FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Parts 303, 337 and 362

RIN 3064–AC12

Activities of Insured State Banks and Insured Savings Associations

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Final rule.

SUMMARY: As part of the FDIC's systematic review of its regulations and written policies under section 303(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI), the FDIC has revised and consolidated its rules and regulations governing activities and investments of insured state banks and insured savings associations. The rule implements sections 24, 28, and 18(m) of the Federal Deposit Insurance Act, and also establishes certain safety and soundness standards pursuant to the FDIC's authority under section 8. The FDIC's final rule establishes a number of new exceptions and allows institutions to conduct certain activities after providing the FDIC with notice rather than filing an application. Subject to appropriate separations and limitations, the activities that may be conducted through a majority-owned subsidiary under these expedited notice processing criteria are real estate investment and securities underwriting. The FDIC combined its regulations governing the activities and investments of insured state banks with those governing insured savings associations. In addition, the FDIC's final rule updates its regulations governing the safety and soundness of securities activities of subsidiaries and affiliates of insured state nonmember banks. The FDIC's final rule modernizes this group of regulations and harmonizes the provisions governing activities that are not permissible for national banks with those governing the securities underwriting and distribution activities of subsidiaries of state nonmember banks. The FDIC's final rule makes a number of substantive changes and amends the regulations by deleting obsolete provisions, rewriting the regulatory text to make it more readable, conforming the treatment of state banks and savings associations to the extent possible given the underlying statutory and regulatory scheme governing the different charters. The FDIC's final rule also conforms most of the disclosures required under the current regulation to the Interagency Statement on the Retail Sale of Nondeposit Investment Products.

EFFECTIVE DATE: January 1, 1999.

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SUPPLEMENTARY INFORMATION:

I. Background

Section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994 (RCDRIA) required that the FDIC review its regulations for the purpose of streamlining those regulations, reducing any unnecessary costs and eliminating unwarranted constraints on credit availability while faithfully implementing statutory requirements. Pursuant to that statutory direction, the FDIC reviewed part 362 ''Activities and Investments of Insured State Banks,'' subpart G of Part 303, effective October 1, 1998, (formerly § 303.13) ''Filings by Savings Associations'', and § 337.4 ''Securities Activities of Subsidiaries of Insured State Banks: Bank Transactions with Affiliated Securities Companies'', and proposed making a number of changes to those regulations. That proposal is found in the September 12, 1997, issue of the **Federal Register** at 62 FR 47969.

The FDIC's final rule restructures existing part 362, placing the substance of the text of the current regulation into new subpart A. Subpart A addresses the Activities of Insured State Banks implementing section 24 of the Federal Deposit Insurance Act (FDI Act). 12 U.S.C. 1831a. Section 24 restricts and prohibits insured state banks and their subsidiaries from engaging in activities and investments of a type that are not permissible for national banks and their subsidiaries. Through this new final rule, the FDIC introduces a new streamlined notice processing concept for insured state nonmember banks that want to engage in certain activities that are impermissible for national banks and their subsidiaries.

Due to the experience that the FDIC has gained in reviewing applications from insured state nonmember banks since the enactment of section 24, the FDIC has standardized the eligibility criteria and conditions for two activities. This mechanism gives insured state nonmember banks a level of certainty that has been lacking for banks that want to diversify their earnings and maintain their competitiveness by investing in subsidiaries that engage in activities not permissible for national banks. This framework sets forth the eligibility criteria and conditions for majority-owned subsidiaries of insured state nonmember banks to engage in real estate investment and securities underwriting. This framework allows insured state nonmember banks to proceed with their business plans in these areas with relative certainty that the FDIC will consent to the execution of their plans and with assurance that consent will be forthcoming on a predictable schedule. This framework allows the insured state nonmember banks to be creative and innovative in their business plan within the structure appropriate to the activities being undertaken. The FDIC hopes that this rule will assist the insured state nonmember banks as they progress into the competitive financial environment of the 21st century in which they operate their business.

The FDIC's final rule moves the part of the FDIC's regulations governing securities underwriting not permissible for national banks (currently at 12 CFR 337.4) into subpart A of part 362. Although the proposal contemplated that the entire regulation, Securities Activities of Insured State Nonmember Banks, found in § 337.4 of this chapter would be removed and reserved, we have postponed that action while redeveloping some of the safety and soundness criteria that govern insured state bank subsidiaries that engage in the public sale, distribution or underwriting of securities and other activities that are not permissible for a national bank but that are permissible for national bank subsidiaries. The redeveloped regulatory language that will amend subpart B of this regulation is published as a proposed rule elsewhere in this issue of the **Federal Register** for further public comment. During the period that § 337.4 still exists, where activities are covered by both § 337.4 and this final rule, we have provided relief from the requirements of § 337.4 in this rulemaking.

For those activities that were covered under § 337.4 and are now covered under this part 362, we have attempted to modernize the regulations governing those activities by updating the requirements, revising the regulations by deleting obsolete provisions, rewriting the regulatory text to make it more readable, removing a number of the obsolete current restrictions on those activities, and removing the disclosures required under the current regulation.

Safety and Soundness Rules Governing Insured State Nonmember Banks is found in the new subpart B. Subpart B establishes modern standards for insured state nonmember banks to conduct real estate investment activities through a subsidiary, and for those insured state nonmember banks that are not affiliated with a bank holding company (nonbank banks), to conduct securities activities in an affiliated organization. The existing restrictions on these securities activities are found in § 337.4 of this chapter.

Subpart G of part 303, effective October 1, 1998, (formerly § 303.13) of this chapter which relates to activities and filings by savings associations is revised in a number of ways. First, the substantive portions applicable to state savings associations of subpart G are placed in new subpart C of part 362. The substantive requirements applicable to all savings associations when Acquiring, Establishing, or Conducting New Activities through a Subsidiary are moved to new subpart D.

In the proposal, subpart E contained the revised application and notice procedures as well as delegations of authority for insured state banks, and subpart F contained the revised application and notice procedures as well as delegations of authority for insured savings associations. On a parallel track, the FDIC has completed its revision of part 303 of the FDIC's rules and regulations. Part 303 contains substantially all of the FDIC's applications procedures and delegations of authority. Subparts G and H of part 303 were designated as the place where the text of subparts E and F of our proposed rule would be located. As a part of the part 303 review process and for ease of reference, the FDIC is removing the applications procedures relating to activities and investments of insured state banks from part 362 and placing them in subpart G of part 303. The procedures applicable to insured savings associations are consolidated in subpart H of part 303. These subparts are published as an amendment to part 303 as a part of this final regulation.

Part 362 of the FDIC's regulations implements the provisions of section 24 of the FDI Act. Section 24 was added to the FDI Act by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). With certain exceptions, section 24 limits the direct equity investments of state chartered insured banks to equity investments of a type permissible for national banks. Section 24 prohibits an insured state bank from directly, or indirectly through a subsidiary, engaging as principal in any activity that is not permissible for a national bank unless the bank meets its capital requirements and the FDIC determines that the activity will not pose a significant risk to the appropriate deposit insurance fund. In addition, section 24 prohibits the subsidiary of an insured state bank from directly or indirectly engaging as principal in any activity that is not permissible for a national bank subsidiary unless the bank meets its capital requirements and the FDIC determines that the activity will not pose a significant risk to the appropriate deposit insurance fund. The FDIC may make such determinations by regulation or order. The statute requires institutions that held equity investments not conforming to the new requirements to divest no later than December 19, 1996. The statute also requires that banks file certain notices with the FDIC concerning grandfathered investments.

Part 362 was adopted in two stages. The provisions of the current regulation concerning equity investments appeared in the **Federal Register** on November 9, 1992, at 57 FR 53234. The provisions of the current regulation concerning activities of insured state banks and their majority-owned subsidiaries appeared in the **Federal Register** on December 8, 1993, at 58 FR 64455.

Subpart G of Part 303, effective October 1, 1998, (formerly § 303.13) of the FDIC's regulations (12 CFR 303.140) implements FDI Act sections 28 (12 U.S.C. 1831e) and 18(m) (12 U.S.C. 1828(m)). Both sections were added to the FDI Act by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). While section 28 of the FDI Act and section 24 of the FDI Act are similar, there are a number of fundamental differences between the two provisions which caused the implementing regulations to differ in some respects.

Section 18(m) of the FDI Act requires state and federal savings associations to provide the FDIC with notice 30 days before establishing or acquiring a subsidiary or engaging in any new activity through a subsidiary. Section 28 governs the activities and equity investments of state savings associations and provides that no state savings association may engage as principal in any activity of a type or in an amount that is impermissible for a federal savings association unless the FDIC determines that the activity will not pose a significant risk to the affected deposit insurance fund and the savings association is in compliance with the fully phased-in capital requirements prescribed under section 5(t) of the Home Owners' Loan Act (12 U.S.C. 1464(t)) (HOLA). Except for its investment in service corporations, a state savings association is prohibited from acquiring or retaining any equity investment that is not permissible for a federal savings association. A state savings association may acquire or retain an investment in a service corporation of a type or in an amount not permissible for a federal savings association if the FDIC determines that neither the amount invested in the service corporation nor the activities of the service corporation pose a significant risk to the affected deposit insurance fund and the savings association continues to meet the fully phased-in capital requirements. A savings association was required to divest itself of prohibited equity investments no later than July 1, 1994. Section 28 also prohibits state and federal savings associations from acquiring any corporate debt security that is not of investment grade (commonly known as ''junk bonds'').

Section 303.13 of the FDIC's regulations was adopted as an interim final rule on December 29, 1989 (54 FR 53548). The FDIC revised the rule after reviewing the comments and the regulation as adopted appeared in the **Federal Register** on September 17, 1990 (55 FR 38042). The regulation established application and notice procedures governing requests by a state savings association to directly, or through a service corporation, engage in activities that are not permissible for a federal savings association; the intent of a state savings association to engage in permissible activities in an amount exceeding that permissible for a federal savings association; or the intent of a state savings association to divest corporate debt securities not of investment grade. The regulation also established procedures to give prior notice for the establishment or acquisition of a subsidiary or the conduct of new activities through a subsidiary. Section 303.13 was recently moved with stylistic, but not substantive changes, to subpart G of part 303, effective October 1, 1998 of the FDIC's regulations.

Section 337.4 of the FDIC's regulations (12 CFR 337.4) governs securities activities of subsidiaries of insured state nonmember banks as well as transactions between insured state nonmember banks and their securities subsidiaries and affiliates. The regulation was adopted in 1984 (49 FR 46723) and is designed to promote the safety and soundness of insured state nonmember banks that have subsidiaries which engage in securities activities, including activities that are impermissible for banks directly under section 16 of the Banking Act of 1933

(12 U.S.C. section 24 (seventh)), commonly known as the Glass-Steagall Act. For those subsidiaries that engage in underwriting activities that are prohibited for a bank, the regulation requires that these subsidiaries qualify as bona fide subsidiaries, establishes transaction restrictions between a bank and its subsidiaries or other affiliates that engage in such securities activities, requires that an insured state nonmember bank give prior notice to the FDIC before establishing or acquiring any securities subsidiary, requires that disclosures be provided to securities customers in certain instances, and requires that a bank's investment in such a securities subsidiary be deducted from the bank's capital.

On August 23, 1996, the FDIC published a notice of proposed rulemaking (61 FR 43486, August 23, 1996) (August 1996 proposed rule) to amend part 362. Under that proposed rule, a notice procedure would have replaced the application currently required in the case of real estate, life insurance, and annuity investment activities provided certain conditions and restrictions were met. The proposed rule set forth notice processing procedures for real estate, life insurance policies, and annuity contract investments for well-capitalized, well-managed insured state banks. While the August 1996 proposed rule would have amended existing part 362, this new final rule replaces existing part 362.

After considering the comments to the August 1996 proposed rule and reconsidering the issues underlying the current regulation, the FDIC withdrew that proposed rule in favor of the more comprehensive approach presently adopted. One major change was the elimination of a life insurance policy and annuity contract investment notice due to intervening guidance provided by the Office of the Comptroller of the Currency (OCC) that appears to eliminate the necessity for an application with respect to virtually all of the life insurance and annuity investments received by the FDIC in the past. While section 24 and the part 362 application process would continue to apply to those life insurance and annuity investments which are impermissible for national banks, the FDIC has decided that there is no need to adopt a notice process that specifically addresses what we expect to be an extremely small number of situations.

II. Description of the Final Rule

The FDIC divided part 362 into four subparts and changed some of the structure of the rule. Generally, we moved substantive aspects of the regulation that were formerly found in the definitions of terms like "bona fide subsidiary" to the applicable regulation text. This reorganization should assist the reader in understanding and applying the regulation. Next we deleted most of the provisions relating to divesture because we found them to be unnecessary due to the passage of time. Third, we combined the rules covering the equity investments of banks and savings associations into part 362 to regulate these investments as consistently as possible given the limitations imposed by the different statutes that govern each kind of insured institution. Finally, although the FDIC agrees with the principles applicable to transactions between insured depository institutions and its affiliates contained in sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and 371c–1), our experience over the last five years in applying section 24 has led us to conclude that extending 23A and 23B by reference to bank subsidiaries is inadvisable. For that reason, the final regulation does not incorporate sections 23A and 23B of the Federal Reserve Act by cross-reference; rather, the regulation adapts similar principles to those set forth in sections 23A and 23B to the bank/subsidiary relationship as appropriate. In drafting the final rule, we have considered each of the requirements contained in sections 23A and 23B in the context of transactions between an insured institution and its subsidiary and refined the restrictions appropriately. We are comfortable that this approach strikes a better balance between caution and commercial reality by harmonizing the capital deductions and the principles of 23A and 23B.

Subpart A of the final rule deals with the activities and investments of insured state banks. Except for those sections pertaining to the applications, notices and related delegations of authority (procedural provisions), existing part 362 essentially becomes subpart A under the current proposal. The procedural provisions of existing part 362 have been transferred to subpart G of part 303. Subpart A addresses the activities of insured state banks in § 362.3. The activities carried on in subsidiaries of insured state banks are addressed separately in § 362.4.

Under a safety and soundness standard, subpart B of the final regulation requires subsidiaries of insured state *nonmember* banks engaged in certain activities to meet the standards established by the FDIC, even if the OCC determines that those activities are permissible for a national bank subsidiary. The FDIC has determined that real estate investment activities may pose significant risks to the deposit insurance funds. For that reason, the FDIC established standards that an insured state nonmember bank must meet before engaging in real estate investment activities that are not permissible for a national bank, even if they are permissible for the subsidiary of a national bank.

Subpart B also establishes modern standards for insured state nonmember banks to govern transactions between those insured state nonmember banks that are not affiliated with a bank holding company (nonbank banks) and affiliated organizations conducting securities activities. The existing restrictions on these securities activities are found in § 337.4 of this chapter. The new rule only covers those entities not covered by orders issued by the Board of Governors of the Federal Reserve System (FRB) governing the securities activities of those banks that are affiliated with a bank holding company or a member bank.

In addition, subpart B prohibits an insured state nonmember bank not affiliated with a company that is treated as a bank holding company (see section 4(f) of the Bank Holding Company Act, 12 U.S.C. 1843(f)), from becoming affiliated with a company that directly engages in the underwriting of securities not permissible for a bank itself unless the standards established under the proposed regulation are met.

Subpart C of the final rule concerns the activities and investments of insured state savings associations. The substantive provisions applicable to activities of savings associations currently appearing in subpart G of part 303, effective October 1, 1998, (formerly § 303.13) would be revised in a number of ways and placed in new subpart C. To the extent possible, activities and investments of insured state savings associations are treated consistently with the treatment accorded insured state banks. Thus, we revised a number of definitions currently contained in subpart G of part 303 to track the definitions used in subpart A of part 362.

Subpart D of the final rule requires that an insured savings association provide a 30-day notice to the FDIC whenever the institution establishes or acquires a subsidiary or conducts a new activity through a subsidiary. This provision does not alter the notice required by statute and current subpart G of part 303. We moved this requirement to a new subpart to accommodate Federally chartered savings associations by limiting the amount of regulation text they would have to read to learn how to comply with this statutory notice.

III. Comment Summary

The FDIC received 129 comments in response to the proposed regulation. The overall comments generally favored the FDIC's approach to streamlining the consent process for banks and savings associations to engage in activities using standardized criteria with seven comments specifically supporting the FDIC's efforts to streamline these rules. Comments were received from 102 financial institutions, 2 one bank holding companies, 3 state banking departments, 14 trade associations, 2 investment companies, 4 Congressmen, 1 federal banking regulator and 1 individual.

The overwhelming majority of the comments (107), primarily from Massachusetts, were focused on concerns over proposed changes to the standards governing holding equity securities in subsidiaries by banks having grandfathered authority to hold the securities at the bank level. We have responded to these comments by reinstating the exception for a grandfathered bank to hold equity securities in a subsidiary. A complete discussion of this issue is found in the section by section analysis.

With regard to the structure of the rule and the consolidation of the banking and savings activities into a single rule, five comments expressly supported the FDIC's efforts to accomplish these goals. However, one comment suggested using a table like the Office of Thrift Supervision (OTS) has used to aid understanding this complex and difficult regulation. Three comments support cross-referencing the Interagency Statement rather than restating disclosure requirements. A readability analysis was submitted by one individual and, based upon the results, the individual questioned whether the FDIC was successful in achieving the stated objective of using plain English. This individual offered his services to the FDIC as a writing consultant. Other general comments observed that diversifying into new activities increases safety and soundness and were pleased that the FDIC supports state institutions' exercising of new powers. Two comments indicated that in the preamble, the FDIC had overstated the authority of the FRB to impose more stringent standards on any activity conducted by a state member bank. This statement is derived from section 24(i); however, we intended to refer to those activities not permissible for national banks. At least one bank and the state banking departments advocate further streamlining of the regulations to make it easier for banks to use their capital through subsidiaries. The bank suggested that banks must have more flexibility to keep their capital in the banking system, rather than paying out more dividends to shareholders. Although we favor diversifying the banks' income stream and making bankers' compliance burden as light as possible, we also are charged with maintaining safety and soundness and meeting the requirements of section 24 of the FDI Act. Thus, we strive to balance these interests in crafting more flexible regulations.

Most of the remaining comments addressed the substance of the regulation and provided constructive feedback on the regulation text. Two comments focusing on the Purpose and Scope Section suggested a definition of what is meant by "acting as principal," although we already had a definition of "as principal." Two comments objected to the FDIC accepting the time period imposed by the National Bank Act on real estate that is acquired for debts previously contracted as a limitation that carries over to state banks. We believe that the authority of a national bank to own real estate is governed by the statute and that this limitation is inherent in that authority. Thus, we believe that a state bank is constrained by this same limitation unless relief can be granted by the FDIC. Relief may be granted by the FDIC only if the state bank transfers the property to a majority-owned subsidiary with appropriate capital and complies with whatever other constraints the FDIC deems adequate to protect the deposit insurance fund from significant risk.

In the definitions section, eight comments requested that we expand the definition of majority-owned subsidiary to include limited liability companies and limited partnership interests. One comment suggested that the qualified housing exception also include limited liability companies. Four comments expressed concern over the change to the definition of "change of control." Four comments expressed concern about the change to the definition of "significant risk to the deposit insurance fund." One comment suggested a definition of "investment in subsidiary" and further clarification of the items to be included in debt and equity.

With regard to the activities of insured state banks, two comments supported the FDIC's new interpretation of when the "in an amount" limitation is applicable. Six comments addressed insurance activities, including three addressing the appropriate disclosures. Five comments addressed the change in the measurement of the applicable capital limit for adjustable rate and money market preferred stock. Six comments addressed the 4(c)(8) list (closely related to banking) activities, including specific alternatives on real estate leasing. One comment supported the change in the qualified housing projects exception to conform the meaning of lower income to that used in the community reinvestment regulations in defining low and moderate income.

With regard to the activities of subsidiaries of insured state banks, one comment thought the control concept was unnecessary for lower tier subsidiaries. Over one hundred ten comment letters addressed the various issues involving the holding of equity securities through a majority-owned subsidiary, with the overwhelming majority of the comments coming from Massachusetts banking interests to advocate not changing the constraints governing banks in that state owning grandfathered equity securities in a subsidiary. Several of these comment letters identified more than one issue. Twenty comments addressed the issues involved with engaging in real estate investment activity through a majority-owned subsidiary. Nine comments addressed the issues identified in securities underwriting activity through a majority-owned subsidiary. Eleven comments addressed the eligible depository institution criteria. Twelve comments addressed the eligible subsidiary criteria and generally expressed the view that the eligible subsidiary was an improvement over the bona fide subsidiary concept found in the old rule. Seventeen comments addressed the investment and transaction limits criteria. Eight comments were directed to the way the capital requirements operate. One comment said that banks should have the option of complying with original conditions or the new rule.

With regard to the real estate activities covered by subpart B, five comments addressed this issue and generally thought that the FDIC should not impose additional regulations on state nonmember banks.

With regard to subpart C governing savings associations, one comment expressed the view that thrifts do not know what is permissible for national banks and needed greater specificity in the regulation. There were no comments on subpart D; however, no substantive change was made to this statutory filing requirement.

With regard to subparts E and F governing the notice and application processing and content, two comments were received in favor of firmer processing deadlines.

IV. Section by Section Analysis

A. Subpart A—Activities of Insured State Banks

Section 362.1 Purpose and Scope

As described in the preamble accompanying the proposal, included within the proposed changes to the regulation was the inclusion of a purpose and scope paragraph describing the statutory background, intent, and nature of items covered by this subpart. Several commenters acknowledged the FDIC's efforts to restructure the regulation and agreed that the proposed reorganization simplifies what continues to be complex material. These commenters stated that the use of purpose and scope paragraphs helps clarify the coverage of each subpart.

The intent of § 362.1 is to clarify that the purpose and scope of subpart A is to ensure that activities and investments undertaken by insured state banks and their subsidiaries do not present a significant risk to the deposit insurance funds, are not unsafe and are not unsound, are consistent with the purposes of federal deposit insurance, and are otherwise consistent with law. Subpart A implements the provisions of section 24 of the FDI Act that restrict and prohibit insured state banks and their subsidiaries from engaging in activities and investments of a type that are not permissible for national banks and their subsidiaries. The phrase ''activity permissible for a national bank'' means any activity authorized for national banks under any statute including the National Bank Act (12 U.S.C. 21 *et. seq.*), as well as activities recognized as permissible for a national bank in regulations, official circulars, bulletins, orders or written interpretations issued by the OCC.

This subpart governs activities conducted ''as principal'' and therefore does not govern activities conducted as agent for a customer, conducted in a brokerage, custodial, advisory, or administrative capacity, conducted as trustee, or conducted in any substantially similar capacity. As explained in the preamble accompanying the proposal, we moved this language from § 362.2(c) of the former version of part 362 where the term ''as principal'' was defined to mean acting other than as agent for a customer, acting as trustee, or conducting an activity in a brokerage, custodial or advisory capacity. The FDIC previously described this definition as not covering, for example, acting as agent for the sale of insurance, acting as agent for the sale of securities, acting as agent for the sale of real estate, or acting as agent in arranging for travel services. Likewise, providing safekeeping services, providing personal financial planning services, and acting as trustee were described as not being ''as principal'' activities within the meaning of this definition. In contrast, real estate development, insurance underwriting, issuing annuities, and securities underwriting would constitute ''as principal'' activities.

Further, for example, travel agency activities have not been brought within the scope of part 362 and would not require prior consent from the FDIC even though a national bank is not permitted to act as travel agent. Agency activities are not covered by the regulations because the state bank would not be acting ''as principal'' in providing those services. Thus, the fact that a national bank may not engage in travel agency activities is of no consequence. Of course, state banks would have to be authorized to engage in travel agency activities under state law. We intend to continue to interpret section 24 and part 362 as excluding any coverage of activities being conducted as agent. To highlight this issue, provide clarity, and alert the reader of this rule that activities being conducted as agent are not within the scope of section 24 and part 362, this language was moved to the purpose and scope paragraph in the proposal.

Comments addressing the proposed treatment of ''as principal'' were submitted by two industry trade groups. One group agreed that moving the applicable language to the purpose and scope paragraph helps clarify that section 24 does not apply to activities conducted in an agency or similar capacity. However, both commenters recommended that the FDIC define ''as principal'' by specifying what is meant by acting as principal rather than providing a list of capacities exempt from that definition. In other words, the commenters desired a definition consisting of an inclusive list rather than a list of exemptions. Additionally, one commenter expressed concern that the current list of exempt capacities may omit certain agency-like roles. As such, the commenter recommended that the FDIC include ''substantially similar capacities'' in the list of capacities that are not considered to be conducted ''as principal''.

The FDIC continues to believe that including the ''as principal'' language in the purpose and scope paragraph provides clarity regarding activities coming within the scope of section 24. As such, the FDIC elects not to separately define ''as principal'', and has deleted as redundant an overlapping definition of ''as principal'' contained in § 362.2(c) of the proposal. Additionally, the FDIC cannot reasonably list all capacities that will be considered to be ''as principal''. Therefore, the FDIC is not persuaded that changing the nature of the definition to an inclusive list of capacities that are considered ''as principal'' would alleviate confusion. Instead, ''as principal'' activities will continue to be described as being all capacities other than the listed exceptions. The FDIC nonetheless agrees that the current list may exclude certain agency-like roles and is therefore adding the phrase ''or in any substantially similar capacity'' to the regulatory language of § 362.1(b)(1). Also, the FDIC has added a list of examples of activities that are not ''as principal'' to provide the public with additional guidance.

The preamble of the proposal also explains that equity investments acquired in connection with debts previously contracted (DPC) are not within the scope of this subpart when held within the shorter of the time limits prescribed by state or federal law. The exclusion of equity investments acquired in connection with DPC was moved from the definition of ''equity investment'' in the former regulation to the purpose and scope paragraph to highlight this issue, provide clarity, and alert the reader of this rule that these investments are not within the scope of section 24 and part 362. Interests taken as DPC are excluded from the scope of this regulation provided that the interests are not held for investment purposes and are not held longer than the shorter of any time limit on holding such interests (1) set by applicable state law or regulation or (2) the maximum time limit on holding such interests set by applicable statute for a national bank. The result of the modification would be to make it clear, for example, that real estate taken DPC may not be held for longer than 10 years (see 12 U.S.C. 29) or any shorter period of time set by the state. In the case of equity securities taken DPC, the bank must divest the equity securities ''within a reasonable time'' (i.e, as soon as possible consistent with obtaining a reasonable return) (see OCC Interpretive Letter No. 395, August 24, 1987, (1988–89 Transfer Binder) Fed Banking L. Rep. (CCH) p. 85619, which interprets and applies the National Bank Act) or no later than the time permitted under state law if that time period is shorter. Of course, a state bank permitted to hold such interests under state law may apply to the FDIC for consent to continue to hold the real property through a majority-owned subsidiary. In the final rule, the FDIC has added some general information about the manner in which a national bank may hold DPC.

Two commenters objected to the FDIC imposing the national bank holding period limits on insured state banks if those limits are shorter than otherwise permitted under state law. One commenter suggested applying a ''reasonable time period'' divestiture standard similar to that concerning equity securities acquired DPC. The holding periods governing a national bank's ability to own real estate acquired DPC are contained within section 29 of the National Bank Act (12. U.S.C. 29). Because a national bank can hold real estate acquired DPC in limited circumstances, section 24 only allows a state bank to hold such interests under the same constraints, *i.e.*, for a maximum of 10 years. Conversely, section 29 does not contain divestiture periods for equity securities acquired DPC and the FDIC has therefore elected to defer to a ''reasonable time'' standard. However, due to the statutory limitation in section 29, no changes are made to the exception for real estate acquired DPC and the regulation will continue to apply the holding periods in the manner proposed.

As discussed in the proposal's preamble, the intent of the insured state bank in holding equity investments acquired in connection with DPC is also relevant to the analysis of whether the equity investment is permitted. Any interest taken DPC may not be held for investment purposes. For example, a bank may be able to expend monies in connection with DPC property and/or take other actions with regard to that property. However, if those expenditures and actions are not permissible for a national bank, the property will not fall within the DPC exception. For an additional example, if the bank's actions are speculative in nature or go beyond what is necessary and prudent in order for the bank to recover on the loan, a national bank would not be permitted to take these actions. The FDIC expects bank management to document that DPC property is being actively marketed; current appraisals or other means of establishing fair market value may be used to support management's decision not to dispose of property if offers to purchase the property have been received and rejected by management.

Similarly, the proposal also moved to the purpose and scope paragraph language governing any interest in real estate in which the real property is (1) used or intended in good faith to be used within a reasonable time by an insured state bank or its subsidiaries as offices or related facilities for the conduct of its business or future expansion of its business or (2) used as public welfare investments of a type permissible for national banks. Again, this language was moved from the definition of ''equity investment'' in the former regulation to highlight this issue, provide clarity, and alert the reader of this rule that such investments are not within the scope of this subpart. In the case of real property held for use at some time in the future as premises, the holding of the property must reflect a bona fide intent on the part of the bank to use the property in the future as premises. We are not aware of any statutory time frame that applies in the case of a national bank which limits the holding of such property to a specific time period. Therefore, the issue of the precise time frame under which future premises may be held without implicating part 362 must be decided on a case-by-case basis. If the holding period allowed under state law is longer than what the FDIC determines to be reasonable and consistent with a bona fide intent to use the property for future premises, the bank will be so informed and will be required to convert the property to use, divest the property, or apply for consent to hold the property through a majority-owned subsidiary of the bank. We note that the OCC's regulations indicate that real property held for future premises should normally be converted to use within five years after which time it will be considered other real estate owned and must be actively marketed and divested within no more than ten years (12 CFR part 34). We understand that the time periods set forth in the OCC's regulations reflect safety and soundness determinations by that agency. As such, and in keeping with what has been to date the FDIC's posture with regard to safety and soundness determinations of the OCC, the FDIC will make its own judgment to determine when a reasonable time has elapsed for holding property for future premises.

The purpose and scope paragraph also explains that a subsidiary of an insured state bank may not engage in activities that are not permissible for a subsidiary of a national bank unless the bank is in compliance with applicable capital standards and the FDIC has determined that the activity poses no significant risk to the deposit insurance fund. Subpart A provides standards for certain activities that are not permissible for a subsidiary of a national bank. Additionally, because of safety and soundness concerns relating to real estate investment activities, subpart B reflects special rules for subsidiaries of insured state nonmember banks that engage in real estate investment activities of a type that are not permissible for a national bank, but that may be otherwise permissible for a subsidiary of a national bank.

The FDIC intends to allow insured state banks and their subsidiaries to undertake safe and sound activities and investments that do not present a significant risk to the deposit insurance funds and that are consistent with the purposes of federal deposit insurance and other applicable law. This subpart does not authorize any insured state bank to make investments or to conduct activities that are not authorized or that are prohibited by either state or federal law.

Section 362.2 Definitions

Revised subpart A § 362.2 contains the definitions applicable to this subpart. Most definitions are unchanged from those used in the current regulation. Nonetheless, the proposal contains edits to enhance clarity and readability, define additional terms, and delete certain definitions as unnecessary.

To standardize as many definitions as possible, we incorporated the following definitions from section 3 of the FDI Act (12 U.S.C. 1813): ''depository institution'', ''insured state bank'', ''bank'', ''state bank'', ''savings association'', ''state savings association'', ''insured depository institution'', ''federal savings association'', and ''insured state nonmember bank''. This standardization required that we delete the definitions of the first two terms, ''depository institution'' and ''insured state bank'', currently found in part 362. No substantive change was intended by this modification. The remaining terms were added by reference to provide clarity throughout the proposed part 362 because we incorporate many of the definitions from subpart A into the other part 362 subparts. The FDIC received no comments concerning these changes and is therefore adopting the referenced definitions as proposed.

Several definitions were carried forward in the proposal from the current regulation either unchanged or containing only minor edits to enhance clarity or readability without changing the meaning. The following definitions were carried forward without any substantive meaning changes: ''control'', ''extension of credit'', ''executive officer'', ''director'', ''principal shareholder'', ''related interest'', ''national securities exchange'', ''residents of state'', ''subsidiary'', and ''tier one capital''. Again, the FDIC received no comments on the referenced definitions which are adopted as proposed.

The name of one definition was simplified without substantively changing its meaning. The subject definition was formerly found in § 362.2(g) and was described as follows ''an insured state bank will be considered to convert its charter''. This definition is now provided by § 362.2(f) and is named ''convert its charter''. No commenters addressed this simplified title which is adopted as proposed.

The definitions of ''activity permissible for a national bank'', ''an activity is considered to be conducted as principal'', and ''equity investment permissible for a national bank'' were deleted in the proposed and final rule because the substance of the information contained in those definitions was incorporated into the scope paragraph in § 362.1. When developing the proposal, the FDIC concluded that moving the information contained in these definitions to the scope paragraph made the coverage of the rule clearer. Additionally, placing this information at the beginning of the subpart is consistent with the purpose of a scope paragraph. Some readers may save time by realizing sooner that the regulation may be inapplicable to conduct contemplated by a particular bank. It also may be more logical for the reader to consider the scope paragraph to determine the rule's applicability, rather than having to rely on the definition section. Moreover, we concluded that it would be unnecessary to duplicate this same information in the definition section. The FDIC received no specific comments on the proposed treatment, but respondents commenting on the overall structure of the proposal generally favored the use of the purpose and scope paragraphs. The final regulation incorporates the changes as proposed. The proposed definition of ''as principal'' at § 362.2(c) duplicates material set out in the scope section at § 362.1(b)(1), and has therefore been eliminated in the final rule. Appropriate definitional language has been added to § 362.1(b)(1).

