).

4(c), BHCA[690] to the extent Section 4(c), BHCA or Regulation Y requires prior notice.[691]

2. Post-Transaction Notices

The BHCA requires an FHC that (i) commences a financial activity,[692] (ii) acquires shares of a company engaged in a financial activity (an activity listed in § 225.86, Regulation K[693]) or (iii) acquires in exercise of the financial activities authority shares in a company engaged in nonfinancial activities[694] to notify the appropriate Federal Reserve Bank[695] in writing 30 calendar days after commencing the activity or consummating the acquisition (the "*post-transaction notice*").[696]

Section 225.87, Regulation Y,[697] which implements the post-transaction notice requirement of the BHCA, is badly drafted in that it does not distinguish between companies engaged in financial activities and portfolio companies acquired by virtue of a financial activity investment authority that are engaged in "any activity" (nonfinancial activities). If an FHC directly or indirectly makes a merchant banking investment in an automobile manufacturer, it is

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690 12 U.S.C. § 1843(c) (1994 & Supp. V 1999).

691 *See supra* text accompanying notes 234, 251–265 for a discussion of FHC § 4(c) permissible activities. *See also* the reference to applicable notice in connection with FHC otherwise permissible Regulation Y activities, discussed *supra* in text accompanying notes 242, 245–255.

692 12 C.F.R. § 225.87(a) (2002) (Regulation Y) seems to say that *any activity* of an FHC requires a post-transaction notice. (The reference in that Section to financial activities listed in 12 C.F.R. § 225.86 (2002) (Regulation Y) related grammatically only to the acquisition of shares.) This is a drafting error. Section 4(k)(6)(A), BHCA, 12 U.S.C. § 1843(k)(6)(A) (1994 & Supp. V 1999), requires a notice only in the case of the commencement of any activity "pursuant to this subsection [*i.e.*, § 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999)]", *i.e.*, a financial activity.

693 12 C.F.R. § 225.86 (2002) (Regulation Y).

694 Section 4(k)(6)(A), BHCA, 12 U.S.C. § 1843(k)(6)(A) (1994 & Supp. V 1999), refers to the acquisition of any company pursuant to Section 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999). This includes the acquisition of companies engaged in financial activities under Section 4(k)(4), BHCA, 12 U.S.C. § 1843(k)(4) (1994 & Supp. V 1999), as well as the acquisition in exercise of the financial activities investment authorities of companies that are engaged in nonfinancial activities, *i.e.*, companies acquired through the merchant banking investment authority, the insurance company portfolio investment authority or the underwriting, dealing or merchant banking activities authority. Section 4(k)(4)(E), (H) & (I), BHCA, 12 U.S.C. § 1843(k)(4)(E), (H) & (I) (1994 & Supp. V 1999).

695 *Appropriate Federal Reserve Bank* is defined in 12 C.F.R. § 225.3(b) (2002) (Regulation Y).

696 Section 4(k)(6)(A), BHCA, 12 U.S.C. § 1843(k)(6)(A) (1994 & Supp. V 1999); 12 C.F.R. § 225.87(a) (2002) (Regulation Y). The post-transaction notice must be given by U.S. BHCs on Form F.R. Y-10 and by foreign banks on Form FR Y-10F. *See* Final FHC Release, *supra* note 32, at 406 n.15 and *supra* note 564. Experience shows that compliance with the requirement of Form F.R. Y-10F can be extremely onerous, in particular in cases of acquisitions of companies engaged in financial activities. Companies that are not subject to Board supervision do not keep records in a manner that facilitates completing Form FR Y-10F.

697 12 C.F.R. § 225.87 (2002) (Regulation Y).

neither useful nor correct to call, as Section 225.87, Regulation Y does, the activity of the automobile manufacturer a financial activity. Section 4(k)(4)(H), BHCA[698] uses correct terminology: it calls the "acquiring or controlling" of the portfolio company by an FHC, and not the activity in which the portfolio company is engaged ("engaged in any activity"), a financial activity. Section 225.87(a), Regulation Y[699] does not seem to cover notices in connection with the acquisition of a portfolio company (because that Section only refers to the acquisition of companies engaged in financial activities and a portfolio company is not engaged in an activity listed in Section 225.86, Regulation Y),[700] but by implication it follows from Section 225.87(b)(3) & (4), Regulation Y[701] that investments in portfolio companies are intended to be covered by Section 225.87(a), Regulation Y in addition to investments in companies that are engaged in financial activities as such term is used in Section 4(k)(4)(H), BHCA.[702]

There are three broad exemptions from the requirement to file a post-transaction notice.

- In the case of an acquisition, a post-transaction notice is only required if the FHC acquires control of the target.[703]

- Once an FHC has given a post-transaction notice to the appropriate Federal Reserve Bank[704] that it has commenced engagement in securities underwriting, dealing or market making activities,[705] merchant banking investment activities[706] or insurance company portfolio investment activities,[707] no further post-

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698 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). Financial activities are lending, insuring, providing financial services, underwriting, etc. and *acquiring portfolio companies*. *Id.*

699 12 C.F.R. § 225.87(a) (2002) (Regulation Y).

700 12 C.F.R. § 225.86 (2002) (Regulation Y).

701 12 C.F.R. § 225.87(b)(3) & (4) (2002) (Regulation Y).

702 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

703 12 C.F.R. § 225.87(b)(1) (2002) (Regulation Y) (a post-transaction notice is not required in connection with the acquisition of shares of a company if, following the acquisition, the FHC does not control the company). 12 C.F.R. § 225.87(b)(1) (2002) (Regulation Y) is based on § 4(k)(6)(A), BHCA, 12 U.S.C. § 1843(k)(6)(A) (1994 & Supp. V 1999) ("[An FHC] that acquires any company . . . shall provide written notice to the Board . . . ."). *See* Final FHC Release, *supra* note 32, at 406–07.

704 12 C.F.R. § 225.87(a) (2002) (Regulation Y).

705 *See* § 4(k)(4)(E), BHCA, 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999).

706 *See* § 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

707 *See* § 4(k)(4)(I), BHCA, 12 U.S.C. § 1843 (k)(4)(I) (1994 & Supp. V 1999).

transaction notice is required for any individual acquisition of shares of a company in exercise of these authorities.[708]

- Once an FHC has provided a post-transaction notice in connection with a particular financial activity, it is not required to submit an additional notice to commence such activity *de novo* through any (other) subsidiary of the FHC.[709] This exception applies only if the FHC already controls the company through which the activity will be commenced and, thus, the acquisition by an FHC of control of a company engaged in a listed financial activity does not qualify for this exception.[710] In addition, this exemption is not available if the Board, in the exercise of its supervisory authority, informs the FHC that notice is required for the commencement *de novo* of financial activities.[711]

The exemptions to the post-transaction notice requirement available for (1) noncontrolling investments (first bullet point) and (2) individual acquisitions of shares in exercise of the merchant banking investment and the insurance company portfolio investment authorities (second bullet point) are not available and post-transaction notices must be filed (x) if the FHC in exercise of its merchant banking investment authority or in exercise of its insurance company portfolio investment authority acquires more than 5 percent of the shares, assets or ownership interests of any company at a total cost that exceeds the lesser of 5 percent of the

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708 12 C.F.R. § 225.87(b)(3) (2002) (Regulation Y). Oddly enough, this provision is repeated for merchant banking investments in 12 C.F.R. § 225.175(c)(1) (2002) (Regulation Y). The Board justifies this unusual drafting technique by stating that the repetition is "for the convenience of users". Final Merchant Banking Release, *supra* note 418, at 8,480. It is *per se* more difficult for users to have to work with and to have to reconcile two provisions addressing the same rule.

709 12 C.F.R. § 225.87(b)(2) (2002) (Regulation Y). The FHC must be authorized to control the subsidiary or other subsidiary through which it commences the activity *de novo*. *Id.* This exception does not apply where an FHC has previously commenced through a subsidiary an activity under an authority other than Section 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999) (although the activity is also authorized as a financial activity under Section 4(k), BHCA), without having submitted a post-transaction notice. As the Board pointed out, some activities are authorized by more than one source of authority. *See supra* C.8. An FHC therefore may commence the same activity in different subsidiaries using different sources of authority in accordance with the procedures applicable to the chosen authority. *See* Final FHC Release, *supra* note 32, at 407 n.16.

710 *See* Final FHC Release, *supra* note 32, at 407.

711 12 C.F.R. § 225.87(b)(2) (2002) (Regulation Y) ("unless otherwise notified by the Board"). *See* Final FHC Release, *supra* note 32, at 407.

FHC's Tier I capital or $200 million,[712] or (y) if the Board in exercise of its supervisory authority notifies the FHC that a post-transaction notice is necessary.[713]

The scope of the exemptions from the requirement to file a post-transaction notice is not clear. If an FHC acquires a controlling interest in, for instance, a broker-dealer or a company engaged in making merchant banking investments, notice under Section 225.87(a), Regulation Y[714] is necessary. However, if the FHC has previously given notice for securities underwriting, dealing and market-making activities[715] or merchant banking activities[716] is the FHC still required to give notice in connection with the new acquisition of the broker-dealer or company engaged in merchant banking activities or does the exemption of Section 225.87(b)(3), Regulation Y apply?[717] Is the $200 million threshold provision relevant?[718] The exemption from the post-transaction filing requirement of Section 225.87(b)(3), Regulation Y probably does not apply because the acquisition of the broker-dealer or merchant bank is not made "as part of" the merchant banking investment activity.[719] The FHC does not intend to sell the broker-dealer or the merchant bank after a holding period.[720]

3. Filings Under the Hart-Scott-Rodino Act

If an FHC makes an acquisition of a company engaged in financial activities or makes an acquisition in exercise of its financial activities investment authority (*i.e.*, the merchant banking investment authority or the insurance company portfolio investment authority) of a company engaged in nonfinancial activities, it may be necessary to file a pre-merger notification under the Hart-Scott-Rodino Antitrust Improvement Act of 1976[721] [*herein* HSRA].

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712 12 C.F.R. § 225.87(b)(4)(i) & (ii) (2002) (Regulation Y). Oddly enough, this provision is repeated for merchant banking investments in 12 C.F.R. § 225.175(c)(2) (2002) (Regulation Y). *See supra* note 707. The danger inherent in repetition becomes apparent: whereas notice pursuant to 12 C.F.R. § 225.87(b)(4)(i) in connection with 12 C.F.R. § 225.87(a) must be given within 30 calendar days, the same notice pursuant to 12 C.F.R. § 225.175(c)(2) must be given within 30 days.

713 12 C.F.R. § 225.87(b)(4)(iii) (2002) (Regulation Y). This Section does not specify the basis of its supervisory authority. *See* 12 C.F.R. § 225.85(c)(2) (2002) (Regulation Y) (referring to the basis of supervisory authority).

714 12 C.F.R. § 225.87(a) (2002) (Regulation Y).

715 Section 4(k)(4)(E), BHCA, 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999).

716 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

717 12 C.F.R. § 225.87(b)(3) (2002) (Regulation Y).

718 12 C.F.R. § 225.87(b)(4)(i) (2002) (Regulation Y).

719 *See* 12 C.F.R. § 225.87(b)(3) (2002) (Regulation Y).

720 *See supra* D. 2. k.

721 15 U.S.C. § 18a (1994 & Supp. V 1999). *See* Conference Report on S. 900, *supra* note 4, at 160–62.

The HSRA is a procedural statute, intended to give the U.S. antitrust enforcement authorities advance notice of certain mergers and acquisitions so that the enforcement authorities may detect and prevent transactions that may violate the U.S. antitrust laws before they are consummated. The HSRA prohibits acquisitions of substantial amounts of voting securities and assets unless (1) a pre-merger notification is filed with both the Federal Trade Commission [FTC] and the Assistant Attorney General in charge of the Antitrust Division of the Department of Justice [DOJ], and (2) a waiting period subsequent to those filings has passed.[722]

The HSRA provides[723] that no pre-merger notification is necessary for transactions which require notice to and approval by the Board under Section 3, BHCA[724] in

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722 Pursuant to 15 U.S.C. § 18a(a) (1994 & Supp. V 1999) the HSRA requires a pre-merger notification and a 30-day waiting period (i) if, as a result of the acquisition, the acquiring person would have an aggregate amount of voting securities and assets of the acquired person in excess of $200 million (§18a(a)(2)(A)); or (ii) if, as a result of the acquisition, the acquiring person would hold an aggregate total amount of voting securities and assets of the acquired person in excess of $50 million but not in excess of $200 million, and one of the three following situations apply (§ 18a(a)(2)(B)): (I) the acquired person, if engaged in manufacturing, has annual net sales or total assets of $10 million or more and the acquiring person has total assets or annual net sales of $100 million or more; or (II) the acquired person, if not engaged in manufacturing, has total assets of $10 million or more and the acquiring person has total assets or annual net sales of $100 million or more; or (III) the acquired person has total assets or annual net sales of $100 million or more and the acquiring person has total assets or annual net sales of $10 million or more. The dollar amounts are subject to adjustments beginning after Sept. 30, 2004. The adjustments will be determined by the percentage change in the gross national product from Fiscal Year 2003 to the fiscal year in question.

There are a number of exemptions from the pre-merger notification requirement for acquisitions by foreign persons. The most relevant for acquisitions made by foreign banks is 16 C.F.R. § 802.51(b)(2002) of the FTC Rules under the HSRA. Pursuant to 16 C.F.R. § 802.51(b) (2002) the acquisition by a foreign person is exempt from the pre-merger notification requirement if: (a) the acquisition is of assets located outside the United States; (b) the acquisition is of voting securities of a foreign issuer, and will not confer control of: (1) an issuer which holds assets located in the United States (other than investment assets, voting or nonvoting securities of another person, and assets included pursuant to 12 C.F.R. § 801.40(c)(2) (2002) having an aggregate book value of $ 15 million or more, or (2) a U.S. issuer with annual net sales or total assets of $ 25 million or more; (c) the acquisition is of less than $ 15 million of assets located in the United States (other than investment assets); or (d) the acquired person is also a foreign person, the aggregate annual sales of the acquiring and acquired persons in or into the United States are less than $110 million, and the aggregate total assets of the acquiring and acquired persons located in the United States (other than investment assets, voting or nonvoting securities of another person, and assets included pursuant to 12 C.F.R. § 801.40(c)(2) (2002)) are less than $ 110 million. The term control in this context is defined — different from the definition in the BHCA — as holding 50% or more of the outstanding voting securities of the target. 16 C.F.R. § 801.1(b)(2002).