The proposal also deleted the definition of ''equity interest in real estate'' and moved the recitation of the permissibility of owning real estate for bank premises and future premises, owning real estate for public welfare investments, and owning real estate from DPC to the scope paragraph for the reasons stated in the preceding paragraph. These activities are permissible for national banks and we concluded that it was unnecessary to continue to restate this information in the definition section of the regulation. No substantive change is intended by the simplification of this language. Further, we determined that the remainder of the definition of ''equity interest in real estate'' did little to enhance clarity or understanding; therefore, we are relying on the language defining ''equity investment'' to cover real estate investments.

Conforming changes were made to the definition of ''equity investment'' by removing the reference to the deleted definition of ''equity interest in real estate''. Additionally, the remaining part of the ''equity investment'' definition was shortened and edited to enhance readability. This definition is intended to encompass an investment in an equity security, partnership interest, or real estate as it did in the former regulation. No substantive changes were intended by the changes described in this or the preceding paragraph. The FDIC received no comments on these changes which are adopted as proposed.

With regard to the definition of ''equity security'', we modified the definition by deleting references to circumstances where holding equity securities is permissible for national banks, such as when equity securities are held as a result of a foreclosure or other arrangements concerning debts previously contracted. Language discussing the exclusion of DPC and other investments that are permissible for national banks was relocated to the scope paragraph for the reasons previously stated. Like the exceptions concerning equity investments in real estate, no substantive change is intended by the relocation of the subject exceptions to the purpose and scope paragraph. No comments were received on this proposed treatment which is adopted as proposed.

The definitions of ''investment in a department'' and ''department'' were deleted because they are no longer needed in the revised regulation text. The core standards applicable to a department of a bank are detailed in § 362.3(c) and defining the term ''department'' is therefore unnecessary. If a calculation of an ''investment in a department'' needs to be made, the FDIC intends to defer to governing state law. As a result, a definition of ''investment in a department'' is unnecessary and was deleted. There were no comments addressing the removal of these definitions.

Similarly, we deleted the definition of ''investment in a subsidiary'' because the definition is no longer needed in the revised regulation text. Amounts subject to the investment limits of § 362.4(d) are listed clearly in that subsection. The FDIC opted to list amounts subject to investment limits in § 362.4(d) to separate those debt-type investments from the equity-type investments subject to the capital treatment of § 362.4(e). The regulation also contains other investment limits applicable to both debt and equity investments. Because of these different types of investment limits, the FDIC did not find a single ''investment in a subsidiary'' definition helpful. Therefore, the FDIC has elected not to incorporate such a definition despite a request by one commenter. However, as the same commenter suggested, the FDIC has attempted to clearly delineate amounts subject to the various investment limits, transaction restrictions, and capital requirements when applicable through both the regulation text and the corresponding preamble language.

We deleted the definition of ''bona fide subsidiary'' and chose to make similar characteristics part of the ''eligible subsidiary'' criteria in § 362.4(c)(2). Including these criteria as a part of the substantive regulation text in the referenced subsection, rather than as a definition, makes reading the rule easier and the meaning clearer. No commenters addressed this treatment. Comments concerning the various elements of the eligible subsidiary criteria are discussed elsewhere in this preamble under the appropriate section.

The regulation substitutes the current definition of ''lower income'' with a cross reference in § 362.3(a)(2)(ii) to the definition of ''low income'' and ''moderate income'' used for purposes of part 345 of the FDIC's regulations (12 CFR 345) which implements the Community Reinvestment Act (CRA). 12 U.S.C. 2901, et. seq. Under part 345, ''low income'' means an individual income that is less than 50 percent of the area median income or a median family income that is less than 50 percent in the case of a census tract or a block numbering area delineated by the United States Census in the most recent decennial census. ''Moderate income'' means an individual income that is at least 50 percent but less than 80 percent of the area median or a median family income that is at least 50 but less than 80 percent in the case of a census tract or block numbering area.

The ''lower income'' definition is relevant for purposes of applying the exception in the regulation which allows an insured state bank to be a partner in a limited partnership whose sole purpose is direct or indirect investment in the acquisition, rehabilitation, or new construction of qualified housing projects (housing for lower income persons). As we anticipate that insured state banks will seek to use such investments in meeting their community reinvestment obligations, the FDIC is of the opinion that conforming the definition of lower income to that used for CRA purposes will benefit banks. This change has the effect of expanding the housing projects that qualify for the exception. The FDIC received one comment addressing the altered definition with the respondent favorably noting and supporting the resultant effect. The final regulation adopts this change as proposed.

The regulation includes an altered definition of the term ''activity''. As modified, the definition includes both activities and investments. Where equity investments are intended to be excluded from a particular section of the regulation, we expressly exclude those investments in the regulatory text. Previously, the term ''activity'' was defined differently depending upon whether it was used in connection with the direct conduct of business by an insured state bank or in connection with the conduct of business by a subsidiary of the bank. This change was made both to simplify the regulation and to reflect the section 24 definition of ''activity''. No comments were received on this proposed change.

It is noted that no comments were received regarding the proposed suggestion also to modify the ''activity'' definition to incorporate a recent interpretation by the agency that determined that the act of making a political campaign contribution does not constitute an ''activity'' for purposes of part 362. The referenced interpretation uses a three prong analysis to help determine whether particular conduct should be considered an activity and therefore subject to review under part 362 if the conduct is not permissible for a national bank.

First, any conduct that is an integral part of the business of banking as well as any conduct which is closely related or incidental to banking should be considered an activity. In applying this factor, it is important to focus on what banks do that makes them different from other types of businesses. For example, lending money is clearly an ''activity'' for purposes of part 362. The second factor asks whether the conduct is merely a corporate function as opposed to a banking function. For example, paying dividends to shareholders is primarily a general corporate function and not one associated with banking because of some unique characteristic of banking as a business. Generally, activities that are not general corporate functions will involve interaction between the bank and its customers rather than its employees or shareholders. The third factor asks whether the conduct involves an attempt by the bank to generate a profit. For example, banks make loans and accept deposits in an effort to make money. However, contracting with another company to generate monthly customer statements should not be considered to be an activity in and of itself as it simply is entered into in support of the ''activity'' of taking deposits. If at least two of the factors yield a conclusion that the conduct is part of the authorized conduct of business by the bank, the better conclusion is that the conduct is an activity. Because of the lack of interest received on expanding the definition to reflect this interpretation, no change is made to the definition proposed. The FDIC intends to continue to apply the above analysis when determining whether particular conduct should be considered an activity.

The definition of ''real estate investment activity'' was shortened to mean any interest in real estate held directly or indirectly that is not permissible for a national bank. This term is used in § 362.4(b)(5) of subpart A. Additionally, it is used in § 362.8 of subpart B which contains safety and soundness restrictions on real estate activities of subsidiaries of insured state nonmember banks that may be deemed to be permissible for operating subsidiaries of national banks but that would not be permissible for a national bank itself. The proposed definition contained a parenthetical excluding real estate leasing from the definition of real estate investment activities. By excluding leasing from the proposed ''real estate investment activity'' definition, the FDIC was attempting to clearly separate leasing activity from other real estate investment activities.

Under the current regulation, banks and their majority-owned subsidiaries are allowed to engage in real estate leasing under the regulatory exceptions enabling them to engage in activities closely related to banking.[1] These regulatory exceptions were carried forward in the proposal. However, the FDIC is concerned about certain activities encompassed within this section. For example, the 4(c)(8) list includes real estate leasing. When an individual or entity engages in leasing activity as the lessor of a particular parcel, the landlord has an ownership interest in the underlying real estate. Under section 24 of the FDI Act, insured state banks are limited in their ability to own real estate. We are concerned that an insured state bank could consider this regulation and its certain conditions as the FDIC having permitted the bank or its majority-owned subsidiaries to own real estate interests that would not be permissible for a national bank or a subsidiary of a national bank. To prevent insured state banks from attempting to use this consent to leasing activity as a way to avoid the corporate separations, transaction limitations and restrictions, and capital treatment applicable to other real estate investment activities, the proposed definition expressly excluded leasing. Additionally, the FDIC was attempting to ensure that banks using the notice procedure to engage in real estate investment activities were not, in effect, operating a commercial business by virtue of the terms of the leasing activity.

The FDIC recognizes, however, that the proposed definition would have effectively prevented an insured state bank's majority-owned subsidiary that was proceeding under the notice procedure from leasing property that it is otherwise permitted to own or develop.[2] As a result, the insured state bank would have been required to submit an application to seek further consent from the FDIC to lease real property it was allowed to own. To correct this anomaly, the FDIC has deleted the parenthetical from the definition and deals with the activities of real estate leasing and other real estate investment activities separately as discussed elsewhere in this preamble. The subject definition is otherwise unchanged from the proposal.

The final rule includes a modified definition of ''company'' to which we added limited liability companies to the list of entities considered to be a company. This change was made to recognize the creation of limited liability companies and their growing prevalence in the market place. Four

[1] These regulatory exceptions were provided by § 362.4(c)(3)(ii)(A) and (B) depending upon whether conducted by the bank or through a majority-owned subsidiary, respectively. The exceptions provided that insured state banks or their majority-owned subsidiaries could engage in principal in activities that the FRB by regulation or order has found to be closely related to banking for the purposes of section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)).

[2] Provided it meets the conditions imposed by § 362.4(b)(5).

commenters suggested explicitly adding limited liability partnerships to the list of business structures included in the ''company'' definition. The FDIC believes the suggested change is unnecessary because limited liability partnerships are already included in the definition through the term ''partnership''.

As proposed, the FDIC adopted the modified definition of ''significant risk to the fund'' with the second sentence that clarifies that this definition includes the risk that may be present either when an activity or an equity investment contributes or may contribute to the decline in condition of a particular state-chartered depository institution or when a type of activity or equity investment is found by the FDIC to contribute or potentially contribute to the deterioration of the overall condition of the banking system. Our interpretation of the definition remains unchanged. Significant risk to the deposit insurance fund is understood to be present whenever there is a high probability that any insurance fund administered by the FDIC may suffer a loss. The preamble accompanying the adoption of this definition in 1992 (57 FR 53220, November 9, 1992) indicated that the FDIC recognizes that no investment or activity may be said to be without risk under all circumstances and that such a fact alone will not cause the agency to determine that a particular activity or investment poses a significant risk of loss to the fund. The definition emphasizes that there is a high degree of likelihood under all of the relevant circumstances that an investment or activity by a particular bank, or by banks in general or in a given market or region, may ultimately produce a loss to either of the funds. The relative or absolute size of the loss that is projected in comparison to the fund is not determinative of the issue. The preamble indicated that the definition is consistent with and derived from the legislative history of section 24 of the FDI Act. Previously, the FDIC rejected the suggestion that a risk to the fund be found only if a particular activity or investment is expected to result in the imminent failure of a bank. The suggestion was rejected in 1992 as the FDIC determined that it was inappropriate to approach the issue this narrowly in light of the legislative intent.

Four commenters addressed the proposed change to the wording of this definition. One industry trade association complimented the change. However, two other groups expressed concern that the added sentence results in a definition that is overly broad, and a state bank stated that the change makes the definition incoherent. The latter three commenters expressed concern that the added sentence contains no qualifications or limitations. These commenters state that numerous activities may negatively impact the condition of an institution or may contribute to deterioration in the overall banking system without causing loss to the insurance fund. The commenters suggest that section 24 requires the FDIC to consider the extent of the impact before determining that an activity presents a significant risk to the fund. The FDIC agrees with the commenters that consideration must be given to the extent that a negative event may harm an institution or the overall banking industry. However, the FDIC believes that both sentences contained in the definition must be read together. The second sentence clarifies that significant risk is present whenever there is a high probability that an activity or an equity investment will or could result in a loss to an insurance fund administered by the FDIC, regardless of whether the loss results from one or multiple institutions. After consideration of the comments and the wording, the FDIC adopts the expanded definition as proposed.

The proposal re-defined the term ''well-capitalized'' to incorporate the same meaning set forth in part 325 of this chapter for an insured state nonmember bank. For other state-chartered depository institutions, the term ''well-capitalized'' has the same meaning as set forth in the capital regulations adopted by the state. Importing the capital definitions used by the various state-chartered depository institutions should simplify the calculations when they deal with their appropriate federal banking agency. The other terms defined under § 362.2(x) of the current regulation were deleted as unnecessary due to the other changes in the regulation text.

The proposal added definitions of the following terms: ''change in control'', ''institution'', ''majority-owned subsidiary'', ''security'' and ''state-chartered depository institution.''

After reconsideration of the proposed definition of ''change in control'', the FDIC decided to adopt certain changes to bring the definition back into substantive consistency with the broader reach of the term as is provided by the current regulation. The change in control definition comes into play primarily in connection with section 24's grandfather with respect to common or preferred stock listed on a national securities exchange and shares of registered investment companies. Section 24 states that the grandfather ceases to apply if the bank converts its charter or undergoes a change in control.

The definition proposed at § 362.2(c) covered any instance in which the bank undergoes a transaction which requires a notice to be filed under section 7(j) of the FDI Act (12 U.S.C. 1817(j)) except a transaction which is presumed to be a change in control for the purposes of that section under FDIC's or FRB's regulations implementing section 7(j), or in which the bank is acquired by or merged into a bank that is not eligible for the grandfather. This proposed definition eliminated two other instances which the current regulation, at § 362.3(b)(4)(ii), treats as a change in control: any transaction subject to section 3 of the Bank Holding Company Act (12 U.S.C. 1842) other than a one bank holding company formation (section 3 transactions), and a transaction in which control of the bank's parent company changes (parent control changes).

In the preamble to the proposal, the FDIC indicated that elimination of the section 3 transactions and the parent control changes would bring the definition more in line with what constituted a true change in control. For example, the section 3 transaction language in the current rule would encompass all mergers between the holding company of a grandfathered bank and another bank holding company, regardless of which holding company was the survivor. However, upon further reflection, the FDIC has decided that total elimination of the section 3 transactions would create anomalous results. If a controlling interest in a grandfathered bank was acquired by an unrelated holding company (which requires approval under section 3), it is difficult to argue how this is materially less of a change in control than if control of the bank was acquired by an individual in a section 7(j) transaction. Still, there are cases in which a rigid application of the section 3 transactions would reach too far. In contrast to the example in which a bank holding company acquires control of a grandfathered bank, the FRB's approval under section 3 is required if a bank holding company acquires anything more than five percent of any outstanding class of a bank's voting shares. The revised definition at § 362.2(c) contained in the final rule therefore includes transactions subject to section 3 approval only when a bank holding company acquires control of a grandfathered bank through the section 3 transaction. The current exclusion for one bank holding company formations also is maintained in the final rule.

Also, the elimination of the parent control changes in the proposed rule created potentially confusing ambiguities, particularly when coupled with the elimination of the section 3 transactions. For example, if the holding company of a bank eligible for the grandfather is acquired and merged into an unrelated bank holding company (again, which requires approval under section 3), it is difficult to argue how this is materially less of a change in control than if the bank itself was merged with an unrelated bank. But the merger and acquisition language in the proposed definition referred only to the bank itself. The final rule expands the merger language to holding companies, accordingly. As another example, it is difficult to argue that a transaction requiring the holding company of a grandfathered bank to submit a change in control notice under section 7(j) is materially less of a change in control than a transaction requiring the grandfathered bank itself to file such a notice, and the 7(j) language in the proposed rule did not expressly refer to holding company transactions. In the final rule, the FDIC has therefore revised the 7(j) language to clarify its applicability to both scenarios.

The FDIC received three similar comments expressing concern about the proposed changes to the ''change in control'' definition. The commenters acknowledge that deleting certain instances from the current definition reduces the instances in which a bank would lose its grandfathered rights. Nonetheless, the commenters feel that it is unclear whether the proposed changes may have also inadvertently broadened the reach of the remaining transactions causing the grandfathered right to be terminated. This ambiguity appears to result from an incomplete understanding of whether the definition continues to exclude transactions presumed to be a change in control under the FDIC's and FRB's regulations implementing section 7(j) of the FDI Act. The FDIC wants to assure commenters that the regulatory language of the final definition, like that of the proposal, continues to exclude such presumed changes in control from the events that result in a loss of the subject grandfathered rights.

One additional commenter took exception to the FDIC's position concerning the ability to look to the substance of a transaction in determining whether grandfather rights terminate. The commenter objected to the FDIC's statement in the preamble to the proposed rule that state banks should be aware that, depending upon the circumstances, the grandfather could be considered terminated after a merger transaction in which an eligible bank is the survivor. For example, if a state bank that is not eligible for the grandfather is merged into a much smaller state bank that is eligible for the grandfather, the FDIC may determine that in substance the eligible bank has been acquired by a bank that is not eligible for the grandfather. The commenter argues that the FDIC's interpretation is inconsistent with the FDIC's current regulations, and claims that if the FDIC subjects such transactions to subjective criteria such as relative asset size, institutions considering mergers or acquisitions will be disadvantaged because of the uncertainty regarding the potential loss of grandfathered status. The commenter also asserts that the FDIC's interpretation is inconsistent with congressional intent because section 24 did not define change in control; Congress clearly intended the use of ''change in control'' language in section 24(f)(5) to reference the meaning of the phrase ''change in control'' established by the Change in Bank Control Act (CBCA) (12 U.S.C. 1817(j)). In the commenter's view, since the CBCA predates section 24 by nine years, Congress intended to use ''change in control'' as a term of art.

The interpretation set out in the preamble to the proposal is consistent with the FDIC's current regulation and is in fact set out in the preamble accompanying the FDIC's original adoption of the change in control provisions under part 362 in 1992. 57 FR 53227 (Nov. 9, 1992). The commenter's argument takes too narrow a view of section 24(f)(5), as the FDIC pointed out in proposing the change of control provisions of current part 362. In light of the broader congressional action under section 24 to generally prohibit equity investments by state banks which are not permissible for a national bank, and the limited nature of the grandfather exception, it is appropriate to define the universe of events constituting a change in control so as to encompass transactions constituting a true acquisition. 57 FR 30444 (July 9, 1992). In modifying the change in control provisions of part 362, the FDIC has narrowed the definition somewhat, as discussed above, to approximate more closely when a true change in control of the bank has taken place. If, as the commenter argues, change in control only includes transactions subject to the CBCA, the exclusion under the CBCA for all transactions reviewable under the Bank Merger Act (12 U.S.C. 1828(c)) or the Bank Holding Company Act would be brought to bear. Therefore, the FDIC rejects the arguments provided by the commenter as being an overly narrow interpretation of the statute.

We defined ''state-chartered depository institution'' and ''institution'' to mean any state bank or state savings association insured by the FDIC. These definitions should enhance readability and eliminate ambiguity concerning the subject terms. Defining ''institution'' enables us to shorten the drafting of the rule. No comments were received regarding these definitions which are adopted as proposed.

Additionally, the proposal added a definition of ''majority-owned subsidiary'' which was defined to mean any corporation in which the parent insured state bank owns a majority of the outstanding voting stock. This definition was added to clarify our intention that expedited notice procedures only be available when an insured state bank interposes an entity providing limited liability to the parent institution. We interpret Congress's intention in imposing the majority-owned subsidiary requirement in section 24 of the FDI Act to generally require that such a subsidiary provide limited liability to the insured state bank. Thus, except in unusual circumstances, we have and will require majority-owned subsidiaries to adopt a form of business that provides limited liability to the parent bank. In assessing our experience with applications, we have determined that the notice procedure will be available only to banks that engage in activities through a majority-owned subsidiary that takes the corporate form of business. We welcome applications that may take a different form of business such as a limited partnership or limited liability company, but would like to develop more experience with appropriate separations to protect the bank from liability under these other forms of business enterprise through the application process before including such entities in a notice procedure.

Eight commenters objected to the FDIC's decision to construct the definition around the corporate form of business. The commenters were unanimous in suggesting that the FDIC expand the definition to include limited liability companies (LLCs), limited liability partnerships (LLPs), and limited partnerships. Several of the commenters note that these forms of business have been in existence in many states for a number of years, and they project that the presence of such structures will continue to increase given the tax benefits, limited liability, and flexible structure provided by these business forms. The respondents contend that these business forms sufficiently insulate the members and partners from liability. One commenter noted that they are aware of no significant judicial challenge to the liability insulation provided by these business forms. As such, the commenter asserts that the proposed definition contravenes congressional intent because it does not recognize a business form that would provide limited liability to the insured state bank. Finally, the commenters note that both the FRB and the OCC have recently permitted the limited liability organizational form for operating subsidiaries.

Limited liability partnerships and companies are both relatively new business forms. There is little definitive legal guidance concerning the liability protection offered by these organizational structures. Among the unresolved issues is the question of how to structure the management of LLCs and LPs to afford the same level of separateness provided by the corporate form under the eligible subsidiary criteria. Because of the limited existing case law regarding piercing the veil of LLCs and LLPs, the FDIC is unable to determine the appropriate objective separation criteria that will provide the parent bank with substantially the same liability protection offered by an independent corporate structure. Thus, we have not expanded the definition to include LLCs and LLPs at this time. The FDIC views this decision to preclude LLCs and LLPs as consistent with the agency's interpretation of the congressional intent to limiting liability for subsidiaries' activities from accruing to the insured state bank.

The effect of the FDIC's decision is that the notice process is limited to banks with subsidiaries organized using the corporate form. We encourage banks to submit applications when they want to use an alternative business form. Then, the banks can propose appropriate objective separations that fit the particular activity and the FDIC can evaluate these separations on a case-by-case basis. At some future date, more standardized criteria may emerge. Then, the FDIC may consider re-visiting this issue. The FDIC does not intend any exclusion of these forms by omitting them from the notice processing criteria. They simply do not allow for the more limited review involved in an expedited notice processing system.

Although the FDIC requires the first level majority-owned subsidiary to be a corporation, it is noted that the final regulation contains a provision, at § 362.4(b)(3), allowing lower level subsidiaries to assume other business forms including LLCs and LLPs. Please refer to the applicable discussion of this section elsewhere in this preamble.

The final rule also incorporates the definition of ''security'' from part 344 of this chapter to eliminate any ambiguity over the coverage of this rule when securities activities and investments are contemplated.

Section 362.3 Activities of Insured State Banks

Equity Investment Prohibition. Section 362.3(a) restates the statutory prohibition on insured state banks making or retaining any equity investment of a type that is not permissible for a national bank. The prohibition does not apply if one of the statutory exceptions contained in section 24 of the FDI Act (as restated in the current regulation and carried forward in the final regulation) applies. As discussed in the preamble accompanying the proposal, the final regulation eliminates the reference to ''amount'' that is contained in the current version of § 362.3(a). The FDIC reconsidered our interpretation of the language of section 24 in which paragraph (c) prohibits an insured state bank from acquiring or retaining any equity investment of a type that is impermissible for a national bank and paragraph (f) prohibits an insured state bank from acquiring or retaining any equity investment of a type or in an amount that is impermissible for a national bank. We previously interpreted the language of paragraph (f) as controlling and read that language into the entire statute. We reconsidered this approach and decided that it was not the most reasonable construction of this statute and determined that the language of the earlier paragraph (c) is controlling without the necessity to import the language of (f). We believe that the second mention as contained in paragraph (f) should be limited to those items discussed under paragraph (f). Thus, the language of paragraph (c) controls when any other equity investment is being considered. Therefore, we deleted the amount language from the prohibition stated in the regulation. The FDIC received comments from two parties expressly approving this revised interpretation.

Exception for subsidiaries of which the bank is majority owner. The final regulation retains the exception allowing investments in subsidiaries of which the bank is majority owner as currently in effect without any substantive change. However, the FDIC has modified the language of this section to remove negative inferences and make the text clearer. Rather than stating that the bank may do what is not prohibited, the FDIC affirmatively states that an insured state chartered bank may acquire or retain investments in these subsidiaries. If an insured state bank holds less than a majority interest in the subsidiary, and that equity investment is of a type that would be prohibited to a national bank, the exception does not apply and the investment is subject to divestiture.

Majority ownership for the exception is understood to mean ownership of greater than 50 percent of the outstanding voting stock of the subsidiary. National banks may own a minority interest in certain types of subsidiaries. (*See* 12 CFR 5.34 (1998)). Therefore, an insured state bank may hold a minority interest in a subsidiary if a national bank could do so. Thus, section 24 does not necessarily require a state bank to hold at least a majority of the stock of a company in order for the equity investment in the company to be permissible.

For purposes of the notice procedure, the regulation defines the business form of a majority-owned subsidiary to be a corporation. As is discussed above in connection with the definition of a ''Majority-owned subsidiary'', there may be other forms of business organization that are suitable for the purposes of this exception such as partnerships or limited liability companies, but the FDIC prefers to review such alternate forms of organization on a case-by-case basis through the application process to assure that appropriate separation between the insured depository institution and the subsidiary is in place.

To qualify for the exception, the majority-owned subsidiary may engage only in the activities described in § 362.4(b). The allowable activities include exceptions to the general statutory prohibition, some of which have a statutory basis and others of which are derived through the FDIC's power to create regulatory exceptions.

Investments in qualified housing projects. Section 362.3(a)(2)(ii) of the final regulation provides an exception for qualified housing projects. The final regulation combines the language found in two paragraphs of the current regulation with the resulting paragraph retaining substantially the same language. Changes were made to clarify some technical aspects of the manner in which the qualified housing rules work and are not intended to be substantive. In addition, the FDIC modified the language of the text to remove negative inferences and make the text clearer.

Under this exception, an insured state bank is allowed to invest as a limited partner in a partnership, the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation, or new construction of a residential housing project intended to primarily benefit lower income persons throughout the period of the bank's investment. The bank's investments, when aggregated with any existing investment in such a partnership or partnerships, may not exceed 2 percent of the bank's total assets. The FDIC expects a bank to use the figure reported on the bank's most recent consolidated report of condition (Call Report) prior to making the investment as the measure of its total assets. If an investment in a qualified housing project does not exceed the limit at the time the investment is made, the investment shall be considered to be a legal investment even if the bank's total assets subsequently decline.

The current exception is limited to instances in which the bank invests as a limited partner in a partnership. In the proposal, comment was invited on (1) whether the FDIC should expand the exception to include limited liability companies and (2) whether doing so is permissible under the statute. (Section 24(c)(3) of the FDI Act provides that a state bank may invest ''as a limited partner in a partnership''.). No comments were received on the legal issue. One comment applauded our suggestion to expand this statutory exception by regulation. In the final rule, we have expanded § 362.3(a)(2)(ii) to permit insured state banks to invest in qualified housing projects as a limited partner or through a limited liability company.

Although the statutory language in the paragraph allowing an investment in qualified housing projects explicitly allows only a limited partnership investment, it does not prohibit other forms of ownership. For the purpose of this investment and consistent with the underlying public policy purposes of this statute, we consider limited liability companies to be substantially equivalent to limited partnership interests. It is consistent with the FDIC's authority under the statute to extend the qualified housing projects exception by regulation to cover the limited liability company form of business enterprise in this circumstance. Limited partnership interests and limited liability companies provide similar forms of business enterprise. Although we have been unwilling to expand the regulatory exceptions to allow limited liability companies to substitute for corporate forms of business enterprise where uniform separation standards were required to protect the bank from the liability of its subsidiaries that conduct activities not permissible for national bank subsidiaries, we believe that no similar impediments exist here. We also acknowledge that we have been reluctant to extend this exception to limited liability companies in the past when informal interpretations were requested.[3] However, we believe, and no commenter raised any contrary argument, that it is appropriate to extend the statutory exception to cover these substantially similar organizational structures through this regulation. Thus, subject to the other limitations in the rule, we are allowing by regulation insured state banks to invest in limited liability companies that invest in the acquisition, rehabilitation or construction of a qualified housing project.

Grandfathered investments in listed common or preferred stock and shares of registered investment companies. Available only to certain grandfathered state banks, § 326.3(a)(2)(iii) of the final regulation carries forward the statutory exception for investments in common or preferred stock listed on a national securities exchange and for shares of investment companies registered under the Investment Company Act of 1940. Although there is no substantive change, the FDIC has modified the language of this section to remove negative inferences and make the text clearer.

To use the grandfathered authority, section 24 requires, among other things, that a state bank file a notice with the FDIC before relying on the exception and that the FDIC approve the notice. The notice requirement, content of notice, presumptions with respect to the notice, and the maximum permissible investment under the grandfather also are set out in the current regulation. The references contained in the current regulation describing the notice content and procedures were deleted because we believe that most, if not all, of banks eligible for the grandfather already have filed notices with the FDIC. Thus, we eliminated language governing the specific content and processing of notices and cross-referencing the notice procedures under subpart G of part 303. Any bank that has filed a notice need not file again.

Paragraph (B) of this section of the final regulation provides that the exception for listed stock and registered shares ceases to apply in the event that the bank converts its charter or the bank or its parent holding company undergoes a change in control. This language restates the statutory language governing when grandfather rights terminate. As is discussed in the preamble above in connection with the definition of ''change in control'', the FDIC has revised both the current and proposed scope of transactions encompassed in the notion of a change in control.

The regulation continues to provide that in the event an eligible bank undergoes any transaction that results in the loss of the exception, the bank is not prohibited from retaining its existing investments unless the FDIC determines that retaining the investments will adversely affect the bank and the FDIC orders the bank to divest the stock and/ or shares. This provision has been retained in the final rule without any change except for the deletion of the citation to specific authorities the FDIC may rely on concerning divestiture. Rather than containing specific citations, the final regulation merely references the FDIC's ability to order divestiture under any applicable authority. State banks should continue to be aware that any inaction by the FDIC would not preclude a bank's appropriate banking agency (when that agency is an agency other than the FDIC) from taking steps to require divestiture of the stock and/or shares if, in that agency's judgment, divestiture is warranted.

The FDIC has moved, simplified, and shortened the limit on the maximum permissible investment in listed stock and registered shares. The final regulation limits the bank's investment in grandfathered listed stock and registered shares, when made, to a maximum of 100 percent of tier one capital as measured on the bank's most recent Call Report prior to the investment. The final rule modifies the proposed regulatory language somewhat, to clarify how the maximum investment limit is to be determined. The final rule uses the lower of the bank's cost or the market value of the stock and shares as the measure of compliance with this limit. The proposal referred to book value. At the time the FDIC adopted the current version of the rule, call report instructions and generally accepted accounting principles (GAAP) provided that equity securities were generally to be carried at the lower of cost or market value. The FDIC adopted the book value

[3] *See* 2 FDIC Law, Regulations, Related Acts (FDIC) 4903; 1994 WL 763183 (F.D.I.C.) and FDIC 94–50, 1994 FDIC Interp. Ltr. LEXIS 89, October 12, 1994.

approach at that time, in response to industry comments that a market value approach would exhaust a bank's grandfather authority as the value of its stock and shares appreciated. Now that call report instructions and GAAP require stock and shares covered by the rule to be reported at market value in many cases, the book value approach no longer serves the desired purpose. The FDIC is expressly referring to the lower of cost or market approach in the final rule, in order to maintain consistency with the current rule. The lower of cost or market approach is also consistent with the federal banking agencies' rules for determining tier one capital, which require exclusion of net unrealized holding losses on available-for-sale equity securities with readily determinable fair values.

Language indicating that investments by well-capitalized banks in amounts up to 100 percent of tier one capital will be presumed not to present a significant risk to the fund was deleted, as was language indicating that it will be presumed to present a significant risk to the fund for an undercapitalized bank to invest in amounts that high. In addition, the proposed rule deleted the language stating the presumption that, absent some mitigating factor, it will not be presumed to present a significant risk for an adequately capitalized bank to invest up to 100 percent of tier one capital. The FDIC received one comment asking that we retain regulatory language describing these presumptions for well- and adequately-capitalized banks. The commenter believes that removal of the presumptions will create uncertainty and may cause banks to hesitate to take full advantage of these investment opportunities. The FDIC nonetheless believes at this time that it is not necessary to expressly state these presumptions in the regulation. However, this action does not alter the FDIC's position regarding the presumptions.

Language in the current regulation concerning the divestiture of stock and/or shares in excess of that permitted by the FDIC (as well as such investments in excess of 100 percent of the bank's tier one capital) has been deleted under the proposal as no longer necessary due to the passage of time. In both instances, the time allowed for such divestiture has passed.