723 *See* 15 U.S.C. § 18a(c)(7) & (8) (1994 & Supp. V 1999). Clause 7 provides that exempt from the HSRA filing requirements are "transactions which require agency approval under . . . [§ 3, BHCA], except that a portion of the transaction is not exempt under this paragraph if such portion of the transaction (A) is subject to . . . [§ 4(k), BHCA]; and (B) does not require agency approval under . . . [§ 3, BHCA]"; and clause 8 provides that exempt from HSRA filing requirements are "transactions which require agency approval under [§ 4, BHCA] . . . , if copies of all information and documentary material filed with any such agency are contemporaneously filed with the Federal Trade Commission and the Assistant Attorney General at least 30 days prior to consummation of the proposed transaction, except that a portion of the transaction is not exempt under this paragraph if such portion of the transaction (A) is subject to . . . [§ 4(k), BHCA]; and (B) does not require agency approval under . . . [§ 4, BHCA]."

connection with the acquisition of a U.S. bank or BHC or under Section 4, BHCA[725] in connection with acquisitions permitted by Section 4, BHCA.[726] However, a pre-merger notification under the HSRA is required in connection with acquisitions under Section 4(k), BHCA[727] that do not require Board approval.[728] Section 4(k), BHCA acquisitions generally do not require Board approval but merely a post-transaction notice or no notice to the Board.[729]

If the acquired company engages, directly or indirectly, in financial activities or the investment is made in exercise of the merchant banking investment authority or the insurance company portfolio investment authority, and therefore qualifies as financial activity,[730] the acquiror must file either a post-transaction notice or no notice[731] and a pre-merger notification under the HSRA is necessary.[732] If the acquired company engages in activities permitted by

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724 12 U.S.C. § 1842 (1994).

725 Notice for § 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999) activities is required under § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999); however, approval may be required under § 4(c)(9) or (13) BHCA, 12 U.S.C. § 1843(c)(9) or (13) (1994). Note that § 4(k)(6)(B), BHCA, 12 U.S.C. § 1843(k)(6)(B) (1994 & Supp. V 1999) (acquisition of a savings association and holding companies of savings associations), requires Board approval under § 4(j), BHCA, even if acquired in exercise of the investment authority of a financial activity.

726 12 U.S.C. § 1843 (1994 & Supp. V 1999).

727 *See* 15 U.S.C. § 18a(c)(7) & (8) (1994 & Supp. V 1999). *See* 12 U.S.C. § 1843(k) (1994 & Supp. V 1999).

728 Acquisitions of companies engaged in financial activities (§ 4(k)(1)(A), BHCA, 12 U.S.C. § 1843(k)(1)(A) (1994 & Supp. V 1999)) or acquisitions of companies not engaged in financial activities that were acquired in exercise of a financial activity investment authority (merchant banking investment authority or insurance company portfolio investment authority, § 4(k)(4)(H) & (I), BHCA, 12 U.S.C. § 1843(k)(4)(H) & (I) (1994 & Supp. V 1999)) do not require Board approval. *See supra* F.2. Acquisitions of companies engaged in complementary activities (§ 4(k)(1)(B), BHCA, 12 U.S.C. § 1843(k)(1)(B) (1994 & Supp. V 1999)) require prior Board approval under § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999). *See supra* C.7.

Acquisitions under § 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999), require Board approval under § 4(j), BHCA, 12 U.S.C. § 1843(j) (1994 & Supp. V 1999) if they involve savings associations or holding companies of savings associations. § 4(k)(6)(B), BHCA, 12 U.S.C. § 1843(k)(6)(B) (1994 & Supp. V 1999).

The Board may require an FHC to provide notice to or obtain approval from the Board prior to acquiring shares of any company engaged in a financial activity. 12 C.F.R. § 225.85(c)(2) (2002) (Regulation Y). However, this approval requirement is based on the Board's general supervisory authority (*see supra* note 687) and not on § 4, BHCA, 12 U.S.C. § 1843 (1994 & Supp. V 1999), and, therefore, does not exempt from the HSRA pre-merger notification.

729 *See supra* F.2.

730 *See supra* note 728.

731 *See supra* F.2. The acquisition of securities by an underwriter in a firm commitment underwriting is exempt from pre-merger filing requirements of the HSRA pursuant to 16 C.F.R. § 802.60 (2002).

732 15 U.S.C. § 18a(c)(7) & (8) (1994 & Supp. V 1999).

Section 4(c), BHCA[733] or in complementary activities[734] or the acquired company is a U.S. bank or BHC[735] or a savings association or savings association holding company,[736] the acquiror must file a prior notice with the Board under Section 4(j), BHCA or Section 3, BHCA,[737] as applicable, and no pre-merger notification under the HSRA is necessary.[738]

If the acquired company is engaged (directly or indirectly through subsidiaries) in banking activities, activities permitted by Section 4, BHCA that require Board approval, and in financial activities under Section 4(k), BHCA that do not require Board approval, the transaction is split for purposes of the HSRA into portions: that portion of the acquisition transaction that is covered by Section 4(k), BHCA and does not require Board approval requires an HSRA pre-merger notification, the portion of the acquisition that does require Board approval does not require an HSRA pre-merger notification.[739] For instance, if the acquired company is a U.S. bank engaged, directly or indirectly, in (i) banking, (ii) financial activities under Section 4(k), BHCA and (iii) activities under Section 4(c), BHCA or complementary activities, the acquiror would be required to file both a notice with the Board (for the portion of the transaction that is subject to Section 4(c), BHCA, the complementary activities and the acquisition of the bank) and an HSRA pre-merger notification with the FTC and the DOJ (for the portion of the transaction that involves financial activities subject to Section 4(k), BHCA).[740] Financial activities subject to Section 4(k), BHCA do not require prior notice to or approval by the Board and, hence the acquisition of a company engaged in financial activities requires notification under the HSRA. Complementary activities are subject to Section 4(k), BHCA but require Board approval; therefore, a notification under the HSRA is not required. The following diagram illustrates the above:

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733 12 U.S.C. § 1843(c) (1994 & Supp. V 1999). Activities permitted under § 4(c), BHCA include, of course, activities permitted upon Board approval under § 4(c)(9) or (13), BHCA, 12 U.S.C. § 1843(c)(9) or (13) (1994).

734 Section 4(k)(1)(B), BHCA, 12 U.S.C. § 1843(k)(1)(B) (1994 & Supp. V 1999). *See supra* C.7.

735 *See* § 3, BHCA, 12 U.S.C. § 1842 (1994). Activities permitted by § 4(c), BHCA, 12 U.S.C. § 1843(c) (1994 & Supp. V 1999), complementary activities under § 4(k)(1)(B), BHCA, 12 U.S.C. § 1843(k)(1)(B) (1994 & Supp. V 1999), and U.S. banks and BHCs are referred to above as *FHC otherwise permissible Regulation Y activities*. *See supra* text accompanying notes 242, 245–255.

736 Section 4(k)(6)(B), BHCA, 12 U.S.C. § 1843(k)(6)(B) (1994 & Supp. V 1999).

737 12 U.S.C. § 1843(j) (1994 & Supp. V 1999) & 12 U.S.C. § 1842 (1994). For a discussion of the filing requirements under § 4(j), BHCA, *see* Gruson, *supra* note 1, § 10.10 D. For a discussion of the filing requirements relating to complementary activities, *see supra* C.7. Applications for Board action under § 4(c)(9) and (13), BHCA, 12 U.S.C. § 1843(c)(9) & (13) (1994) are not governed by § 4(j), BHCA.

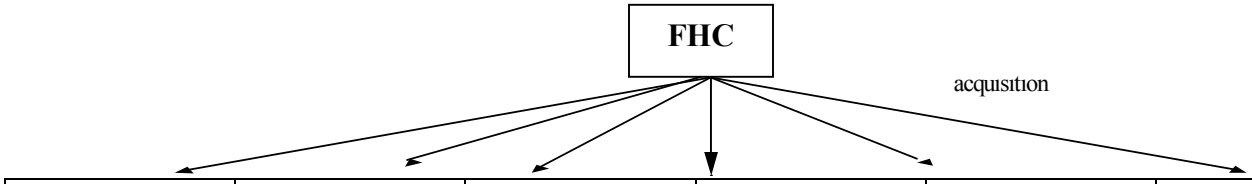
738 15 U.S.C. § 18a(c)(7) & (8) (1994 & Supp. V 1999).

739 15 U.S.C. § 18a(c)(7) & (8) (1994 & Supp. V 1999).

740 *See* 15 U.S.C. § 18a(c)(7) & (8) (1994 & Supp. V 1999).

Diagram 9

FHC acquires an entity that is engaged, directly or through subsidiaries, in one or more of the following activities



financial activities	**nonfinancial activities if acquisition pursuant to merchant banking or insurance company portfolio investment authority**	**Section 4(c), BHCA activities**	**U.S. bank/BHC**	**savings association**	**complementary activities**
-no pre-transaction Board notice -notice under HSRA	-no pre-transaction Board Notice -notice under HSRA	-pre-transaction Board notice -no notice under HSRA	-pre-transaction Board notice -no notice under HSRA	-pre-transaction Board notice -no notice under HSRA	-pre-transaction Board notice -no notice under HSRA

From a practical point of view, it may be difficult for a target company, that has not been under Board supervision and therefore does not keep its records in a manner that facilitates separation of its activities according to BHCA authorities, to separate its activities as indicated above, and it may be easier to give an HSRA pre-merger notification for the company as a whole.

G. Consequences of Becoming an FHC

1. Board Supervision over FHCs

The GLBA combines two principles of supervision of BHC/FHC groups: functional regulation and umbrella supervision.

The GLBA imposes on BHCs, regardless of whether they elected to become FHCs or not, the principle of functional regulation.[741] Functional regulation is the opposite of

[741] *See* § 5(c)(1) & (2), BHCA, 12 U.S.C. § 1844(c)(1) & (2) (1994 & Supp. V 1999).

regulation along industry lines. Functional regulation means that the Securities and Exchange Commission is the regulator of broker-dealers, registered investment advisers and registered investment companies that are BHCs having elected to be FHCs or are subsidiaries of an FHC; the state insurance supervisory authorities are the regulators of insurance companies that are BHCs having elected to be FHCs or are subsidiaries of an FHC; and the Commodity Futures Trading Commission is the regulator of entities subject to its regulations.[742] The functional regulation relates, of course, only to those activities of the entity subject to the jurisdiction of the respective regulator. The Office of the Comptroller of the Currency remains the supervisor of national banks, the Federal Deposit Insurance Corporation remains the supervisor of insured depository institutions, and the Office of Thrift Supervision remains the supervisor of thrifts.

Umbrella supervision gives the Board overall supervisory responsibility for BHCs and FHCs[743] but limits the direct supervisory power over functionally regulated companies in the holding company group by instructing the Board to rely primarily on, and to show deference to, reports filed with and examinations conducted by their functional regulators.[744] In keeping with the Board's role as an umbrella supervisor of BHCs, the BHCA provides that the Board may require any BHC and any of its subsidiaries to submit reports regarding its financial condition, risk control systems, transactions with depository institution subsidiaries of the BHC, and compliance with the BHCA or other federal laws under the enforcement jurisdiction of the Board.[745] The Board may also examine any BHC and any of its subsidiaries in order to inform the Board of its nature of operation, financial condition, threats to safety and soundness of any depository institution subsidiary of such BHC and the system for monitoring and controlling such risks, and to monitor compliance with the BHCA or other federal law under the

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742 *See* § 5(c), BHCA, 12 U.S.C. § 1844(c) (1994 & Supp. V 1999), and § 5(g), BHCA, 12 U.S.C. § 1844(g) (1994 & Supp. V 1999); § 45, FDIA, 12 U.S.C. § 1831v (1994 & Supp. V 1999); § 10A, BHCA, 12 U.S.C. § 1848a (1994 & Supp. V 1999); § 210, GLBA, 113 Stat. at 1396 (1999) (preserving the applicability of the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.* (1994 & Supp. V 1999)).

743 Section 5(c), BHCA, 12 U.S.C. § 1844(c) (1994 & Supp. V 1999). One commentator said that the GLBA allocated to the Board "regulatory responsibility for overseeing all financial services organizations from a safety and soundness perspective." Jonathan R. Macey, *The Business of Banking: Before and After Gramm-Leach-Bliley*, 25 J. CORP. L. 691, at 711 (2000). *See* Carter H. Golembe, *Reform of the Financial Regulatory Structure*, Golembe Report, Nos. 2 & 3, at 1 & 3 (2000).

The stated ground for ceding such massive power to the Board was the perceived need "for oversight of the [financial services] organizations as a whole as well as subsidiaries not subject to functional regulation." Senate Report on S. 900, *supra* note 400, at 16. For a critical view of the functional/umbrella regulatory scheme of the GLBA, *see* Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 IOWA J. CORP. L. 723, at 761–65, 776–84 (2000).

744 Section 5(c)(2)(D) & (E), BHCA, 12 U.S.C. § 1844(c)(2)(D) & (E) (1994 & Supp. V 1999). *See also* § 5(c)(1)(B), BHCA, 12 U.S.C. § 1844(c)(1)(B) (1994 & Supp. V 1999). One could say that the regulation by the Board of BHCs/FHCs and its subsidiaries constitutes functional regulation by the Board to the extent such BHCs/FHCs or subsidiaries are not subject to functional regulation by other agencies.

745 Section 5(c)(1)(A), BHCA, 12 U.S.C. § 1844(c)(1)(A) (1994 & Supp. V 1999).

enforcement jurisdiction of the Board.[746] It may examine, however, functionally regulated subsidiaries of a BHC only under enumerated circumstances.[747]

The Board supervision over BHCs is largely based on the so-called source of strength doctrine, pursuant to which a BHC and indirectly its subsidiaries are expected to support the deposit-taking subsidiaries in case of need.[748] The GLBA amendments to the BHC limit the source of strength doctrine by prohibiting the Board from requiring an insurance company, a registered broker-dealer, a registered investment company, or a registered investment adviser, that is a BHC or is an affiliate of a depository institution, to provide funds or other assets to a subsidiary depository institution of the BHC if the Securities and Exchange Commission or the state insurance authority as the functional regulator of such company determines that such action would have a materially adverse effect on the financial condition of such company.[749] If the functional regulator of the BHC or its affiliates refuses the use of funds of such functionally regulated company for the depository institution, the Board may order the BHC to divest the depository institution within 180 days and may impose conditions and restrictions on the BHC's ownership and operation of the depository institution during the divestiture period.[750] By limiting the doctrine, the BHCA permits the inference that the doctrine is, in general, legitimately available with respect to BHCs.[751]

2. Foreign Banks with Grandfathered Activities that Elect to Be FHCs

If a foreign bank[752] or other foreign company covered by Section 8(a), IBA[753] is engaged in grandfathered activities under Section 8(c), IBA[754] and those activities are financial

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746 Section 5(c)(2)(A), BHCA, 12 U.S.C. § 1844(c)(2)(A) (1994 & Supp. V 1999).

747 Section § 5(c)(2)(B) & (C), BHCA, 12 U.S.C. § 1844(c)(2)(B) & (C) (1994 & Supp. V 1999). The supervisory purpose must always be the protection of the safety and soundness of the depository institution subsidiary of the BHC, § 5(c)(2)(B)(i) & (ii), BHCA, 12 U.S.C. § 1844(c)(2)(B)(i) & (ii) (1994 & Supp. V 1999), or compliance with federal banking law, § 5(c)(2)(B)(iii), BHCA, 12 U.S.C. §1844(c)(2)(B)(iii) (1994 & Supp. V 1999). This applies even to examinations of BHC subsidiaries that are not functionally regulated. Section 5(c)(2)(A) & (C), BHCA, 12 U.S.C. § 1844(c)(2)(A) & (C) (1994 & Supp. V 1999).

748 *See* James F. Groth, Comment, *Can Regulators Force Bank Holding Companies to Bail Out Their Failing Subsidiaries? – An Analysis of the Federal Reserve Board's Source-of-Strength Doctrine*, 86 NW. U. L. REV. 112-42 (1991).

749 Section 5(g)(1), BHCA, 12 U.S.C. § 1844(g)(1) (1994 & Supp. V 1999). *See* Conference Report on S. 900, *supra* note 4, at 158. The Board must notify the functional regulator of its request that the BHC or its functionally regulated affiliates provide funds to the depository institution subsidiary of the BHC. Section 5(g)(2), BHCA, 12 U.S.C. § 1844(g)(2) (1994 & Supp. V 1999). Under the source of strength doctrine, the functionally regulated affiliates of the depository institution would provide funds or amounts to the BHC which would then provide them to the depository institution subsidiary. *See* § 5(g)(1), BHCA.

750 Section 5(g)(3) & (4), BHCA, 12 U.S.C. § 1844(g)(3) & (4) (1994 & Supp. V 1999). The Board may extend the 180-day period. Section 5(g)(3), BHCA.

751 *See* MCORP Fin. v. Board of Governors, 900 F.2d 852 (5th Cir. 1990) (refusing to recognize the legitimacy of the source of strength doctrine), *aff'd in part, rev'd in part on other grounds*, 502 U.S. 32 (1991).

752 *See supra* note 43.

activities or complementary activities,[755] it will lose such grandfather rights upon filing a declaration to be an FHC.[756] For example, a foreign bank with a grandfathered broker-dealer subsidiary that elects to be an FHC can no longer rely on the grandfather authority under Section 8(c), IBA but must rely on Section 4(k)(4)(F), BHCA[757] for the activities of its subsidiary. This provision is in the nature of a clean-up provision and should create no disadvantage for foreign banks. However, the prudential safeguards applicable to transactions between depository institutions and its affiliates in a BHC group, which did not apply to affiliates involved in grandfathered activities, will apply to such affiliates after the FHC election.[758] Nonfinancial activities of a foreign bank subsidiary that were grandfathered continue to be grandfathered.

The GLBA creates one disadvantage for foreign banks: the Board may impose restrictions and requirements on the conduct of grandfathered financial or complementary activities[759] of foreign banks that are comparable to the restrictions and requirements imposed on FHCs organized under U.S. law if such foreign banks did not elect FHC status by November 12, 2001.[760] These restrictions will mainly consist of the imposition of prudential safeguards on the

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753 12 U.S.C. § 3106(a) (1994). *See supra* note 14.

754 12 U.S.C. § 3106(c) (1994 & Supp. V 1999). A foreign bank that prior to the enactment of the IBA in 1978 was engaged in activities which were permitted at that time but prohibited after the enactment of the IBA was under § 8(c), IBA allowed to continue these activities (so-called grandfathered activities). *See* Michael Gruson & Jonathan M. Weld, *Nonbanking Activities of Foreign Banking Operations in the United States*, 1980 Ill. L.F. 129, 137–44 (1980), for a discussion of grandfathered activities.

755 Section 8(c), IBA, 12 U.S.C. § 3106(c) (1994 & Supp. V 1999), as amended by the GLBA, refers to "any activity that the Board has determined to be permissible for [FHCs]" under § 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999). For a discussion of financial activities and complementary activities, *see supra* C.3. & C.7. Financial activities that will lose their grandfathered status include, *e.g.*, the financial activities investment authority to invest in companies engaged in any nonfinancial activity pursuant to the underwriting, dealing and market-making authority, the merchant banking investment authority and the insurance company portfolio investment authority, § 4(k)(4)(E), (H) & (I), BHCA, 12 U.S.C. § 1843(k)(4)(E), (H) & (I) (1994 & Supp. V 1999). However, a portfolio company operated pursuant to the grandfather authority will not lose its right to continue to engage in its nonfinancial activities.

756 Section 8(c)(3)(A), IBA, 12 U.S.C. § 3106(c)(3)(A) (1994 & Supp. V 1999). *See* § 4(*l*)(1)(C), BHCA, 12 U.S.C. § 1843(*l*)(1)(C) (1994 & Supp. V 1999) (filing of declaration of election). Although the IBA provides that the foreign bank or other foreign company covered by § 8(a), IBA, 12 U.S.C. § 3106(a) (1994), loses its grandfather rights upon filing a declaration to be an FHC, the meaning probably is that there must have been an effective election to be an FHC.

757 12 U.S.C. § 1843(k)(4)(F) (1994 & Supp. V 1999). *See* 12 C.F.R. § 225.86(a)(1) in connection with 12 C.F.R. § 225.28(b)(7)(i) (2002) (Regulation Y).

758 *See infra* G. 4.

759 *See supra* note 755.

760 Section 8(c)(3)(B), IBA, 12 U.S.C. § 3106(c) (1994 & Supp. V 1999). Although the IBA requires that the foreign bank or foreign company covered by § 8(a), IBA, 12 U.S.C. § 3106(a) (1994), must have filed a declaration to be an FHC by the stated date, the meaning probably is that it must have made an effective election to be an FHC. In imposing such restrictions and requirements, the Board must give due regard to the principle of national treatment and equality of competitive opportunity. Section 8(c)(3)(B), IBA.

relationship between grandfathered broker-dealer subsidiaries of foreign banks and the U.S. branches or agencies of such foreign banks.[761]

A foreign bank with grandfathered activities other than financial activities or complementary activities does not lose those grandfather rights by electing to be an FHC and the conduct of such grandfathered activities by the foreign bank or its subsidiaries will not be subject to the imposition of prudential safeguards. More importantly, as discussed above, if a foreign bank that is a Qualified Foreign Banking Organization elects to be an FHC, it does not lose its status as, and the advantages of being, a Qualified Foreign Banking Organization.[762]

3. Limitations on Cross-Marketing

a. The Rule

The BHCA imposes cross-marketing restrictions on the relationship between the depository institution controlled by an FHC, on the one hand, and companies whose shares are owned or controlled by the FHC in exercise of the merchant banking investment authority, the insurance company portfolio investment authority or the underwriting authority and companies that are engaged in grandfathered activities pursuant to Section 4(n), BHCA, on the other hand [all such companies are referred to in this Section G.3. as *restricted companies*].[763] A purpose of the cross-marketing restrictions is to assist in maintaining the separation between banking and commerce.[764]

In particular, the BHCA prohibits any depository institution controlled by an FHC from offering or marketing, directly or through any arrangement, any product or service of a restricted company, or allowing any product or service of the depository institution to be offered

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761 *See infra* G.4. Section 8(c)(3)(B), IBA, 12 U.S.C. § 3106(c)(3)(B) (1994 & Supp. V 1999), refers by way of example specifically to 12 U.S.C. § 1828(a) (1994 & Supp. V 1999).

762 *See supra* E.1.

763 Section 4(n)(5)(A), BHCA, 12 U.S.C. § 1843(n)(5)(A) (1994 & Supp. V 1999). That Section refers to companies whose shares are owned or controlled or whose activities are conducted by an FHC pursuant to § 4(k)(4)(H) or (I), BHCA, 12 U.S.C. § 1843(k)(4)(H) or (I) (1994 & Supp. V 1999), or pursuant to § 4(n), BHCA, 12 U.S.C. § 1843(n) (1994 & Supp. V 1999). Although § 4(n)(5)(A), BHCA does not say whether all *or any* of the shares of such companies must be owned or controlled by an FHC, this Section also applies to minority-owned companies because § 4(k) and 4(n), BHCA, 12 U.S.C. § 1843(k) & (n) (1994 & Supp. V 1999), permit noncontrolling investments in portfolio companies or companies grandfathered under § 4(n)(1), BHCA. Thus, ownership of *any* shares seems to trigger the cross-marketing prohibition. This is, however, not a very practical conclusion. Note the difference in language between § 4(n)(5)(A), BHCA ("a company . . . whose shares are owned or controlled by the [FHC] . . .") and § 4(n)(5)(B), BHCA, 12 U.S.C. § 1843(n)(5)(B) (1994 & Supp. V 1999) ("a company owned or controlled [by an FHC]"). Note also that § 4(n)(6), BHCA, 12 U.S.C. § 1843(n)(6) (1994 & Supp. V 1999), makes § 23A, FRA, *infra* note 793, applicable only to affiliates, *i.e.*, companies in a control relationship. *See infra* note 810. As to companies engaged in grandfathered activities pursuant to § 4(n), BHCA, *see supra* E.2.

764 *See* H.R. Rep. 106-74 pt. 1, 106th Cong. 1st Sess., at 122–23 (1999); Final Merchant Banking Release, *supra* note 418, at 8,480 (text accompanying n. 27).

or marketed, directly or through any arrangement, by or through any restricted company.[765] Section 225.176, Regulation Y implements these restrictions for companies more than 5 percent of whose shares are owned or controlled by an FHC in exercise of the merchant banking investment authority[766] [such restricted companies covered by Section 225.176, Regulation Y are refereed to in this G.3. as *restricted portfolio companies*]. Regulation Y does not contain rules relating to cross-marketing of controlled depository institutions and companies whose shares are owned or controlled by an FHC pursuant to the insurance company portfolio investment authority[767] or that are engaged in grandfathered activities pursuant to Section 4(n), BHCA.[768]

Neither the BHCA nor Regulation Y defines the term *cross-marketing*. In its Merchant Banking Release, the Board states that companies use a wide variety of methods or arrangements to market or offer their products with those of other companies, and that new methods or arrangements for cross-marketing may develop with advances in technology, changes in consumer shopping or purchasing habits or other developments.[769] For this reason, the Board refrained from defining the terms. The Board believes "that questions concerning the application of [Regulation Y's] cross-marketing restrictions to particular types of activities or arrangements are handled most appropriately on a case-by-case basis".[770]

b. Restricted Depository Institutions

The cross-marketing restrictions of Regulation Y apply to companies more than 5 percent of whose shares are owned by an FHC in exercise of the merchant banking investment

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765 Section 4(n)(5)(A), BHCA, 12 U.S.C. § 1843(n)(5)(A) (1994 & Supp. V 1999).

766 12 C.F.R. § 225.176 (2002) (Regulation Y). 12 C.F.R. § 225.176(a)(1)(i) (2002) (Regulation Y) limits the application of 12 C.F.R. § 225.176 to companies more than 5 percent of the shares, assets or ownership interests of which are owned or controlled by an FHC pursuant to Subpart J (Merchant Banking Investments) of Regulation Y.

767 Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999). *See supra* D.4.

The BHCA contains special rules regarding cross-marketing arrangements between FHC-controlled depository institutions and companies whose shares are owned or controlled by the FHC pursuant to the insurance company portfolio investment authority for marketing of products or services through statement inserts or Internet Web sites. Section 4(n)(5)(B), BHCA, 12 U.S.C. § 1843(n)(5)(B) (1994 & Supp. V 1999). The Board regulations called for in that provision has not yet been promulgated. The special rules of § 4(n)(5)(B), BHCA are not applicable to investments made under the merchant banking investment authority. *See* Final Merchant Banking Release, *supra* note 418, at 8,480 n.26 (erroneously referring to § 4(k)(5)(B), BHCA, 12 U.S.C. § 1843(k)(5)(B) (1994 & Supp. V 1999)).

Regulation Y does not contain rules relating to cross-marketing of controlled depository institutions and companies whose shares are owned or controlled by an FHC pursuant to the underwriting, dealing or market-making authority of § 4(k)(4)(E) & (H), BHCA, 12 U.S.C. § 1843(k)(4)(E) & (H) (1994 & Supp. V 1999).

768 12 U.S.C. § 1843(n) (1994 & Supp. V 1999). *See supra* E.2.