We note that the statute does not impose any conditions or restrictions on a bank that enjoys the grandfather in terms of per issuer limits. The proposal invited comment on whether the FDIC should impose restrictions under the regulation that would, for example, limit a bank to investing in less than a controlling interest in any given issuer. Additionally, we asked whether the regulation should incorporate other limits or restrictions to ensure the grandfathered investments do not pose a risk. Although no comments specifically addressed these questions, several commenters referred to the fact that most institutions to which the grandfather is applicable have already filed notices with the FDIC regarding those investments. These institutions have since complied with any imposed conditions, or subsequently applied to have the conditions altered or removed. The commenters do not feel that banks should now be subject to requirements the FDIC did not originally impose. Moreover, the commenters point out that the FDIC and state banking authorities routinely review investment portfolios as part of the supervisory process and can address any deficiencies on a case-by-case basis. Upon further reflection, the FDIC is persuaded not to impose any new regulatory requirements on these grandfathered institutions for directly held investments. However, the FDIC wants to emphasize that it expects banks using this grandfathered investment authority to establish prudent limits and controls governing these investments. Equity securities and registered shares that are held by the bank must be consistent with the institution's overall investment goals and will be reviewed by examiners in that context. The FDIC will not take exception to listed stock and registered shares that are well regarded by knowledgeable investors, marketable, held in moderate proportions, and meet the institution's overall investment goals.

Stock investment in insured depository institutions owned exclusively by other banks and savings associations (banker's banks). Section 362.3(b)(2)(iv) of the final regulation continues to reflect the statutory exception that an insured state bank is not prohibited from acquiring or retaining the shares of depository institutions that engage only in activities permissible for national banks, are subject to examination and are regulated by a state bank supervisor, and are owned by 20 or more depository institutions not one of which owns more than 15 percent of the voting shares. In addition, the voting shares must be held only by depository institutions (other than directors' qualifying shares or shares held under or acquired through a plan established for the benefit of the officers and employees). Note that the proposal modified this exception to no longer limit the bank's investment in such depository institutions to ''voting'' stock. This change was made to allow banks to hold non-voting interests in these entities because section 24(f)(3)(B) of the FDIC Act does not limit the exception to voting stock. However, the final regulation retains the reference to ''voting'' stock in determining the various ownership and control thresholds. The FDIC received no comments on this provision which is adopted as proposed.

Stock investments in insurance companies. Section 362.3(a)(2)(v) of the final regulation incorporates statutory exceptions permitting state banks to hold equity investments in insurance companies. The exceptions are provided by statute and are implemented in the current version of part 362. For the most part, the exceptions are carried forward into the final regulation with no substantive editing. The exceptions are discussed separately below.

Directors and officers liability insurance corporations. The first exception permits insured state banks to own stock in corporations that solely underwrite or reinsure financial institution directors' and officers' liability insurance or blanket bond group insurance. A bank's investment in any one corporation is limited to 10 percent of the outstanding stock. Consistent with the proposal, we eliminated the present limitation of 10 percent of the ''voting'' stock and changed the present reference from ''company'' to ''corporation'' conforming the language to the statutory exception.

While the statute and regulation provide a limit on a bank's investment in the stock of any one insurance company under this provision, there is no statutory or regulatory ''aggregate'' investment limit in all insurance companies, nor does the statute combine these investments with any other exception under which a state bank may invest in equity securities. In the past, the FDIC has addressed investment concentration and diversification issues on a case-by-case basis. Nonetheless, the FDIC invited comment on whether it should incorporate aggregate limits on grandfathered bank investments in insurance companies. Responses addressing this issue were submitted by two trade associations and one bank consortium. While one trade association suggested that it would be prudent for the FDIC to incorporate some form of investment limit, the other two parties strongly opposed the imposition of any regulatory limit on what are statutory exceptions. The FDIC has elected not to impose aggregate investment limits on equity investments specifically permitted by statute, nor will it combine the bank's investments in insurance companies with other equity investments made pursuant to any regulatory exception. Instead, the FDIC will continue to address investment concentration and diversification issues on a case-by-case basis.

Stock of savings bank life insurance company. The second exception for equity investments in insurance companies permits any insured state bank located in New York, Massachusetts, or Connecticut to own stock in savings bank life insurance companies provided that certain consumer disclosures are made. Again, this regulatory provision mirrors the specific statutory exception found in section 24. The savings bank life insurance investment exception is broader than the director and officer liability insurance company exception discussed above. There are no individual or aggregate investment limitations for investments in savings bank life insurance companies.

Consistent with the proposal, the provision implementing this exception in the current regulation was carried forward into the final regulation with some modifications. The language describing this exception was revised to affirmatively permit banks located in New York, Massachusetts, or Connecticut to own stock in a savings bank life insurance company provided the company provides the required disclosures. Additionally, the final regulation alters the required disclosure from that provided by the current regulation. Rather than continue the disclosure language currently contained in § 362.3(b)(3), the FDIC has decided to require disclosures of the type provided for in the Interagency Statement. As a result, these companies are required to provide their retail customers with written and oral disclosures consistent with the Interagency Statement when selling savings bank life insurance policies, other insurance products, and annuities. The required disclosures in the Interagency Statement include a statement that the products are not insured by the FDIC, are not a deposit or other obligation of, or guaranteed by, the bank, and are subject to investment risks, including the possible loss of the principal amount invested. While the existing regulatory language is similar to the Interagency Statement in what it requires to be disclosed, it is not identical. The last disclosure—that such products may involve risk of loss—is not required under the current regulation.

Although commenters generally supported referencing the Interagency Statement rather than incorporating a different disclosure standard, a savings bank life insurance company and a United States Congressman objected to the ''risk of loss'' disclosure. The savings bank life insurance company claims that a disclosure of that nature is a falsehood unsupported by factual data. Both commenters are concerned that the ''risk of loss'' disclosure places savings bank life insurance companies at a competitive disadvantage relative to other entities selling life insurance products. The Congressman suggested replacing the required disclosure concerning ''may involve risk of loss'' with ''may involve market risk, if applicable''.

It is the FDIC's view that FDIC-insured deposits differ from savings bank life insurance products and annuities because investors in such products are exposed to a possible loss of the principal amount invested. The Interagency Statement does not distinguish between the relative loss exposure presented by various nondeposit investment products. The distinction is simply between insured deposits and other investment products. Savings bank life insurance, other insurance products, and annuities contain an investment risk component exposing the investor to a loss of principal despite the assertion offered by one commenter. Further, investors in nondeposit products are exposed to more than market risks. The FDIC is therefore unwilling to change the nature of the required disclosure.

Nevertheless, the FDIC recognizes that the language proposed in § 362.3(a)(2)(v)(B) may be interpreted to mean the subject disclosure must contain the phrase ''may involve risk of loss''. The FDIC intends for the disclosures to be consistent with the Interagency Statement and was simply paraphrasing the respective disclosure content in the event the Interagency Statement is succeeded by another statement or regulation. Included in the required disclosures is a statement specifying that the nondeposit product is ''subject to investment risks, including possible loss of the principal amount invested''. The actual Interagency Statement language may convey a less threatening tone concerning the possibility of loss. To avoid confusion and reflect the FDIC's actual intent, the phrase ''may involve risk of loss'' was replaced with ''are subject to investment risks, including possible loss of the principal amount invested'' in the final rule.

The FDIC is aware that insurance companies, including savings bank life insurance companies, typically offer annuity products and that many states regulate annuities through their insurance departments. The FDIC agrees with the OCC that annuities are investment products that are subject to the requirements found in the Interagency Statement when sold to retail customers on bank premises as well as in other instances specified in the Interagency Statement.

Other activities prohibition. Section 362.3(b) of the final regulation restates the statutory limit prohibiting insured state banks from directly or indirectly engaging as principal in any activity that is not permissible for a national bank. Activity is defined in the rule as the conduct of business by a state-chartered depository institution and includes acquiring or retaining any investment. Because acquiring or retaining an investment is an activity by definition, the proposal added language to make clear that this prohibition does not supersede the equity investment exceptions of § 362.3(a)(2). The prohibition does not apply if one of the statutory exceptions contained in section 24 of the FDI Act (restated in the current regulation and carried forward in the final regulation) applies. The FDIC has also provided a regulatory exception to the prohibition on other activities concerning the acquisition of certain debt-like instruments. Insured state banks desiring to engage in other activities must submit an application to the FDIC pursuant to § 362.3(b)(2)(i).

Consent through Application. The limit on activities contained in section 24 states that an insured state bank may not engage as principal in any type of activity that is not permissible for a national bank unless the FDIC has determined that the activity would pose no significant risk to the appropriate deposit insurance fund, and the bank is and continues to be in compliance with applicable capital standards prescribed by the appropriate federal banking agency. Section 362.3(b)(2)(i) establishes an application process for the FDIC to make the determination concerning risk to the funds. The substance of this process is unchanged from the current regulation.

Insurance underwriting. This exception tracks the statutory exception in section 24 which grandfathers: (1) Certain insured state banks engaged in the underwriting of savings bank life insurance through a department of the bank; (2) any insured state bank that engaged in underwriting of insurance on or before September 30, 1991, which was reinsured in whole or in part by the Federal Crop Insurance Corporation; and (3) certain well-capitalized banks engaged in insurance underwriting through a department of a bank. The exception is carried forward from the current regulation with a number of modifications.

The savings bank life insurance exception applies to insured state banks located in Massachusetts, New York, or Connecticut. To use this exception, banks must engage in the activity through a department of the bank meeting the core standards discussed below. The standards for conducting this activity are taken from the current regulation with the exception of the disclosure standards which are discussed below. We moved the requirements for a department from the definitions section to the substantive portion of the regulation text.

The exception for underwriting federal crop insurance is unchanged from the current regulation, and there are no regulatory limitations on the conduct of the activity.

An insured state bank that wishes to use the remaining grandfathered insurance underwriting exception may do so only if the insured state bank was lawfully providing insurance, as principal, as of November 21, 1991. Further, the insured state bank must be well-capitalized if it is to engage in insurance underwriting and the bank must conduct the insurance underwriting in a department that meets the core standards described below. Banks taking advantage of this grandfather provision may underwrite only the same type of insurance that was underwritten as of November 21, 1991, and may operate and have customers only in the same states in which it was underwriting policies on November 21, 1991. The grandfather authority for this activity does not terminate upon a change in control of the bank or its parent holding company.

Both savings bank life insurance activities and grandfathered insurance underwriting must take place in a department of the bank which meets certain core operating and separation standards. Consistent with the disclosure requirements of the current regulation, the core operating standards require the department to inform its customers that only the assets of the department may be used to satisfy the obligations of the department. Note that this language does not require the bank to say that the bank is not responsible for the obligations of the department. The bank and the department constitute one corporate entity. In the event of insolvency, the insurance underwriting department's assets and liabilities would be segregated from the bank's assets and liabilities due to the requirements of state law. The regulatory language of the final rule has been changed to clarify that a bank seeking to operate its department under separation standards different than the core standards in the rule may submit an application to the FDIC.

The final regulation eliminates the proposed operating standard requirement that the department provide customers with written disclosures consistent with those in the Interagency Statement. The FDIC proposed replacing the disclosure statement currently imposed by § 362.4(g)(1)(iii) with that required in the Interagency Statement to increase consistency and reduce the regulatory burden of differing requirements. Upon further reflection, the FDIC has decided that while it is prudent to eliminate the disclosure currently required by part 362, the proposal to impose the Interagency Statement in connection with this activity in this regulation is unnecessary. Unlike the statutory exception permitting banks to engage in savings bank life insurance activities, the authorizing statute does not require a customer disclosure as a condition of engaging in other grandfathered insurance activities. Nevertheless, banks engaged in grandfathered insurance underwriting continue to be subject to the Interagency Statement in connection with sales to bank customers, including the disclosure provisions of that statement. Comments support this change and recognize that any retail sale of nondeposit investment products to bank customers is subject to the Interagency Statement if made on bank premises, by a bank employee, or pursuant to a compensated referral.

The FDIC cannot, however, eliminate the regulatory requirement that insured state banks engaged in savings bank life insurance activities make disclosures to all consumers. Section 24(e) of the FDI Act authorizes this activity only if the bank meets the consumer disclosure requirements. Thus, under the statute, the FDIC must promulgate consumer disclosures for savings bank life insurance. Section 362.4(c)(1) of the current regulation addresses banks engaging in savings bank life insurance underwriting activities. The referenced section requires the bank to make certain disclosures to purchasers of life insurance policies, other insurance products, and annuities. As discussed previously in this preamble, these disclosures are similar to those set out in the Interagency Statement but they are not identical. Currently, banks engaging in savings bank life insurance underwriting are covered by the Interagency Statement and part 362. As a result, banks have been required to comply with both of these similar but somewhat different requirements. The final regulation replaces the current disclosure requirement with a cross reference to the Interagency Statement to make compliance easier. Banks engaging in savings bank life insurance activities should note, however, that consistent with the proposal and the current regulation, the final rule carries forward the requirement that the department also inform purchasers that only the assets of the insurance department may be used to satisfy the obligations of the department. Comments and the FDIC's response are described elsewhere in this preamble.

The core separation standards in the final rule restate the requirements currently found in the definition of department. These standards require the department to: (1) Be physically distinct from the remainder of the bank; (2) maintain separate accounting and other records; (3) have assets, liabilities, obligations, and expenses that are separate and distinct from those of the remainder of the bank; and (4) be subject to state statutes that permitting the obligations, liabilities, and expenses to be satisfied only with the assets of the department. The standards are unchanged from those in the current regulation, but they have been moved from the definitions section to ensure that the requirements are shown in connection with the appropriate regulatory exception.

Acquiring and retaining adjustable rate and money market preferred stock. The proposal provides an exception that allows a state bank to invest in up to 15 percent of the bank's tier one capital in adjustable rate preferred stock and money market (auction rate) preferred stock without filing an application with the FDIC. The exception was adopted when the 1992 version of the regulation was adopted in final form. After reviewing comments at that time, the FDIC found that adjustable rate preferred stock and money market (auction rate) preferred stock were essentially substitutes for money market investments such as commercial paper and that these investments possess characteristics closer to debt than to equity securities. Therefore, money market preferred stock and adjustable rate preferred stock were excluded from the definition of equity security. As a result, these investments are not subject to the equity investment prohibitions of the statute or the regulation and they are considered to be an ''other activity'' for the purposes of this regulation.

This exception focuses on two categories of preferred stock. This first category, adjustable rate preferred stock, refers to shares where dividends are established by contract through the use of a formula based on Treasury rates or some other readily available interest rate levels. Money market preferred stock refers to those issues where dividends are established through a periodic auction process that establishes yields in relation to short-term rates paid on commercial paper issued by the same or a similar company. The credit quality of the issuer determines the value of the security. Money market preferred shares are sold at auction.

Consistent with other parts of the proposal, the FDIC has modified the exception by limiting the 15 percent measurement to tier one capital, rather than total capital. Throughout the final regulation, all capital-based limitations are measured against tier one capital to increase uniformity within the regulation. The FDIC recognizes that this change may lower the permitted amount of these investments held by institutions already engaged in the activity. An insured state bank that has investments exceeding the proposed limit, but within the total capital limit, may continue holding those investments until they are redeemed or repurchased by the issuer. The 15 percent of tier one capital limitation should be used in determining the allowable amount of new purchases of money market preferred and adjustable rate preferred stock. Of course, institutions wanting to increase their holdings of these securities may submit an application to the FDIC.

The FDIC received five comments regarding this proposed change. Although the commenters applaud the desire for consistency, they contend that the results of such a change are unjustified when done principally for the sake of uniformity. Thus, the commenters suggest that the FDIC either leave the measurement base unchanged or increase the limit to offset the impact of the change. While the FDIC acknowledges the concerns expressed by commenters, it is not persuaded that changing the capital base from total to tier one capital creates a significant hardship. Therefore, the final regulation uses the tier one capital base to measure the applicable limit. The FDIC will handle applications to exceed the governing threshold in an expeditious manner according to procedures detailed in subpart G of part 303.

The final regulation incorporates a provision allowing insured state banks to acquire and retain other instruments of a type determined by the FDIC to have the character of debt securities provided the instruments do not represent a significant risk to the deposit insurance funds. In response to investor and client needs, the financial markets continually develop new financial products. A recent example of such an instrument is trust preferred stock. Trust preferred stock is a hybrid instrument possessing characteristics typically associated with debt obligations. Trust preferred securities are issued by an issuer trust that uses the proceeds to purchase subordinated deferrable interest debentures in a corporation. The corporation guarantees the obligations of the issuer trust and agrees to indemnify third parties for other expenses and liabilities incurred by the issuer trust. Taken together, the debentures, guarantee, and expense indemnity agreement constitute a full, irrevocable, and unconditional guarantee of the obligations of the issuer trust by the issuer corporation. With the exception of credit risk, investors in trust preferred stock are protected from changes in the value of the instruments. Like investors in debt securities, trust preferred stock investors do not share any appreciation in the value of the issuer trust and have no voting rights in the management or ordinary course of business of the issuer trust. Additionally, trust preferred stock is not perpetual and distributions on the stock resemble the periodic interest payments on debt. In essence, such investments are functionally equivalent to investments in the underlying debentures. In the future, as such new instruments come to the FDIC's attention, the FDIC will provide public notice of its determinations under the rule by issuing Financial Institution Letters describing its decisions. Any investments in such instruments would be aggregated with investments in adjustable rate and money market preferred stock for purposes of applying the 15 percent of tier one capital limit.

Activities that are closely related to banking. The language in the proposal providing a regulatory exception allowing insured state banks to engage in activities closely related to banking has been eliminated. The proposed regulation continued language found in the current regulation entitled ''Activities that are closely related to banking''. Section 362.3(b)(2)(iv) of the proposal permitted an insured state bank to engage as principal in any activity that is not permissible for a national bank provided that the FRB by regulation or order has found the activity to be closely related to banking for the purposes of section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)). However, the proposed exception was subject to the statutory restrictions prohibiting the bank from directly holding equity investments that a national bank may not hold or which are not otherwise permissible investments for insured state banks pursuant to § 362.3(b). Additionally, the proposal imposed limits on certain of the activities authorized by the 4(c)(8) reference. Included in the limits was a provision requiring the bank, when acting as a real property lessor, to either re-lease the real estate or dispose of the same within two years after the lease expires.

The FDIC received six comments on this provision, four of them objecting to the two-year disposition period at the conclusion of a real estate lease. Another opined that the bank's survival depends on its ability to diversify by engaging in real estate leasing through a subsidiary. An industry trade association supports continued reliance on activities authorized by the FRB pursuant to 4(c)(8) of the Bank Holding Company Act.

Upon further analysis, the FDIC has deleted the reference to the 4(c)(8) list because the activities included on that list generally are of a type permissible for national banks. The one exception that clearly is not generally permissible for a national bank involves real estate leasing. It is noted that national banks are permitted to engage in certain real estate leasing activities. As with other activities permissible for national banks, insured state banks can engage in the same real estate leasing activities subject to any limitations imposed by the applicable state law. However, since section 24 of the FDI Act does not permit the FDIC to allow insured state banks, at the bank level, to hold equity investments that are not permissible for national banks, any FDIC authorization for real estate leasing raises a question whether, under a particular leasing arrangement, the bank as lessor holds an interest in real estate tantamount to an equity investment. Given the variety of potential lease structures, it is not practicable for the FDIC to deal with this issue categorically, under a regulatory exception, at this time. If authorized under state law, state banks are permitted to engage in leasing activities through majority-owned subsidiaries. This exception is discussed in the description of § 362.4(b) in this preamble.

Guarantee activities. The current regulation contains a provision that permits a state bank with a foreign branch to directly guarantee the obligations of its customers as set out in what was formerly § 347.3(c)(1) of the FDIC's regulations without filing any application under part 362. A technical amendment to part 362 was recently made to update this reference to § 347.103(a)(1) as published in the **Federal Register** on April 8, 1998 (63 FR 17090). The current regulation also permits a state bank to offer customer-sponsored credit card programs in which the bank guarantees the obligations of its retail banking deposit customers. This provision has been deleted as unnecessary since these activities are permissible for a national bank. In its current rule, the FDIC used this provision to clarify that part 362 does not prohibit these activities. To shorten the regulation, such clarifying language has been deleted since the activity is permissible for a national bank. The FDIC received no comments addressing this provision and it is dropped as proposed.

Section 362.4 Subsidiaries of Insured State Banks

General prohibition. The regulatory language implementing the statutory prohibition on an insured state bank engaging in ''as principal'' activities that are not permissible for a national bank is separated from the prohibition on an insured state bank subsidiary engaging in activities which are not permissible for a subsidiary of a national bank. For ease of reference we separated bank and subsidiary activities. Section 362.4 deals exclusively with activities that may be conducted in a subsidiary of an insured state bank. Five commenters supported this restructuring of the regulation. The FDIC believes that separating the activities that may be conducted at the bank level from the activities that must be or may be conducted by a subsidiary makes it easier for the reader to focus on the analysis of the regulation. Therefore, the general prohibition in the final regulation is adopted as proposed.

Exceptions. First, the regulation provides that activities not permissible for a national bank subsidiary may not be conducted by the subsidiary of an insured state bank unless one of the exceptions in the regulation applies. This language is similar to the current part 362 and we received no comments on the provision. The final regulation contains no changes to the proposed language.

Consent obtained through application. The revised regulation allows approval by individual application provided that the insured state bank meets and continues to meet the applicable capital standards and the FDIC finds there is no significant risk to the fund. Language from the current regulation is deleted that expressly provides that approval is necessary for each subsidiary even if the bank received approval to engage in the same activity through another subsidiary. Deleting this language does not automatically permit a state bank to establish a second subsidiary to conduct the same activity that was approved for another subsidiary of the same bank; however, the issue will be handled on a case-by-case basis by the FDIC pursuant to order. For example, if the FDIC approves an application by a state bank to establish a majority-owned subsidiary to engage in real estate investment activities, the order may (in the FDIC's discretion) be written to allow more than one subsidiary to conduct the activity or to require that any additional real estate subsidiaries must be individually approved.

Application procedures may be used by a bank to request the FDIC's consent to engage in an activity that is limited but not specifically prohibited by this part. For instance, the notice procedures require that the subsidiary take the corporate organizational form. Several comments expressed concern about the restriction on the form of business enterprise. Any subsidiary that is organized as a limited liability company would be required to use the application procedures. The FDIC does not intend to prohibit insured state banks from organizing subsidiaries in a form other than a corporation, or to make it more difficult to establish these other forms of business enterprise. However, the FDIC would like to review other forms of organizations, on a case-by-case basis, to satisfy itself that adequate separations are placed between the bank and its subsidiary. At this time, we have not found a way to craft standardized separation criteria for these other forms of business enterprise. No commenters suggested any criteria. Other requests that do not meet the notice criteria or that desire relief from a limit or restriction included in the notice criteria also are encouraged. Application instructions have been moved to subpart G of part 303.

Consistent with the proposal, the final rule eliminates language that prohibited an insured state bank from engaging in insurance underwriting through a subsidiary except to the extent that such activities are permissible for a national bank. Eliminating this language does not result in any substantive change as section 24 of the FDI Act clearly provides that the FDIC may not approve an application for a state bank to directly or indirectly conduct insurance underwriting activities that are not permissible for a national bank. The FDIC received no comment on this change. Therefore, the language is unnecessary and has been eliminated as proposed.

The current part 362 allows state banks that do not meet their minimum capital requirements to gradually phase out otherwise impermissible activities that were being conducted as of December 19, 1992. These provisions are eliminated due to the passage of time. The relevant outside dates to complete the phase out of those activities have passed (December 19, 1996, for real estate activities and December 8, 1994, for all other activities).

Grandfathered Insurance Underwriting. The regulation provides for three statutory exceptions that allow subsidiaries to engage in insurance underwriting, covering ''grandfathered'' insurance activities, title insurance, and crop insurance.

Subsidiaries may engage in the same grandfathered insurance underwriting as the bank if the bank or subsidiary was lawfully providing insurance as principal on November 21, 1991. The limitations under which this subsidiary may operate have been changed.

The current standard that the bank must be well-capitalized has been changed. Consistent with the proposal, the final rule requires the bank to be well-capitalized after deducting its investment in the insurance subsidiary. One comment on this change argues that the risk involved in insurance underwriting depends upon the type of insurance and that not all insurance underwriting is inherently risky enough to justify an automatic capital deduction. The FDIC believes that this capital treatment is an important element to separate the operations of the bank and the subsidiary. This treatment clearly delineates and identifies the capital that is available to support the bank and the capital that is available to support the subsidiary. Capital standards for insurance companies are based on different criteria from bank capital requirements. Most states have minimum capital requirements for insurance companies. The FDIC believes that a bank's investment in an insurance underwriting subsidiary is not actually ''available'' to the bank in the event the bank experiences losses and needs additional capital. As a result, the bank's investment in the insurance subsidiary should not be considered when determining whether the bank has sufficient capital.

Another commenter objects to the introduction of the ''capital deduction'' arguing that providing insurance as principal under the ''grandfather'' provision is not an activity for which a state bank must obtain a risk to the fund determination. The comment asserts that the provision is self-operative in the absence of any determination or regulations of the FDIC, since Congress evaluated the risk to the insurance funds created by the activity and found that risk to be acceptable. The FDIC agrees that, other than the requirement that the bank must be well-capitalized, section 24 itself imposes no additional conditions or restrictions on the activity. Nevertheless, ever since the FDIC originally promulgated its part 362 rules regarding the conduct of this activity, the FDIC has noted that the activity can involve material risks, and it is therefore prudent to separate those risks from the insured state bank. *See* 58 FR 64482 (Dec. 8, 1993). The FDIC has always imposed conditions on this activity, over and above those addressed in section 24 itself, to protect bank safety and soundness and protect the deposit insurance funds. *See* 58 FR 6465 (January 29, 1993). As noted at the time, the FDIC is not precluded from imposing such restrictions, as section 24(i) itself clearly indicates.

Commenters disagreed on the need for an aggregate investment limit for equity investments in grandfathered insurance activities. One comment argues that it is important to limit the maximum exposure to the depository institution. Another comment states that such a limit is not suggested by the statute, and the FDIC should retain the flexibility to act on a case-by-case basis. After further consideration of this issue, the FDIC is not convinced that the risks from the different types of insurance subject to grandfather provisions are similar. Therefore, an aggregate limit would not necessarily enhance the safety and soundness of the banks involved in this activity. After considering the comments received and for the reasons stated above, the language in the final regulation is unchanged from the proposal.

The revisions to the regulation require a subsidiary engaging in grandfathered insurance underwriting to meet the standards for an ''eligible subsidiary'' discussed below. This standard replaces the ''bona fide'' subsidiary standard in the current regulation. The ''eligible subsidiary'' standard generally contains the same requirements for corporate separateness as the ''bona fide'' subsidiary definition but adds the following provisions: (1) The subsidiary has only one business purpose; (2) the subsidiary has a current written business plan that is appropriate to its type and scope of business; (3) the subsidiary has adequate management for the type of activity contemplated, including appropriate licenses and memberships, and complies with industry standards; and (4) the subsidiary establishes policies and procedures to ensure adequate computer, audit and accounting systems, internal risk management controls, and the subsidiary has the necessary operational and managerial infrastructure to implement the business plan. No comment was received relating to the effect of these additional requirements on banks engaged in insurance underwriting. We believe that the standards for adequate separation between an insured state bank and any subsidiary engaged in insurance underwriting should be similar to those that separate other subsidiaries that engage in activities not permitted to the bank. Therefore, no changes have been made to the proposed separation standards.

In lieu of the prescribed disclosures contained in the current regulation and in a departure from the proposal, the revision does not prescribe disclosures. Instead, the FDIC is relying on the terms of the Interagency Statement as applicable guidance when the subsidiary's products are sold on bank premises, are sold by bank employees, or are sold when the bank receives remuneration for a referral. The FDIC has made the change primarily because it recognizes that there is a reduced likelihood of customer confusion when sales of insurance products by a subsidiary of an insured state bank are not made on bank premises, are not made by bank employees, and are not a result of a referral from the bank.

However, there is an increased risk of customer confusion where the insured state bank and the subsidiary selling the product have similar names. Those cases are addressed in part by a separation standard which is discussed below. The separation standard requires that the subsidiary conduct its business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the state-chartered depository institution and that the state-chartered depository institution is not responsible for and does not guarantee the obligations of the subsidiary. The institution and its subsidiary should take any steps necessary to avoid customer confusion on behalf of non-bank customers, or bank customers in transactions not covered by the Interagency Statement.

Under § 362.5(b)(2), banks with subsidiaries engaged in grandfathered insurance underwriting activities are expected to meet the new requirements, and have 90 days from the effective date to achieve compliance or apply to the FDIC for approval to operate otherwise. The FDIC will consider any such applications on a case-by-case basis.

The regulation provides that a subsidiary may continue to underwrite title insurance based on the specific statutory authority from section 24. This provision is currently in part 362 and is carried forward with no substantive change. The insured state bank is permitted only to retain the investment if the insured state bank was required, before June 1, 1991, to provide title insurance as a condition of the bank's initial chartering under state law. The authority to retain the investment terminates if a change in control of the grandfathered bank or its holding company occurs after June 1, 1991. There are no statutory or regulatory investment limits on banks holding these types of grandfathered investments.

The exception for subsidiaries engaged in underwriting crop insurance is continued. Under section 24, insured state banks and their subsidiaries are permitted to continue underwriting crop insurance under two conditions: (1) They were engaged in the business on or before September 30, 1991; and (2) the crop insurance was reinsured in whole or in part by the Federal Crop Insurance Corporation. While this grandfathered insurance underwriting authority requires that the bank or its subsidiary had to be engaged in the activity as of a certain date, the authority does not terminate upon a change in control of the bank or its parent holding company.

Majority-owned subsidiaries ownership of equity investments that represent a control interest in a company. In proposed § 362.4(b)(3), the FDIC would have allowed majority-owned subsidiaries of insured state banks to hold controlling interests in lower-level subsidiaries engaged in certain activities which the FDIC authorized to be conducted at the bank level in proposed § 362.3(b)(2). These activities were holding adjustable rate and money market preferred stock; and engaging in activities found by the FRB to be closely related to the business of banking under section 4(c)(8) of the Bank Holding Company Act (subject to certain restrictions). Proposed § 362.4(b)(3) differed from current § 362.4(c)(3)(iv)(C), which effectively authorizes the majority-owned subsidiary to own stock of a corporation engaged in 4(c)(8) activities by authorizing the ownership of stock of a corporation that engages in activities permissible for a bank service corporation but imposes no control requirement. Proposed § 362.4(b)(3) also contained no counterpart to current § 362.4(c)(3)(iv)(D), authorizing a majority-owned subsidiary to invest in 50 percent or less of the stock of a corporation engaging solely in activities which are not ''as principal'.

In the final version, at § 362.4(b)(3), the FDIC has broadened the proposed language, so that the overall effect of the section is to authorize insured state banks to have lower-level subsidiaries engaged in many of the same types of activities which the FDIC previously found do not pose a significant risk when conducted at the bank level or through a majority-owned subsidiary. The FDIC has received questions concerning the types of activities and the restrictions on these activities if conducted by lower-level subsidiaries. This addition to the final regulation is intended to clarify that generally, the same limitations are imposed on the lower-level subsidiary as are imposed on the majority-owned subsidiary conducting the same type of activity. As discussed below, the FDIC has retained the control requirement (subject to one modification), because the overall design of the section is to authorize lower-level subsidiaries to engage in approved activities. Of course, banks also may apply to the FDIC for permission to make additional investments in excess of or which differ from those where general consent is granted under the rule.

As is also discussed below, the activities covered by the final version of § 362.4(b)(3) still differs from current § 362.4(c)(3)(iv)(C) and current § 362.4(c)(3)(iv)(D), but changes made from the proposed language narrow the gap.

First, the FDIC has found that it is not a significant risk to the deposit insurance funds if a majority-owned subsidiary holds a controlling interest in a company engaged in real estate or securities activities authorized under the real estate investment activities and securities activities sections of this regulation at § 362.4(b)(5), discussed below. The bank must file notice with the FDIC, and may proceed if the FDIC does not object. The bank must meet the same core eligibility criteria in § 362.4(c)(1) that would apply if the bank were conducting the activity directly through a majority-owned subsidiary. The bank's investments in and transactions with the lower tier company are subject to the same limits under § 362.4(d) as would apply if the bank were conducting the activity directly through a majority-owned subsidiary. The majority-owned subsidiary must also comply with the investment and transaction limits, to ensure that the majority-owned subsidiary is not used as a conduit to the lower tier company in derogation of the § 362.4(d) limits on the lower tier company. The bank must also deduct its equity investment in the majority-owned subsidiary and the lower tier company from its capital in accordance with § 362.4(e), as would be the case if the bank were conducting the activity directly through a majority-owned subsidiary. If the lower tier company is engaged in securities activities of the type contemplated by § 362.4(b)(5)(ii), the bank and the lower tier company must observe the additional requirements set out in that section. Finally, either the majority-owned subsidiary must observe the core eligibility criteria in § 362.4(c)(2), or the lower tier company must observe them. However, absent an application to the FDIC, the latter option is available only if the lower tier company takes corporate form. The FDIC's rationale for each of these limits on the activities authorized by § 362.4(b)(5) is discussed in detail below.

Second, the FDIC also has found that it is not a significant risk to the deposit insurance funds if a majority-owned subsidiary holds a controlling interest in a company which engages in: (1) Any activity permissible for a national bank including such permissible activities that may require the company to register as a securities broker; (2) acting as an insurance agency; (3) acquiring or retaining adjustable rate and money market preferred stock or other instruments of a similar character to the same extent allowed for the bank itself under § 362.3(b)(2)(iii) and combined with the 15 percent limit therein; or (4) engaging in real estate leasing activities to the same extent permissible for the majority-owned subsidiary under § 362.4(b)(6), discussed below.