769 *See* Final Merchant Banking Release, *supra* note 418, at 8,481.

770 *Id*.

authority and to any depository institutions controlled by such FHC.[771] Regulation Y extends the cross-marketing restrictions, with certain exceptions, to subsidiaries of such depository institution.[772] The extension of the cross-marketing restrictions to depository institution subsidiaries has the purpose of applying the restrictions to operating subsidiaries[773] of depository institutions, *i.e.*, subsidiaries that engage in activities permissible for the parent depository institution on the basis that the subsidiary is, in essence, a department or division of the institution.[774] The very nature of operating subsidiaries of depository institutions makes it reasonable to treat them as one and the same for purposes of the cross-marketing restrictions.

It stands to reason that subsidiaries of a depository institution that are authorized to engage in activities different from those permissible for the parent depository institution are not subject to the cross-marketing restrictions. Such subsidiaries that are exempt from the cross-marketing prohibition are:

- financial subsidiaries of a depository institution;[775]
- a company held by an Edge Act Corporation or Agreement Corporation subsidiary of a depository institution;[776] and
- any company held by a small business investment company owned in accordance with the Small Business Investment Company Act of 1958.[777]

Since Regulation Y defines for purposes of the merchant banking rules (Subpart J of Regulation Y) the term *depository institution* to include U.S. branches and agencies of a foreign bank,[778] such branches and agencies may not cross-market the products or services of a restricted portfolio company of the foreign bank FHC (or an FHC controlling the foreign bank

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771 12 C.F.R. § 225.176(a)(1) (2002) (Regulation Y).

772 12 C.F.R. § 225.176(a)(1) & (2) (2002) (Regulation Y).

773 *See* Gruson, *supra* note 1, at 662 n.10.

774 *See* Final Merchant Banking Release, *supra* note 418, at 8,480.

775 12 C.F.R. § 225.176(a)(2) (2002) (Regulation Y). Such subsidiaries are permitted by Section 5136A, Revised Statutes, 12 U.S.C. § 24a (1994 & Supp. V 1999), or § 46, FDIA, 12 U.S.C. § 1831w (1994 & Supp. V 1999). *See* Gruson, *supra* note 1, § 10.15 for a discussion of financial subsidiaries of national banks.

776 12 C.F.R. § 225.176(a)(2) (2002) (Regulation Y). Such subsidiaries are permitted by § 25 or 25A, FRA, 12 U.S.C. § 601 *et seq*. & § 611 *et seq*. (1994). *See* Gruson, *supra* note 1, at 676 n.40.

777 12 C.F.R. § 225.176(a)(2) (2002) (Regulation Y). *See* Small Business Investment Company Act of 1958, 15 U.S.C. § 661 *et seq*. (1994).

778 12 C.F.R. § 225.177(b) (2002) (Regulation Y).

FHC) held under the merchant banking investment authority[779] or allow any product or service of the branch or agency to be offered by such restricted portfolio company.[780]

c. FHC Affiliates Not Covered

The cross-marketing restrictions of the BHCA and Section 225.176, Regulation Y[781] do not apply to the relationship between nondepository affiliates of FHCs. Thus, for instance, two companies (that are not depository institutions) shares of which are owned by an FHC under any investment authority may cross-market each other's products. In addition, the cross-marketing restrictions do not apply to companies in which the FHC, directly or indirectly, owns under the merchant banking investment authority[782] less than 5 percent of the voting shares or ownership interests since the FHC could own such interests under Section 4(c)(6) or 4(c)(7), BHCA[783] without being subject to the BHC's cross-marketing restrictions.[784] If a noncontrolled restricted portfolio company owns more than 5 percent of the shares of another company, that other company is not controlled by the FHC and is not covered by the cross-marketing prohibition.

d. Cross-Marketing Restrictions and Private Equity Funds

Generally, the cross-marketing restrictions apply to a private equity fund held by an FHC under the merchant banking investment authority and to restricted portfolio companies held by such private equity fund, because both kinds of entities are companies owned or controlled by an FHC pursuant to Subpart J (Merchant Banking Investments) of Regulation Y.[785] Since private equity funds, by definition, may engage only in investment activities for resale or

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779 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

780 *See* Final Merchant Banking Release, *supra* note 418, at 8,480. The Final Merchant Banking Release, *id*., inaccurately states that a branch or agency of a foreign bank may not cross-market products or services of a restricted portfolio company "owned or controlled by the foreign bank or an affiliate of the foreign bank" under the merchant banking investment authority. As stated in 12 C.F.R. § 225.176(a)(1)(i) (2002) (Regulation Y), the cross-marketing prohibition applies to any restricted portfolio company more than 5 percent of whose shares are owned or controlled by the FHC. The Final Merchant Banking Release seems to require contrary to Regulation Y, a control relationship between the foreign bank and the restricted portfolio company. It does not clearly follow from the language of 12 C.F.R. § 225.176(a)(1) (2002) (Regulation Y) that the cross-marketing prohibition relating to branches and agencies of foreign banks includes restricted portfolio companies, shares of which are owned by an *affiliate* of the foreign bank FHC operating the branch or agency, but such inclusion appears to be reasonable.

781 12 C.F.R. § 225.176 (2002) (Regulation Y).

782 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

783 12 U.S.C. § 1843(c)(6) & (7) (1994).

784 *See* Final Merchant Banking Release, *supra* note 418, at 8,480. With this argument the Board "corrects" the drafting error of § 4(n)(5)(A), BHCA, 12 U.S.C. § 1843(n)(5)(A) (1994 & Supp. V 1999), that applies the cross-marketing prohibition to portfolio companies *any* shares of which are owned by an FHC. *See supra* note 763.

785 *See* 12 C.F.R. § 225.176(a)(3)(i) (2002) (Regulation Y).

other disposition in accordance with Regulation Y and may not be engaged in impermissible commercial activities,[786] Regulation Y permits FHC controlled depository institutions (and their subsidiaries) to sell, offer or market the shares or other ownership interest in a private equity fund in which the FHC has an interest, whether or not such interest is controlling.[787]

Furthermore, the cross-marketing restrictions do not prohibit an FHC controlled depository institution (and its subsidiaries) from engaging in cross-marketing activities with a restricted portfolio company held by a private equity fund that is owned but not controlled by the FHC.[788] Where the FHC does not control a private equity fund, shares held by the fund generally are not attributed to the FHC.[789]

e. Permitted Marketing Activities of Depository Institutions

The BHCA and Regulation Y do not prohibit an FHC controlled depository institution or subsidiary of a depository institution from marketing its own products or services - such as deposit, lending, and advisory products or services to a restricted company so long as the restricted company does not then market those products or services to its customers or others.[790] In addition, the BHCA and Regulation Y do not prohibit an FHC controlled depository institution from purchasing the products or services of a restricted company - such as data processing hardware, software or services - to support the depository institution's own operations, provided that the institution does not, directly or indirectly or through arrangements, market the restricted company's products or services for the institution's customers or others.[791] Likewise, the cross-marketing restrictions do not prohibit an FHC controlled depository institution from engaging in cross-marketing activities with a company that is a co-investor with the FHC in a restricted company, so long as those activities do not involve products or services of the restricted company.[792]

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786 *See supra* D. 2. e.

787 12 C.F.R. § 225.176(a)(3)(ii) (2002) (Regulation Y).

788 12 C.F.R. § 225.176(a)(3)(i) (2002) (Regulation Y).

789 *See* Final Merchant Banking Release, *supra* note 418, at 8,481.

790 *Id.*

791 *Id.* Since the Final Merchant Banking Release, *supra* note 418, at 8,481, states that this rule follows from the GLBA, the rule is not only applicable to restricted portfolio companies but also to restricted companies (*supra* note 763).

792 *Id*. n.28. Since the Final Merchant Banking Release, *supra* note 418, at 8,481, states that the rule follows from the GLBA, the rule is not only applicable to restricted portfolio companies but also to restricted companies (*supra* note 763).

4. Application of Prudential Safeguards and Sections 23A and 23B, FRA

a. Sections 23A & 23B, FRA and Bank Subsidiaries of FHCs

Sections 23A and 23B, Federal Reserve Act [*herein* FRA][793] impose specific quantitative, qualitative and collateral requirements on certain types of transactions between a

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[793] 12 U.S.C. § 371c (1994 & Supp. V 1999) & 12 U.S.C. § 371c-1 (1994 & Supp. V 1999). *See* proposed Regulation W, 66 Fed. Reg. 24,209 (May 11, 2001) (to be codified at 12 C.F.R. pt. 223); Board release accompanying proposed Regulation W, 66 Fed. Reg. 24,186-219 (Docket No. R-1103) (May 11, 2001) [*herein* Proposed Regulation W Release]. The Proposed Regulation W Release, at 24,186-87 summarizes §§ 23A & 23B, FRA as follows:

> [S]ections 23A and 23B of the Federal Reserve Act are designed to limit the risks to a bank (and the Federal deposit insurance funds) from transactions between the bank and its affiliates and to limit the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the Federal safety net. Section 23A achieves these goals in three major ways. First, it limits a bank's "covered transactions" with any single "affiliate" to no more than 10 percent of the bank's capital and surplus, and transactions with all affiliates combined to no more than 20 percent of capital and surplus. "Covered transactions" include purchases of assets from an affiliate, extensions of credit to an affiliate, investments in securities issued by an affiliate, guarantees on behalf of an affiliate, and certain other transactions that expose the bank to an affiliate's credit or investment risk. A bank's "affiliates" include, among other companies, any companies that control the bank, any companies under common control with the bank, and certain investment funds that are advised by the bank or an affiliate of the bank.
>
> Second, the statute requires all transactions between a bank and its affiliates to be on terms and conditions that are consistent with safe and sound banking practices, and prohibits a bank from purchasing low-qualify assets from its affiliates. Finally, the statute requires that a bank's extensions of credit to affiliates and guarantees on behalf of affiliates be appropriately secured by a statutorily defined amount of collateral.
>
> Section 23B protects a bank by requiring that certain transactions between the bank and its affiliates occur on market terms; that is, on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies. Section 23B applies this restriction to any covered transaction (as defined in section 23A) with an affiliate as well as certain other transactions, such as the sale of securities or other assets to an affiliate and the payment of money or furnishing of services to an affiliate.

Sections 23A and 23B, FRA apply by their terms to "member banks" — that is, national banks, State banks, trust companies, and other institutions that are members of the Federal Reserve System. The Federal Deposit Insurance Act (12 U.S.C. 1828(j) (1994)) subjects insured nonmember banks to sections 23A and 23B, FRA as if they were member banks. *See* § 223.1(c), Proposed Regulation W, 66 Fed. Reg. 24,210 (May 11, 2001). Accordingly, §§ 23A & 23B, FRA apply to all insured depository institutions and uninsured member banks. Proposed Regulation W Release, *supra*, at 24,187, 24,188 & 24,207; § 223.26(c), Proposed Regulation W, 66 Fed. Reg. 24,218 (May 11,2001).

See *generally* Robert E. Mannion & Linda B. Coe, *Transactions Between Banks and Affiliated Entities,* Chapter 11 *in* MICHAEL GRUSON & RALPH REISNER (eds.), REGULATION OF FOREIGN BANKS, UNITED STATES AND INTERNATIONAL, vol. 1 (3d ed. 2000) for a discussion of §§ 23A & 23B, FRA.

bank and its affiliates, principally companies that are under common control with the bank.[794] Section 23A and 23B, FRA apply to such transactions between an FHC controlled bank,[795] on the one hand, and such FHC and subsidiaries of such FHC, including its subsidiaries engaged in financial activities and controlled portfolio companies, on the other hand.[796]

If an FHC owns or controls 25 percent or more of a class of voting securities of a company under the merchant banking investment authority[797] or the insurance company portfolio investment authority,[798] the company is an affiliate of a bank controlled by the FHC.[799] Section 23A, FRA, as amended by the GLBA, lowers the threshold of control for portfolio companies of FHCs. Section 23A(b)(11), FRA creates a rebuttable presumption that a portfolio company [*herein* an (H) or (I) portfolio company], 15 percent or more of whose equity capital is owned or controlled by an FHC pursuant to the merchant banking investment authority or the insurance company portfolio investment authority, is an affiliate of the bank subsidiary of such FHC for purposes of Sections 23A and 23B, FRA.[800] Thus, unless the presumption is rebutted, the 15 percent-owned (H) or (I) portfolio company is an affiliate of the bank subsidiary of the parent

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794 *See* Final Merchant Banking Release, *supra* note 418, at 8,481. *See* § 23A(a)(1) & (b)(1), FRA, 12 U.S.C. § 371c(a)(1) & (b)(1) (1994).

795 As to the scope of the term bank for purposes of § 23A, FRA, 12 U.S.C. § 371c (1994 & Supp. V 1999), *see* § 223.1(c), Proposed Regulation W, 66 Fed. Reg. 24,210 (May 11, 2001). *See supra* note 793 (penultimate paragraph).

796 Section 23A, FRA, 12 U.S.C. § 371c (1994 & Supp. V 1999), addresses transactions between banks and *affiliates*. *Affiliate* is defined in § 23A (b)(1), (2) & (3), FRA, 12 U.S.C. § 371c (b)(1), (2) & (3) (1994), and in § 223.24, Proposed Regulation W, 66 Fed. Reg. 24,216 (May 11, 2001), in terms of control. *Control* is defined in § 223.26(f), Proposed Regulation W, 66 Fed. Reg. 24,218 (May 11, 2001). This definition is substantially identical to the definition of control in § 2(a)(2), BHCA, 12 U.S.C. § 1841(a)(2) (1994). Section 23B(d)(1), FRA, 12 U.S.C. § 371c-1 (d)(1) (1994), defines *affiliate* by reference to § 23A, FRA.

797 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

798 Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999).

799 Section 23A (b)(3)(A), FRA, 12 U.S.C. § 371c (b)(3)(A) (1994); §§ 223.24(a)(2) & § 223.26(f), Proposed Regulation W, 66 Fed. Reg. 24,216 & 24,218 (May 11, 2001). *See* Proposed Regulation W Release, *supra* note 793, at 24,204.