One comment, on the use of the control test for defining activities for lower level subsidiaries, indicated concern over the change from the current regulation. Specifically, concern was expressed relating to a group of insured depository institutions that collectively own through majority-owned subsidiaries a company engaged in securities brokerage and insurance underwriting. None of the banks involved own a control interest. The structure of the ownership was set up in reliance upon the exception in current § 362.4(c)(3)(iv)(D). The FDIC recognizes that many community banks rely on formation of a consortium of banks to provide permissible financial services for its customers that one bank could not efficiently provide. We believe it would be imprudent to penalize institutions that have invested in these activities through a majority-owned subsidiary. Therefore, the proposed regulatory language has been changed, creating an exception to the control requirement where the company in question is controlled by insured depository institutions.

The scope of the activities authorized under final § 362.4(b)(3) differ from current § 362.4(c)(3)(iv)(C) and current § 362.4(c)(3)(iv)(D). The FDIC eliminated proposed § 362.3(b)(2)(iv), which would have authorized 4(c)(8) activities at the bank level. In a parallel fashion, we eliminated current § 362.4(c)(3)(iv)(C), which effectively authorizes the majority-owned subsidiary to own stock of a corporation engaged in 4(c)(8) activities. As is discussed above in connection with that change, the activities included on the 4(c)(8) list are generally of a type permissible for national banks, and the authorization in § 362.4(b)(3)(ii)(A) of the final rule authorizes the lower-level subsidiary to engage in activities permissible for national banks. As is also discussed above, the 4(c)(8) list's inclusion of real estate leasing is the one significant exception that was not otherwise dealt with in this regulation. To address the elimination of real estate leasing under the 4(c)(8) list, the FDIC has created § 362.4(b)(6) to govern real estate leasing by a majority-owned subsidiary. Such activity also is authorized for a lower-level subsidiary under § 362.4(b)(3)(ii)(D) of the final rule.

With regard to current § 362.4(c)(3)(iv)(D), authorizing a majority-owned subsidiary to invest in 50 percent or less of the stock of a corporation engaging solely in activities which are not ''as principal'', the final version of § 362.4(b)(3) has the effect of authorizing non-principal activities which are financially-related. Section 362.4(b)(3)(ii)(B) of the final rule authorizes insurance agency activities by the lower-level subsidiary; and 362.4(b)(3)(ii)(A), authorizing the lower-level subsidiary to engage in activities permissible for national banks, encompasses certain non-principal activities, such as securities brokerage and investment advisory services.

We have previously required applications to hold savings association stock, although a savings association could be owned, controlled or operated if the savings association engages only in deposit-taking and other activities that are permissible for a bank holding company.[4]

If a bank was relying on a previous regulatory exception that has now been eliminated, § 362.5(b)(3) of the final rule provides the activity may continue as previously conducted for 90 days after the effective date of this regulation. If the activity of the lower-level subsidiary is not authorized by the new rule, or the control standard is not met in that time frame, the insured state bank must apply to the FDIC for permission to continue the activity.

Equity securities held by a majority-owned subsidiary. The FDIC sought comment on whether the final regulation should contain an exception that would allow an insured state bank to hold equity securities at the subsidiary level. In light of comments received on this issue, Staff is further analyzing the proposal. Thus, the final rule does not contain the provision that would have permitted a majority-owned subsidiary of a state bank and savings association to engage in equity securities investment activities. At this time, we are proceeding with the remainder of the final regulation so as to avoid further delay in the streamlining benefits that state banks and savings associations will enjoy from the revisions. As a part of this regulation, we are inserting provisions from the current regulation that allow: (1) An insured state bank through a majority-owned subsidiary to invest in up to ten percent of the stock of another insured bank; and (2) an insured state bank that has received approval to invest in equity securities pursuant to the statutory grandfather to conduct these activities through a majority-owned subsidiary without any additional approval from the FDIC. The provisions have been continued to allow previously approved activities to continue while staff is analyzing equity securities investment activities further.

The FDIC proposed to eliminate the notice for these activities, the specific reference to grandfathered activity, and to allow similar activity for all insured state banks. However, the exception provided that the bank's investment in the majority-owned subsidiary be deducted from capital and that the activity be subject to certain eligibility requirements and transaction limitations. Comment was frequent and strong that this proposal was unacceptable to the banks that held stocks under the current regulation.

Numerous commenters argued that the statutory grandfather for banks holding common and preferred stock investments and registered shares extends to the bank and its subsidiaries. Section 24(f) is the governing statute in this matter. The exception contained in this provision extends only to the insured state bank. The statute makes no mention of the bank's subsidiary. Section 24(c) of the FDI Act does allow the bank to hold common or preferred stock or shares of registered investment companies through a majority-owned subsidiary. Activities conducted in a majority-owned subsidiary are subject to the bank's compliance with applicable capital standards and the FDIC's finding under section 24(d) that the activity poses no significant risk to the funds.

Most of the comments received came from interested parties in the Commonwealth of Massachusetts and referred to a type of subsidiary authorized in Massachusetts to hold all types of securities, whether permissible or impermissible for a national bank. These subsidiaries were established to take advantage of specialized tax treatment under Massachusetts law. The FDIC understands the tax-favored treatment of these subsidiaries; however, that tax treatment is a matter of state tax law and is not a factor in the FDIC's risk to the fund determination under this statute. However, the FDIC is not unsympathetic to the plight of insured state banks that have acted lawfully in structuring their business to achieve tax-favored treatment. The FDIC is unwilling to upset such good faith arrangements without considering other alternatives.

Reflecting a sentiment that is contained in many comment letters, one commenter stated, ''as a practical matter, we are unaware of any circumstance where banks have been harmed by conducting these activities through a subsidiary, and thus we believe that conducting the grandfathered activities in that manner poses no risk to the deposit insurance funds''. The FDIC recognizes that for the past 15 years there has been an unprecedented rise in the value of common and preferred stock and registered shares, and these markets have experienced no sustained, appreciable downturn in value in over 10 years. The FDIC does not base its risk to the fund determination on the recent history of markets for listed common and preferred stock and registered shares. The FDIC's policy regarding holding individual stocks is to not take exception to holding corporate equities which are well regarded by knowledgeable investors, marketable and held in moderate proportions. In reviewing equities held on an aggregate basis, the bank's portfolio of common and preferred stock and registered shares is reviewed in context of its overall investment portfolio. The holding of common and preferred stock and registered shares must be in the context of the bank's overall goals of investment quality, maturity pattern, diversification of risks, marketability of the portfolio, and income production. The bank's overall investment strategies are then judged in relationship to the: (1) General character of the institution's business; (2) analysis of funding sources; (3) available capital funds; and (4) economic and monetary factors.

The FDIC proposed that the bank's investment in a subsidiary investing in equity securities be deducted from the bank's capital before determining the adequacy of the bank's capital. This treatment would separate the capital that is available to support the bank from the capital that is available to support the activities of the subsidiary. In that scenario, because the risks of holding equity securities is borne by the capital of the subsidiary, the portfolio of equity securities and registered shares does not have to be analyzed in context of the bank's overall investment strategies. If the capital separations are not present, then the risks of holding equity securities through a fully consolidated subsidiary must be considered in context of the bank's overall investment strategies. In addition, if a bank chooses to hold investments that are permissible for a national bank in a subsidiary that also may hold investments that are not permissible for a national bank, the FDIC will treat the entire subsidiary as engaged in an activity that is not permissible for a national bank.

Many comments say that the FDIC's proposal for deducting a bank's investment in its securities subsidiary from the bank's capital before determining capital adequacy is inconsistent with the capital treatment for recognition of 45% of net unrealized gains in the equities portfolio under the FDIC's capital regulations (12 CFR part 325).[5] The argument that has been made by these comments is persuasive to the FDIC. The two approaches to treatment of gains on securities do seem inconsistent, and the capital regulation is consistent with the other federal financial institution regulators' approach to capital treatment of common and preferred stock and shares of registered investment companies.

[4] 12 U.S.C. 1843(c) and 12 CFR 225.28(b)(4)(ii).

[5] 63 FR 46518 (Sept. 1, 1998).

State law in Massachusetts permits a state bank to establish a subsidiary to hold the equity security and investment company share of investments that the bank is permitted to make under state law. Those investments if made directly by the bank are eligible for the ''grandfather'' provided for by section 24(f) of the FDI Act and § 362.3(a)(2)(iii). According to the comments, such subsidiaries should be given the same treatment accorded to the bank, i.e., if the bank is permitted by the FDIC to exercise its direct investment authority, the bank should be permitted to invest in those securities and investment company shares through a subsidiary under the same terms as exist under the current rule without a capital deduction.

After considering the comments, the FDIC has decided to retain the current provision allowing grandfathered banks to hold their investments in common or preferred stock and shares of investment companies through a majority-owned subsidiary until the staff analysis of equity securities investments is completed. Section 362.4(b)(4)(i) of the final regulation provides that any insured state bank that has received approval to invest in common or preferred stock or shares of an investment company pursuant to § 362.3(a)(2)(iii) may conduct the approved investment activities through a majority-owned subsidiary provided that any conditions or restrictions imposed with regard to the approval granted under § 362.3(a)(2)(iii) are met. Section 362.3(a)(2)(iii) provides that no insured state bank may take advantage of the ''grandfather'' provided for investments in common or preferred stock listed on a national securities exchange and shares of an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1, *et seq.*) unless the bank files a notice with the FDIC of the bank's intent to make such investments and the FDIC determines that such investments will not pose a significant risk to the deposit insurance funds. In no event may the bank's investments in such securities and/or investment company shares exceed 100% of the bank's tier one capital. The FDIC may condition its finding of no risk upon whatever conditions or restrictions it finds appropriate. The ''grandfather'' will be lost if certain events occur (see § 362.3(a)(2)(iii)).

The maximum permissible investment by the consolidated bank and majority-owned subsidiary engaged in this activity is 100 percent of the bank's consolidated tier one capital. If the bank also holds listed common or preferred stock or shares of registered investment companies at the bank level pursuant to the grandfather, such securities will count toward the limit. For a particular bank, the FDIC may impose a limit on a case-by-case basis at its discretion of less than the maximum permissible investment of 100 percent of tier 1 capital. The FDIC may require divestiture of some or all of the investments if it is determined that retention of the investments will have an adverse effect on the safety and soundness of the consolidated bank. The limitation of up to 100 percent of tier one capital, the requirement for bank policies, and the reservation of the authority to require divestiture are taken directly from the current regulation of these activities when conducted at the bank level.

Bank stock. Section § 362.4(b)(4)(ii) of the final regulation restores the exception which allows an insured state bank to invest in up to ten percent of the outstanding stock of another insured bank without the FDIC's prior consent provided that the investment is made through a majority-owned subsidiary which was organized for the purpose of holding such shares. This exception is restored to the regulation to provide relief for those state banks which are permitted under state law to invest in the stock of other banks and have done so in reliance on the current regulation. Insured state banks should note, however, that the holding of such shares must of course be permissible under other relevant state and federal law.

The FDIC has become aware that some insured state banks own a sufficient interest in the stock of other insured state banks to cause the bank which is so owned to be considered a majority-owned subsidiary under part 362. It is the FDIC's posture that such an owner bank does not need to file a request under part 362 seeking approval for its majority-owned subsidiary that is an insured state bank to conduct as principal activities that are not permissible for a national bank. As the majority-owned subsidiary is itself an insured state bank, that bank is required under part 362 and section 24 of the FDI Act to request consent on its own behalf for permission to engage in any as principal activity that is not permissible for a national bank.

Again, we are reinstating the provision in the current rule that permits a majority-owned subsidiary of a state bank to invest in up to ten percent of the outstanding stock of another insured bank. No other restrictions on this investment are imposed until the staff analysis of equity securities investment activities is complete.

Majority-owned subsidiaries conducting real estate investment activities and securities underwriting. The FDIC has determined that real estate investment and securities underwriting activities do not represent a significant risk to the deposit insurance funds, provided that the activities are conducted by a majority-owned subsidiary in compliance with the requirements set forth. These activities require the insured state bank to file a notice. Then, as long as the FDIC does not object to the notice, the bank may conduct the activity in compliance with the requirements. The FDIC is not precluded from taking any appropriate action or imposing additional requirements with respect to the activities when the facts and circumstances warrant such action.

Engage in real estate investment activities. Section 24 of the FDI Act and the current version of part 362 generally prohibit an insured state bank from engaging in real estate investment activities not permissible for a national bank, absent FDIC approval. Section 24 does not grant FDIC authority to permit an insured state bank to directly engage in real estate investment activities not permissible for a national bank. The circumstances under which national banks may hold equity investments in real estate are limited. If a particular real estate investment is permissible for a national bank, an insured state bank only needs to document that determination. If a particular real estate investment is not permissible for a national bank and an insured state bank wants to engage in real estate investment activities (or continue to hold the real estate investment in the case of investments acquired before enactment of section 24 of the FDI Act), the insured state bank must file an application with FDIC for consent. The FDIC may approve such applications if the investment is made through a majority-owned subsidiary, the institution meets the stated capital requirements and the FDIC determines that the activity does not pose a significant risk to the affected deposit insurance fund.

The FDIC evaluates a number of factors when acting on requests for consent to engage in real estate investment activities. In evaluating a request to conduct equity real estate investment activity, the FDIC considers the type of proposed real estate investment activity to determine if the activity is suitable for the insured depository institution. Where appropriate, the FDIC fashions conditions designed to address potential risks that have been identified in the context of a given request. The FDIC also reviews the proposed subsidiary structure and its management policies and practices to determine if the insured state bank is adequately protected and analyzes capital adequacy to ensure that the insured institution has sufficient capital to support its banking activities.

In all of the applications that have been approved to conduct a real estate investment activity to date, the FDIC has imposed a number of conditions in granting the approval. In short, the FDIC has determined on a case-by-case basis that the conduct of certain real estate investment activities by a majority-owned corporate subsidiary of an insured state bank will not present a significant risk to the deposit insurance fund provided certain conditions are observed. In drafting these notice provisions, the FDIC has evaluated the conditions usually imposed when granting approval to insured state banks to conduct real estate activities and incorporated these conditions within the revised regulation where appropriate.

The revised rule allows majority-owned subsidiaries to invest in and/or retain equity interests in real estate not permissible for a national bank under an expedited notice process, provided certain criteria are met. Institutions not meeting the criteria must make application to the FDIC and obtain the FDIC's approval on a case-specific basis. To use the notice process, the insured state bank must qualify as an ''eligible depository institution'', as that term is defined within the revised regulation, and the majority-owned subsidiary must qualify as an ''eligible subsidiary'', which is also defined within the revised rule. These criteria are discussed below. The insured state bank must also abide by the investment and transaction limitations set forth in the revised regulation.

Under the revisions, the insured state bank may not invest more than 20 percent of the bank's tier one capital in all of its majority-owned subsidiaries which are conducting activities subject to the investment limits. This language reflects two changes from the proposal. First, the 10 percent per subsidiary limit has been eliminated. Second, the revisions provide that the 20 percent aggregate investment limit applies to all subsidiaries engaged in activities that are being separated from the insured depository institution. Under the regulation, the activities subject to the investment limit are real estate investment activities and securities underwriting. These investment limits may cover any other activities that the FDIC deems appropriate by regulation or any FDIC order. For the purpose of calculating the dollar amount of the investment limitations, the bank would calculate 20 percent of its tier one capital after deducting all amounts required by the regulation or any FDIC order.

Comments received were generally supportive of the overall investment limit but were critical of a provision in the proposed regulation that the bank could invest no more than 10 percent of its tier one capital in any one subsidiary engaged in real estate activities. The comments questioned the rationale for requiring more than one subsidiary if a bank is investing up to its aggregate limit in real estate investment activities. The FDIC in its proposal attempted to have the restrictions on transactions between an insured state bank and its subsidiaries reflect as closely as possible the same restrictions that are imposed on a bank/affiliate relationship. The 10 percent limitation per subsidiary in the proposal reflected the desire of the FDIC that a bank engaging in real estate investment activities diversify its risks. Upon reflection, the FDIC believes an arbitrary limit on the amount that can be invested in any one subsidiary does not necessarily accomplish the desired diversification. In reviewing notices of intent to engage in this activity, the FDIC will look at the bank's diversification of risks when making a determination of whether to consent to the planned activity. Therefore, the final rule drops the proposed 10 percent limit on investment in each subsidiary. The 20 percent limitation on the investment in real estate investment activities provides an important safeguard against excessive investment in these activities, and is retained in the final regulation. However, that limit now includes all subsidiaries engaged in activities that are being separated from the insured depository institution. This change occurred when the FDIC reassessed the limit and decided to make it more closely parallel the 23A standard governing affiliates. Thus, the 20 percent limit will apply to all activities that are separated from the insured depository institution. Under the final regulation, the activities subject to the investment limit are real estate investment activities and securities underwriting. Of course this limit may be modified by application.

The FDIC recognizes that some real estate investments or activities are more time, management and capital intensive than others. Our experience in reviewing the requests submitted under section 24 has led us to conclude that small equity investments in real estate—held under certain conditions—do not pose a significant risk to the deposit insurance fund. As a result, the final rule provides relief to insured state banks having small investments in a majority-owned subsidiary engaging in real estate investment activities. The FDIC is attempting to strike a reasonable balance between prudential safeguards and regulatory burden in its revisions. As a result, the final rule establishes certain exceptions from the requirements necessary to establish an eligible subsidiary whenever the insured state bank's investment is of a de minimis nature and meets certain other criteria. Under the final rule, whenever the bank's investment in its majority-owned subsidiary conducting real estate activities does not exceed 2 percent of the bank's tier one capital and the bank's investment in the subsidiary does not include extensions of credit from the bank to the subsidiary, a debt instrument purchased from the subsidiary or any other transaction originated from the bank to the benefit of the subsidiary, the subsidiary is relieved of certain of the requirements that must be met to establish an eligible subsidiary under the regulation. For example, the subsidiary need not be physically separate from the insured state bank; the chief executive officer of the subsidiary is not required to be an employee separate from the bank; a majority of the board of directors of the subsidiary need not be separate from the directors or officers of the bank; and the subsidiary need not establish separate policies and procedures as described in the regulation in § 362.4(c)(2)(xi). Commenters did not object to the elimination of these eligible subsidiary standards in these circumstances. Several commenters expressed concern that the de minimis investment level is too low. The comments suggested that 2 percent of tier one capital is an arbitrary limit and should be raised to 5 percent. Another commenter supported the limit stating that it is an appropriate safe harbor limit. The FDIC recognizes that arguments can be made for varying limits in this regard. We have chosen a conservative limit. With further experience that provides evidence that this limit can be safely increased, we can reconsider the appropriate level to be considered de minimis activity in the future.

One commenter suggested that both investment limits should be measured against tier one and tier two capital rather than using only tier one capital. The FDIC believes that certain elements of tier two capital such as the allowance for loan and lease losses do not provide protection against activities such as real estate investment. Therefore, the FDIC has decided to retain tier one capital as the appropriate capital against which to measure risk in these activities.

Another commenter suggested that extensions of credit should be permitted subject to an aggregate limit. This same comment added that the restriction to a single subsidiary could be eliminated. In creating the de minimis exception, the FDIC wanted this exception to be used primarily for the passive holding of real estate. Multiple subsidiaries and bank lending to fund the investments is indicative of a more active investment.

If the institution or its investment does not meet the criteria established under the revised regulation for using the notice procedure, an application may be filed with the FDIC. A description of the requisite contents of notices and applications, and the FDIC's processing thereof, is contained in subpart G of part 303. The FDIC encourages institutions to file an application if the institution wishes to request relief from any of the requirements necessary to be considered an eligible depository institution or an eligible subsidiary. The FDIC recognizes that not all real estate investment should require a subsidiary to be established exactly as outlined under the eligible subsidiary definition. However, the FDIC is unwilling to eliminate those criteria under the expedited notice process.

Engage in the public sale, distribution or underwriting of securities that are not permissible for a national bank under section 16 of the Banking Act of 1933. The current regulation provides that an insured state nonmember bank may establish a majority-owned subsidiary that engages in the underwriting and distribution of securities without filing an application with the FDIC if the requirements and restrictions of § 337.4 of the FDIC's regulations are met. Section 337.4 governs the manner in which subsidiaries of insured state nonmember banks must operate if the subsidiaries engage in securities activities that would not be permissible for the bank itself under section 16 of the Banking Act of 1933, commonly known as the Glass-Steagall Act. In short, the regulation lists securities underwriting and distribution as an activity that will not pose a significant risk to the deposit insurance funds if conducted through a majority-owned subsidiary that operates in accordance with § 337.4. The proposed revisions made significant changes to that exception. Most of the proposal has been adopted without significant change in the final rule.

Due to the existing cross reference to § 337.4, the FDIC reviewed § 337.4 as a part of its review of part 362 for CDRI. The purpose of the review was to streamline and clarify the regulation, update the regulation as necessary given any changes in the law, regulatory practice, and the marketplace since its adoption, and remove any redundant or unnecessary provisions. As a result of that review, the FDIC is making a number of substantive changes to the rules which govern securities sales, distribution, or underwriting by subsidiaries of insured state nonmember banks. Although the FDIC has chosen to place the exception in the part of the regulation governing activities by insured state banks, by law, only subsidiaries of state nonmember banks may engage in securities underwriting activities that are not permissible for national banks. As we have previously stated, subpart A of this regulation does not grant authority to conduct activities or make investments. Subpart A only gives relief from the prohibitions of section 24 of the FDI Act. Insured state banks must be in compliance with applicable state law when engaging in any activity.

Since the FDIC issued its proposal to amend part 362, the OCC has given its consent to an operating subsidiary of a national bank to conduct municipal revenue bond underwriting. This activity currently is not permissible for the national bank even though the activity has been approved for a subsidiary of a national bank. Concurrent with these revisions, the FDIC is issuing a proposal to address activities that are permissible for a subsidiary of a national bank that are not permissible for the national bank itself. Until that regulation is finalized, § 337.4 will remain operative to govern only activities that are not covered by the final rule in subpart A of part 362.

The FDIC is also issuing a technical amendment to § 337.4, at § 337.4(i), in connection with this rulemaking to make this clear. It provides that any state nonmember bank subsidiary or affiliate conducting securities activities governed by § 362.4(b)(5)(ii) or § 362.8(b) must comply with such rules, and such compliance satisfies their obligations under § 337.4.

Background of section 337.4. On August 23, 1982, the FDIC adopted a policy statement on the applicability of the Glass-Steagall Act to securities activities of insured state nonmember banks (47 FR 38984). That policy statement expressed the opinion of the FDIC that under the Glass-Steagall Act: (1) Insured state nonmember banks may be affiliated with companies that engage in securities activities; and (2) securities activities of subsidiaries of insured state nonmember banks are not subject to section 21 of the Glass-Steagall Act (12 U.S.C. 378) which prohibits deposit taking institutions from engaging in the business of issuing, underwriting, selling, or distributing stocks, bonds, debentures, notes, or other securities.

The policy statement applies solely to insured state nonmember banks. As noted in the policy statement, the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*) places certain restrictions on non-banking activities. Insured state nonmember banks that are members of a bank holding company system need to take into consideration sections 4(a) and 4(c)(8) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843 (a) and (c)) and applicable FRB regulations before entering into securities activities through subsidiaries.

The policy statement also expressed the opinion of the Board of Directors of the FDIC that there may be a need to restrict or prohibit certain securities activities of subsidiaries of state nonmember banks. As the policy statement noted, ''the FDIC * * * recognizes its ongoing responsibility to ensure the safe and sound operation of insured state nonmember banks, and depending upon the facts, the potential risks inherent in a bank subsidiary's involvement in certain securities activities''.

In November 1984, after notice and comment proceedings, the FDIC adopted a final rule regulating the securities activities of affiliates and subsidiaries of insured state nonmember banks under the FDI Act. 49 FR 46709 (Nov. 28, 1984), regulations codified at 12 CFR 337.4 (1986).[6] Although the rule

[6] After the regulations were adopted, the representatives of mutual fund companies and investment bankers brought another action challenging the regulations allowing insured banks, which are not members of the Federal Reserve System, to have subsidiary or affiliate relationships with firms engaged in securities work. The United States District Court for the District of Columbia, Gerhard A. Gesell, J., 606 F. Supp. 683, upheld the regulations, and representatives appealed and also petitioned for review. The Court of Appeals held that: (1) representatives had standing to challenge regulations under both the Glass-Steagall Act and the FDI Act, but (2) regulations did not violate either Act. *Investment Company Institute* v. *Federal Deposit Insurance Corporation,* 815 F.2d 1540 (D.C. Cir. 1987).

A trade association representing Federal Deposit Insurance Corporation-insured savings banks also brought suit challenging FDIC regulations respecting proper relationship between FDIC-insured banks and their securities-dealing ''subsidiaries'' or ''affiliates.'' On cross motions for summary judgment, the District Court, Jackson, J., does not prohibit such securities activities outright, it does restrict these activities in a number of ways and only permits the activities if authorized under state law.

Section 337.4 is structured to ensure the separateness of the subsidiary and the bank. This separation is necessary as the bank would be prohibited by the Glass-Steagall Act from engaging in many activities the subsidiary might undertake and the separation safeguards the soundness of the parent bank.

Section 337.4 adopted a tiered approach to the activities of the subsidiary and limits the underwriting of securities that would otherwise be prohibited to the bank itself under the Glass-Steagall Act unless the subsidiary and bank meet the separation standards in the regulation and the activities are limited to underwriting of investment quality securities. Section 337.4 permitted a subsidiary to engage in additional underwriting if it meets the separation standards and the subsidiary is a member in good standing with the National Association of Securities Dealers and management has at least five years experience in the industry.

The subsidiaries engaged in activities not permissible for the bank itself also are required to be adequately capitalized, and therefore, these subsidiaries are required to meet the capital standards of the NASD and SEC. As a protection to the deposit insurance fund, a bank's investment in these subsidiaries is not counted toward the bank's capital.

An insured state nonmember bank that has a subsidiary or affiliate engaging in the sale, distribution, or underwriting of stocks, bonds, debentures or notes, or other securities, or acting as an investment advisor to any investment company is prohibited under § 337.4 through a series of restrictions from engaging in transactions which could create a conflict of interest or the appearance of a conflict of interest.

Under § 337.4, the FDIC created an atmosphere in which bank affiliation with entities engaged in securities activities is very controlled. The FDIC has examination authority over bank subsidiaries. Under section 10(b) of the FDI Act (12 U.S.C. 1820(b)), the FDIC has the authority to examine affiliates to determine the effect of that relationship on the insured institution. Nevertheless, the FDIC generally has allowed these entities to be functionally regulated, that is the FDIC usually examines the insured state nonmember bank and primarily relies on the SEC and the NASD oversight of the securities subsidiary or affiliate. The FDIC views its established separations for banks and securities firms as creating an environment in which the FDIC's responsibility to protect the deposit insurance funds has been met without creating too much overlapping regulation for the securities firms. The FDIC maintains an open dialogue with the NASD and the SEC concerning matters of mutual interest. To that end, the FDIC has entered into an agreement in principle with the NASD concerning examination of securities companies affiliated with insured institutions.

The number of banks which have subsidiaries engaging in securities activities that can not be conducted in the bank itself is very small. These subsidiaries engage in the underwriting of debt and equity securities and distribution and management of mutual funds.

The FRB permits a nonbank subsidiary of a bank holding company to underwrite and deal in securities through its orders under the Bank Holding Company Act and section 20 of the Glass-Steagall Act.[7] The FDIC has reviewed its securities underwriting activity regulations in light of the FRB's recently-adopted operating standards that modify the FRB's section 20 orders.[8] The FDIC also reviewed the comments received by the FRB. The FRB conducted a comprehensive review of the prudential limitations established in its section 20 decisions. The FRB sought comment on modifying these limitations to allow section 20 subsidiaries to operate more efficiently and serve their customers more effectively.[9] The FDIC found the analysis of the FRB instructive and has determined that its regulation already incorporates many of the same modifications that the FRB has made.

In the final rule, the FDIC is not adopting all of the standards of the FRB. For instance, the FDIC is not requiring a separate statement of operating standards. The final regulation applies certain standards to insured state banks engaging in securities underwriting activities through majority-owned through the ''eligible subsidiary'' requirements. Separate operating standards are unnecessary because each of these safeguards provides appropriate protections for bank subsidiaries engaged in underwriting activities.

However, the FDIC has retained the proposed requirement that the chief executive officer of the subsidiary may not be an employee of the bank and a majority of the subsidiary's board of directors must not be directors or officers of the bank. This standard is the same as the operating standard on interlocks adopted by the FRB to govern its section 20 orders.

One of the reasons for these safeguards involves the FDIC's continuing concerns that the bank should be protected from liability for the securities underwriting activities of the subsidiary. Under the securities laws, a parent company may have liability as a ''controlling person''.[10] The FDIC views management and board of director separation as enhanced protection from controlling person liability as well as protection from disclosures of material nonpublic information. Protection from disclosures of material nonpublic information also

held that: (1) trade association had standing, and (2) regulations were within authority of FDIC. *National Council of Savings Institutions* v. *Federal Deposit Insurance Corporation*, 664 F.Supp. 572 (D.C. 1987).

[7] The affiliate restrictions under § 337.4 were created prior to the time the FRB had approved securities activities under section 20 of the Glass-Steagall Act as an activity that is closely related to banking. Given the regulatory structure now in place for affiliates of banks engaged in securities activities, the FDIC's affiliate restrictions are no longer necessary except for those holding companies that are not subject to the restrictions of the Bank Holding Company Act. The restrictions on affiliation have been moved to subpart B of this regulation and are focused only on those companies that are not registered bank holding companies.

[8] 62 FR 45295, August 21, 1997.

[9] 61 FR 57679, November 7, 1996, and 62 FR 2622, January 17, 1997.

[10] Liability of ''controlling persons'' for securities law violations by the persons or entities they ''control'' is found in section 15 of the Securities Act of 1933, 15 U.S.C. 77o, and section 20 of the Securities and Exchange Act of 1934, 15 U.S.C. 78t(a). Although the tests of liability under these statutes vary slightly, the FDIC is concerned that under the most stringent of these authorities liability may be imposed on a parent entity. Under the Tenth Circuit's permissive test for controlling person liability, any appearance of an ability to exercise influence, whether directly or indirectly, and even if such influence cannot amount to control, is sufficient to cause a person to be a controlling person within the meaning of sections 15 or 20. Although liability may be avoided by proving no knowledge or good faith, proving no knowledge requires no knowledge of the general operations or actions of the primary violator and good faith requires both good faith and nonparticipation. *See First Interstate Bank of Denver, N.A.* versus *Pring*, 969 F.2d 891 (10th Cir. 1992), rev'd on other grounds, 511 U.S. 164 (1994); *Arena Land & Inv. Co. Inc.* versus *Petty*, 906 F.Supp. 1470 (D. Utah 1994); *San Francisco-Oklahoma Petroleum Exploration Corp.* versus *Carstan Oil Co., Inc.*, 765 F.2d 962 (10th Cir. 1985); *Seattle-First National Bank* versus *Carlstedt*, 678 F.Supp. 1543 (W.D. Okla. 1987). However, to the extent that any securities underwriting liability may have been reduced due to the enactment of The Private Securities Litigation Reform Act of 1995, Pub. L. 104–67, then the FDIC's concerns regarding controlling person liability may be reduced. It is likely that the FDIC will want to await the development of the standards under this new law before taking actions that could risk liability on a parent bank that has an underwriting subsidiary.

may be enhanced by the use of appropriate policies and procedures.[11]

Substantive changes to the subsidiary underwriting activities. Generally, the regulations governing the securities underwriting activity of state nonmember banks have been streamlined to make compliance easier. In addition, state nonmember banks that deem any particular constraint to be burdensome may file an application with the FDIC to have the constraint removed for that bank and its majority-owned subsidiary. The FDIC has eliminated those constraints that were deemed to overlap other requirements or that could be eliminated while maintaining safety and soundness standards. For example, the FDIC has eliminated the notice requirement for all state nonmember bank subsidiaries that engage in securities activities that are permissible for a national bank. Under the final regulation, a notice is required only of state nonmember banks with subsidiaries engaging in securities activities that would be impermissible for a national bank. The FDIC has determined that it can adequately monitor the other securities activities through its regular reporting and examination processes.

As indicated in the following discussion on core eligibility requirements, the final rule permits a state nonmember bank meeting certain criteria to conduct, as principal, securities activities through a subsidiary that are not permissible for a national bank after filing an expedited notice with the FDIC, rather than a full application. The insured state bank must be an ''eligible depository institution'' and the subsidiary must be an ''eligible subsidiary''. Briefly, an ''eligible depository institution'' must be chartered and operating for at least three years, have satisfactory composite and management ratings under the Uniform Financial Institution Rating System (UFIRS) as well as satisfactory compliance and CRA ratings, and not be subject to any formal or informal corrective or supervisory order or agreement. These requirements are uniform with other part 362 notice procedures for insured state banks to engage in activities not permissible for national banks. These requirements are not presently found in § 337.4 but the FDIC believes that only banks that are well-run and well-managed should be given the opportunity to engage in securities activities that are not permissible for a national bank under the streamlined notice procedures. These criteria are imposed as expedited processing criteria rather than substantive criteria. Other banks that want to enter these activities should be subject to the scrutiny of the application process. Although operations not permissible for a national bank are conducted and managed by a separate majority-owned subsidiary, such activities are part of the analysis of the consolidated financial institution. The condition of the institution and the ability of its management are an important component in determining if the risks of the securities activities will have a negative impact on the insured institution. The ''eligible subsidiary'' definition, discussed below, recognizes the level of risk present in securities underwriting activities. Commenters did not object to using these standards for institutions that wish to engage in these securities activities.

One of the other notable differences between the current and final regulations is the substitution of the ''eligible subsidiary'' criteria for that of the ''bona fide subsidiary'' definition contained in § 337.4(a)(2). The definitions are similar, but changes have been made to the existing capital and physical separation requirements. Also, new requirements have been added to ensure that the subsidiary's business is conducted according to independent policies and procedures. With regard to those subsidiaries which engage in the public sale, distribution or underwriting of securities that are not permissible for a national bank, additional conditions also must be met. The conditions are that: (1) The state-chartered depository institution must adopt policies and procedures, including appropriate limits on exposure, to govern the institution's participation in financing transactions underwritten or arranged by an underwriting majority-owned subsidiary; (2) the state-chartered depository institution may not express an opinion on the value or the advisability of the purchase or sale of securities underwritten or dealt in by a majority-owned subsidiary unless the state-chartered depository institution notifies the customer that the majority-owned subsidiary is underwriting, making a market, distributing or dealing in the security; (3) the majority-owned corporate subsidiary is registered and is a member in good standing with the appropriate self-regulatory organization (SRO), and promptly informs the appropriate regional director of the Division of Supervision (DOS) in writing of any material actions taken against the majority-owned subsidiary or any of its employees by the state, the appropriate SROs or the SEC; and (4) the state-chartered depository institution does not knowingly purchase as principal or fiduciary during the existence of any underwriting or selling syndicate any securities underwritten by the majority-owned subsidiary unless the purchase is approved by the state-chartered depository institution's board of directors before the securities are initially offered for sale to the public. These additional requirements are similar to but simplify the requirements currently contained in § 337.4. Commenters did not offer objection to these simplified standards and they have been adopted as proposed.

In addition, the FDIC has eliminated the five-year period limiting the securities activities of a state nonmember bank's underwriting subsidiary's business operations. Rather, with notice and compliance with the safeguards, a state nonmember bank's securities subsidiary may conduct any securities business set forth in its business plan after the notice period has expired without an objection by the FDIC. The reasons the FDIC initially chose the more conservative posture are rooted in the time they were adopted. When the FDIC approved establishment of the initial underwriting subsidiaries, it had no experience supervising investment banking operations in the United States. Because affiliation between banks and securities underwriters and dealers was long considered impractical or illegal, banks had not operated such entities since enactment of the Glass-Steagall Act in 1933. Moreover, pre-Glass-Steagall affiliations were considered to have caused losses to the banking industry and investors, although some modern

[11] *See* ''Anti-manipulation Rules Concerning Securities Offerings'', Regulation M, 17 CFR part 242 (1997) where the SEC grapples with limiting trading advantages that might otherwise accrue to affiliates by limiting trading in prohibited securities by affiliates. The SEC is attempting to prevent trading on material nonpublic information. To reduce the danger of such trading, the SEC has a broad ban on affiliated purchasers. To narrow that exception while continuing to limit access to the nonpublic information that might otherwise occur, the SEC has limited access to material nonpublic information through restraints on common officers. Alternatively, the SEC could prohibit trading by affiliates that shared any common officers or employees. In narrowing this exception to ''those officers or employees that direct, effect or recommend transactions in securities'', the SEC stated that it ''believes that this modification will resolve substantially commenters'' concerns that sharing one or more senior executives with a distribution participant, issuer, or selling security holder would preclude an affiliate from availing itself of the exclusion''. 62 FR 520 at 523, fn. 22 (January 3, 1997). As the SEC also stated, the requirement would not preclude the affiliates from sharing common executives charged with risk management, compliance or general oversight responsibilities.

research questions this view.[12] Thus, the affiliation of banks and investment banks presented unknown risks that were considered substantial in 1983. In addition, although the FDIC recognized that supervision and regulation of broker-dealers by the SEC provided significant protections, the FDIC had little experience with how these protections operated. The FDIC has now gained experience with supervising the securities activities of banks and is better able to assess which safeguards are appropriate to impose on these activities to protect the bank and the deposit insurance funds. For those reasons, the limitations and restrictions contained in § 337.4 on underwriting other than ''investment quality debt securities'' or ''investment quality equity securities'' have been eliminated from the regulation. It should be noted that certain safeguards have been added to the system since § 337.4 was adopted. These safeguards include risk-based capital standards and the Interagency Statement. The FDIC has removed the disclosures currently contained in § 337.4, which are similar to the disclosures required by the Interagency Statement. In lieu of the prescribed disclosures, the FDIC will rely on the Interagency Statement as applicable guidance when the subsidiary's products are sold on bank premises, by bank employees or when the bank receives remuneration for a referral. This change makes compliance easier. Comments support this change and recognize that any retail sale of nondeposit investment products to bank customers is subject to the Interagency Statement when the subsidiary's products are sold on bank premises, by bank employees, or as a result of a compensated referral.

The FDIC has changed its disclosure standards relating to subsidiaries engaged in insurance underwriting to those found in the Interagency Statement for reasons similar to those discussed above. In addition, securities firms are subject to a comprehensive Federal supervisory and regulatory system designed to inform investors of risks inherent in their transactions. However, as was also discussed above in connection with insurance subsidiaries, there is a risk of customer confusion where the insured state bank and the subsidiary selling the product have similar names. Those cases are addressed in this part by a separation standard which is discussed below. The separation standard requires that the subsidiary conduct its business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the state-chartered depository institution and that the state-chartered depository institution is not responsible for and does not guarantee the obligations of the subsidiary. The institution and its subsidiary should take any steps necessary to avoid customer confusion on behalf of non-bank customers, or bank customers in transactions not covered by the Interagency Statement.

Finally, the FDIC will continue to impose many of the safeguards found in section 23A of the Federal Reserve Act and to impose the types of safeguards found in section 23B of the Federal Reserve Act. Although section 23B did not exist until 1987 and only covers transactions where banks and their subsidiaries are on one side and other affiliates are on the other side, the FDIC had included some similar constraints in the original version of § 337.4. Now, most of the transaction restrictions found in section 23B are adopted by the FDIC in the final rule to promote consistency with the restrictions imposed by other banking agencies on similar activities. These restrictions require that bank/subsidiary transactions be on an arm's length basis and that the subsidiary disclose that the bank is not responsible for the subsidiary's obligations. The bank also is prohibited from purchasing certain products from the subsidiary. While imposing the arm's length restrictions, the FDIC is eliminating any overlapping safeguards. Comments received did not recommend reinstating any of the restrictions from the current § 337.4.

In contrast to the arm's length transaction restrictions, transaction limitations did exist and were incorporated into § 337.4 by reference to section 23A of the Federal Reserve Act. To simplify compliance for transactions between state nonmember banks and their subsidiaries, the FDIC has placed the transactions limits and arm's length requirements in the regulatory text language and only included the restrictions that are relevant to a particular activity. The FDIC hopes that this restatement will clarify the standards being imposed on state nonmember banks and their subsidiaries.

On June 11, 1998, the FRB requested comment on an interpretation of section 23A that would exempt certain transactions between an insured depository institution and its affiliates. These interpretations would be published in part 250 of the FRB's regulations. 63 FR 32766 (June 16, 1998). Specifically, the interpretation would expand the exemption of section 23A(d)(6), which permits a bank to purchase assets of an affiliate when the assets have a ''readily identifiable and publicly available market quotation''. The proposal would, with some caveats, bring within the exemption securities that have a ''ready market'', as defined by the SEC.

The second interpretation would create two exemptions to the provision of section 23A relating to transactions with third parties that benefit the bank (and are therefore treated as ''covered transactions''.) The context for this exemption is an extension of credit by a bank to a third party to purchase securities through the bank's registered broker-dealer affiliate. The first exemption would apply when the affiliate acts solely as broker or riskless principal in a securities transaction. The second exemption would apply when the extension of credit is made pursuant to a preexisting line of credit that was not established for the purpose of buying securities from or through an affiliate.

In light of the FRB's proposals, we have re-evaluated our proposed coverage of similar transactions and have determined that the language we have crafted to govern securities underwriting subsidiaries would already allow the transactions that the FRB proposes to exempt under these interpretations. We believe that these transactions do not raise safety and soundness issues if conducted under the arm's length standards that we proposed and adopt in our final rule. Thus, we will allow a bank to purchase assets (including securities) when those transactions are carried out on terms and conditions that are substantially similar to those prevailing at the time for comparable transactions with unaffiliated parties. In addition, we already allow an extension of credit to buy an asset from the subsidiary when those transactions are carried out on terms and conditions that are substantially similar to those prevailing at the time for comparable transactions with unaffiliated parties. We consider that language to be broad enough to include purchasing securities, including when the subsidiary acts solely as broker or riskless principal in a securities transaction. A preexisting line of credit that was not established for the purpose of buying securities from or through the subsidiary is also allowed, if it otherwise meets the terms of the FDIC's exception.

[12] *See, e.g.,* George J. Benston, The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered 41 (1990).

In addition, the FDIC has sought to eliminate transaction restrictions that would duplicate the restrictions on information flow or transactions imposed by the SROs and/or by the SEC.[13] The FDIC does not seek to eliminate the obligation to protect material nonpublic information nor does it seek to undercut or minimize the importance of the restrictions imposed by the SROs and SEC. Rather, the FDIC seeks to avoid imposing burdensome overlapping restrictions merely because a securities underwriting entity is owned by a bank. Further, the FDIC seeks to avoid restrictions where the risk of loss or manipulation is small or the costs of compliance are disproportionate to the purposes the restrictions serve. In addition, the FDIC defers to the expertise of the SEC which has found that greater flexibility for market activities during public offerings is appropriate due to greater securities market transparency, the surveillance capabilities of the SROs, and the continuing application of the anti-fraud and anti-manipulation provisions of the federal securities laws.[14]

Consistent with the current notice procedure found in § 337.4, an insured state nonmember bank may indirectly through a majority-owned subsidiary engage in the public sale, distribution or underwriting of securities that would be impermissible for a national bank provided that the bank files notice prior to initiating the activities, the FDIC does not object prior to the expiration of the notice period and certain conditions are, and continue to be, met. The FDIC has shortened the notice period from the existing 60 days to 30 days and placed filing procedures in subpart G of part 303. Previously, specific instructions and guidelines on the form and content of any applications or notices required under § 337.4 were found within that section. With regard to those insured state nonmember banks that have been engaging in a securities activity covered by the new § 362.4(b)(5) under a notice filed and in compliance with § 337.4, § 362.5(b) of the regulation allows those activities to continue as long as the bank and its majority-owned subsidiaries meet the core eligibility requirements, the investment and transaction limitations, and capital requirements contained in § 362.4 (c), (d), and (e). The revised regulation requires these securities subsidiaries to meet the additional conditions specified in § 362.4(b)(5)(ii) that require securities subsidiaries to adopt appropriate policies and procedures, register with the SEC and take steps to avoid conflicts of interest. The revisions also require the state nonmember bank to adopt policies concerning the financing of issues underwritten or distributed by the subsidiary. The state nonmember bank and its securities subsidiary will have one year from the effective date of the regulation to meet these restrictions and would be expected to be working toward full compliance over that time period. Failure to meet the restrictions within a year after the adoption of a final rule will necessitate an application for the FDIC's consent to continue those activities.

To qualify for the streamlined notice procedure, a bank must be well-capitalized after deducting from its tier one capital the equity investment in the subsidiary as well as the bank's pro rata share of any retained earnings of the subsidiary. The deduction must be reflected on the bank's consolidated report of income and condition and the resulting capital will be used for assessment risk classification purposes under part 327 and for prompt corrective action purposes under part 325. However, the capital deduction will not be used to determine whether the bank is ''critically undercapitalized'' under part 325. Since the risk-based capital requirements had not been adopted when the current version of § 337.4 was adopted, no similar capital level was required of banks to establish an underwriting subsidiary, although the capital deduction has always been required. This requirement is uniform with the requirements found in the other part 362 notice procedures for insured state banks to engage in activities not permissible for national banks. The well-capitalized standard and the capital deduction recognize the level of risk present in securities underwriting activities by a subsidiary of a state nonmember bank. This risk includes the potential that a bank could reallocate capital from the insured depository institution to the underwriting subsidiary. Thus, it is appropriate for the FDIC to retain the capital deduction even though the FRB eliminated the requirement that a holding company deduct its investment in a section 20 subsidiary on August 21, 1997.

Comment was divided on the issue of whether the FDIC should impose revenue limits similar to those the FRB has established for section 20 affiliates. One comment noted that in order to provide for consistency between regulators and limit exposure to risk, the FDIC should adopt a limitation similar to that adopted by the FRB for section 20 affiliates that a securities subsidiary may earn no more than 25 percent of its income from activities that are ineligible for the bank. Other comments countered that there is not a legal or safety and soundness reason to apply such a revenue limit. We agree that there is no legal reason for a revenue limit. Because of the restrictions on transactions, the capital deduction, and separations required between a bank and a subsidiary, the FDIC does not believe that the revenue limit is necessary to control the risk to the affected deposit insurance fund.

One comment asserts that there are significant benefits of securities underwriting and no material disadvantages. The revisions that have been made are intended to strike a balance between enabling banks to compete in the financial services arena and allowing activities without consideration of risks involved. With appropriate safeguards, any material disadvantages can be mitigated or eliminated.

Notice for change in circumstances. The regulation requires the bank to provide written notice to the appropriate Regional Office of the FDIC within 10 business days of a change in circumstances in its real estate or securities subsidiary. Under the revised regulation, a change in circumstances is described as a material change in a subsidiary's business plan or management. The standard of material change would indicate such events as a change in chief executive officer of the subsidiary or a change in investment strategy or type of business or activity engaged in by the subsidiary. The regional director also may address other changes that come to the attention of the FDIC during the normal supervisory process. The FDIC received two comments concerning the change of circumstance notice. Both comments indicated that the notice is burdensome and unnecessary. The comments argue that a change in the chief executive office or investment strategies are routine. The FDIC is putting significant reliance on the management and the business plan presented when an activity is approved for a majority-owned subsidiary. The FDIC does not consider either change to be routine and believes that it is important that the FDIC be aware of material changes in the operations of the subsidiary. One

[13] *See* ''Anti-manipulation Rules Concerning Securities Offerings,'' 62 FR 520 (January 3, 1997); 15 U.S.C. 78o(f), requiring registered brokers or dealers to maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information; and ''Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information,'' A Report by the Division of Market Regulation, U.S. SEC, (March 1990).

[14] Id. at 520.

comment requested that the notice period be extended from ten days to 30 days. The FDIC believes that both a change in management and a change in the business plan of the subsidiary should be matters that have received significant prior consideration before these events occur. It is not unreasonable to request notice of these events within ten days of the change. Therefore, after careful consideration of the comments, we have not changed the proposed requirement for a notice of change of circumstances to be submitted within 10 business days after any such change.

In the case of a state member bank, the FDIC will communicate our concerns to the appropriate persons in the Federal Reserve System regarding the continued conduct of an activity after a change in circumstances. The FDIC will work with the identified persons within the Federal Reserve System to develop the appropriate response to the new circumstances.

The FDIC does not intend to require a bank which falls out of compliance with eligibility conditions to immediately cease any activity in which the bank had been engaged. The FDIC will deal with each situation on a case-by-case basis through the supervision and examination process. In short, the FDIC intends to utilize its supervisory and regulatory tools in dealing with a bank's failure to meet the eligibility requirements on a continuing basis. The issue of the bank's ongoing activities will be dealt with in the context of that effort. The FDIC views the case-by-case approach to whether a bank will be permitted to continue an activity as preferable to forcing a bank to, in all instances, immediately cease the activity. Such an inflexible approach could exacerbate an already poor situation.

Real estate leasing. As was discussed above, the FDIC has deleted the current exception allowing a majority-owned subsidiary to engage in activities included on the referenced list of activities determined by the FRB to be closely related to the business of banking under section 4(c)(8) of the Bank Holding Company Act, because the activities included on that list are generally of a type permissible for national banks. The one exception that clearly is not generally permissible for a national bank involves real estate leasing. The FDIC has inserted a real estate leasing provision to allow continuation of activities that are permitted under the current exception but may be lost with the elimination of the reference to the 4(c)(8) list.

For the purposes of part 362, the FDIC studied real estate leasing to make a determination if there is a significant risk to the fund. The FDIC's determination requires that we look at the possibility of loss inherent in the leasing transaction.

In a real estate leasing transaction, the lessor is the owner of the parcel subject to the lease. The FDIC has defined equity investment to include any interest in real estate. A threshold question for the FDIC involves whether an ownership interest as lessor carries all of the risks and rewards of ownership when there is no lease.

By inserting a reference to the 4(c)(8) list, the FDIC consented that real estate leasing could be conducted under the standards set by the FRB. These standards provided that leasing real property or acting as agent, broker, or adviser in leasing such property is allowed if: (1) The lease is on a nonoperating basis which means that the banking holding company may not engage in operating, servicing, maintaining, or repairing leased property during the lease term; (2) the initial term of the lease is at least 90 days; (3) at the inception of the lease, the effect of the transaction will yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated cost of financing the property over the term of the lease from rental payments, estimated tax benefits, and the estimated residual value of the property and the expiration of the initial lease; and (4) the estimated residual value of the property shall not exceed 25 percent of the acquisition cost of the property to the lessor. In defining the real estate leasing parameters, the FRB's definition focuses on characteristics that make the activity closely related to banking.

In making its risk to the fund determination, the FDIC looked not only at banking standards for leasing transactions but also at GAAP. Under GAAP, a lease is defined as the right to use an asset for a stated period of time. Generally, a transaction is not a lease if the right to use the property is not transferred; the transaction involves the right to explore natural resources; or the transaction represents licensing agreements. Also under GAAP, leases are considered under two broad categories: (1) Capital leases which effectively transfer the benefits and risks of ownership from the lessor to the lessee; and (2) operating leases which is everything that is not a capital lease and represents a series of cash flows. If any one of the following criteria is met, a lease may be considered to be a capital lease:

- Ownership of the property is transferred to the lessee at the end of the lease term; or
- The lease contains a bargain purchase option; or
- The lease term represents at least 75 percent of the estimated economic life of the leased property; or
- The present value of the minimum lease payments at the beginning of the lease term is 90 percent of more of the fair value of the leased property to the lessor at the inception of the lease less any related investment tax credit retained by and expected to be realized by the lessor.

Two other criteria must be present in order for the lessor to determine that a lease is a capital lease: (1) Collection of minimum lease payments is reasonably predictable; and (2) no important uncertainties exist for unreimbursable costs to be borne by the lessor.

The FDIC has decided that a majority-owned subsidiary acting as lessor under a real property lease which meets certain criteria does not represent a significant risk to the deposit insurance fund. To meet these criteria, the lease must qualify as a capital lease under GAAP and the bank and the majority-owned subsidiary may not provide servicing, repair, or maintenance to the property except to the extent needed to protect the value of the property. In addition, the majority-owned subsidiary may not acquire real estate to be leased unless it has entered into a capital lease, or has a binding commitment to enter into such a lease, or has a binding written agreement that indemnifies the subsidiary against loss in connection with its acquisition of the property. Any expenditures by the majority-owned subsidiary to make reasonable repairs, renovations, and necessary improvements shall not exceed 25 percent of the subsidiary's full investment in the property. These standards provide a framework in which the risks and rewards of ownership of the leased property have effectively been transferred from the lessor to the lessee.

A majority-owned subsidiary that acquires property for lease under this provision may not use this exception as a vehicle to acquire an equity investment in real estate. Upon expiration of the initial lease, the majority-owned subsidiary must as soon as practicable, but in any event in less than two years, re-lease the property under a capital lease or divest itself of the property. An application will be required if the subsidiary cannot meet the two-year deadline.

Acquiring and retaining adjustable rate and money market preferred stock. The proposed regulation text has been revised in the final rule to provide that a majority-owned subsidiary may acquire and retain adjustable rate and money market preferred stock and any other instrument that the FDIC has determined to have the character of debt securities to the same extent that these activities may be conducted by the bank itself. Since these subsidiaries are fully consolidated with the bank, the 15 percent of tier one capital limitation will be calculated against the consolidated tier one capital of the bank and subsidiary. If a bank and its majority-owned subsidiary both engage in this activity, the authority to conduct this activity in a majority-owned subsidiary may not be used to exceed the 15 percent limitation on this type of activity without further consent of the FDIC. This exception is provided to allow consistency between the authorized activities of the bank and its majority-owned subsidiary.

Core eligibility requirements. Consistent with the proposal, the revised regulation has been organized much differently from the current regulation where separation standards between an insured state bank and its subsidiary are contained in the regulation's definition of ''bona fide'' subsidiary. The revised regulation introduces the concept of core eligibility requirements. These requirements are defined in two parts. The first part defines the eligible depository institution criteria and the second part defines the eligible subsidiary standards.

Eligible depository institution. An ''eligible depository institution'' is a depository institution that has been chartered and operating for at least three years; received an FDIC-assigned composite UFIRS rating of 1 or 2 at its most recent examination; received a rating of 1 or 2 under the ''management'' component of the UFIRS at its most recent examination; received at least a satisfactory CRA rating from its primary federal regulator at its last examination; received a compliance rating of 1 or 2 from its primary federal regulator at its last examination; and is not subject to any corrective or supervisory order or agreement. The FDIC believes that these criteria are appropriate to ensure that expedited processing under the notice procedures is available only to well-managed institutions that do not present any supervisory, compliance or CRA concerns.

The standards for an ''eligible depository institution'' are being coordinated with similar requirements for other types of notices and applications made to the FDIC. In developing the eligibility standards, several items have been added that previously were not a stated standard for banks wishing to engage in activities not permissible for a national bank.

The requirement that the institution has been chartered and operated for three or more years reflects the experience of the FDIC that newly formed depository institutions need closer scrutiny. Therefore, a request by this type of institution to become involved in activities not permissible for a national bank should receive consideration under the application process rather than being eligible for a notice process. Several comments noted that the provision requiring the bank to be operating for three or more years ignores the presence of an established bank holding company or seasoned management. The FDIC is persuaded by the arguments that an exception is appropriate when there is an established holding company or seasoned management is present. Therefore, the criterion has been changed to require that the bank must have been chartered and operating for 3 or more years unless the appropriate regional director (DOS) finds that the bank is owned by an established, well-capitalized, well-managed holding company or is managed by seasoned management.

The revised regulation provides that the notice procedures should be available only to well-managed, well-capitalized banks. Banks which have composite and management ratings of 1 or 2 have shown that they have the requisite financial and managerial resources to run a financial institution without presenting a significant risk to the deposit insurance fund. While lower-rated financial institutions may have the requisite financial and managerial resources and skills to undertake such activities, the FDIC believes that those institutions should be subject to the formal part 362 application process as opposed to the streamlined notice process. Institutions that do not meet the eligibility criteria have been evaluated and have been determined to have some weaknesses that may require additional attention before allowing them to engage in additional activities. For that reason, the FDIC has concluded that it is more prudent to require institutions rated 3 or below to utilize the application process.

Comments received did not object to the standard of a composite rating of 1 or 2 or a management rating of 1 or 2; however, the regulatory language that the ratings used be assigned by the appropriate federal banking agency was questioned. Some comments contended that this provision fails to consider that the FDIC and FRB recognize and generally adopt the ratings assigned by the state banking departments under an alternate examination program. The language does not ignore ratings assigned by the state banking authorities. All ratings, whether state or Federal, considered by the FDIC for purposes of processing applications must be assigned by the FDIC after reviewing the results of an examination conducted by another banking agency. Although the language differs between this processing criteria and the proposal to amend our applications processing regulation (part 303), there is no intention of establishing a different standard. To reduce confusion, the language in the revised regulation has been changed to reflect that the ratings are the FDIC-assigned rating at the institution's most recent state or Federal examination.

In setting criteria to define which banks are eligible to use the notice process, the FDIC has determined it is appropriate to take into account all areas of managerial and operational expertise. In particular, the revised regulation requires that the institution have a satisfactory or better CRA rating, a 1 or 2 compliance rating, and not be subject to any formal or informal enforcement action before it may use the notice procedures.

The proposal to use the CRA ratings as an eligibility criteria drew negative comments. One commenter even expressed the opinion that the FDIC's use of a CRA rating as an eligibility criterion for expedited processing is a violation of the CRA itself. The FDIC is not proposing some alternative method of CRA enforcement. The CRA criterion is not intended to ''punish'' any bank which the FDIC has previously criticized for substandard CRA performance; nor is it intended to ''reward'' a bank with satisfactory performance. The CRA criterion acts solely as a procedural device for application processing, in connection with the other criteria, to identify applications for further review if they come from banks which have not been meeting all the primary supervisory requirements. If a bank has not complied with all of these primary supervisory expectations, it may be a symptom of financial, management, or operational deficiencies which could be exacerbated by undertaking the proposed additional activities. The consequence of failing to meet all the eligibility criteria is only that the request will be subject to exactly the same kind and level of review to which it is subject under the current rules which have no expedited processing procedures. Therefore, the FDIC retains the same eligibility criteria in the final regulation as proposed.

Eligible Subsidiary. The eligible subsidiary requirements are also used to determine which institutions qualify for notice processing. Additionally, the requirements are also criteria the FDIC is likely to take into account when reviewing and considering applications. The FDIC's support of the concept of the expansion of bank powers is based in part on establishing a corporate separateness between the insured state bank and the entity conducting activities that are not permissible for the depository institution directly. The revised regulation establishes these separations as well as standards for operations through the concept of ''eligible subsidiary''. An entity is an ''eligible subsidiary'' if it: (1) Meets applicable statutory or regulatory capital requirements and has sufficient operating capital in light of the normal obligations that are reasonably foreseeable for a business of its size and character; (2) is physically separate and distinct in its operations from the operations of the bank, provided that this requirement shall not be construed to prohibit the bank and its subsidiary from sharing the same facility if the area where the subsidiary conducts business with the public is clearly distinct from the area where customers of the bank conduct business with the institution—the extent of the separation will vary according to the type and frequency of customer contact; (3) maintains separate accounting and other business records; (4) observes separate business formalities such as separate board of directors' meetings; (5) has a chief executive officer who is not an employee of the bank; (6) has a majority of its board of directors who are neither directors nor officers of the bank; (7) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the bank and that the bank is not responsible for and does not guarantee the obligations of the subsidiary; (8) has only one business purpose; (9) has a current written business plan that is appropriate to the type and scope of business conducted by the subsidiary; (10) has adequate management for the type of activity contemplated, including appropriate licenses and memberships, and complies with industry standards; and (11) establishes policies and procedures to ensure adequate computer, audit and accounting systems, internal risk management controls, and has the necessary operational and managerial infrastructure to implement the business plan.

The separations currently necessary between the bank and subsidiary are outlined in the definitions of ''bona fide'' subsidiary contained in § 337.4 and part 362. The broad principles of separation upon which the ''bona fide'' subsidiary definition and the ''eligible subsidiary'' definition are based include: (1) Adequate capitalization of the subsidiary; (2) separate corporate functions; (3) separation of facilities; (4) separation of personnel; and (5) advertising the bank and the subsidiary as separate entities. In developing the standards for an ''eligible subsidiary'', the FDIC has modified some of the criteria used in the current regulation. The changes are found in the capital requirement, the physical separation requirement, the separate employee standard, and the requirement that the subsidiary's business be conducted pursuant to independent policies and procedures.

The language in the current part 362 allows the subsidiary and the parent bank to share officers so long as a majority of the subsidiary's executive officers were neither officers nor directors of the bank. Section 337.4 contains a requirement that there be no shared officers. The ''eligible subsidiary'' concept adopts a standard that the chief executive officer of the subsidiary should not be an employee of the bank. The eligible subsidiary requirements in this regard are thus less restrictive than those found in both § 337.4 and the current version of part 362, as well as those in many FDIC orders authorizing real estate activities. The eligible subsidiary definition only requires that the chief executive officer not be an employee of the bank. Officers are employees of the bank. This limitation would allow the chief executive officer to be an employee of an affiliated entity or be on the board of directors of the bank. Two comments indicated that the requirement for an independent chief executive officer is too restrictive. One comment suggested that this requirement be dropped for small banks. The FDIC is sympathetic to the concerns of small banks; however, banks that desire relief from this standard may apply to the FDIC for approval. The FDIC recognizes that there may be instances in which this standard may not be needed. The FDIC will consider such requests and waive the standard in appropriate situations.

The current rule's requirement that the subsidiary be adequately capitalized was revised to provide that the subsidiary must meet any applicable statutory or regulatory capital requirements, that the subsidiary have sufficient operating capital in light of the normal obligations that are reasonably foreseeable for a business of its size and character, and that the subsidiary's capital meet any commonly accepted industry standard for a business of its size and character. This definition clarifies that the FDIC expects the subsidiary to meet the capital requirements of its primary regulator, particularly those subsidiaries involved in securities and insurance. No comments objected to this change. This standard is unchanged in the final rule.

The physical separation requirement of the current rule was clarified by the addition of a sentence which indicates that the extent to which the bank and the subsidiary must carry on operations in physically distinct areas will vary according to the type and frequency of public contacts. The FDIC does not intend to require physical separation where such a standard adds little value such as where a subsidiary engaged in developing commercial real estate has little or no customer contact. The possibility of customer confusion should be the determining factor in deciding the physical separation requirements for the subsidiary.

One commenter stated that this clarification is an improvement over the existing regulation; however, the comment encourages the FDIC to clarify that the subsidiary and the bank may conduct activities in the same location if the subsidiary is engaging in activities that are permissible for the bank to engage. The FDIC agrees that this point is important. The requirements of this regulation apply to activities that are not permissible for a national bank. Activities such as the sale of securities are covered by the requirements of the Interagency Statement. We have decided that no change in the regulation language is necessary to further clarify that these standards do not apply to subsidiaries engaging solely in activities permissible for a national bank. We believe it is clear that the coverage of the core eligibility requirements is for institutions to conduct as principal activities through a subsidiary that are not permissible for a subsidiary of a national bank.

We eliminated the provision contained in the current regulation that required employees of the bank and subsidiary to be separately compensated when they have contact with the public. This requirement was imposed to reduce confusion relating to whether customers were dealing with the bank or the subsidiary. Since the adoption of the current regulation, the Interagency Statement was issued. The Interagency Statement recognizes the concept of employees who work both for a registered broker-dealer and the bank. Because of the disclosures required under the Interagency Statement informing the customer of the nature of the product being sold and the physical separation requirements, the need for separate public contact employees is diminished. No objections to the proposed changes were offered, and the requirement for separate public contact employees is dropped from the revised regulation.

Language was added that the subsidiary must conduct business in a manner that informs customers that the bank is not responsible for and does not guarantee the obligations of the subsidiary. This standard is taken from section 23B of the Federal Reserve Act which prohibits banks from entering into any agreement to guarantee the obligations of their affiliates and prohibits banks as well as their affiliates from advertising that the bank is responsible for the obligations of its affiliates. In the proposal, we made this standard an affirmative duty of disclosure. This type of disclosure is intended to reduce customer confusion concerning who is responsible for the products purchased. Two comments questioned the affirmative nature of the standard. The duty to inform customers would in many cases be unnecessary. For instance, when a transaction is covered by the Interagency Statement disclosures are already required to inform customers that the product is not an obligation of the bank. The commenters believe that the requirement should be analogous to section 23B and only require that the subsidiary not mislead its customers. The FDIC has not been persuaded by the arguments. The affirmative requirement to make disclosures applies to the subsidiary and the Interagency Statement disclosures apply to the bank. One of the most important steps the subsidiary can take to assure a separate corporate existence from the parent bank is to make affirmative disclosures to its customers as prescribed. Therefore, the disclosure requirement remains as proposed.

The regulation contains a standard that a majority of the board of directors of the eligible subsidiary act as neither a director nor an officer of the bank. Commenters suggested that this standard be altered. One comment suggested that the standard be eliminated for small banks. The issue of the need for management separation is not an issue that clearly relates to the size of the bank. We recognize that this requirement for some small banks may present a challenge. The FDIC believes that management separations are an important safeguard. If an institution desires a different structure than that proposed in these standards, they may submit an application for FDIC consideration. Another commenter suggested that the FDIC defer to the OCC standard that permits ⅔ of the subsidiary's board members to be directors of the depository institution. The FDIC believes that the majority of the board standard provides a structure in which decisions relating to the subsidiary are being made by a majority of persons who are not associated with the bank. This standard provides an easily identifiable level of separation. If the standard creates a burden for a bank, the FDIC will consider a request for relief. After considering the comments, the FDIC has decided not to change this standard.