800 Section 23A(b)(11), FRA, 12 U.S.C. § 371c(b)(11) (1994 & Supp. V 1999); 12 C.F.R. § 225.176(b)(1) (2002) (Regulation Y) (referring only to the investment authority under § 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999)); § 223.24(a)(9)(i), Proposed Regulation W, 66 Fed. Reg. 24,217 (May 11, 2001) (referring to the investment authority under § 4(k)(4)(H) &(I), BHCA, 12 U.S.C. § 1843(k)(4)(H) & (I) (1994 & Supp. V 1999). Section 23A(b)(11), FRA uses the term *equity capital* without defining that term, but a definition is contained in § 223.26(i), Proposed Regulation W, 66 Fed. Reg. 24,218 (May 11, 2001). 12 C.F.R. § 225.176(b)(1) (2002) (Regulation Y) uses the term *equity* which is not defined in Regulation Y or in the BHCA. For purposes of the presumption of control of 12 C.F.R. § 225.176(b)(1) (2002) (Regulation Y), *equity capital* includes options, warrants and other instruments convertible into equity capital. 12 C.F.R. § 225.176(b)(4) (2002) (Regulation Y) (the Section should refer to *equity* rather than *equity capital*, or 12 C.F.R. § 225.176(b)(1) should refer to *equity capital* rather than *equity*). *See* the definition of *equity* in 12 C.F.R. § 211.2(h) (2002) (Regulation K).

FHC for purposes of §§ 23A and 23B, FRA. Section 23A gives the Board the power to determine whether the presumption of control is rebutted.[801]

Section 225.176(b)(3), Regulation Y[802] and Section 223.24(a)(9)(iii), Proposed Regulation W[803] set forth situations in which the BHCA's presumption of control will be considered rebutted:

- no director, officer or employee of the FHC serves as a director, trustee or general partner of the H or I portfolio company;
- a person that is not affiliated or associated with the FHC owns or controls a greater percentage of the equity capital of the H or I portfolio company than is owned or controlled by the FHC, and no more than one officer or employee of the FHC serves as a director or trustee of the H or I portfolio company; or
- a person that is not affiliated or associated with the FHC owns or controls more than 50 percent of the voting shares of the H or I portfolio company, and officers and employees of the FHC do not constitute a majority of the directors or trustees of the H or I portfolio company.[804]

These safe harbors operate automatically; they do not require Board review or approval.[805] On the other hand, the situations identified in Section 225.176(b)(3), Regulation Y and Section

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801 Section 23A(b)(11), FRA, 12 U.S.C. § 371c(b)(11) (1994 & Supp. V 1999) ("unless the company or shareholder provides information acceptable to the Board to rebut this presumption of control"). *See* 12 C.F.R. § 25.176(b)(2) (2002) (Regulation Y); § 223.24(a)(9)(ii), Proposed Regulation W, 66 Fed. Reg. 24,217 (May 11, 2001).

802 12 C.F.R. § 225.276(b)(3) (2002) (Regulation Y).

803 66 Fed. Reg. 24,217 (May 11, 2001).

804 In each of these situations the FHC is assumed to own more than 15 percent of the total equity of the portfolio company (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the H or I portfolio company (thereby not meeting the statutory definition of control). *See* Final Merchant Banking Release, *supra* note 418, at 8,481; Proposed Regulation W Release, *supra* note 793, at 24, 204. For purposes of the safe harbors, the terms *holding company* and *FHC* include any subsidiary of the holding company/FHC, including any subsidiary depository institution. Accordingly, if a director of a subsidiary bank or nonbank subsidiary of an FHC also serves as a director of a portfolio company, such person counts as director of the FHC. Section 223.24(a)(9)(v), 66 Fed. Reg. 24,217 (May 11, 2001); 12 C.F.R. § 225.177(a)(1) (2002) (Regulation Y). *See* Proposed Regulation W Release, *supra* note 793, at 24,205.

805 12 C.F.R. § 225.176(b)(3) (2002) (Regulation Y) ("without Board approval"); § 223.24(a)(9)(ii), Proposed Regulation W, 66 Fed. Reg. 24,217 (May 11, 2001). *See* Final Merchant Banking Release, *supra* note 418, at 8,481; Proposed Regulation W Release, *supra* note 793, at 24,204 & 24,205. Although the Board calls the presumptions of nonexistence of control "safe harbors" (s*ee* Final Merchant Banking Release, *supra* note 418, at 8,481) they are not really safe harbors in the generally accepted meaning of that term because 12 C.F.R. § 225.176(b)(3) (2002) (Regulation Y) permits these presumptions only "[a]bsent evidence to the contrary". It is unclear who could bring such evidence and in what procedure. Section 223.24(a)(9)(iii), Proposed Regulation W, 66 Fed. Reg. 24,217 (May 11, 2001) does not contain such qualification; and the

223.24(a)(9)(iii), Proposed Regulation W are not an exclusive list of circumstances in which the presumption may be rebutted, and Regulation Y and Proposed Regulation W permit FHCs to submit to the Board evidence of other circumstances that would support rebuttal of the presumption of control.[806]

An FHC indirectly owns or controls shares of a company that are owned or controlled by its subsidiary.[807] Regulation Y and Proposed Regulation W clarify that for purposes of applying the presumption of control, an FHC that has an investment in a private equity fund will not be considered indirectly to own the equity capital of a portfolio company owned by the fund *unless* the FHC controls the private equity fund.[808] On the other hand, an H or I portfolio company is presumed to be an affiliate of the bank subsidiary of an FHC for purposes of Sections 23A and 23B, FRA, if the FHC controls a private equity fund and the private equity fund owns or controls more than 15 percent of the total equity of such portfolio company.[809]

In addition, Section 23A, FRA is made applicable to the transactions between banks controlled by an FHC and affiliates controlled by the FHC engaged in grandfathered activities pursuant to Section 4(n), BHCA.[810]

The Board has emphasized that an FHC may not own any shares of a company in reliance on Sections 4(c)(6) or (7), BHCA[811] where the FHC owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company.[812] Thus, an FHC may not own in addition to the 15 percent of the total equity of the H

Proposed Regulation W Release, *supra* note 793, at 24,205 states that these safe harbors do not require Board review or approval.

806 12 C.F.R. § 225.176(b)(2) (2002) (Regulation Y); § 223.24(a)(9)(ii), Proposed Regulation W, 66 Fed. Reg. 24,217 (May 11, 2001). *See* Final Merchant Banking Release, *supra* note 418, at 8,481; Proposed regulation W Release, *supra* note 793, at 24,205.

807 *See* Gruson, *supra* note 1, § 10.05 C.

808 12 C.F.R. § 225.176(b)(5) (2002) (Regulation Y); § 223.24(a)(9)(iv), Proposed Regulation W, 66 Fed. Reg. 24,217 (May 11,2001). *Control* of an FHC over a private equity fund is described in 12 C.F.R. § 225.173(d)(4) (2002) (Regulation Y). *Private equity fund* is defined in 12 C.F.R. § 225.73(a) (2002) (Regulation Y).

809 12 C.F.R. § 225.176(b)(5) (2002) (Regulation Y); § 223.24(a)(9)(iv), Proposed Regulation W, 66 Fed. Reg. 24,217 (May 11, 2001). *See* Final Merchant Banking Release, *supra* note 418, at 8,482. *Control* of an FHC over a private equity fund is described for purposes of Regulation Y and Proposed Regulation W in 12 C.F.R. § 225.173(d)(4) (2002) (Regulation Y). An FHC, *e.g.*, controls a private equity fund if it acts as general partner of the private equity fund. *Id.*

810 Section 4(n)(6), BHCA, 12 U.S.C. § 1843(n)(6) (1994 & Supp. V 1999). As to companies engaged in grandfathered activities pursuant to § 4(n), BHCA, *see supra* E.2.

811 12 U.S.C. § 1843(c)(6) & (7) (1994).

812 *See* Final Merchant Banking Release, *supra* note 418, at 8,469, n.10 & 8,481 n.29; Proposed Regulation W Release, *supra* note 793, at 24,204 n.95. *See supra* note 387.

or I portfolio company shares in reliance on Section 4(c)(6) or (7), BHCA.

b. Sections 23A and 23B, FRA and Branches and Agencies of Foreign Banks

The Board is empowered to adopt prudential safeguards governing the relationships or transactions between depository institution subsidiaries of a BHC (regardless whether or not the BHC is an FHC) and any affiliate of such depository institution (other than a subsidiary of such depository institution) so as to avoid, among other factors, significant risk to the safety and soundness of depository institutions or unsound banking practices.[813] For the same purpose the Board may also adopt prudential safeguards governing the relationships or transactions between a U.S. branch, agency or commercial lending company of a foreign bank and any affiliate in the United States of such foreign bank.[814]

The Board's authority to impose prudential safeguards includes the authority to apply the restrictions under Sections 23A and 23B, FRA[815] to transactions between depository institution subsidiaries of a BHC and its affiliates as well as to transactions between U.S. branches and agencies of a foreign bank and its U.S. affiliates. As stated above, Sections 23A and 23B, FRA limit credit and other transactions between a bank and its affiliates in order to limit the possibility that the risks of activities conducted in a nonbank affiliate of a bank be transferred to the bank.[816]

The Board has implemented the authority in Section 4(g), Regulation Y[817] by applying the Sections 23A & 23B, FRA standards to the extension of credit by banks, thrifts, branches and agencies that are part of an FHC group to broker-dealer subsidiaries of such group. In particular, Section 4(g), Regulation Y requires that any intra-day extension of credit by a bank or thrift, or a U.S. branch or agency of a foreign bank, to a securities affiliate engaged in securities underwriting, dealing or market-making must be on market terms consistent with Section 23B, FRA.[818] Proposed Regulation W sets forth a more comprehensive proposal on the

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813 12 U.S.C. § 1828a(b)(1) & (2) (1994 & Supp. V 1999). In addition, the relationship between depository institutions and their subsidiaries is subject to prudential safeguards established by (i) the Office of the Comptroller of the Currency pursuant to 12 U.S.C. § 1828a(a) (1994 & Supp. V 1999), in the case of national banks, (ii) the Board, in the case of state member banks pursuant to 12 U.S.C. § 1828a(b)(1)(B) (1994 & Supp. V 1999), and (iii) the Federal Deposit Insurance Corporation, in the case of state non-member banks pursuant to 12 U.S.C. § 1828a(c) (1994 & Supp. V 1999).

814 12 U.S.C. § 1828a(b)(4) (1994 & Supp. V 1999).

815 Section 23A, FRA, 12 U.S.C. § 371c (1994 & Supp. V 1999); § 23B, FRA, 12 U.S.C. § 371c-1 (1994 & Supp. V 1999). *See supra* note 793 for a summary of §§ 23A & 23B, FRA.

816 *See* Board release accompanying interim rule 12 C.F.R. § 225.4(g) (2002) (Regulation Y), 65 Fed. Reg. 14,440-42, at 14,441 (Mar. 17, 2000) [*herein* Section 225.4(g) Release]. For a definition of *bank*, *see supra* note 793.

817 12 C.F.R. § 225.4(g) (2002) (Regulation Y) (interim rule). *See* Section 225.4(g) Release, *supra* note 816.

818 12 C.F.R. § 225.4(g)(1) (2002) (Regulation Y). The affiliated company must be engaged in underwriting, dealing in, or making a market in, securities pursuant to § 4(k)(4)(E), BHCA, 12 U.S.C. § 1843(k)(4)(E)

treatment of intra-day extensions of credit under Section 23A, FRA than is contained in Section 4(g), Regulation Y.[819]

In addition, a U.S. branch or agency of a foreign bank[820] will be required to comply with Sections 23A and 23B, FRA with respect to lending and securities purchase transactions between the U.S. branch or agency and a securities affiliate engaged in securities underwriting, dealing or market-making.[821] These restrictions on purchases apply only if the

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(1994 & Supp. V 1999). The purpose of this restriction is to ensure that intra-day extensions of credits are not subsidizing the activities of the securities firm to the detriment of the depository institution affiliate. Section 225.4(g) Release, *supra* note 816, at 14,441.

819 Section 223.8(b), Proposed Regulation W, 66 Fed. Reg. 24,211 (May 11, 2001). *See* Proposed Regulation W Release, *supra* 793, at 24,191. Section 23A(f)(3)(A), FRA, 12 U.S.C. § 371c(f)(3)(A) (1994 & Supp. V 1999), requires the Board to address in a final rule the application of the restrictions of § 23A, FRA, 12 U.S.C. § 371c (1994 & Supp. V 1999), on intra-day extensions of credit to all affiliates. *See* interim rule § 250.248 (Miscellaneous Interpretations), issued on May 3, 2001, 66 Fed. Reg. 24,233 (May 11, 2001) (to be codified as 12 C.F.R. § 250.248) providing for the application of §§ 23A and 23B, FRA to intra-day extensions of credit by insured depository institutions to their affiliates. *See also* the accompanying Board release, 66 Fed. Reg. 24,229–233 (May 11, 2001).

820 12 C.F.R. § 225.4(g)(2) (2002) (Regulation Y) is applicable to any foreign bank that "is or is treated as" an FHC. This refers to (i) foreign banks that are treated as BHCs pursuant to the IBA because they maintain a branch, agency or commercial banking company in the United States and (ii) foreign banks that are BHCs pursuant to the BHCA because they control a U.S. bank that has elected FHC status. *See supra* notes 30, 31 & 41 and accompanying text. It is not clear why 12 C.F.R. § 225.4(g)(2) (2002) (Regulation Y) refers to foreign banks that are U.S. BHCs, because the rule applies only to branches and agencies of foreign banks.

821 12 C.F.R. § 225.4(g)(2) (2002) (Regulation Y). The affiliated company must be engaged in underwriting, dealing in, or making a market in, securities pursuant to § 4(k)(4)(E), BHCA, 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999).

12 C.F.R. § 225.4(g) (2002) (Regulation Y) applies two of the so-called § 20 operating standards (Operating Standards 5 & 8) to the extension of credit by banks, thrifts, U.S. branches and U.S. agencies that are part of an FHC group to a broker-dealer subsidiary of such group. These Section 20 operating standards imposed restrictions on relationships and transactions between depository institutions and so-called § 20 subsidiaries engaged in underwriting and dealing. *See* Securities Activities – Conditions to Board's Section 20 Orders, 2 Fed. Res. Reg. Serv. 4-867.2, 12 C.F.R. § 225.200 (2002) (Regulation Y Conditions to Orders). *See supra* note 12 referring to § 20 subsidiaries. The Board is of the view that the policies underlying Operating Standard 5 (reflected in 12 C.F.R. § 225.4 (g)(1) (2002) (Regulation Y)) and Operating Standard 8 (reflected in 12 C.F.R. § 225.4(g)(2)(i) & (ii) (2002) (Regulation Y)) remain relevant for FHCs. *See* Section 225.4(g) Release, *supra* note 816, at 14,441. In particular, §§ 23A & 23B, 12 U.S.C. §§ 371c & 371c-1 (1994 & Supp. V. 1999), do not by their terms apply to branches and agencies of foreign banks and the extension of the applicability to branches and agencies of foreign banks insures competitive equality between foreign banks and U.S. banks in the funding of securities affiliates in an FHC group. *See* Section 225.4(g) Release, *supra*, at 14,441. 12 C.F.R. § 225.4(g)(2) (2002) applies only to branches and agencies of a foreign bank, not to the foreign bank itself. *See id*.

In order to avoid customer confusion, the U.S. branches and agencies of a foreign bank FHC may not advertise or suggest that they are responsible for the obligations of a securities affiliate engaged in underwriting, dealing or market-making pursuant to § 4(k)(4)(E), 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999), consistent with § 23B(c), FRA, 12 U.S.C. § 371c-1 (c) (1994). 12 C.F.R. § 225.4(g)(2)(iii) (2002) (Regulation Y).

U.S. branch or agency of a foreign bank purchases as principal or fiduciary securities for which the securities affiliate is the principal underwriter.[822]

The Board proposes to further implement the authority to adopt prudential safeguards governing the relationships or transactions between U.S. branches and agencies of a foreign bank and any U.S. affiliates of such foreign bank in Proposed Regulation W. Proposed Regulation W would fully apply Sections 23A and 23B, FRA to covered transactions between a U.S. branch, agency or commercial lending company of a foreign bank and any affiliate of such foreign bank *directly* engaged in the United States in any of the following financial activities newly authorized under the BHCA:[823] (i) insurance underwriting pursuant to Section 4(k)(4)(B), BHCA;[824] (ii) securities underwriting, dealing or market-making pursuant to Section 4(k)(4)(E), BHCA;[825] (iii) merchant banking investment activities pursuant to Section 4(k)(4)(H), BHCA;[826] or (iv) insurance company portfolio investment activities pursuant to Section 4(k)(4)(I), BHCA.[827]

Proposed Regulation W also would apply these restrictions to transactions between a U.S. branch, agency or commercial lending company of a foreign bank and any subsidiary of an affiliate directly engaged in the four activities set forth above (regardless of whether the subsidiary itself engages in any of the four activities).[828] Proposed Regulation W, consistent with the rule on merchant banking investments,[829] would impose Sections 23A and 23B, FRA on a covered transaction between a U.S. branch, agency or commercial lending company of a foreign bank and its U.S. merchant banking affiliate only to the extent the proceeds of the covered transaction are used for the purpose of funding the affiliate's merchant banking activities.[830] In addition, Regulation W would apply Sections 23A and 23B, FRA to transactions between a U.S. branch, agency or commercial lending company of a foreign bank and any portfolio company controlled by the foreign bank under the BHCA's merchant banking investment or insurance company portfolio investment authorities.[831] Proposed Regulation W

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822 12 C.F.R. § 225.4(g)(2)(ii) (2002) (Regulation Y).

823 Section 223.23(a)(1), Proposed Regulation W, 66 Fed. Reg. 24,216 (May 11, 2001). *See* Proposed Regulation W Release, *supra* note 793, at 24,202.

824 12 U.S.C. § 1843(k)(4)(B) (1994 & Supp. V 1999).

825 12 U.S.C. § 1843(k)(4)(E) (1994 & Supp. V 1999).

826 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999).

827 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999).

828 Section 223.23(a)(2), Proposed Regulation W, 66 Fed. Reg. 24,216 (May 11, 2001). Proposed Regulation W would cover subsidiaries of affiliates directly engaged in the four activities in order to prevent evasion. *See* Proposed Regulation W Release, *supra* note 793, at 24,202 n.80.

829 12 C.F.R. § 225.176(b)(6)(ii) (2002) (Regulation Y).

830 Section 223.23(a)(1)(iii), Proposed Regulation W, 66 Fed. Reg. 24,216 (May 11,2001).

831 Section 223.23(a)(3), Proposed Regulation W, 66 Fed. Reg. 24,216 (May 11,2001). That Section would apply §§ 23A and 23B, FRA to any portfolio company (as defined in 12 C.F.R. § 225.177(c) (2002)

would not apply Sections 23A or 23B, FRA to transactions between a U.S. branch, agency or commercial lending company and any other type of affiliate of the foreign bank (*e.g.*, foreign affiliates or U.S. affiliates engaged in nonbanking activities under Section 4(c)(8), BHCA[832]), or to transactions between the foreign bank's non-US. offices and its U.S. affiliates.[833]

Although the rationale of Sections 23A and 23B, FRA is the protection of federally insured deposits of insured depository institutions, and branches and agencies of foreign banks do not hold federally insured deposits, the Board applied Sections 23A and 23B, FRA to such branches and agencies to ensure competitive equality and safe and sound banking.[834]

H. Failure to Continue Compliance with FHC Requirements

1. Failure to Remain Well Capitalized and Well Managed

If the Board finds that a Foreign Bank FHC,[835] a Controlled Foreign Bank[836] or any U.S. depository institution subsidiary[837] controlled by a Foreign Bank FHC or a Foreign Company FHC[838] ceases to be well capitalized or well managed, the Board shall give written

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(Regulation Y)) that the foreign bank or affiliate controls (for purposes of 12 C.F.R. § 225.173(d)(4) (2002) (Regulation Y)) and any company that would be an affiliate of the branch, agency or commercial lending company of the foreign bank under § 223.24(a)(9), Proposed Regulation W, 66 Fed. Reg. 24,217 (May 11, 2001) if the branch, agency or commercial lending company were a bank.

832 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999).

833 Proposed Regulation W Release, *supra* note 793, at 24,202.

834 Final Merchant Banking Release, *supra* note 418, at 8,482; Proposed Regulation W Release, *supra* note 793, at 24,202. For purposes of applying the restrictions of §§ 23A and 23B, FRA to U.S. branches and agencies of foreign banks, the "capital stock and surplus" of the U.S. branch, agency or commercial lending company is determined by reference to the capital of the foreign bank as calculated under its home country capital standards. *See* Final Merchant Banking Release, *supra* note 418, at 8,482 n.32; § 223.23(b)(3), Proposed Regulation W, 66 Fed. Reg. 24,216 (May 11, 2001). This approach represents a relaxation from the Board's position with respect to foreign banks that operate § 20 subsidiaries (*see supra* note 12) in the United States. *See* Proposed Regulation W Release, *supra* note 793, at 24,203 n.83.

835 A foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States and that has made an effective election to be treated as an FHC pursuant to 12 C.F.R. § 225.91(a) (2002) (Regulation Y).

836 A foreign bank that maintains a branch or agency or owns or controls a commercial lending company in the United States and that is controlled by a Foreign Bank FHC or by a Foreign Company FHC but that has not made an effective election to be treated as an FHC. *See* 12 C.F.R. § 225.91(b)(3) & (4) (2002) (Regulation Y). *See supra* B. 2. c.

837 A U.S. depository institution that is a subsidiary of a Foreign Bank FHC or of a Foreign Company FHC. *See* 12 C.F.R. § 225.91(b)(5) (2001) (Regulation K). For a definition of *depository institution, see supra* note 33.

838 A company that owns or controls a Foreign Bank FHC and that has made an effective election to be treated as an FHC pursuant to 12 C.F.R. § 225.91(a) (2002) (Regulation Y).

notice to the Foreign Bank FHC and the Foreign Company FHC, if there is one, to that effect.[839] The same applies if the Board finds that a depository institution subsidiary of a U.S. BHC/FHC[840] ceases to be well capitalized and well managed: the Board must give written notice to the BHC/FHC to that effect.[841] Regulation Y requires also the reverse: the Foreign Bank FHC and the Foreign Company FHC, if any, and the U.S. BHC/FHC must notify the Board promptly upon becoming aware that any of the above-mentioned institutions ceases to be well capitalized and well managed.[842] Noncompliance could be the result of business developments in the foreign bank or the U.S. depository institution or the result of an acquisition by the FHC of a U.S. depository institution or a Controlled Foreign Bank that does not meet the well-capitalized and well-managed requirements.[843]

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839 Section 4(m)(1), BHCA, 12 U.S.C. § 1843(m)(1) (1994 & Supp. V 1999); 12 C.F.R. § 225.93(a) (2002) (Regulation Y).

Section 4(m)(1), BHCA requires such Board notice only with respect to FHCs that are engaged, directly or indirectly, in any activity under § 4(k), (n) or (o), BHCA, 12 U.S.C. § 1843(k), (n) or (o) (1994 & Supp. V 1999), other than activities that are permissible for a BHC under § 4(c)(8), BHCA, 12 U.S.C. 1843(c)(8) (1994 & Supp. V 1999). 12 C.F.R. §§ 225.83 & 225.93 (2002) (Regulation Y) omit the BHCA exception that notice is not required for FHCs that are only engaged in activities permissible under § 4(c)(8), BHCA. Presumably the Board is of the view that only in rare cases an FHC will only be engaged in § 4(c)(8) activities. *See supra* note 37. Presumably, § 4(m)(1), BHC refers to activities engaged in on the authority of § 4(c)(8), BHCA and not to financial activities that are derived from § 4(c)(8), BHCA, but are exercised on the authority of § 4(k), BHCA, *i.e.*, activities pursuant to 12 C.F.R. § 225.86(a) (2002) (Regulation Y). The exception for § 4(c)(8), BHCA activities must relate to an FHC that is *only* engaged in such activities because if the FHC is engaged in § 4(k), BHCA and § 4(c)(8), BHCA activities, a Board notice should be required if the FHC is in noncompliance with the well-capitalized or well-managed standard.

840 A U.S. or foreign bank that controls a U.S. bank and that has made an effective election to be an FHC. *See supra* note 31.

841 12 C.F.R. § 225.83(a) (2002) (Regulation Y) for U.S. BHCs/FHCs.

842 12 C.F.R. § 225.93(b)(1) (2002) (Regulation Y) for Foreign Bank BHCs and Foreign Company BHCs (the provision does not specify the time period in which such notice must be given); 12 C.F.R. § 225.83(b)(1) (2002) (Regulation Y) for U.S. BHCs/ FHCs (a U.S. BHC/FHC must give notice within 15 calendar days of awareness). 12 C.F.R. § 225.93(b)(2) sets forth certain events upon the occurrence of which the Foreign Bank FHC (not the Foreign Company FHC) is deemed to have become aware that it is no longer well capitalized or well managed ("triggering events"). These triggering events relate only to the Foreign Bank FHC and create deemed awareness only for the Foreign Bank FHC. 12 C.F.R. § 225.83(b)(2) (2002) (Regulation Y) sets forth the triggering events for U.S. BHCs/FHCs. *See* the Board Order of Jan. 9, 2002 in the Matter of Dexia, S.A., Dexia Bank Belgium, S.A. and Dexia Credit Local de France, foreign banks that are FHCs, assessing a $50,000 civil money penalty for failure to comply with the requirement of 12 C.F.R. § 225.93(b) (2002) (Regulation Y) to timely notify the Board when they fell out of compliance with the standards for being FHCs.

Notice from the Foreign Bank FHC, the Foreign Company FHC or the U.S. BHC/FHC to the Board is not a condition for the Board notice. This is expressly stated in 12 C.F.R. § 225.83(a) (2002) (Regulation Y) for U.S. BHCs/FHCs, but is not expressly stated for Foreign Bank FHCs and Foreign Company FHCs.

843 *See* the example given in the Final FHC Release, *supra* note 32, at 403. Noncompliance has the same consequences, regardless whether it is caused by internal developments or by acquisition. The 2-year conformance period of § 4(a)(2), BHCA, 12 U.S.C. § 1843(a)(2) (1994), does not apply. Thus, FHC status of a Foreign Bank FHC could be endangered if, for instance, its Foreign Company FHC acquires a foreign

Within 45 days after receipt of notice of noncompliance from the Board by the Foreign Bank FHC or the Foreign Company FHC,[844] the Foreign Bank FHC or the Foreign Company FHC and the Board shall enter into an agreement (a "corrective action agreement")[845] to comply with all applicable capital and management requirements.[846] Equally, if a U.S. BHC/FHC receives notice of noncompliance, it must enter into a corrective action agreement with the Board within 45 days.[847] The corrective action agreement must address the correction of the capital or management deficiency; in particular, it must explain the specific actions that the Foreign Bank FHC, the Foreign Company FHC or the U.S. BHC/FHC will take to correct all areas of noncompliance and provide a schedule in which each action will be taken.[848] Difficulties will arise when a Controlled Foreign Bank that is not controlled in a corporate sense by the Foreign Bank FHC or the Foreign Company FHC no longer meets the FHC requirements, because the Foreign Bank FHC and the Foreign Company FHC may not be in a position to make commitments about the correction of the capital or management deficiencies.[849]

During the period of noncompliance, (1) the Board may impose any limitations or conditions on the conduct or the U.S. activities of the Foreign Bank FHC or the Foreign Company FHC or its affiliates and on the conduct or activities of a U.S. BHC/FHC or its

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bank with a branch in the United States and the acquired foreign bank does not meet the well-capitalized requirements, or its Foreign Company FHC acquires a foreign bank with a banking subsidiary in the United States and the banking subsidiary does not meet the well-capitalized requirements.