In a previous proposal a question was raised if this standard prohibited directors of a subsidiary from serving as directors and officers of the parent holding company or an affiliated entity. The FDIC is primarily concerned about risk to the deposit insurance funds and is therefore looking to establish separation between the insured bank and its subsidiary. The eligible subsidiary requirement is designed to assure that the subsidiary is in fact a separate and distinct entity from the bank. This requirement should prevent ''piercing of the corporate veil'' and insulate the bank, and the deposit insurance fund, from any liabilities of the subsidiary.

We recognize that a director or officer employed by the bank's parent holding company or a sister affiliate is not as ''independent'' as a totally disinterested third party. The FDIC is, however, attempting to strike a reasonable balance between prudential safeguards and regulatory burden. The requirement that a majority of the board not be directors or officers of the bank will provide certain benefits that the FDIC thinks are very important in the context of subsidiary operations. The FDIC expects these persons to act as a safeguard against conflicts of interest and to be independent voices on the board of directors. While the presence of ''independent'' directors may not, in and of itself, prevent piercing of the corporate veil, it will add incremental protection and in some circumstances may be key to preserving the separation of the bank and its subsidiary in terms of liability. In view of the other standards of separateness that have been established under the eligible subsidiary standard as well as the imposition of investment and transaction limits, we do not believe that a connection between the bank's parent or affiliate will pose undue risk to the insured bank.

In addition to the separation standards, the ''eligible subsidiary'' concept introduces operational standards that are not part of the current regulation. These standards provide guidance concerning the organization of the subsidiary that the FDIC believes important to the independent operation of the subsidiary.

The revised regulation requires that a bank that wishes to file a notice to establish a subsidiary to engage in insurance, real estate or securities have only one business purpose among those categories. Several comments objected to this standard. One comment stated that the subsidiary should be allowed to engage in similar business lines rather than being held to a strict sole purpose standard. Other comments encouraged a broad definition of the term ''one business purpose''. Other comments recommended eliminating the requirement stating the FDIC should rely on the business plan for information needed to address any concerns. Because the FDIC is limiting a bank's transactions with subsidiaries engaged in real estate, or securities activities authorized under subpart A, and the aggregate limits only extend to subsidiaries engaged in the activities subject to the investment limits, the FDIC believes it is important to limit the scope of the subsidiary's activities when using the expedited procedures. The FDIC will use the business plan as a tool to review the lines of business engaged in by the subsidiary. The FDIC will be flexible in its interpretation of the term ''one business purpose.'' For instance, the FDIC would consider a subsidiary engaged in underwriting a financial product and also selling that product to have one business purpose.

The regulation contains a standard that the subsidiary have a current written business plan that is appropriate to its type and scope of business. The FDIC believes that an institution that is contemplating involvement with activities that are not permissible for a national bank or a subsidiary of a national bank should have a carefully conceived plan for how it will operate the business. We recognize that certain activities do not require elaborate business plans; however, every activity should be considered by the board of the bank to determine the scope of the activity allowed and how profitability is to be attained. We received no comments on this requirement. This standard is adopted without change.

The requirement for adequate management of the subsidiary establishes the FDIC's view that insured depository institutions should consider the importance of management in the success of an operation. The requirement to obtain appropriate licenses and memberships and to comply with industry standards indicates the FDIC's support of securities and insurance industry standards in determining adequacy of subsidiary management. We received no comments, and this standard is adopted without change.

An important factor in controlling the spread of liabilities from the subsidiary to the insured depository institution is that the subsidiary establishes necessary internal controls, accounting systems, and audit standards. The FDIC does not expect to supplement this requirement with specific guidance since the systems must be tailored to specific activities, some of which are otherwise regulated. We received no comments on this standard, and it is unchanged.

Investment and transaction limits. The revised regulation contains investment limits and other requirements that apply to an insured state bank and its subsidiaries that engage in ''as principal'' activities that are not permissible for a national bank if the requirements are imposed by order or expressly imposed by regulation. The provision is not contained in the current regulation; however, § 337.4 imposes by reference the limitations of section 23A of the Federal Reserve Act (§ 337.4 was adopted prior to the adoption of section 23B of the Federal Reserve Act). Both section 23A and section 23B restrictions have been imposed by the FDIC through its orders authorizing insured state banks to engage in activities not permissible for a national bank.

Some of the provisions of sections 23A and 23B are inconsistent when applied in the context of a bank/ subsidiary relationship. The FDIC believes that merely incorporating sections 23A and 23B by reference raises significant interpretative issues and only promotes confusion in an already complex area.

For these reasons, the FDIC has adopted a separate subsection which sets forth the specific investment limits and arm's length transaction requirements. In general, the provisions impose an aggregate investment on all subsidiaries that engage in activities covered by the investment limits, require that extensions of credit from a bank to its subsidiaries be fully-collateralized when made, prohibit the bank from taking a low quality asset as collateral on such loans, and require that transactions between the bank and its subsidiaries be on an arm's length basis. The comments received state that the investment and transaction limits which have been proposed are preferable to incorporating sections 23A and 23B by reference. Two comments suggested that this section be eliminated if the FRB adopts its proposal to expand sections 23A and 23B coverage to subsidiaries engaged in activities not permissible for a national bank. The FDIC will not respond to this scenario until the FRB has issued a final regulation. Another comment expressed the opinion that in view of the explicit statutory exception in sections 23A and 23B for transactions between an insured bank and its subsidiaries, the restrictions in these provisions should not be applied in any form by the FDIC. The FDIC agrees that section 23A and 23B should not be applied to a bank/ subsidiary relationship that is fully consolidated for capital reporting purposes. For subsidiaries that are engaged in activities for which the FDIC imposes a requirement that capital of the subsidiary be deducted from the bank's capital in determining the bank's capital adequacy, we believe that restrictions on transactions between the bank and the subsidiary are also necessary. Another comment indicated that the investment and transaction limits proposed are unnecessarily complex and would make many activities uneconomic. Specifically, the cost of collateral requirements would diminish if not eliminate the potential profit from the permitted activity. The FDIC is concerned that an insured bank not be allowed to easily and cheaply transfer risks from the uninsured entity to the insured depository institution. Collateral requirements are a method of assuring that any money lent by the bank to its subsidiary will ultimately be repaid. This comment also suggests that Regulation K of the FRB would provide a more appropriate analogue than sections 23A and 23B. In this regulation, appropriate safeguards are provided by focusing on the capital strength of the bank and the extent of its investment in the entity. We believe that capital strength of the bank and the extent of its investment in a subsidiary are important considerations. The revised regulation addresses each of those areas. In addition, restrictions on the flow of funds from an insured bank to a subsidiary engaged in activities not permissible for the bank itself are necessary. We have chosen to keep the investment and transaction limitations in the final regulation.

The revised regulation expands the definition of bank for the purposes of the investment and transaction limitations. A bank includes not only the insured entity but also any subsidiary that is engaged in activities that are not subject to these investment and transaction limits. Sections 23A and 23B of the Federal Reserve Act combine the bank and all of its subsidiaries in imposing investment limitations on all affiliates. The FDIC is using the same concept in separating subsidiaries conducting activities that are subject to investment and transaction limits from the bank and any other subsidiary that engages in activities not subject to the investment and transaction limits. This rule will prohibit a bank from funding a subsidiary that is subject to the investment and transaction limits through a subsidiary that is not subject to the limits. One comment expressed support for this concept but emphasized that there is no need to include ''eligible subsidiaries'' in the restrictions since these entities have already been separated from the insured depository institution. The FDIC did not intend to extend these restrictions to transactions between ''eligible subsidiaries''. Therefore, this language has not been changed.

Investment limit. Under the proposed rule, the FDIC limited bank investments in certain subsidiaries. Those limits are basically the same as would apply between a bank and its affiliates under section 23A. As is the case with covered transactions under section 23A, extensions of credit and other transactions that benefit the bank's subsidiary would be considered part of the bank's investment. The only exception would be for arm's length extensions of credit made by the bank to finance sales of assets by the subsidiary to third parties. These transactions would not need to comply with the collateral requirements and investment limitations of section 23A, provided that they met certain arm's length standards.

In contrast to the bank-affiliate relationship being governed by the statutory limits of sections 23A and 23B, inherent in the idea of a subsidiary is the subsidiary's value to the bank as an asset. That value increases as the subsidiary earns profits and decreases as the subsidiary loses money. The increases are reflected in the subsidiary's retained earnings and the consolidated retained earnings of the bank as a whole. The FDIC wants to separate the bank's equity investment in the subsidiary from any lending to or covered transactions with the subsidiary. Thus, the FDIC proposed to treat the bank's equity investment as a deduction from capital, while limiting any lending to or covered transactions with the subsidiary in a similar fashion as these transactions are limited in the bank-affiliate relationship. Then, the question arises as to how to properly treat retained earnings at the subsidiary level. If retained earnings at the subsidiary level were treated as subject to the investment limits, the bank could be forced to take the retained earnings out of the subsidiary to stay under the applicable limits. If retained earnings are allowed to accumulate without limit, then the bank could declare dividends to its shareholders based on the retained earnings at the subsidiary. Later, in the event that the subsidiary incurred losses, the bank's capital could become inadequate based on the subsidiary's losses. Thus, the FDIC decided that retained earnings should be deducted from capital in the same way as the equity investment is deducted.

Comments were supportive of the proposed concept of investment limits for loans to and debt of the subsidiary in contrast to the capital deduction for equity investments in and retained earnings of the subsidiary. One commenter expressed reservations about the structure of the investment limits. The proposal to limit transactions between a bank and its eligible subsidiary to 10 percent of capital to any one subsidiary and 20 percent of capital to all eligible subsidiaries conducting the same activity was questioned. By including the 10 percent limitation to any one subsidiary, the FDIC would only create burden to institutions without the benefit of appreciably limiting or diversifying risk. The commenter points out that since the eligible subsidiaries are not subject to transaction limitations between each other, it would be easy to structure the use of the entire 20 percent investment provision between the two subsidiaries but really for the benefit of the same project or business. The comment accepts that the 20 percent aggregate limit is appropriate, and recommends that the regulation be amended to apply only the 20 percent limitation. The FDIC is persuaded by this argument, and the final rule has dropped the 10 percent to any one subsidiary limitation.

The definition of ''investment'' under this provision has four components. The first component is any extension of credit by the bank to the subsidiary. The term ''extension of credit'' is defined in part 362 to have the same meaning as that under section 22(h) of the Federal Reserve Act (12 U.S.C. 375b) and would therefore apply not only to loans but also to commitments of credit. The second component is ''any debt securities of the subsidiary'' held by the bank. This component recognizes that debt securities are very similar to extensions of credit. The third component is the acceptance of securities issued by the subsidiary as collateral for extensions of credit to any person or company. The fourth and final component addresses any extensions or commitments of credit to a third party for investment in the subsidiary, investment in a project in which the subsidiary has an interest, or extensions of credit or commitments of credit which are used for the benefit of, or transferred to, the subsidiary. Commenters did not object to these components of ''investment,'' and the definition is unchanged.

The revised regulation calculates the 20 percent limit based on tier one capital. Also, the revisions limit the aggregate investment to all subsidiaries conducting activities subject to the investment limits. Comments note that the 20 percent limit is calculated against tier one capital instead of capital and surplus as is the standard for section 23A. One comment goes on to state that even though the FDIC has proposed a more restrictive standard, the 20 percent limit applies to an aggregate of the same activity rather than the section 23A standard covering all affiliates. In that respect, the 20 percent limit in the proposal is less restrictive. Although the FDIC does not intend to mimic section 23A in all respects, the FDIC has determined that an aggregate limit on activities that are covered by the investment limits is appropriate. The standard established is intended to reflect an appropriate limitation for subsidiary activities. The FDIC continues to use the more restrictive tier one capital as its measure to create consistency throughout the regulation. The FDIC does not find the burden of this more restrictive capital base to be unreasonable.

Arm's length transaction requirement. For subsidiaries engaged in activities covered by the investment and transactions limitations, the revisions require that any transaction between a bank and its subsidiary must be on terms and conditions that are substantially the same as those prevailing at the time for comparable transactions with unaffiliated parties. This ''arm's length transaction'' requirement is intended to make sure that the business of the subsidiary does not take place to the disadvantage of the bank. The types of transactions covered by the requirement include: (1) Investments in the subsidiary; (2) the purchase from or sale to the subsidiary of any assets, including securities; (3) entering into any contract, lease or other agreement with the subsidiary; and (4) paying compensation to the subsidiary or any person who has an interest in the subsidiary. The revised regulation indicates, however, that the restrictions do not apply to an insured state bank giving immediate credit to a subsidiary for uncollected items received in the ordinary course of business.

The arm's length transaction requirement is meant to protect the bank from abusive practices. To the extent that the subsidiary offers the parent bank a transaction which is at or better than market terms and conditions, the bank may accept such transaction since the bank is receiving a benefit, as opposed to being harmed. It may be the case, however, that a bank will be unable to meet the regulatory standard because there are no known comparable transactions between unaffiliated parties. In these situations, the FDIC will review the transactions and expect the bank to meet a ''good faith'' standard.

This section and the language therein is not a substantive change from the proposal. Comments had mixed messages about this section of the regulation. Commenters agreed that this proposal is preferable to the incorporation by reference to section 23B. One comment stated that if the FRB's proposal to impose section 23B on subsidiaries is finalized, the FDIC should withdraw its regulatory language to avoid confusion. The FDIC is aware of the FRB proposal and will react once the final position of the FRB is known. Another comment stated that in view of the explicit statutory exception in section 23B between an insured depository institution and its subsidiaries, these restrictions in any form should not be applied by the FDIC. When engaging in transactions with a subsidiary, banks and bank counsel should be aware of the FDIC's separate corporate existence concerns. Bank subsidiaries should be organized and operated as separate corporate entities. Subsidiaries should be adequately capitalized for the business they are engaged in and separate corporate formalities should be observed. Frequent transactions between the bank and its subsidiary which are not on an arm's length basis may lead to questions as to whether the subsidiary is actually a separate corporate entity or merely the alter ego of the bank. One of the primary reasons for the FDIC requiring that certain activities be conducted through an eligible subsidiary is to provide the bank, and the deposit insurance funds, with liability protection. To the extent a bank ignores the separate corporate existence of the subsidiary, this liability protection is jeopardized. We believe setting forth the exact requirements will reduce regulatory burden and confusion as banks and bank counsel will more readily know what requirements are to be followed.

Banks will be prohibited from buying low quality assets from their subsidiaries. We received no comments objecting to this standard. The FDIC has taken the definition of ''low quality asset'' from the proposal without modification.

The revised regulation contains provisions addressing insider transactions and product tying. The arm's length standard addresses transactions between an insured depository institution and its subsidiaries. The FDIC is adding a provision that an arm's length standard applies to transactions between the subsidiary and insiders of the insured depository institution. The revised regulation requires that any transactions with insiders must meet the requirements that transactions be on substantially the same terms and conditions as generally available to unaffiliated parties. Banks engaging in such transactions should retain proper documentation showing that the transactions meet the arm's length requirement. The FDIC will review transactions with insiders in the normal course of the examination process and take such actions as may be necessary and appropriate if problems arise. Questionable transactions will have to be justified under the standards of the regulation.

Comments were not supportive of this standard. One comment stated that the new restriction is unnecessary since such insiders would already be subject to the restrictions set forth in Regulation O. The FDIC has recognized this overlap by excluding transactions covered by § 337.3, which implements many of the restrictions contained in Regulation O for insured state nonmember banks. The comment also contends that if the subsidiary is isolated from the bank as would be required by the revised regulation, there should be no need to regulate transactions between bank insiders and the eligible subsidiary. The FDIC is implementing these provisions in an abundance of caution. The standard is that insider transactions should be on the same terms and conditions as those prevailing at the time for comparable transactions with persons not affiliated with the insured state bank. The standard does not prohibit transactions; it merely sets parameters that does not allow insiders to engage in transactions that are on terms more favorable than those available in the market. Another comment states that, for example, this standard potentially would prohibit an executive officer from participating in an employee benefit program that waives trustee fees for IRA accounts if the assets of such accounts are invested in mutual funds distributed by a securities firm affiliate of the bank. The FDIC is persuaded by this argument and has added an exception that the standard shall not prohibit any transaction made pursuant to a benefit or compensation program that is widely available to employees of the insured state bank and that does not give preference to any insider of the insured state bank over other employees of the insured state bank.

The proposed regulation also contained a requirement that neither the insured state bank nor the majority-owned subsidiary may require a customer to either buy a product or use a service from the other as a condition of entering into a transaction. While the condition may duplicate existing standards under applicable law for banks to some extent, it is not clear that all circumstances addressed by the proposed condition are covered by the existing statutory and regulatory restrictions. Banks are subject to statutory anti-tying restrictions at 12 U.S.C. § 1972. The OCC extends anti-tying provisions to national bank subsidiaries. *See* OCC Bulletin 95–20. The extension of anti-tying restrictions to savings and loan holding companies and their affiliates in transactions involving a savings association is statutory. Consequently, the OTS is not authorized to exempt savings and loan holding companies and their affiliates entirely from all tying restrictions. 62 FR 15819.

The FDIC specifically requested public comment on whether the proposed anti-tying restriction was appropriate. The FDIC received five comments opposed to the proposed anti-tying requirement. One commenter objected to the requirement on general grounds. The other four asserted that statutory tying limits imposed by Congress in 1970 (12 U.S.C. 1972) are sufficient, and that the FDIC should not impose additional restrictions on tying by bank subsidiaries. Of these, two commenters were of the view that statutory tying limits are based on outdated views of banks' market power and constitute a competitive disadvantage for banks which should not be compounded by the addition of the FDIC's proposed tying restriction for real estate investment and securities underwriting subsidiaries. These commenters also made note of recent FRB action (as discussed in the FDIC's preamble to the proposed rule) eliminating the FRB's extension of tying restrictions to bank holding companies and their nonbank affiliates. The FRB based its action on its experience that bank holding companies and their nonbank affiliates do not possess the market power over credit or other unique competitive advantages that Congress assumed that banks enjoyed in 1970, when Congress adopted 12 U.S.C. 1972, and nonstatutory blanket anti-tying restrictions are therefore not justified. 62 FR 9312. The commenters suggest the FDIC take a similar approach.

The FDIC is concerned that opportunities may exist for abusive tying arrangements. It is this concern which has caused the FDIC to include particular tying restrictions of varying types in its approval orders governing real estate investment activities, and in its rules under § 337.4 on securities underwriting. In the real estate orders, the FDIC has typically prohibited the bank from conditioning an extension of credit on the borrower's agreement to also acquire real estate from the real estate development subsidiary. Under § 337.4, a bank could not directly or indirectly condition an extension of credit on the borrower's agreement to contract with the securities subsidiary to underwrite or distribute the borrower's securities, or to purchase any security currently underwritten by the subsidiary. The inclusion of these conditions highlighted the FDIC's concerns with these particular practices. Because of the FDIC's concern about the potential for abusive tying practices, and because the tying restrictions as proposed are only used to further delineate the circumstances in which a notice, rather than an application, is required, the FDIC has decided to adopt the tying restriction as proposed. Any bank wishing to conduct business on a basis different than the general rule set out in the tying restriction may submit an application. Then, the FDIC can evaluate the arrangement in light of its particular facts, including the permissibility of the arrangement under other applicable tying laws, its safety and soundness, and what risk it poses to the fund.

Collateralization requirements. The revised regulation provides that an insured state bank is prohibited from making an extension of credit to a subsidiary covered by the investment and transaction limits unless such transaction is fully-collateralized at the time the bank makes the loan or extension of credit. This requirement is intended to protect the bank in the event of a loan default. ''Fully collateralized'' under the regulation means extensions of credit secured by collateral with a market value at the time the extension of credit is entered into of at least 100 percent of the extension of credit amount for government securities or a segregated deposit in a bank; 110 percent of the extension of credit amount for municipal securities; 120 percent of the extension of credit amount for other debt securities; and 130 percent of the extension of credit amount for other securities, leases or other real or personal property. One comment objected to the fact that the FDIC proposed to use this schedule as minimum guidance. The comment questions if the FDIC intends to require collateral standards that are more rigid than those in effect under section 23A. As stated, the FDIC intends to look to the collateralization schedule as minimum guidance, but wants to retain flexibility in making the determination if additional collateral is necessary. Maintaining flexibility does not mean that the FDIC intends to impose harsh new standards; however, we intend on a case-by-case basis to reserve the ability to require greater collateral in situations where the risk potential is higher.

Two comments were received on this issue. Both commenters believe the collateral requirements are unnecessary. The comments argue that if collateralization were a normal term of the transaction, it would be required by the arms length transaction requirements. One commenter noted that the cost of the collateral requirements would diminish if not eliminate the potential profit from the permitted activity. The FDIC understands the concerns about the collateral requirement; however, this provision provides a higher level of protection to the insured state bank. If there are instances in which the collateral requirements are uneconomical, the insured state bank may use the application procedures of this regulation to request relief. Therefore, the FDIC has decided to make no change to the collateral requirements of this section.

Capital requirements. Under the revised rule, a bank using the notice process to invest in a subsidiary engaging in certain activities authorized by subpart A would be required to deduct its equity investment in the subsidiary as well as its pro rata share of retained earnings of the subsidiary when reporting its capital position on the bank's consolidated report of income and condition, in assessment risk classification and for prompt corrective action purposes (except for the purposes of determining if an institution is critically undercapitalized). Such a capital deduction may be required as a condition of an order issued by the FDIC, is required to use the notice procedure to request consent for real estate investment activities and securities underwriting and distribution, and is required to engage in grandfathered insurance underwriting. The purpose of the restriction is to ensure that the bank has sufficient capital devoted to its banking operations and that it would not be adversely impacted even if its entire investment in the subsidiary is lost.

This treatment of the bank's investment in subsidiaries engaged in activities not permissible for a national bank creates a regulatory capital standard. Section 37 of the FDI Act (12 U.S.C. 1831n) generally requires that accounting principles applicable to depository institutions for regulatory reporting purposes must be consistent with, or not less stringent than, GAAP. The FDIC believes that this requirement does not extend to the Federal banking agencies' definitions of regulatory capital. It is well established that the calculation of regulatory capital for supervisory purposes may differ from the measurement of equity capital for financial reporting purposes, and section 37 by its terms contemplates the necessity of such differences. For example, statutory restrictions against the recognition of goodwill for regulatory capital purposes may lead to differences between the reported amount of equity capital and the regulatory capital calculation for tier one capital. Other types of intangible assets are also subject to limitations under the agencies' regulatory capital rules. In addition, subordinated debt and the allowance for loan and lease losses are examples of items where the regulatory reporting and the regulatory capital treatments differ.

The capital deduction as contained in the revised regulation is not a new concept for the federal banking regulators. The FDIC has required a capital deduction for investments by state nonmember banks in securities underwriting subsidiaries for years. *See* 12 CFR 325.5(c). In addition, the OCC recently endorsed the idea of deducting from capital a national bank's investments in certain types of operating subsidiaries. *See* 12 CFR 5.34(f)(3)(i), 61 FR 60342, 60377 (Nov. 27, 1996).

The calculation of the amount deducted from capital in this proposal includes the bank's equity investment in the subsidiary as well as the bank's share of retained earnings. The calculation does not require the deduction of any loans from the bank to the subsidiary or the bank's investment in the debt securities of the subsidiary.

Several comments questioned the capital deduction requirement. One commenter suggested that the FDIC should consider the impact of this provision on state laws, standards and policies. For example, state loan-to-one borrower restrictions that are determined by the bank's capital level may be affected. The FDIC is setting a capital standard for regulatory purposes. The effect of this standard on limitations based on capital under state law depend on the construction of state laws and regulations.

One comment was supportive of the capital deduction concept but also encouraged the FDIC to reconsider activities at a future date to determine whether it is appropriate to eliminate this requirement. The FDIC agrees with this suggestion and will consider such requests as experience is gained. Affected institutions also have the option of applying to the FDIC and setting forth their arguments why the capital deduction is unnecessary in their cases.

One other comment suggests that if the FDIC imposes the capital deduction, then it is essential that the deduction be limited to the bank's investment in the subsidiaries and not include retained earnings. The commenter contends that this requirement would result in the bank's capital being adversely affected by the subsidiary's success. The FDIC does not agree with this conclusion. The capital deduction required by this standard is a requirement for calculating regulatory capital. Under GAAP, a majority-owned subsidiary is fully consolidated with the bank and included in the amount reported on Statements of Condition and Income in the Consolidated Reports of Condition and Income. The subsidiary's retained earnings are incorporated into the bank's capital through this consolidation process. The treatment required by § 362.4(e) simply isolates the capital used to support the insured state bank from that supporting the subsidiary for regulatory capital purposes. The referenced requirement accomplishes that goal by subtracting both the bank's stock investment in the subsidiary and the bank's share of the subsidiary's retained earnings from the parent bank's capital. This requirement is not punitive as the only amounts subtracted are those equity investments already included on the balance sheet (and thereby balance sheet capital) through consolidation.

Other underwriting activities. The regulatory text does not directly address the underwriting of annuities. The FDIC has opined that annuities are not an insurance product and are not subject to section 24(b) and 24(d)(2), prohibiting the FDIC from authorizing insurance underwriting. The FDIC has approved two requests from insured state banks to engage in annuity underwriting activities through a majority-owned subsidiary. The revised regulation does not provide a notice procedure to engage in such activities. No comment was received on this activity. The FDIC has decided to continue handling such requests on a case-by-case basis through the applications procedures established under this regulation.

Section 362.5 Approvals Previously Granted

There are a number of areas in which the final rule differs in approach from the current part 362. Because of these differing approaches, the revised regulation contains a section dealing with approvals previously granted.

Insured state banks that have previously received consent by order or notice from this agency should not need to reapply to continue the activity, including real estate investment activities, provided the bank and subsidiary, as applicable, continue to comply with the conditions of the order of approval. It is not the intent of the FDIC to require insured state banks to request consent to engage in an activity which has already been approved previously by this agency. Section 362.5(a) of the final rule makes this clear.

One comment stated that banks that have previously received approval from the FDIC should have the option of complying with the original order or the new regulation. The FDIC agrees with this approach. Because previously granted approvals may contain conditions that are different from the standards that are established in this proposal, in certain circumstances, the bank may elect to operate under the restrictions of this proposal. Specifically, the bank may comply with the investment and transaction limitations between the bank and its subsidiaries contained in § 362.4(d), the capital requirement limitations detailed in § 362.4(e), and the subsidiary restrictions as outlined in the term ''eligible subsidiary'' and contained in § 362.4(c)(2) in lieu of similar requirements contained in its approval order. Any conditions that are specific to a bank's situation and do not fall within the above limitations will continue to be effective. Language has been added to the final rule to clarify that once a bank elects to follow the regulatory restrictions instead of those in the approval order, the bank may not elect to revert to the applicable conditions of the order.

An insured state bank that has received a previous approval and qualifies for the exception in § 362.4(b)(5)(i) relating to real estate investment activities that do not exceed 2 percent of the bank's tier one capital may take advantage of the exceptions contained in that section without further application or notice to the FDIC. Additional regulatory language clarifying this point has been added to the final rule in § 362.5(a).

The FDIC has also approved certain activities through its current regulations. Specifically, the FDIC has incorporated and modified the restrictions of § 337.4 in this revision. The revised rule will allow an insured state nonmember bank engaging in a securities activity covered by § 362.4(b)(5)(ii), which has engaged in such activity prior to this rule's effective date in accordance with § 337.4, to continue those activities if the bank and its subsidiary meet the restrictions of § 362.4(b)(5)(ii), (c), (d), and (e). For securities activity covered by § 362.4(b)(5)(ii), the FDIC intends that these requirements replace the restrictions contained in § 337.4.

The FDIC recognizes that the requirements of the final rule differ from the requirements of § 337.4. Because the transition from the current § 337.4 requirements to the new regulatory requirements may have unforeseen implementation problems, the bank and its subsidiary will have one year from the effective date to comply with new restrictions and conditions without further application or notice to the FDIC. If the bank and its subsidiary are unable to comply within the one-year time period, the bank must apply in accordance with § 362.4(b)(1) and subpart G of part 303 to continue with the securities underwriting activity. Commenters did not object to this transition language and it is being implemented as proposed.

The restrictions for engaging in grandfathered insurance underwriting through a subsidiary have also been changed from the current regulation. The current regulation prescribes disclosures, requires that the subsidiary be a bona fide subsidiary, and requires that the bank be adequately capitalized after deducting the bank's investment in the grandfathered insurance subsidiary. The revisions rely on disclosures to bank customers when required by the Interagency Statement, require that the subsidiary meet the requirements of an eligible subsidiary, and require that the bank be well-capitalized after deducting its investment in the grandfathered insurance subsidiary. The FDIC recognizes that these standards are not the same as previous requirements, and the capital standard in particular is more stringent. For grandfathered insurance conducted at the bank level, the final rule also makes certain changes from the current rule, including the requirement that the bank disclose the separate nature of the department to insurance customers. Section 362.5(b)(2) of the final rule provides that an insured state bank which is engaged in providing insurance as principal may continue that activity if it complies with the final rule within 90 days of the effective date of the regulation. If the bank is unable to comply with these provisions setting forth the FDIC's guidance for conducting grandfathered insurance activities in a safe and sound manner, the bank should submit a notice to the FDIC concerning the deficiencies.

Insured state banks that have subsidiaries that have been operating under the exceptions relating to owning stock of a company engaged in activities permissible for a bank service corporation or activities that are not ''as principal'' in the current regulation are now subject to new requirements including the requirement that the subsidiary have at least a control interest in the company conducting the activity. The scope of authorized activities has also been changed slightly. Any bank affected by these changes will have 90 days to meet the requirements of the final rule. If the bank or its subsidiary does not meet these requirements, the bank must apply for the FDIC's consent. The FDIC does not intend to use this request for consent as a punitive measure; however, the FDIC would like to review a bank's investment in these equity securities of companies that are engaged in these activities. Comments did not indicate any circumstance in which this request for consent may be necessary.

The FDIC also is requiring that an insured state bank that converts from a savings association charter and engages in activities through a subsidiary, even if such activity was permissible for a subsidiary of a federal savings association, shall make application or provide notice, whichever applies, to the FDIC to continue the activity unless the activity and manner and amount in which the activity is operated is one that the FDIC has determined by regulation does not pose a significant risk to the deposit insurance fund. Since the statutory and regulatory systems developed for savings associations are different from the bank systems, the FDIC believes that any institution that converts its charter should be subject to the same regulatory requirements as other institutions with the same type of charter.

If, prior to conversion, the savings association had received approval from the FDIC to continue through a subsidiary the activity of a type or in an amount that was not permissible for a federal savings association, the converted insured state bank need not reapply for consent provided the bank and subsidiary continue to comply with the terms of the approval order, meet all the conditions and restrictions for being an eligible subsidiary contained in § 362.4(c)(2), comply with the investment and transactions limits of § 362.4(d), and meet the capital requirement of § 362.4(e). If the converted bank or its subsidiary, as applicable, does not comply with all these requirements, the bank must obtain the FDIC's consent to continue the activity. The FDIC has imposed these conditions to fill a regulatory gap. Savings associations and their service corporations are subject to regulatory standards of separation, the savings association is limited in the amount it may invest in the service corporation, and the savings association must deduct its investment in the service corporation from its capital if the service corporation engages in activities that are not permissible for a national bank. The eligible subsidiary standard, the investment and transaction limits, and the capital requirements replace these standards once the savings association has converted its charter to a bank.

If the bank does not receive the FDIC's consent for its subsidiary to continue an activity, the bank must divest its nonconforming investment in the subsidiary within two years of the date of conversion either by divesting itself of its subsidiary or by the subsidiary divesting itself of the impermissible activity. The FDIC did not receive comment concerning these transition issues for charter conversions. The final rule adopts the language as proposed.

B. Subpart B—Safety and Soundness Rules Governing State Nonmember Banks

Section 362.6 Purpose and Scope

This subpart, along with the notice and application provisions of subpart G of part 303, applies to certain banking practices that may have adverse effects on the safety and soundness of insured state nonmember banks. The FDIC intends to allow insured state nonmember banks and their subsidiaries to undertake only safe and sound activities and investments that would not present a significant risk to the deposit insurance fund and that are consistent with the purposes of federal deposit insurance and other law. The safety and soundness standards of this subpart apply to activities undertaken by insured state nonmember banks through a subsidiary if those activities are permissible for a national bank subsidiary but that are not permissible for the national bank itself. This subpart addresses only real estate investment activities undertaken through a subsidiary; however, the FDIC is issuing concurrently a notice of proposed rulemaking published elsewhere in today's **Federal Register** which addresses securities underwriting and distribution activities conducted by a subsidiary of an insured state nonmember bank if those activities are permissible for a national bank only through a subsidiary. The FDIC has a long history of considering the risks from activities such as real estate investment and securities underwriting and distribution to be unsafe and unsound for a bank to undertake without appropriate safeguards to address that risk. The FDIC also proposes a notice requirement for other activities permissible for a national bank only through a subsidiary.