844 12 C.F.R. § 225.93(c)(1) (2002) (Regulation Y). Regulation Y does not address the question when the 45-day period starts to run if the Foreign Bank FHC and the Foreign Company FHC receive the Board notice on different days. *See* 12 C.F.R. § 225.83(c) (2002) (Regulation Y) relating to U.S. FHCs.

It is somewhat confusing that 12 C.F.R. § 225.93(c)(1) (2002) (Regulation Y) states that the Foreign Bank FHC *or* the Foreign Company FHC must execute an agreement with the Board. If there are several tiers of Foreign Company FHCs, presumably any one of them could enter into the corrective action agreement. The Board is protected by the requirement that the agreement "must be acceptable to the Board". 12 C.F.R. § 225.93(c)(1) & (3)(iv) (2002) (Regulation Y). If, *e.g.*, a Foreign Company FHC does not control the Foreign Bank FHC in a corporate sense, an agreement with such Foreign Company FHC relating to an increase of the capital of the Foreign Bank FHC would probably not be *acceptable* to the Board. Otherwise, the reference to an agreement with the Board that is acceptable to the Board is odd, because presumably any agreement (that is not a contract of adhesion) signed by a party is acceptable to that party.

845 The Final FHC Release, *supra* note 32, at 403 introduced this term.

846 Section 4(m)(2), BHCA, 12 U.S.C. § 1843(m)(2) (1994 & Supp. V 1999); 12 C.F.R. § 225.93(c)(1) (2002) (Regulation Y). 12 C.F.R. § 225.93(c)(2) (2002) (Regulation Y) permits in accordance with § 4(m)(2), BHCA an extension of the 45-day period.

847 Section 4(m)(2), BHCA, 12 U.S.C. § 1843(m)(2) (1994 & Supp. V 1999); 12 C.F.R. § 225.83(c)(1) (2002) (Regulation Y). Section 225.83(c)(2) (2002) (Regulation Y) permits in accordance with § 4(m)(2), BHCA an extension of the 45-day period.

848 12 C.F.R. § 225.93(c)(3)(i) & (ii) (2002) (Regulation Y) for Foreign Bank FHCs and Foreign Company FHCs; 12 C.F.R. § 225.83(c)(3)(i) & (ii) (2002) (Regulation Y) for U.S. BHCs/FHCs.

849 *See supra* notes 84–90 and accompanying text for a discussion of this issue.

affiliates,[850] and (2) the Foreign Bank FHC, the Foreign Company FHC, the U.S. BHC/FHC and their respective affiliates may not commence any additional activity in the United States or acquire control or shares of any company under Section 4(k), BHCA (financial activities, including investments in nonfinancial companies in the exercise of financial activity investment authorities)[851] without prior approval of the Board.[852] The power of the Board to impose limitations or conditions on the conduct of the U.S. activities of any affiliate of an FHC goes very far and gives, for instance, the Board the authority to prohibit a U.S. subsidiary of a foreign industrial company that is controlled by the Foreign Bank FHC or Foreign Company FHC to expand into new areas of business. However, the authority of the Board is limited by the purpose of the authority: the Board must determine that the limitation on the conduct or activities of the affiliate is "appropriate under the circumstances and consistent with the purposes of the [BHCA]".[853] A restriction on the activities of an industrial affiliate of the Foreign Bank

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850 Section 4(m)(3), BHCA, 12 U.S.C. § 1843(m)(3) (1994 & Supp. V 1999); 12 C.F.R. § 225.93(d)(1) (2002) (Regulation Y) for Foreign Bank FHCs and Foreign Company FHCs; 12 C.F.R. § 225.83(d)(1) (2002) (Regulation Y) for U.S. BHCs/FHCs. The authority to impose limitations on activities is limited to activities in the United States in the case of Foreign Bank FHCs and Foreign Company FHCs but not in the case of U.S. BHCs/FHCs. *Compare* 12 C.F.R. § 225.93(d)(1) *with* 12 C.F.R. § 225.83(d)(1) (2002) (Regulation Y).

Since 12 C.F.R. §§ 225.93(d)(2) & 225.83(d)(2) (2002) (Regulation Y) cover *additional* activities, 12 C.F.R. §§ 225.93(d)(2) & 225.83(d)(1) must refer to *existing* activities.

12 C.F.R. § 225.93(d)(1) (2002) (Regulation Y) is not clearly drafted in that it is not clear whether "its affiliates" refers only to the Foreign Company FHC or also to the Foreign Bank FHC. It should refer to both, because § 4(m)(3), BHCA refers to activities of the FHC "or any affiliate of that company" and, both the Foreign Bank FHC and the Foreign Company FHC are FHCs. It should be noted that restrictions can be imposed on any affiliates, not only U.S. depository institution subsidiaries. *Affiliate* is defined in § 2(k), BHCA, 12 U.S.C. § 1841(k) (1994), and in 12 C.F.R. § 225.2(a) (2002) (Regulation Y). *See* Gruson, *supra* note 1, § 10.03.

851 12 U.S.C. § 1843(k) (1994 & Supp. V 1999).

852 12 C.F.R. § 225.93(d)(2) (2002) (Regulation Y) for Foreign Bank FHCs and Foreign Company FHCs; 12 C.F.R. § 225.83(d)(2) (2002) (Regulation Y) for U.S. BHCs/FHCs. The Board may determine to grant approval to engage in additional financial activities on a general basis or only on a transaction-by-transaction basis as appropriate, given the circumstances that caused the FHC to fail the well-capitalized and well-managed requirements. Final FHC Release, *supra* note 32, at 403. The Board gives as an example for a general approval the case of an FHC that controlled only well-capitalized and well-managed institutions, then acquired a relatively smaller troubled institution and immediately developed a plan to improve the conditions of the troubled institution. *Id.* The requirement of Board approval for the commencement of additional activities is limited to activities in the United States in the case of Foreign Bank FHCs and Foreign Company FHCs and their affiliates but not in the case of U.S. BHCs/FHCs and their affiliates. *Compare* 12 C.F.R. § 225.93(d)(2) *with* 12 C.F.R. § 225.83(d)(2) (2002) (Regulation Y).

The prohibition of 12 C.F.R. §§ 225.93(d)(2) & 225.83(d)(2) (2002) (Regulation Y) relates only to activities and investments on the basis of the authority granted by § 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999), not to activities and investments made on the basis of other authorities, such as §§ 2(h)(2), 4(c)(6), 4(c)(8), 4(c)(9), BHCA, 12 U.S.C. §§ 1841(h)(2), 1843(c)(6), 1843(c)(8), 1843(c)(9) (1994 Supp. V 1999).

853 Section 4(m)(3), BHCA, 12 U.S.C. § 1843(m)(3) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.93(d)(1) & 225.83(d)(1) (2002) (Regulation Y).

FHC would be consistent with the BHCA if such expansion diverts resources from improving the conditions of the Foreign Bank FHC or its U.S. depository institution subsidiaries.[854]

If the Foreign Bank FHC or Foreign Company FHC or the U.S. BHC/FHC fails to correct the condition within 180 days after receipt of the notice of noncompliance from the Board, the Board may order (1) the Foreign Bank FHC or the Foreign Company FHC to terminate the Foreign Bank FHC's U.S. branches and agencies and divest any commercial lending companies owned or controlled by the Foreign Bank FHC or the Foreign Company FHC and (2) the U.S. BHC/FHC to divest ownership or control of any depository institution owned or controlled by the U.S. BHC/FHC.[855] The Foreign Bank FHC, the Foreign Company FHC and the U.S. BHC/FHC, however, may comply with this termination or divestiture order by retaining, in the case of the Foreign Bank FHC and the Foreign Company FHC, the branch, agency or commercial lending company and, in the case of the U.S. BHC/FHC, the depository institution, and, in all cases, instead thereof ceasing to engage (both directly and indirectly) in any activity that may be conducted only under Sections 4(k), (n) or (o), BHCA,[856] *i.e.*, financial activities and grandfathered activities permitted by the BHCA.[857] The foreign bank retaining its branch,

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The requirement of § 4(m)(3), BHCA that Board action must be "appropriate under the circumstances and consistent with the purposes of the [BHCA]" is repeated in 12 C.F.R. §§ 225.93(d)(1) & 225.83(d)(1) (imposition of limitations on existing activities) but not in 12 C.F.R. §§ 225.93(d)(2) & 225.83(d)(2) (approval of additional activities) (2002) (Regulation Y). The Board takes the position that it is appropriate and consistent with the purposes of the BHCA to require a noncomplying FHC and its affiliates to obtain the Board's approval prior to commencing any new activities, or acquiring control or shares of any company, under § 4(k) BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999). *See* Final FHC Release, *supra* note 32, at 403. This power is reflected in 12 C.F.R. §§ 225.93(d)(2) & 225.83(d)(2) (2002) (Regulation Y). Because the legal basis for these Sections is § 2(m)(3), BHCA, the statutory restriction, namely, that Board action "must be appropriate under the circumstances and consistent with the purposes of the [BHCA]" also applies to any Board action under 12 C.F.R. §§ 225.93(d)(2) & 225.83(d)(2) (2002) (Regulation Y), even though those restrictions are not repeated in such Sections.

854 In connection with U.S. BHCs the Final FHC Release, *supra* note 32, at 403 states that the approval requirement prior to conducting any of the activities that are newly authorized for FHCs by the GLBA by companies subject to a corrective action agreement "allows the Board to assure that the FHC is not inappropriately diverting resources from improving the condition of its subsidiary depository institutions".

855 Section 4(m)(4), BHCA, 12 U.S.C. § 1843(m)(4) (1994 & Supp. V 1999); 12 C.F.R. § 225.93(e)(1) (2002) (Regulation Y) for Foreign Bank FHCs and Foreign Company FHCs; 12 C.F.R. § 225.83(e)(1) (2002) (Regulation Y) for U.S. BHCs/FHCs. Such divestiture must be done in accordance with the terms and conditions established by the Board. 12 C.F.R. §§ 225.93(e)(1) & 225.83(e)(1) (2002) (Regulation Y). Regulation Y does not empower the Board to terminate the U.S. branches and agencies of a Controlled Foreign Bank. Section 225.93(e)(1) (2002), (Regulation Y) is based on § 4(m)(4)(A), BHCA, 12 U.S.C. § 1843(m)(4)(A) (1994 & Supp. V 1999), although § 4(m)(4)(A), BHCA only refers to the divestiture of subsidiary depository institutions.

The 180-day period may be extended by the Board. Section 4(m)(4), BHCA, 12 U.S.C. § 1843(m)(4) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.93(e)(1) & 225.83(e)(1) (2002) (Regulation Y).

856 12 U.S.C. § 1843(k), (n) & (o) (1994 & Supp. V 1999).

857 Section 4(m)(4)(B), BHCA, 12 U.S.C. § 1843(m)(4)(B) (1994 & Supp. V 1999); 12 C.F.R. § 225.93(e)(2) (2002) (Regulation Y) for Foreign Bank FHCs and Foreign Company FHCs; 12 C.F.R. § 225.83(e)(2) (2002) (Regulation Y) for U.S. BHCs/FHCs. For a discussion of grandfathered activities, *see supra* E. 2.

agency or commercial lending company in the United States and its holding company must try to find another legal authority for these activities, for instance the authority under Section 2(h)(2), BHCA in connection with Section 211.23(f)(5)(iii), Regulation K if the foreign bank qualifies as a Quality Foreign Banking Organization,[858] or the investment authority under Section 4(c)(8), BHCA.[859]

The Board's ability to impose limitations on the activities of,[860] or to require termination or divestitures[861] by, FHCs that fail to comply with the well-capitalized and well-

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Section 4(m)(4)(B), BHCA provides that the FHC could elect not to divest its subsidiary depository institution and instead thereof cease to engage, directly or indirectly, in any activity conducted by an FHC that is not an activity permissible for BHCs under § 4(c)(8), BHCA, 12 U.S.C. § 1841(c)(8) (1994 & Supp. V 1999). This is probably a drafting error because there is no reason to assume that the GLBA intended to restrict an FHC that fails to comply with the FHC requirements and reverts to a regular BHC status from activities and investments under § 4(c)(2), (6), (9) or (13), or § 2(h)(2), BHCA, 12 U.S.C. § 1843(c)(2), (6), (9) & (13), and § 1841(h)(2) (1994 & Supp. V 1999). The interim regulation solved the issue by referring in § 225.93(e)(2) to § 2(h), BHCA and generally to § 4(c), BHCA [and not only to § 4(c)(8), BHCA] activities that may be continued. 65 Fed. Reg. 3,794 (Jan. 25, 2000) and 65 Fed. Reg. 15,057 (Mar. 21, 2000). The interim regulation in § 225.83(e)(2) permitted noncomplying U.S. FHCs only the continuation of § 4(c)(8), BHCA activities. 65 Fed. Reg. 3,792 (Jan. 25, 2000). The Board recognized the problem and solved it by permitting an FHC to comply with a Board order to terminate or divest by ceasing to engage in any activity that *may* be conducted *only* under §§ 4(k), 4(n) or 4(o), BHCA, 12 U.S.C. § 1843(k), (n) & (o) (1994 & Supp. V 1999). 12 C.F.R. §§ 225.93(e)(2) & 225.83(e)(2) (2002) (Regulation Y). The Board said that it has "changed the statutory reference in order to clarify that a company that complies with the divestiture order by ceasing to engage in certain activities may continue to engage in any conduct permissible for a [BHC] under Section 4(c), not just the conduct permitted by section 4(c)(8)". Final FHC Release, *supra* note 32, at 403 n.5. The word *may* in 12 C.F.R. §§ 225.93(e)(2) & 225.83(e)(2) (2002) (Regulation Y) indicates that the right to continue activities applies also to activities which in this particular case were exercised under the authority of § 4(k), BHCA but could have been exercised under the authority of *e.g.*, § 4(c)(8), BHCA.