Additionally, this subpart sets forth the standards that apply when affiliated organizations of insured state nonmember banks that are not affiliated with a bank holding company conduct securities activities. The collective business enterprises of these entities are commonly described as nonbank bank holding company affiliates. The FDIC has a long history of considering the risks from the conduct of securities activities by affiliates of insured state nonmember banks to be unsafe and unsound without appropriate safeguards to address those risks. This rule incorporates many of the standards currently applicable to these entities through § 337.4 of the FDIC's regulations. This rule will replace § 337.4 although that section of the FDIC's rules will not be eliminated until the FDIC finalizes its rule regarding securities activities of subsidiaries. The scope of this regulation is narrower than § 337.4 due to intervening regulations promulgated by other Federal banking agencies that render more comprehensive rules unnecessary. In addition, the FDIC has updated the restrictions and brought them into line with modern views of appropriate securities safeguards between affiliates and insured banks.

Section 362.7 Definitions

The definitions of ''activity'', ''company'', ''control'', ''equity security'', ''insured state nonmember bank'', ''real estate investment activity'', ''security'', and ''subsidiary'' apply as is described above in subpart A. These definitions remain consistent to avoid confusion among the various subparts of this regulation.

This subpart introduces restrictions on activities of entities that are commonly owned with the insured state bank by a holding company that is not considered to be a bank holding company under the Bank Holding Company Act. Therefore, for the purposes of this subpart, ''affiliate'' is defined as any company that directly or indirectly, through one or more intermediaries, controls or is under common control with an insured state nonmember bank. The proposed definition of the term ''affiliate'' was not intended to include a subsidiary of an insured state nonmember bank, and language expressly stating this has been added in the final rule to clarify this point. Subsidiaries of insured state nonmember banks engaged in these activities are already covered by § 362.4(b)(5)(ii).

Section 362.8 Restrictions on Activities of Insured State Nonmember Banks

Real Estate. Since national banks are generally prohibited from owning and developing real estate, insured state banks have been required to apply to the FDIC under section 24 before undertaking or continuing such real estate activities. The FDIC has concluded as a result of its experience in reviewing these applications that while real estate investments generally possess many risks that are not readily comparable to other equity investments, institutions may contain these risks by undertaking real estate investments within certain parameters. The FDIC has considered the manner under which an insured state nonmember bank may undertake real estate investment activities and determined that insured state nonmember banks and their subsidiaries should generally meet certain standards before engaging in real estate investment activities that are not permissible for national banks. As a result, the final rule establishes standards under which insured state nonmember banks may participate in real estate investment activities. These standards address the FDIC's safety and soundness concerns with real estate investment activities permissible for a national bank subsidiary but not for the national bank itself. Providing this listing of such standards will allow insured state nonmember banks to initiate investment activities with knowledge of what the FDIC considers when evaluating the safety and soundness of the operations of the institution and its subsidiaries. This rule simplifies and clarifies the standards under which insured state nonmember banks may conduct their investment activities while providing comprehensive and flexible regulation of the dealings between a bank and its subsidiaries.

Certain standards under the regulation also pertain to the FDIC's willingness to allow an eligible institution to commence the activity after expedited notice to the FDIC, rather than a full application process. Under the FDIC's regulation, if an institution and its real estate investment operations meet the standards established, the institution need only file notice with the FDIC as outlined in subpart G of part 303. However, if the institution and its operations do not meet the general standards set forth in this rule, or if the institution so chooses, it may file application with the FDIC for the FDIC's consent, in accordance with procedures set out in subpart G of part 303.

One commenter stated that establishing additional regulations on insured state nonmember banks is excessive. Such banks are already regulated by the state in which they are domiciled. The FDIC believes that the risks associated with real estate investment activities are such that it must establish standards for the conduct of that activity. The notice of proposed rulemaking contained an extensive discussion of these risks. In addition to the high degree of market variability, real estate markets are, for the most part, localized; investments are normally not securitized; financial information flow is often poor; and the market is generally not very liquid. A financial institution—like any other investor—faces substantial risks when it takes an equity position in a real estate venture. Market participants face a general trade-off: the riskier the project, the higher the required rate of return. A key aspect of that trade-off is the notion that a riskier project will entail a higher probability of significant losses for the investor. Assessments of the degree of risk will depend on factors affecting future returns such as cyclical economic developments, technological advances, structural market changes, and the project's sensitivity to financial market changes.

The FDIC recognizes its ongoing responsibility to ensure the safe and sound operation of insured state nonmember banks and their subsidiaries. Although this subpart creates new regulation for insured state nonmember banks, the FDIC does not believe that this burden is too great in relation to the risks of real estate investment activities.

Another commenter expressed concern about consistency stating that the unintended consequence of this approach may result in different regulatory treatment applicable to insured state nonmember banks as opposed to national banks and state member banks. Another comment echoes this sentiment stating that it is likely that national banks will be subject to case by case restrictions of the OCC but these restrictions will not carry the weight and force of those set by regulation. The commenter recommends parallel treatment between national and state banks. The FDIC does not believe it is in the best interest of insured state nonmember banks to automatically follow the safety and soundness restrictions of an interpretation, order, circular or official bulletin issued by the OCC regarding real estate investment activities that are permissible for the subsidiary of a national bank but are not permissible for a national bank itself. The process established in this subpart gives insured state nonmember banks the option to apply to the FDIC to engage in real estate investment activities suggesting whatever criteria the applicant believes to be appropriate for the risk involved with the activity. The standards set forth in this regulation allow applicants to use an expedited notice procedure. These standards are not absolute criteria that the FDIC cannot vary. If the FDIC adopted the regulatory and interpretive standards set by the OCC, insured state nonmember banks would have no flexibility to request variance from these standards. The FDIC believes that the risks may be different for different real estate investment activities. Therefore, the flexible approach established in this regulation is important in finding appropriate standards for the risks presented. State nonmember banks are treated consistently with national banks in that each must submit a request to their primary Federal regulator to engage in real estate investment activities through a subsidiary.

Another comment states that the regulatory differences between state and national institutions harm the dual banking system especially during a period of rapid interstate expansion. The FDIC is a strong supporter of the dual banking system. For insured state nonmember banks to compete effectively, the supervisory system should be expeditious in its response to the industry. This regulation establishes procedures in which insured state nonmember banks may use a notice procedure and follow standards established in this regulation or may file an application and request variance from these standards. The FDIC believes that a system that allows an insured state nonmember bank to directly petition its primary federal regulator to conduct real estate investment activities in a subsidiary is more appropriate than a situation in which these activities of insured state nonmember banks are restricted by regulations, orders and interpretations of the OCC.

Section 362.8(a) of the regulation addresses the FDIC's ongoing supervisory concerns regarding real estate investment activities and imposes procedures to address the FDIC's concerns about the safety and soundness of these activities. Depending upon the facts, the potential risks inherent in a bank subsidiary's involvement in real estate investment activities may make restrictions and limitations necessary to protect the bank and ultimately the deposit insurance funds from losses associated with the significant risks inherent in real estate investment activities.

To address its safety and soundness concerns about real estate investment activities not permissible for a national bank, the FDIC has adopted the same standards when insured state banks conduct those real estate investment activities regardless of whether those real estate investment activities are permissible for a national bank subsidiary. This subpart addresses the impact on insured state nonmember banks if the OCC were to approve applications submitted by national banks to conduct real estate investment activities through operating subsidiaries.

Unless the FDIC has previously given its approval for the bank to engage in the particular real estate investment activity that is not permissible for a national bank, an insured state nonmember bank must file a notice or application with the FDIC in order to directly or indirectly undertake a real estate investment activity, even if the real estate investment activity is permissible for the subsidiary of a national bank. To qualify for the notice provision under this new regulation, the insured state nonmember bank and its subsidiary must meet the standards established in § 362.4(b)(5)(i). After filing a notice as provided for in subpart G of part 303 to which the FDIC does not object, the institution may then proceed with its investment activities. If the insured state nonmember bank and its subsidiary do not meet the standards established under the rule, or if the institution so chooses, an application for the FDIC's consent may be filed under the procedures set out in subpart G of part 303.

Affiliation With Securities Companies. Section 362.8(b) reflects the FDIC's longstanding view that an unrestricted affiliation with a securities company may have adverse effects on the safety and soundness of insured state nonmembers banks. This section reiterates the § 337.4 prohibition against any affiliation by an insured state nonmember bank with any company that directly engages in the underwriting of stocks, bonds, debentures, notes, or other securities which is not permissible for a national bank unless certain conditions are met. The final rule permits the affiliation only if:

(1) The securities business of the affiliate is physically separate and distinct in its operations from the operations of the bank, provided that this requirement shall not be construed to prohibit the bank and its affiliate from sharing the same facility if the area where the affiliate conducts retail sales activity with the public is physically distinct from the routine deposit taking area of the bank;

(2) The affiliate has a chief executive officer who is not an employee of the bank;

(3) A majority of the affiliate's board of directors are not directors, officers, or employees of the bank;

(4) The affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and the state-chartered depository institution is not responsible for and does not guarantee the obligations of the affiliate;

(5) The bank adopts policies and procedures, including appropriate limits on exposure, to govern their participation in financing transactions underwritten by an underwriting affiliate;

(6) The bank does not express an opinion on the value or the advisability of the purchase or sale of securities underwritten or dealt in by an affiliate unless it notifies the customer that the entity underwriting, making a market, distributing or dealing in the securities is an affiliate of the bank;

(7) The bank does not purchase as principal or fiduciary during the existence of any underwriting or selling syndicate any securities underwritten by the affiliate unless the purchase is approved by the bank's board of directors before the securities are initially offered for sale to the public;

(8) The bank did not condition any extension of credit to any company on the requirement that the company contract with, or agree to contract with, the bank's affiliate to underwrite or distribute the company's securities;

(9) The bank did not condition any extension of credit or the offering of any service to any person or company on the requirement that the person or company purchase any security underwritten or distributed by the affiliate; and

(10) The bank complies with the investment and transaction limitations of § 362.4(d). These standards have been adopted as proposed although the language of § 362.8(b)(4) has been changed to be consistent with that proposed in subpart A.

Many of the restrictions and prohibitions listed above are contained currently in § 337.4. Additionally, the conditions that are imposed, under § 362.4(b)(5)(ii), on subsidiaries which engage in the sale, distribution, or underwriting of securities such as adopting independent policies and procedures governing participation in financing transactions underwritten by an affiliate, expressing opinions on the advisability of the purchase or sale of particular securities, and purchasing securities as principal or fiduciary only with prior board approval have been added. As indicated earlier, the prohibition against shared officers has been eased and now only refers to the chief executive officer. Comments did not object to these standards and they are not being adopted as proposed.

As written, the regulation only applies these restrictions to an insured state nonmember bank affiliated with a company not treated as a bank holding company pursuant to section 4(f) of the Bank Holding Company Act (12 U.S.C. 1843(f)), that directly engages in the underwriting of stocks, bonds, debentures, notes, or other securities which are not permissible for a national bank. Other affiliates now covered by the safeguards of § 337.4 would no longer be covered under the FDIC's regulations. Other affiliates are adequately separated from the banks by the restrictions imposed by the FRB. Therefore, the final regulation has been streamlined to eliminate duplicative coverage of these affiliates.

Because of the bank/affiliate relationship covered by this subpart, the term ''investment'' also includes the bank's investment in the equity securities of the affiliate. This treatment is consistent with section 23A. No comment was received on this treatment and the definition of investment for subpart B is adopted as proposed.

Disclosure provisions contained in § 337.4 are not contained in this rule. If securities underwritten, distributed or sold by the affiliate are sold on bank premises, are sold by employees of the bank, or are sold subject to the bank receiving remuneration for the transaction, the sale is covered by the disclosures contained in the Interagency Statement on Retail Sales of Nondeposit Investment Products. Sales occurring outside these parameters are not likely to generate customer confusion; however, the affiliate is responsible for informing its customers that the affiliate is a separate organization from the bank and the bank is not responsible for and does not guarantee the obligations of the affiliate whenever confusion is likely to occur.

C. Subpart C—Activities of Insured State Savings Associations

Section 362.9 Purpose and Scope

The intent of § 362.9 is to clarify that the purpose and scope of subpart C is to ensure that activities and investments undertaken by insured state savings associations and their service corporations do not present a significant risk to the deposit insurance funds, are not unsafe and are not unsound, are consistent with the purposes of federal deposit insurance, and are otherwise consistent with law. This subpart, together with the notice and application procedures of subpart H of part 303, implements the provisions of section 28 of the FDI Act that restrict and prohibit insured state savings associations and their service corporations from engaging in activities and investments of a type that are not permissible for federal savings associations and their service corporations. The phrase ''activity permissible for a federal savings association'' means any activity authorized for federal savings associations under any statute including the Home Owners Loan Act (HOLA), as well as activities recognized as permissible for a federal savings association in regulations, official thrift bulletins, orders or written interpretations issued by the OTS, or its predecessor, the Federal Home Loan Bank Board.

Regarding insured state savings associations, this subpart governs only activities conducted ''as principal'' and therefore does not govern activities conducted as agent for a customer, conducted in a brokerage, custodial, advisory, or administrative capacity, conducted as trustee, or conducted in any substantially similar capacity. In the final rule, the FDIC has added a list of examples of what types of activities are not ''as principal.'' This change is consistent with the addition of such material to the purpose and scope section of subpart A. However, this subpart covers all activities regardless of whether conducted ''as principal'' or in another capacity at the service corporation level. This subpart does not restrict any interest in real estate in which the real property is (a) used or intended in good faith to be used within a reasonable time by an insured state savings association or its service corporations as offices or related facilities for the conduct of its business or future expansion of its business or (b) used as public welfare investments of a type and in an amount permissible for federal savings associations. Equity investments acquired in connection with debts previously contracted that are held within the shorter of the time limits prescribed by state or federal law are not subject to the limitations of this subpart.

The FDIC intends to allow insured state savings associations and their service corporations to undertake only safe and sound activities and investments that do not present a significant risk to the deposit insurance funds and that are consistent with the purposes of federal deposit insurance and other applicable law. This subpart does not authorize any insured state savings association to make investments or conduct activities that are not authorized or that are prohibited by either federal or state law.

Section 362.10 Definitions

Section 362.10 of the final regulation contains the definitions used in this subpart. Rather than repeating terms defined in subpart A, the definitions contained in § 362.2 are incorporated into subpart C by reference. Included in the definitions are most of the terms currently defined in subpart G of Part 303, effective October 1, 1998, (formerly § 303.13) of the FDIC's regulations. The proposed rule made editing changes primarily to enhance clarity without changing the meaning. However, certain changes were made to alter the meaning of the terms and these changes are identified in this discussion. The final rule adopts the proposed definitions without further change.

The terms ''corporate debt securities not of investment grade'' and ''qualified affiliate'' have been directly imported into subpart C from subpart G (§ 303.141) without substantive change. Substantially the same ''control'' and ''equity security'' definitions are incorporated by reference to subpart A. The last sentence of the current ''equity security'' definition, which excludes equity securities acquired through foreclosure or settlement in lieu of foreclosure, was deleted for the same reason that similar language was deleted from several definitions in subpart A. Language is now included in the purpose and scope paragraph explaining that equity investments acquired through such actions are not subject to the regulation. No substantive change from current rules is intended by this modification.

Consistent with the proposal, modified versions of ''activity'', ''equity investment'', ''significant risk to the fund'', and ''subsidiary'' were also carried forward by reference to subpart A. As proposed, the definition of activity was expanded to encompass all activities including acquiring or retaining equity investments. This change was made to conform the ''activity'' definition used in the regulation to that provided in the governing statutes. Both sections 24 and 28 of the FDI Act define activity to include acquiring or retaining any investment. Sections of this part governing activities other than acquiring or retaining equity investments include statements specifically excluding the activity of acquiring or retaining equity investments.

Consistent with the proposal, the ''equity investment'' definition was modified to better identify its components. The definition includes any ownership interest in any company. This change was made to clarify that ownership interests in limited liability companies, business trusts, associations, joint ventures and other entities separately defined as a ''company'' are considered equity investments. Additionally, as proposed, the definition was expanded to include any membership interest that includes a voting right in any company, and a sentence was added excluding from the definition any of the identified items when taken as security for a loan. The intended effect of these changes is not to broaden the scope of the regulation, but instead to clarify the FDIC's position that such investments are all considered equity investments notwithstanding the form of business organization.

Consistent with the proposal, the definition of ''significant risk'' was effectively retitled ''significant risk to the fund'' by the reference to subpart A. As proposed, a second sentence was added to the definition explaining that a significant risk to the fund may be present either when an activity or an equity investment contributes or may contribute to the decline in condition of a particular state-chartered depository institution or when a type of activity or equity investment is found by the FDIC to contribute or potentially contribute to the deterioration of the overall condition of the banking system. This sentence is intended to elaborate on the FDIC's position that the absolute size of a projected loss in comparison to the deposit insurance funds is not determinative of the issue. Additionally, it clarifies the FDIC's position that risk to the fund may be present even if a particular activity or investment may not result in the imminent failure of an institution. The FDIC received four comments addressing this definition which are detailed in the discussion of the applicable definition in subpart A.

With the exception of substituting the separately defined term ''company'' for the list of entities such as corporations, business trusts, associations, and joint ventures currently in the ''subsidiary'' definition, the final rule makes little change from the current definition. It is noted that limited liability companies are now included in the company definition and, by extension, are included in the subsidiary definition. The only other change from current rules is that in the definition of subsidiary, the exclusion of ''insured depository institutions'' for purposes of § 303.146 (as effective October 1, 1998, formerly § 303.13(f)) has been moved to the purpose and scope section of proposed subpart D. No substantive changes are intended by these modifications. The FDIC received no comments on these definitions which are adopted as proposed.

While proposed subpart C retained substantially the same ''service corporation'' definition as the current rule, the proposal deleted the word ''only'' from the phrase ''available for purchase only by savings associations''. This change was intended to make it clear that a service corporation of an insured state savings association may invest in lower-tier service corporations if allowed by this part or FDIC order, and it is consistent with the recently amended part 559 of the OTS' regulations (12 CFR part 559). The change was not intended to alter the nature of the requirements governing the savings association's equity investment in the first-tier service corporation. No comments were received on this change and the final rule adopts it as proposed.

As in subpart A and consistent with the proposal, the definition of ''equity interest in real estate'' was deleted in the final regulation. The exceptions detailed in § 303.141(e) (as effective October 1, 1998, formerly § 303.13(a)(5)) of the current definition were moved to the purpose and scope paragraph. As a result, readers are now informed that these excepted real estate investments are not subject to this regulation. The FDIC believes that the remaining content of the current definition fails to provide any meaningful clarity or understanding. Therefore, the FDIC will instead rely on the ''equity investment'' definition to include relevant real estate investments. A related change was made to the ''equity investment'' definition by deleting the reference to ''equity interest in real estate'' and replacing it with language to include any interest in real estate (excluding real estate that is not within the scope of this part). No substantive changes are intended by these modifications.

Consistent with the proposal, a definition for the term ''insured state savings association'' is added to the final rule. Because this term is not explicitly defined in section 3 of the FDI Act, this definition was added to ensure readers clearly understand that an insured state savings association means any state chartered savings association insured by the FDIC.

Other terms that were previously undefined, but that are added by the general incorporation of the definitions in subpart A should not result in any substantive changes to the meanings of those terms as currently used in subpart G of part 303, effective October 1, 1998, (formerly § 303.13) of the FDIC's regulations.

Section 362.11 Activities of Insured State Savings Associations

Equity investment prohibition. Section 362.11(a)(1) of the final regulation replaces the provisions of § 303.144(a) (as effective October 1, 1998, formerly § 303.13(d)) of the FDIC's current regulations and restates the statutory prohibition preventing insured state savings associations from making or retaining any equity investment of a type, or in an amount, not permissible for a federal savings association. The prohibition does not apply if the statutory exception (restated in the current regulation and carried forward in the proposal) contained in section 28 of the FDI Act applies. With the exception of deleting items no longer applicable due to the passage of time, this provision is retained as currently in effect without any substantive changes.

Exception for service corporations. The final regulation retains the exception now in § 303.144(b) (as effective October 1, 1998, formerly § 303.13(d)(2)) which allows investments in service corporations as currently in effect without any substantive change. However, consistent with the proposal, the FDIC has modified the language of this section using a structure paralleling that found in proposed subpart A permitting insured state banks to invest in majority-owned subsidiaries. Similar to the treatment accorded insured state banks, an insured state savings association must meet and continue to be in compliance with the capital requirements prescribed by the appropriate federal banking agency and the FDIC must determine that the activities to be conducted by the service corporation do not present a significant risk to the relevant deposit insurance fund. However, unlike the treatment accorded banks, the FDIC must also determine that the amount of the investment does not present a significant risk to the relevant deposit insurance fund. The criteria identified in the preceding sentences are derived directly from the underlying statutory language. For an insured state savings association to invest in service corporations engaging in activities that are not permissible for a service corporation of a federal savings association, the service corporation must be engaging in activities or acquiring and retaining investments described in § 362.12(b) as regulatory exceptions to the general prohibition.

We moved language currently in § 303.144(b)(2) (as effective October 1, 1998, formerly § 303.13(d)) concerning the filing of applications to acquire an equity investment in a service corporation to § 303.141 of the amended subpart H of part 303.

Activities other than equity investments. Section 362.11(b) of the final regulation replaces the sections now found at §§ 303.142, 303.143 and 303.144 (as effective October 1, 1998, formerly §§ 303.13(b), 303.13(c), and 303.13(e), respectively) of the FDIC's regulations. As proposed, some portions of the existing sections have been eliminated because they are no longer necessary due to the passage of time, and other portions have been edited and reformatted in a manner consistent with the corresponding sections of subpart A. Language currently in the referenced sections of part 303 concerning notices and applications has been edited, reformatted, and moved to the amended subpart H of part 303.

Prohibited activities. Section 362.11(b)(1) of the final regulation restates the statutory prohibition that insured state savings associations may not directly engage as principal in any activity of a type, or in an amount, that is not permissible for a federal savings association unless the activity meets a statutory or regulatory exception. Similar to language found in subpart A for insured state banks, the proposed rule added language to clarify that this prohibition does not supersede the equity investment exception of § 362.11(a)(2). The FDIC added this language because acquiring or retaining any investment is defined as an activity. The language has been adopted in the final rule without change from the proposal.

The statutory prohibition preventing state and federal savings associations from directly, or indirectly through a subsidiary (other than a subsidiary that is a qualified affiliate), acquiring or retaining any corporate debt that is not of investment grade after August 9, 1989, is also carried forward from what is now § 303.145 (as effective October 1, 1998, formerly § 303.13(e)) of the FDIC's regulations. However, consistent with the proposal, the § 303.145 requirement was deleted. The referenced section required savings institutions to file divestiture plans concerning corporate debt that was not of investment grade and that was held in a capacity other than through a qualified affiliate. Divestiture was required by no later than July 1, 1994, rendering that provision unnecessary due to the passage of time.

Exceptions to the other activities prohibition. The statutory exception to the other activities prohibition contained in section 28 of the FDI Act continues to function in a manner similar to the relevant provisions of what is now found in subpart H of part 303. The regulation continues to permit an insured state savings association to retain any asset (including a nonresidential real estate loan) acquired prior to August 9, 1989. However, corporate debt securities that are not of investment grade may only be purchased or held by a qualified affiliate. Whether or not the security is of investment grade is measured only at the time of acquisition.

Additionally, the FDIC has provided regulatory exceptions to the other activities prohibition. The first exception retains the application process now found at § 303.142 (as effective October 1, 1998, formerly §§ 303.13(b)(1)) and provides insured state savings associations with the option of applying to the FDIC for approval to engage in an activity of a type that is not permissible for a federal savings association. Additionally, the notice process currently found at § 303.143 (as effective October 1, 1998, formerly § 303.13(c)(1)) is carried forward for insured state savings associations that want to engage in activities of a type permissible for a federal savings association, but in an amount exceeding that permissible for federal savings associations. The final regulation adds a regulatory exception enabling insured state savings associations to acquire and retain adjustable rate, money market preferred stock, and instruments determined by the FDIC to have similar characteristics without submitting an application to the FDIC if the acquisition is done within the prescribed limits.

The final regulation deletes a proposed exception that would have allowed an insured state savings association to engage as principal in any activity that is not permissible for a federal savings association provided that the FRB has found the activity to be closely related to banking pursuant to 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)). Upon further analysis, the FDIC determined that this exception would have little utility because most of the activities authorized by the FRB under the referenced authority are already permissible for federal savings associations or are otherwise addressed in this regulation. In the preamble to the proposal, the FDIC requested comment from savings associations on whether the proposed standard was appropriate and beneficial. The FDIC received only one comment, indicating that state savings associations were generally unaware of what is authorized by the 4(c)(8) list and that the FDIC should be more specific. The FDIC has decided to eliminate the reference and specifically address those activities that are allowed. The elimination of this proposed authority is consistent with the FDIC's elimination of the corresponding authority for state banks in subpart A.

Consent obtained through application. Section 28 prohibits insured state savings associations from directly engaging in activities of a type or in an amount not permissible for a federal savings association unless: (1) The association meets and continues to meet the capital standards prescribed by the appropriate federal financial institution regulator; and (2) the FDIC determines that conducting the activity in the additional amount will not present a significant risk to the relevant deposit insurance fund. Section 362.11(b)(2)(i) establishes an application option for savings associations that meet the relevant capital standards and that seek the FDIC's consent to engage in activities that are otherwise prohibited. The substance of this process is unchanged from the relevant sections of part 303 of the FDIC's current regulations. The regulation is being adopted without change from its proposed form.

Nonresidential realty loans permissible for a federal savings association conducted in an amount not permissible. Consistent with the proposal, the final regulation carries forward and modifies the provision now found at § 303.142 (as effective October 1, 1998, formerly § 303.13(b)(1)) of this chapter requiring an insured state savings association that wants to hold nonresidential real estate loans in an amount exceeding the limits described in section 5(c)(2)(B) of HOLA (12 U.S.C. 1464 (c)(2)(B)) to apply for the FDIC's consent. Unlike the current regulation, the final regulation enables the insured state savings association to submit a notice to seek the FDIC's approval instead of an application. This change is nonsubstantive and is made to expedite the process for insured state savings associations wanting to exceed the referenced limits. None of the comments submitted addressed this change.

Acquiring and retaining adjustable rate and money market preferred stock. The final regulation extends to insured state savings associations a revised version of the proposed regulatory exception allowing an insured state bank to invest in up to 15 percent of its tier one capital in adjustable rate preferred stock and money market (auction rate) preferred stock without filing an application with the FDIC. By statute, however, insured savings associations are restricted in their ability to purchase debt that is not of investment grade. This regulatory exception does not override that statutory prohibition and any instruments purchased must comply with that statutory constraint. Additionally, this exception is only extended to savings associations meeting and continuing to meet the applicable capital standards prescribed by the appropriate federal financial institution regulator.

When this regulatory exception was adopted for insured state banks in 1992, the FDIC found that adjustable rate preferred stock and money market (auction rate) preferred stock were essentially substitutes for money market investments such as commercial paper and that their characteristics are closer to debt than to equity securities. Therefore, money market preferred stock and adjustable rate preferred stock were excluded from the definition of equity security. As a result, these investments are not subject to the equity investment prohibitions of the statute and the regulation, and they are considered an ''other activity'' for the purposes of this regulation.

This exception focuses on two categories of preferred stock. This first category, adjustable rate preferred stock refers to shares where dividends are established by contract through the use of a formula based on Treasury rates or some other readily available interest rate levels. Money market preferred stock refers to those issues where dividends are established through a periodic auction process that establishes yields in relation to short term rates paid on commercial paper issued by the same or a similar company. The credit quality of the issuer determines the value of the security, and money market preferred shares are sold at auction.

The FDIC continues to believe that the activity of investing up to 15 percent of an institution's tier one capital in the referenced instruments does not represent a significant risk to the deposit insurance funds. Furthermore, the FDIC believes the same funding option should be available to insured state savings associations and extends a similar exception to savings associations subject to the same revised limits.

Additionally, like a similar provision in subpart A, the final regulation allows the state savings associations to acquire and retain other instruments of a type determined by the FDIC to have the character of debt securities provided the instruments do not represent a significant risk to the deposit insurance funds. A recent example of such an instrument is trust preferred stock. Trust preferred stock is a hybrid instrument possessing characteristics typically associated with debt obligations. Trust preferred securities are issued by an issuer trust that uses the proceeds to purchase subordinated deferrable interest debentures in a corporation. The corporation guarantees the obligations of the issuer trust and agrees to indemnify third parties for other expenses and liabilities incurred by the issuer trust. Taken together, the debentures, guarantee, and expense indemnity agreement constitute a full, irrevocable, and unconditional guarantee of the obligations of the issuer trust by the issuer corporation. With the exception of credit risk, investors in trust preferred stock are protected from changes in the value of the instruments. Like investors in debt securities, trust preferred stock investors do not share any appreciation in the value of the issuer and have no voting rights in the management or ordinary course of business of the issuer. Additionally, trust preferred stock is not perpetual and distributions on the stock resemble the periodic interest payments on debt. In essence, such investments are functionally equivalent to investments in the underlying debentures. Investments in such instruments are aggregated with investments in adjustable rate and money market preferred stock for purposes of applying the limit of 15 percent of tier one capital.

Guarantee activities. When drafting the proposal, the FDIC considered adding an exception for guarantee activities including credit card guarantee programs and comparable arrangements that would have been similar to that which we proposed to delete from subpart A. These programs typically involve a situation where an institution guarantees the credit obligations of its retail customers. Although the FDIC continues to believe that these activities present no significant risk to the deposit insurance funds, the FDIC proposed deleting this activity from subpart A because it was determined that national banks, and therefore insured state banks, may already engage in the activities. The FDIC determined that federal savings associations, and by extension insured state savings associations, may engage in these activities as well. The FDIC received no comments advocating the addition of an exception for these activities and, as a result, no exception was crafted.

Section 362.12 Service Corporations of Insured State Savings Associations

Section 362.12 of the final regulation governs the activities of service corporations of insured state savings associations and generally replaces what is now found at § 303.144(b) (as effective October 1, 1998, formerly § 303.13(d)(2)) of the FDIC's regulations. The section reorganizes the substance of the current regulation and consolidates all provisions concerning the activities of service corporations into the same section. Language currently in § 303.144(b) (as effective October 1, 1998, formerly § 303.13(d)(2)) concerning applications was revised and moved to §§ 303.141 and 303.142 of subpart H of part 303. Additionally, the FDIC extended several regulatory exceptions closely resembling similar exceptions provided to subsidiaries of insured state banks in subpart A of this final regulation. The FDIC notes that if the service corporation is a new subsidiary or is a subsidiary conducting a new activity, all of the exceptions in § 362.12 remain subject to the notice provisions contained in section 18(m) of the FDI Act which are now being implemented in subpart D of this regulation.

General prohibition. A service corporation of an insured state savings association may not engage in any activity that is not permissible for a service corporation of a federal savings association unless the savings association submits an application and receives the FDIC's consent or the activity qualifies for a regulatory exception. This provision does not represent a substantive change from the current regulation. The regulatory language implementing this prohibition has been separated from the restrictions in § 362.11 prohibiting an insured state savings association from directly engaging in activities which are not permissible for a federal savings association. By separating the savings association's activities and those of a service corporation, § 362.12 deals exclusively with activities that may be conducted by a service corporation of an insured state savings association.

Consent obtained through application. Consistent with the proposal, the final regulation continues to allow insured state savings associations to submit applications seeking the FDIC's consent to engage in activities through a service corporation that are otherwise prohibited. Section 362.12(b)(1) carries forward the substance of the application option in § 303.144(b) (as effective October 1, 1998, formerly § 303.13(d)(2)) of the FDIC's current regulations. Approval will be granted only if: (1) The savings association meets and continues to meet the applicable capital standards prescribed by the appropriate federal banking agency; and (2) the FDIC determines that conducting the activity in the requested amount will not present a significant risk to the relevant deposit insurance fund.

Service corporations conducting unrestricted activities.

The FDIC has found that it is not a significant risk to the deposit insurance fund if a service corporation engages in certain activities as long as the insured state savings association continues to meet the applicable capital standards prescribed by the appropriate federal banking agency. One of these activities, authorized by § 362.12(b)(2)(i) of the final rule, is owning a control interest in a company that engages in securities activities authorized by § 362.12(b)(4), provided the activity is conducted pursuant to the limitations and requirements of § 362.12(b)(4), including the requirement that the insured state savings association files a notice with the FDIC to which the FDIC does not object. The regulation specifies that both the service corporation and the lower tier company must meet the investment and transaction limits, and the capital deduction, that would apply if the service corporation engaged in the securities activities directly under § 362.12(b)(4), to ensure that the service corporation is not used as a conduit to the lower tier company in derogation of these requirements. The savings association must also meet the same core eligibility requirements that would apply if the service corporation engaged in the activity directly, and the savings association and the lower tier company must meet certain additional requirements in § 362.12(b)(4). However, with regard to the core eligibility requirements applicable to a service corporation conducting the activity under § 362.12(b)(4), these may be observed by the service corporation, or in the alternative by the lower tier company if the company takes corporate form.