The termination of activities must be completed within 180 days of receipt of the notice of noncompliance from the Board or such additional time as the Board may permit. 12 C.F.R. §§ 225.93(e)(1) & (2) & 225.83(e)(1) & (2) (2002) (Regulation Y).

The prohibition to engage indirectly in activities under § 4(k), (n) or (o), 12 U.S.C. § 1843(k), (n) & (o) (1994 & Supp. V 1999), does not apply to such activities conducted through a depository institution subsidiary or a subsidiary of a depository institution subsidiary. Section 4(m)(4), BHCA, 12 U.S.C. § 1843(m)(4) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.93(e)(2) & 225.83(e)(2) (2002) (Regulation Y). Note that 12 C.F.R. § 225.93(e)(1) does not require the Foreign Bank FHC or the Foreign Company FHC to divest any nonbank depository institution. Any deposit taking depository institution subsidiary of a Foreign Bank FHC, Foreign Company FHC or U.S. BHC/FHC would have to be divested under 12 C.F.R. § 225.83(e)(1) (2002) (Regulation Y).

858 12 U.S.C. § 1841(h)(2)(1994); 12 C.F.R. § 211.23(f)(5)(iii) (2002) (Regulation K). *See supra* E.1. for a discussion of QFBOs. As pointed out, *supra* E.1., the QFBO investment authority may not be available for the nonbank company controlling the foreign bank.

859 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999).

860 12 C.F.R. §§ 225.93(d), 225.83(d) (2002) (Regulation Y).

861 12 C.F.R. §§ 225.93(e), 225.83(e) (2002) (Regulation Y).

managed requirements is in addition to, not in lieu of, the Board's ability to take supervisory actions and enforce compliance under Section 8, BHCA and Section 8, FDIA.[862] In addition, the Board has supervisory responsibility to ensure that foreign banks and companies treated as FHCs engage in the expanded activities permitted by the BHCA in a safe and sound manner.[863]

2. CRA Maintenance Requirement

If a Foreign Bank FHC or a U.S. FHC receives notice that an insured depository institution subsidiary of such Foreign Bank FHC or U.S. FHC has received, in its most recent examination under the CRA, a rating of less than "satisfactory", or if a Foreign Bank FHC receives such notice with regard to an insured U.S. branch, such Foreign Bank FHC and any related Foreign Company FHC and such U.S. FHC may not commence any new (additional) financial activity or directly or indirectly acquire control of a company engaged in financial activities.[864] An FHC receives such notice at the time that the appropriate federal banking

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862 12 U.S.C. § 1847 (1994); 12 U.S.C. § 1818 (1994 & Supp. V 1999). *See* Interim FHC Release, *supra* note 32, at 3,788.

863 Under § 7(e), IBA, 12 U.S.C. § 3105(e) (1994 & Supp. V 1999), the Board has the authority to take supervisory action against U.S. offices of foreign banks if the Board determines that the foreign bank, or any affiliate of the foreign bank, has committed a violation of law or engaged in any unsafe or unsound banking practice in the United States. In addition, the IBA makes foreign banks with U.S. branches, agencies or commercial lending companies subject to the provisions of the BHCA. Section 8(a), IBA, 12 U.S.C. § 1306(a) (1994). *See* Final FHC Release, *supra* note 32, at 412 n.26.

In taking any action in connection with a failure of an FHC to remain well capitalized and well managed, the Board is required to consult with the relevant federal and state regulatory authorities and the appropriate home country supervisor(s) of the foreign bank. Section 4(m)(5), BHCA, 12 U.S.C. § 1843(m)(5) (1994 & Supp. V 1999); 12 C.F.R. § 225.93(f) (2002) (Regulation Y) for Foreign Bank FHCs and Foreign Company FHCs; 12 C.F.R. § 225.83(f) (2002) (Regulation Y) for U.S. BHCs/FHCs. *See* Final FHC Release, *supra* note 32, at 412–13.

864 Section 4(*l*)(2), BHCA, 12 U.S.C. § 1843(*l*)(2) (1994 & Supp. V 1999); 12 C.F.R. § 225.84(a)(1), § 225.94 (2002) (Regulation Y). This is the so-called *CRA maintenance requirement*. *See* 145 CONG. REC. S13,893 (daily ed.) (Nov. 4, 1999) (Sen. Shelby). The ratings below the rating "satisfactory record of meeting community credit needs" are: "needs to improve record of meeting community credit needs" and "substantial noncompliance in meeting community credit needs". *See* 12 C.F.R. § 225.84(a)(2) (2002) (Regulation Y).

Section 4(*l*)(2), BHCA requires the Board to apply the CRA maintenance requirement if "any insured depository institution subsidiary" of an FHC has received a less-than-satisfactory CRA rating. The Board reads the language to apply only when an insured depository institution receives a less-than-satisfactory CRA rating while it is under the control of the FHC. *See* Final FHC Release, *supra* note 32, at 404. It does not apply immediately upon acquiring a poorly rated depository institution by an FHC. *Id.* If the depository institution does not achieve at least a satisfactory CRA rating at its first CRA examination following the acquisition, the prohibitions apply to the FHC. *Id*.

12 C.F.R. § 225.94(b) (2002) (Regulation Y) makes the CRA maintenance requirement applicable to a foreign bank that operates an insured branch (12 C.F.R. § 225.94(a) (2002) (Regulation Y)) or an insured depository institution in the United States and to any company that owns or controls such a foreign bank, if such foreign bank and company have made an effective election to be FHCs. This formulation does not cover a Controlled Foreign Bank with an insured branch or a Foreign Company FHC that controls an insured depository institution other than through the Foreign Bank FHC. The latter entity may be covered

agency for such insured depository institution or such insured branch or the Board provides notice to the depository institution, the branch or the FHC regarding such performance under the CRA.[865]

However, new investments made in the ordinary course of engaging in the merchant banking investment authority[866] or in the ordinary course of the insurance company portfolio investment authority[867] are not prohibited, if the FHC or an affiliate of the FHC making such investments was already engaged in such activities prior to the time that an insured depository institution controlled by the FHC or insured branch received a CRA rating below "satisfactory".[868] Thus, an FHC or an existing merchant banking, securities or insurance subsidiary of an FHC may continue to make investments under the merchant banking investment authority and investments under the insurance company portfolio investment authority if it was engaged in such investment activities prior to the less-than-satisfactory rating.[869]

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directly by 12 C.F.R. § 225.84 (2002) (Regulation Y). The formulation of 12 C.F.R. § 225.94(b) is curious: it makes the provisions of 12 C.F.R. § 225.84 applicable to the Foreign Bank FHCs and companies controlling such Foreign Bank FHC that have elected FHC status "in the same manner and to the same extent as they apply to an [FHC]", disregarding the fact that the entities to which 12 C.F.R. § 225.84 (2002) (Regulation Y) is made applicable are FHCs.

Section 4(*l*)(2), BHCA and 12 C.F.R. § 225.84(a)(1) (2002) (Regulation Y) prohibit the commencement of additional activities under § 4(k), BHCA, 12 U.S.C. § 1843(k) (1994 & Supp. V 1999), *i.e.*, financial activities (*see supra* C.), and under § 4(n), BHCA, 12 U.S.C. § 1843(n) (1994 & Supp. V 1999), the provision permitting new FHCs to retain limited nonfinancial activities and affiliations for a 10-year period (*see supra* E.2.). There is no prohibition against continuing to hold all investments previously made on the basis of such authorities. Section 4(*l*)(2), BHCA and 12 C.F.R. § 225.84(a)(1)(2002) (Regulation Y) also prohibit the acquisition of control of a company engaged in any activity under § 4(k), BHCA or § 4(n), BHCA. As to the duration of the prohibition, *see* 12 C.F.R § 225.84(c) (2002) (Regulation Y).

865 12 C.F.R. § 225.84(a)(2) (2002) (Regulation Y). *See* Final FHC Release, *supra* note 32, at 404.

866 Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (1994 & Supp. V 1999). That Section also refers to underwriting. *See supra* D.3.

867 Section 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (1994 & Supp. V 1999).

868 Section 4(*l*)(2)(B), BHCA, 12 U.S.C. § 1843(*l*)(2)(B) (1994 & Supp. V 1999); 12 C.F.R. §§ 225.84(b) & 225.94 (2002) (Regulation Y).

869 Section 4(*l*)(2)(B), BHCA, 12 U.S.C. § 1843(*l*)(2)(B) (1994 & Supp. V 1999), could be read to the effect that investments under the merchant banking investment authority, underwriting authority and insurance company portfolio investment authority can only be continued if an affiliate (a broker-dealer, merchant banking or insurance subsidiary) of the FHC was already engaged in such activities, and that the authority to continue such investments does not apply to an FHC that is a broker-dealer, a merchant bank or an insurance company. Regulation Y, however, applies the exception of § 4(*l*)(2)(B), BHCA in the case in which the FHC was already engaged in such investment activities. 12 C.F.R. § 225.84(b) (2002) (Regulation Y). Regulation Y is correctly written. The FHC can continue to engage in such investment activities directly or indirectly (through a subsidiary) (§ 4(*l*)(2)(B), BHCA) and, as discussed above (*see supra* C.1. *sub* (1)), an FHC may make merchant banking investments, engage in securities activities and make insurance company portfolio investments only directly or through a subsidiary (not through a minority-owned company).

The Board in Regulation Y goes beyond the restrictions of the BHCA and restricts the authority of an FHC whose insured depository institution subsidiary or insured branch has received a less-than-"satisfactory" CRA rating to continue to make investments under the merchant banking investment authority or under the insurance company portfolio investment authority by providing that such continuation is only permitted if "[t]he Board has not, in the exercise of its supervisory authority, advised the [FHC] that these activities must be restricted".[870] There is no basis in the GLBA for this Board authority. The consequences of a failure to obtain a "satisfactory" rating were the results of a carefully negotiated political compromise, and the debates in the Senate and the House show that the issue received much attention.[871] The Board's authority to further restrict these activities in case of a less-than-satisfactory CRA rating disturbs this balance and it has no legal basis.

The prohibition that applies in case of a failure to maintain a satisfactory CRA rating does not prevent an FHC from commencing any additional activity or acquiring control of a company engaged in any activity under Section 4(c), BHCA,[872] if the FHC complies with the applicable notice, approval and other requirements.[873]

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870 12 C.F.R. §§ 225.84(b)(1)(ii) & 225.94 (2002) (Regulation Y).

871 Several Representatives voted against the bill, among other reasons, because of its negative impact on CRA. Rep. Waters stated, "I am absolutely surprised that the Members of this House can support a bill that would do what this bill is about to do to working people and poor people." 145 CONG. REC. H11,523 (daily ed.) (Nov. 4, 1999). The majority of the Representatives, however, argued in support of the bill and did not see any weakening of the CRA. Rep. Bentsen stated "that this bill in many respects strengthens the Community Reinvestment Act. . . . Additionally, it protects CRA for smaller banks." 145 CONG. REC. H11,521 (daily ed.) (Nov. 4, 1999). *See also* comments on CRA in 145 CONG. REC. (daily ed.) (Nov. 4, 1999) by Rep. Moakley at H11,514, Rep. Frost at H11,515, Rep. Castle at H11,517, Rep. LaFalce at H11,519, Rep. Vento at H11,520, H11,521, Rep. Meek at H11,523, H11,524, Rep. Jackson-Lee at H11,525, H11,543, Rep. Leach at H11,529, Rep. Dingell at H11,530, Rep. Gutierrez at H11,536, Rep. Maloney at H11,537, Rep. Schakowsky at H11,537, Rep. Davis at H11,538, Rep. Frank at H11,541, Rep. Levin at H11,543, Rep. Capuano at H11,545, H11,546, Rep. Roybal-Allard at H11,548, Rep. Doolittle at H11,549, Sen. Allard at S13,878, Sen. Bunning at S13,878, Sen. Enzi at S13,880, Sen. Schumer at S13,880, Sen. Edwards at S13,883, Sen. Reed at S13,888, Sen. Shelby at S13,893, Sen. Lieberman at S13,907, S13,908, Sen. Lincoln at S13,908, Sen. Moynihan at S13,910.

872 12 U.S.C. § 1843(c) (1994 & Supp. V 1999).

873 12 C.F.R. § 225.84(b)(2) (2002) (Regulation Y). *See* § 4(c) & (j), BHCA, 12 U.S.C. § 1843(c) & (j) (1994 & Supp. V 1999).

I. The Future of BHCs

U.S. BHCs and foreign banks with a U.S. branch, agency or commercial lending company that do not meet the requirements to become an FHC remain subject to the provisions of the BHCA as they were in effect before the enactment of the GLBA. These BHCs and foreign banks may not engage in financial activities but they may still apply to the Board to be permitted to engage in one of the "closely related to banking" activities under Section 4(c)(8), BHCA that are narrowly defined in Regulation Y.[874] However, the GLBA freezes the permitted activities under Section 4(c)(8), BHCA to those that the Board had permitted by regulation or order as of the day before the date of the enactment of the GLBA (November 11, 1999).[875] In other words, the Board no longer has the power to extend or expand the laundry list of Regulation Y, to adjust it to current developments or to permit certain activities on a case-by-case basis by order upon application. In addition, the GLBA restricts securities transactions that banks and branches of foreign banks were permitted to engage in before the enactment of the GLBA.[876]

With the GLBA, Congress has created two classes of banks: banks that are able to participate in the international financial markets without restrictions and banks that are restricted in the United States to traditional banking activities. For the first group of banks, Congress has raised the capital adequacy requirements without prior coordination with the members of the Basel Committee on Banking Supervision.

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874 *See supra* note 9.

875 Section 4(c)(8), BHCA, 12 U.S.C. § 1843(c)(8) (1994 & Supp. V 1999). *See* Gruson, *supra* note 1, § 10.10.

876 *See*, in particular, § 3(a)(4) & (5) Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(4) & (5) (1994 & Supp. V 1999).

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