The FDIC also extended a regulatory exception enabling service corporations to acquire and retain equity securities of a company engaged in the following activities: (1) Activities permissible for a federal savings association; (2) any activity permissible for the savings association itself under § 362.11(b)(2)(iii); or (3) insurance agency activities. The service corporation must either own a controlling interest in a company engaging in these activities, or the company must be controlled by insured depository institutions. The FDIC provided similar exceptions to majority-owned subsidiaries of insured state banks in subpart A. Sections 362.12(b)(2) (i) through (ii) are intended to cover a service corporation's investment in lower level subsidiaries engaged in activities that the FDIC has found to present no significant risk to the deposit insurance fund.

The final version differs from the proposal in that, as is the case in the corresponding provision of subpart A, the FDIC created a limited exception to the control requirement under § 362.12(b)(2)(ii) if the company is controlled by a group of insured depository institutions. This accommodates community associations wishing to form a consortium of associations to provide financial services for their customers that one association cannot provide on a cost effective basis.

The final version also differs from the proposal in that, as is the case in the corresponding provision of subpart A, the activities authorized for the lower-level company are not identical to the activities proposed.[15] The FDIC made this change to remain consistent with subpart A. The rule as adopted does not eliminate any authorization granted by current rules, and the FDIC received no comments on the proposal, so the change from the proposed activities will have no impact on state savings associations.

Section 28 of the FDI Act requires the FDIC's consent before a service corporation may engage in any activity that is not permissible for a service corporation of a federal savings association. While the language of section 28 governs only activities conducted ''as principal'' by insured state savings associations, the ''as principal'' language was not extended to service corporations in the governing statute. This means that even if the activity is not conducted ''as principal'', the subpart C prohibition applies if the activity is not permissible for a service corporation of a federal savings association.

Because the FDIC believes that activities conducted other than ''as principal'' present no significant risk to the relevant deposit insurance fund, we provided an exception in § 362.12(b)(2)(iii) allowing a service corporation of an insured state savings association to act other than ''as principal,'' if the savings association meets and continues to meet the applicable capital standards prescribed by its appropriate federal banking agency. The FDIC received no comments on this exception. The final regulation also requires a savings association to own a control interest in a service corporation conducting the activities. The control requirement was added to more closely approximate the treatment accorded to insured state banks and their subsidiaries. Insured state bank subsidiaries can act other than ''as principal.'' However, a subsidiary is defined as being a company controlled by a depository institution. Therefore, the control standard imposed in this section equates the ownership interest requirements of insured state savings associations and insured state banks. Additionally, it helps differentiate between an insured state savings association controlling a company and simply investing in the shares of a company.

The FDIC also provided, at § 362.12(b)(2)(iv) of the final rule, an exception allowing service corporations of qualifying savings associations to invest in adjustable rate preferred stock, money market (auction rate) preferred stock, and other instruments of a type determined by the FDIC to have the character of debt securities provided the instruments do not represent a significant risk to the deposit insurance funds. Investments by a service corporation in these instruments are combined with and subject to the same limits applicable to the parent savings association. The FDIC did not receive any comments on extending this exception to insured state savings associations and the exception is adopted as proposed.

Owning equity securities that do not represent a control interest. For the same reasons previously stated in the preamble discussion of subpart A, no notice procedure is being adopted at this time. Staff has been instructed to undertake further study of the proposal.

Securities underwriting. Section 362.12(b)(4) of the final regulation allows an insured state savings association to acquire or retain an investment in a service corporation that underwrites or distributes securities that would not be permissible for a federal savings association to underwrite or distribute if notice is filed with the FDIC, the FDIC does not object to the notice before the end of the notice period, and a number of conditions are and continue to be met.

This exception enabling service corporations to underwrite or distribute securities is patterned on the exception found in subpart A (see § 362.4(b)(5)(ii)). In both cases, the state-chartered depository institution must conduct the securities activity in compliance with the core eligibility requirements, the same additional requirements listed for this activity in subpart A, and the investment and transaction limits. The savings association also must meet the capital requirements and the service corporation must meet the ''eligible subsidiary'' requirements as an ''eligible service corporation''. Since the requirements are the same as those imposed in subpart A and the risks of the activity are identical, the discussion in subpart A is not repeated here.

Notice of change in circumstance. Like subpart A, the final rule requires the insured state savings association to provide written notice to the appropriate Regional Office of the FDIC within 10 business days of a change in circumstances concerning its securities subsidiary authorized by § 362.12(b)(4). Under the regulation, a change in circumstances is described as a material change in the service corporation's business plan or management. Together with the insured state savings association's primary federal financial institution regulator, the FDIC believes that it may address a savings association's falling out of compliance with any of the other conditions of approval through the normal supervision and examination process.

The FDIC is concerned about changes in circumstances which result from changes in management or changes in a service corporation's business plan. If material changes to either condition occur, the regulation requires the association to submit a notice of such changes to the appropriate FDIC regional director (DOS) within 10 days of the material change. The material change standard includes such events as a change in chief executive officer of the service corporation or a change in investment strategy or type of business or activity engaged in by the service corporation. The FDIC received two comments concerning the change of circumstance notice. Both comments indicated that the notice is burdensome and unnecessary. The comments argue that a change in the chief executive office or investment strategies are routine. The FDIC places significant reliance on the management structure and business plan presented when an activity is approved for a service corporation. The FDIC does not consider either change to be routine and believes that it is important that the FDIC be aware of material changes in the operations of service corporations engaging in activities that are not permissible for a service corporation of a federal savings association. One comment requested that the notice period be extended from 10 to 30 days. The FDIC believes that both a change in management and a change in the business plan of the service corporation are matters that should receive significant consideration before these events occur. The FDIC does not believe that it is unreasonable to require notices of these events within 10 days. Therefore, the final regulation retains the requirement that a notice of change of circumstances be submitted to the

[15] The proposal would have authorized the lower tier company to engage in any activity permissible for a federal savings association; hold adjustable rate or money market preferred stock up to 15 percent of tier one capital; engage in activities (subject to certain exceptions) authorized by the FRB under section 4(c)(8) of the Bank Holding Company Act; or engage in activity not as principal.

Regional Director within 10 business days after any such change.

The FDIC will communicate its concerns regarding the continued conduct of an activity after a change in circumstances with the appropriate persons from the insured state savings association's primary federal banking agency. The FDIC will work with the identified persons from the primary federal banking agency to develop the appropriate response to the new circumstances.

The FDIC does not intend to require any savings association which falls out of compliance with eligibility conditions to immediately cease any activity in which the savings association had been engaged. Instead, the FDIC will deal with each situation on a case-by-case basis through its supervision and examination process. In short, the FDIC intends to utilize its supervisory and regulatory tools in dealing with any savings association's failure to meet the eligibility requirements on a continuing basis. The issue of the savings association's ongoing activities will be dealt with in the context of that effort. The FDIC believes that the case-by-case approach to whether a savings association will be permitted to continue an activity is preferable to forcing a savings association to, in all instances, immediately cease the activity. Such an inflexible approach could exacerbate an already unfortunate situation that probably is receiving supervisory attention.

Core eligibility requirements. The proposed regulation imports by reference the core eligibility requirements listed in subpart A. Refer to the discussion on this topic provided under subpart A for additional information. When reading the referenced discussion, ''subsidiary'' and ''majority-owned subsidiary'' should be replaced with ''service corporation''. Additionally, ''eligible subsidiary'' should be replaced with ''eligible service corporation''. Finally, ''insured state savings association'' should be read to replace ''bank'' or ''insured state bank''. Comments addressing these provisions and the FDIC's response are discussed in the relevant section of the preamble for subpart A. The FDIC received no comments directly relating to the application of these requirements to insured state savings associations.

Investment and transaction limits. The final regulation contains investment limits and other requirements that apply to an insured state savings association and its service corporations engaging in activities that are not permissible for a federal savings association if the requirements are imposed by FDIC order or expressly imposed by regulation. In general, the provisions: (1) Impose an aggregate limit on a savings association's investment in all service corporations that engage in an activity that is covered by the investment limits; (2) require extensions of credit from a savings association to these service corporations to be fully-collateralized when made; (3) prohibit low quality assets from being taken as collateral on such loans; and (4) require that transactions between the savings association and its service corporations be on an arm's length basis. The proposed limit restricting a savings association's investment in any one service corporation engaging in the same activity that is not permissible for a service corporation of a federal savings association was deleted for the same reason the requirement was dropped from subpart A.

Like the treatment accorded insured state banks, the regulation expands the definition of insured state savings association for the purposes of the investment and transaction limitations. A savings association includes not only the insured entity, but also any service corporation or subsidiary that is engaged in activities that are not subject to these investment and transaction limits. Sections 23A and 23B of the Federal Reserve Act combine a bank and all of its subsidiaries in imposing investment limitations and transaction restrictions between the bank and its affiliates. The FDIC is using the same concept in separating subsidiaries and service corporations conducting activities that are subject to investment and transaction limits from the insured state savings association and any other service corporations and subsidiaries engaging in activities not subject to the investment and transaction limits.

The only exception to these restrictions is for arm's length extensions of credit made by the savings association to finance sales of assets by the service corporation to third parties. These transactions do not need to comply with the collateral requirements and investment limitations, provided they meet certain arm's-length standards. The imposition of section 23A-type restrictions is intended to make sure that adequate safeguards are in place for the dealings between the insured state savings association and its service corporations.

Investment limits. In a manner similar to that applied to insured state banks in subpart A, the final rule imposes limits on certain of the insured state savings association's investments in service corporations conducting activities that are not permissible for a service corporation of a federal savings association. These investments are limited to 20 percent of the association's tier one capital for the aggregate of all activities covered by the investment limits. As is the case with the ''investment'' definition used in the relevant section of subpart A, investments subject to the applicable limits include: (1) Extensions of credit to any person or company for which an insured state savings association accepts securities issued by the service corporation as collateral; and (2) any extensions or commitments of credit to a third party for investment in the subsidiary, investment in a project in which the subsidiary has an interest, or extensions of credit or commitments of credit which are used for the benefit of, or transferred to, the subsidiary. These provisions also resemble items included in covered transactions subject to the section 23A limits.

However, the ''investment'' definition also is somewhat dissimilar from that used in subpart A due to underlying statutory differences. The definition of investment for insured state savings associations excludes extensions of credit provided to the service corporation and any of its debt securities owned by the savings association. While these items are included in the investment definition in subpart A, insured state banks are not, unlike state savings associations, required by law to deduct these items from regulatory capital. The investment definition coverage in subpart C has been limited because an insured state savings association is required by the Home Owners' Loan Act or OTS regulations to deduct from its regulatory capital any extensions of credit provided to a service corporation and any debt securities owned by the savings association that were issued by a service corporation engaging in activities that are not permissible for a national bank. 12 U.S.C. 1464(t)(5)(A). Since the regulatory exceptions in subpart C that invoke the investment limits are not activities permissible for a national bank, insured state savings associations are required by the referenced statute to deduct these items from regulatory capital. The FDIC finds no reason to impose investment limits on amounts completely deducted from capital and therefore imposes the investment limit only on items that are not deducted from regulatory capital.

Like subpart A, the regulation calculates the 20 percent limit based on tier one capital while section 23A uses total capital. As was discussed in reference to subpart A, the FDIC is using tier one capital as its standard to create consistency throughout the regulation.

Transaction requirements. The arm's length transaction requirement, prohibition on purchasing low quality assets, the insider transaction restriction, and the anti-tying restriction are applicable between an insured state savings association and a service corporation to the same extent and in the same manner as that described in subpart A between an insured state bank and certain majority-owned subsidiaries. The discussion of this topic in subpart A discusses the comments and changes from the proposal.

Collateralization requirement. The collateralization requirement in § 362.4(d)(4) also is applicable between an insured state savings association and a service corporation to the same extent and in the same manner as described in subpart A. Refer to the discussion of this topic in subpart A for the treatment of the comments.

Capital requirements. Under the final rule, an insured state savings association using the notice process to invest in a service corporation engaging in certain activities not permissible for a federal savings association must be ''well-capitalized'' after deducting from its regulatory capital any investment in the service corporation, both debt and equity, unless otherwise relieved of this requirement. The bank's risk classification assessment under part 327 is also determined after making the same deduction. This standard reflects the FDIC's belief that only well-capitalized institutions should be allowed, either without notice or by using the notice process, to engage through service corporations in activities that are not permissible for service corporations of federal savings associations. All savings associations failing to meet this standard and wanting to engage in such activities should be subject to the scrutiny of the application process. The FDIC received no comments concerning this provision.

Approvals previously granted. The final regulation, at § 362.13, does not require insured state savings associations that have previously received consent by order or notice from this agency to reapply to continue the activity provided the savings association and service corporation, as applicable, continue to comply with the conditions of the order of approval. The FDIC does not intend to require insured state savings associations to request consent to engage in an activity which has already been approved.

Because previously granted approvals may contain conditions that are different from the standards that are established in the final rule, in certain circumstances, the insured state savings association may elect to operate under the restrictions of the rule, instead of the order. In that case, the insured state savings association may comply with the investment and transaction limitations between the savings association and its service corporations contained in § 362.12(c), the capital requirement detailed in § 362.12(d), and the service corporation restrictions as outlined in the term ''eligible service corporation'' (by substitution) and contained in § 362.4(c)(2) in lieu of any similar requirements in its approval order. Any conditions that are specific to a savings association's situation and do not fall within the above limitations will continue to be effective. The FDIC intends that once a savings association elects to follow these proposed restrictions instead of those in the approval order, it may not elect to revert to the applicable conditions of the order.

Real estate investment activities. Comments describing the contents of subpart A include an extensive discussion of the FDIC's concerns with real estate investment activities. Subpart A of the final regulation contains significant provisions regarding the real estate investment activities of majority-owned subsidiaries of insured state banks. Additionally, subpart B addresses real estate activities of majority-owned subsidiaries that may become permissible for national bank subsidiaries.

The FDIC believes real estate investment activities present similar risks when conducted by a service corporation of an insured state savings association. However, subpart C of the proposal does not incorporate any of the requirements imposed in subparts A and B on real estate activities conducted by bank subsidiaries. While the FDIC attempted to conform the treatment of insured state banks and their subsidiaries and that of insured state savings associations and their service corporations, differences in the governing statutes resulted in some variances.

Service corporations of federal savings associations may engage in numerous real estate investment activities and, therefore, these activities are permissible for service corporations of insured state savings associations. However, because real estate investment activities are not permissible for a national bank, insured state savings associations are required by the Home Owners' Loan Act or regulations issued by the OTS to deduct from their regulatory capital any investment in a service corporation engaging in these activities. This deduction includes both the savings association's investments in debt and equity of, and extensions of credit to, the service corporation. There are also statutory limitations on the amount of a savings association's investments in and credit extensions to service corporations.

Given that: (1) Real estate investment activities are permissible for service corporations of federal savings associations; (2) there are statutory requirements regarding the capital deduction; and (3) there are statutory limitations on investments and credit extensions, the proposal did not contain any provisions concerning the real estate investment activities of service corporations of insured savings associations. As a result, the arm's length transaction requirements, the prohibition on purchasing low quality assets, the insider transaction restriction, and the collateralization requirements were not applied to transactions between an insured savings association and a service corporation engaging in real estate investment activities. Additionally, neither the insured savings association nor the service corporation was required to meet the eligibility standards; nor was a notice required to be submitted to the FDIC (unless a notice is needed pursuant to proposed subpart D).

The FDIC specifically requested comment on whether provisions should be added to part 362 subjecting service corporations of insured savings state savings associations to the eligibility requirements and various restrictions implemented in subparts A and B. Despite this request, no comments were received addressing this issue. After further consideration, the FDIC has decided not to impose any of the discussed requirements at this time. The FDIC will instead continue to defer to the statutory authority enabling service corporations to engage in the subject real estate activities.

Notice that a federal savings association is conducting activities grandfathered under section 5(i)(4) of HOLA. Section 303.147 (as effective October 1, 1998, formerly § 303.13(g)) of the FDIC's current regulations requires any federal savings association that is authorized by section 5(i)(4) of HOLA to conduct activities that are not normally permitted for federal savings associations to file a notice of that fact with the FDIC. Section 5(i)(4) of HOLA provides that any federal savings bank chartered as such prior to October 15, 1982, may continue to make investments and continue to conduct activities it was permitted to conduct prior to October 15, 1982. It also provides that any federal savings bank organized prior to October 15, 1982, that was formerly a state mutual savings bank may continue to make investments and engage in activities that were authorized to it under state law. Finally, the provision confers this grandfather on any federal savings association that acquires by merger or consolidation any federal savings bank that enjoys the grandfather.

The notice requirement contained in § 303.147 (as effective October 1, 1998, formerly § 303.13(g)) was deleted in the final regulation. The notice was not required by law and was formerly imposed by the FDIC as an information gathering tool. The FDIC determined that eliminating the notice will reduce burden and will not materially affect the FDIC's supervisory responsibilities.

D. Subpart D of Part 362 Acquiring, Establishing, or Conducting New Activities Through a Subsidiary by an Insured Savings Association

Section 362.14 Purpose and Scope

Subpart D implements the statutory requirement of section 18(m) of the FDI Act. Section 18(m) requires that prior notice be given to the FDIC when an insured savings association, either federal or state, establishes or acquires a subsidiary or engages in any new activity in a subsidiary. This requirement is based on the FDIC's role of ensuring that activities and investments of insured savings associations do not represent a significant risk to the affected deposit insurance fund. In fulfilling that role, the FDIC needs to be aware of the activities contemplated by subsidiaries of insured savings associations. It is noted that for purposes of this subpart, a service corporation is a subsidiary, but the term subsidiary does not include any insured depository institution as that term is defined in the FDI Act. Because this requirement applies to both federal and state savings associations, the final regulation segregates the implementing requirements of the FDIC's regulations into a separate subpart D. In that manner, the requirement is highlighted for both federal and state savings associations. The FDIC adopts § 362.14 without change from the proposal.

Notice of the acquisition or establishment of a subsidiary, or notice that an existing subsidiary will conduct new activities. Section 303.146 (as effective October 1, 1998, formerly § 303.13(f)) of the FDIC's current regulations establishes an abbreviated notice procedure concerning subsidiaries created to hold real estate acquired pursuant to DPC (after the first notice, additional real estate subsidiaries created to hold real estate acquired through DPC could be established after providing the FDIC with 14 days prior notice) and lists the content of the notice. The second item is also deleted because the FDIC seeks to conform all notice periods used in this regulation. While § 362.15 continues to require a prior notice, the required content of the notice was revised in a manner consistent with that required for other notices under this regulation and moved to § 303.141 of subpart H of part 303. The FDIC wants to make it clear that any notice or application submitted to the FDIC pursuant to a provision of subpart C of this regulation will satisfy the notice requirement of this subpart D.

The FDIC received no comments on either the proposed structure of this subpart or the proposed treatment of the required notices. The final regulation incorporates these changes as proposed, with one exception. Consistent with the current rule, the savings association must submit the notice at least 30 days before establishing the new subsidiary or commencing the new activity.

Part 303

Subpart G—Activities of Insured State Banks

Overview

As a part of this rulemaking, Part 303—Filing Procedures and Delegations of Authority, is amended to include a new subpart G containing application procedures and delegations of authority for the substantive matters covered by the regulation for insured state banks.[16] As discussed above, the FDIC has prepared a complete revision of part 303 of the FDIC's rules and regulations containing the FDIC's applications procedures and delegations of authority. As part of these revisions to part 303, subpart G of part 303 has been reserved for this purpose. The application procedures were detailed in subpart E of the part 362 proposal but are now being relocated to subpart G of part 303, to centralize all banking application and notice procedures in one convenient place.

The FDIC received four comments about its proposed application procedures. One commenter generally applauded the FDIC's adoption of expedited notice procedures as being consistent with congressional intent to reduce regulatory burden on banks. The remaining three comments are discussed in turn below. After careful consideration of these comments, the FDIC has decided they raise no issues warranting substantive changes to the proposed procedures. The FDIC has made certain technical changes to the proposed procedures, but these consist of minor revisions in order to make the procedures consistent with the other subparts of part 303, as adopted in its final form and published at 63 FR 44686 (August 20, 1998).

Section 303.120 Scope

This subpart contains the procedural and other information for any application or notice that must be submitted under the requirements specified for activities and investments of insured state banks and their subsidiaries under subparts A and B of part 362, including the format, information requirements, FDIC processing deadlines, and other pertinent guidelines or instructions. The regulation also contains delegations of authority from the Board of Directors to the director and deputy director of the Division of Supervision.

Definitions. The proposed subpart E of part 362 contained definitions of the following terms: ''Appropriate regional director'', ''appropriate deputy regional director'', ''appropriate regional office'', ''associate director'', ''deputy director'', ''deputy regional director'', ''DOS'', ''director'', and ''regional director''. These definitions have been eliminated since these terms are defined in part 303, and separate definitions are unnecessary.

Although other subparts of part 303 rely on part 303's definition of an ''eligible insured depository institution'' in connection with granting expedited processing for certain FDIC applications, subpart G does not rely on the part 303 definition. A bank's eligibility for expedited notice processing in connection with an approval required under subpart A or B of part 362 is determined under the criteria contained in part 362.

Section 303.121 Filing Procedures

This section explains to insured state banks where they should file, how they should file and the contents of any filing, including any copies of any application or notice filed with another agency.

This section also explains that the appropriate regional director may request additional information. The FDIC does not anticipate that there will

[16] Under the FDIC's current rules, these application requirements are located in various sections of three different regulations: 12 CFR 303, 12 CFR 337.4 and 12 CFR 362.

be a need routinely to request additional information; however, this reservation is made in anticipation of differences in the way activities are proposed to be conducted.

One commenter expressed concerns regarding the regulation's requirement that the bank submit a copy of the order or other document from the appropriate regulatory authority granting approval for the bank to conduct the activity, if such approval is necessary and has already been granted. The commenter was concerned that this would foreclose the bank from making simultaneous submissions to state regulatory authorities and the FDIC. To the contrary, the language at the end of the sentence, ''if such approval * * * has already been granted'' will accommodate parallel processing. The bank need not wait until the state has issued an approval before applying to the FDIC. The regulatory language permits the bank to make necessary submissions to the state and FDIC in whatever order the bank sees fit. Of course, banks are reminded that an FDIC approval under subpart A or B of part 362 is not sufficient on its own; the activity in question must still be authorized under state law, including any approvals thereunder, before the bank may commence the activity. Where the pendency of state approval creates uncertainty as to the manner or extent to which the activity will be conducted, the appropriate regional director will request additional information from the bank concerning the state approval, and the notice or application may not be sufficiently complete for the FDIC to be able to process it until such uncertainties are resolved.

Section 303.122 Processing

This section sets out the procedures for the FDIC's processing of notices and applications. The expedited processing period for notices will normally be 30 days, subject to extension for an additional 15 days upon written notice to the bank. If the FDIC removes a notice from expedited processing because of significant supervisory concerns, legal or policy issues, or other good cause, as set out in the rule, standard processing will be used. For notices removed in this manner, or for activities requiring a full application rather than a notice, the FDIC will normally review and act within 60 days after receipt of a completed application, subject to extension for an additional 30 days upon written notice to the bank. One comment supported the notice process as regulatory burden reduction. Two comments questioned the time periods for processing. One stated that the 30- and 60-day time frames do not reflect business reality. The commenter requested that institutions have advanced approval to invest up to 10 percent of capital. The other questioned the notice process, stating that the FDIC will not have sufficient opportunity to review the request. Because of the differences among the activities presented, the FDIC does not feel that advance approval is a viable alternative. Given normal lead times for business planning appropriate to a bank's decision to enter into a new field of business activity, and given that the regulation does not require FDIC approval on a project-by-project basis, the FDIC does not believe the proposed time periods will impede banks' ability to compete effectively. The notice and application procedures provide an expedited processing time, but the FDIC feels the time constraints are sufficient for appropriate supervisory consideration. Therefore, no changes have been made to the proposed processing times.

Section 303.123 Delegation of Authority

The authority to review and act upon applications and notices is delegated in this section. One substantive change to the existing delegation is the addition of the deputy director of the Division of Supervision. Another change authorizes the Director (DOS) to make determinations concerning instruments having the character of debt securities. This authority is granted to allow the FDIC to efficiently respond to market changes. Section 24 prohibits insured state banks from investing in equity securities. The FDIC has found that certain instruments have sufficient characteristics of debt securities that they may be excluded from the prohibition of investment in equity securities. If the capital markets create similar such instruments in the future, this provision permits the Director (DOS), either upon request or at the FDIC's instigation, to identify them as such and designate them as being eligible investments for state nonmember banks, subject to the 15 percent of tier one capital limit set under § 362.3. The FDIC would notify state banks of such determination by issuing a Financial Institution Letter, or through other appropriate means.

Subpart H—Activities of Insured Savings Associations

Overview

As a part of this rulemaking, part 303—Filing Procedures and Delegations of Authority, is amended to include a revised subpart H containing application procedures and delegations of authority for the substantive matters covered by the regulation for insured state savings associations. As discussed above, the FDIC has prepared a complete revision of part 303 of the FDIC's rules and regulations containing the FDIC's applications procedures and delegations of authority. As part of these revisions to part 303, subpart H of part 303 has been reserved for this purpose. The application procedures were detailed in subpart F of the part 362 proposal but are now being relocated to subpart H of part 303 to centralize all savings association application and notice procedures in one convenient place.

The FDIC received no comments about its proposed application procedures. The FDIC has made certain technical changes to the proposed procedures, but these changes consist of minor revisions to make the procedures consistent with the other subparts of part 303, as adopted in its final form.

Section 303.140 Scope

This subpart contains the procedural and other information for any application or notice that must be submitted under the requirements specified for activities and investments of insured state savings associations and their subsidiaries under subparts C and D or part 362, including the format, information requirements, FDIC processing deadlines, and other pertinent guidelines or instructions. The regulation also contains delegations of authority from the Board of Directors to the director and deputy director of the Division of Supervision.

Section 303.141 Definitions

The proposed subpart F contained definitions of the following terms: ''Appropriate regional director'', ''appropriate deputy regional director'', ''appropriate regional office'', ''associate director'', ''deputy director'', ''deputy regional director'', ''DOS'', ''director'', and ''regional director''. These definitions have been eliminated since these terms are defined in part 303 and separate definitions are unnecessary.

Although other subparts of part 303 rely on part 303's definition of an ''eligible insured depository institution'' in connection with granting expedited processing for certain FDIC applications, subpart H does not rely on the part 303 definition. A savings association's eligibility for expedited notice processing in connection with an approval required under subpart C or D of part 362 is determined under the criteria contained in part 362.

Section 303.141 Filing Procedures

This section explains to insured savings associations where they should file, how they should file and the contents of any filing, including any copies of any application or notice filed with another agency.

This section also explains that the appropriate regional director may request additional information. The FDIC does not anticipate that there will be a need routinely to request additional information; however, this reservation is made in anticipation of differences in the way activities are proposed to be conducted.

Section 303.142 Processing

This section sets out the procedures for the FDIC's processing of notices and applications. The expedited processing period for notices will normally be 30 days, subject to extension for an additional 15 days upon written notice to the bank. If the FDIC removes a notice from expedited processing because of significant supervisory concerns, legal or policy issues, or other good cause, as set out in the rule, standard processing will be used. For notices removed in this manner, or for activities requiring a full application rather than a notice, the FDIC will normally review and act within 60 days after receipt of a completed application, subject to extension for an additional 30 days upon written notice to the savings association.

Section 303.148 Delegation of Authority

The authority to review and act upon applications and notices is delegated in this section. One substantive change to the existing delegation is the addition of the deputy director of the Division of Supervision. Another change authorizes the Director (DOS) to make determinations concerning instruments having the character of debt securities. This authority is granted to allow the FDIC to efficiently respond to market changes. Section 28 prohibits insured state associations from investing in equity securities. The FDIC has found that certain instruments have characteristics of debt securities and may be excluded from the prohibition of investment in equity securities. If the capital markets create similar such instruments in the future, this provision permits the Director (DOS), either upon request or at the FDIC's instigation, to identify them as such and designate them as being eligible investments for state nonmember banks, up to the 15 percent of tier one capital limit set under § 362.3. The FDIC would notify state banks of such determination by issuing a Financial Institution Letter, or other appropriate means.

V. Paperwork Reduction Act

In accordance with the requirements of the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3501 *et seq.*), the FDIC may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. Public comment was invited on two collections of information contained in the part 362 notice of proposed rulemaking and the two collections were submitted to the Office of Management and Budget (OMB) for review. No comment was received regarding either collection. OMB approved the first collection, Activities and Investments of Insured State Banks, under control number 3064–0111, which will expire November 30, 2000. OMB approved the second collection, Activities and Investments of Insured Savings Associations, under control number 3064–0104, which will expire November 30, 2000. The FDIC continues to welcome comment about the PRA aspects of this regulation. Such comment should identify the particular subpart and information collection for which consideration is desired and should be sent to Steven F. Hanft, Assistant Executive Secretary (Regulatory Analysis), Federal Deposit Insurance Corporation, Room F–4062, 550 17th Street NW, Washington, DC 20429.

VI. Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the FDIC certifies that this rule will not have a significant economic impact on a substantial number of small entities. The rule streamlines requirements for all insured state banks and insured state savings associations. The requirements for insured federal savings associations are statutory and remain unchanged by this rule. It simplifies the requirements that apply when insured state banks and insured state savings associations create, invest in, or conduct new activities through majority-owned corporate subsidiaries and service corporations, respectively, by eliminating requirements for any filing or reducing the burden from filing an application to filing a notice in other instances. The rule also simplifies the information required for both notices and applications. Whenever possible, the rule clarifies the expectations of the FDIC when it requires notices or applications to consent to activities by insured state banks and insured state savings associations. The rule will make it easier for small insured state banks and insured state savings associations to locate the rules that apply to their investments.

VII. Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) (Title II, Public Law 1004–121) provides generally for agencies to report rules to Congress for review. The reporting requirement is triggered when a federal agency issues a final rule. Accordingly, the FDIC will file the appropriate reports with Congress as required by SBREFA.

The Office of Management and Budget has determined that this final rule does not constitute a ''major rule'' as defined by SBREFA.

List of Subjects

12 CFR Part 303

Administrative practice and procedure, Authority delegations (Government agencies), Bank deposit insurance, Banks, banking, Bank merger, Branching, Foreign branches, Golden parachute payments, Insured branches, Interstate branching, Reporting and recordkeeping requirements, Savings associations.

12 CFR Part 337

Banks, banking, Reporting and recordkeeping requirements, Securities.

12 CFR Part 362

Administrative practice and procedure, Authority delegations (Government agencies), Bank deposit insurance, Banks, banking, Insured depository institutions, Investments, Reporting and recordkeeping requirements.

Authority and Issuance

For the reasons set forth above and under the authority of 12 U.S.C. 1819(a)(Tenth), the FDIC Board of Directors hereby amends 12 CFR chapter III as follows:

PART 303—FILING PROCEDURES AND DELEGATIONS OF AUTHORITY

1. The authority citation for part 303 is revised to read as follows:

Authority: 12 U.S.C. 378, 1813, 1815, 1816, 1817, 1818, 1819 (Seventh and Tenth), 1820, 1823, 1828, 1831a, 1831e, 1831*o*, 1831p–1, 1835a, 3104, 3105, 3108, 3207; 15 U.S.C. 1601–1607.

2. Revise the subpart G heading and add subpart G, consisting of §§ 303.120 through 303.123, to read as follows:

Subpart G—Activities of Insured State Banks

Subpart G—Activities of Insured State Banks

§ 303.120 Scope.

This subpart sets forth procedures for complying with notice and application requirements contained in subpart A of part 362 of this chapter, governing insured state banks and their subsidiaries engaging in activities which are not permissible for national banks and their subsidiaries. This subpart also sets forth procedures for complying with notice and application requirements contained in subpart B of part 362 of this chapter, governing certain activities of insured state nonmember banks, their subsidiaries, and certain affiliates.

§ 303.121 Filing procedures.

(a) *Where to file.* A notice or application required by subpart A or subpart B of part 362 of this chapter shall be submitted in writing to the appropriate regional director (DOS).

(b) *Contents of filing*—(1) *Filings generally.* A complete letter notice or letter application shall include the following information:

(i) A brief description of the activity and the manner in which it will be conducted;

(ii) The amount of the bank's existing or proposed direct or indirect investment in the activity as well as calculations sufficient to indicate compliance with any specific capital ratio or investment percentage limitation detailed in subpart A or B of part 362 of this chapter;

(iii) A copy of the bank's business plan regarding the conduct of the activity;

(iv) A citation to the state statutory or regulatory authority for the conduct of the activity;

(v) A copy of the order or other document from the appropriate regulatory authority granting approval for the bank to conduct the activity if such approval is necessary and has already been granted;

(vi) A brief description of the bank's policy and practice with regard to any anticipated involvement in the activity by a director, executive office or principal shareholder of the bank or any related interest of such a person; and

(vii) A description of the bank's expertise in the activity.

(2) [Reserved]

(3) *Copy of application or notice filed with another agency.* If an insured state bank has filed an application or notice with another federal or state regulatory authority which contains all of the information required by paragraph (b) (1) of this section, the insured state bank may submit a copy to the FDIC in lieu of a separate filing.

(4) *Additional information.* The appropriate regional director (DOS) may request additional information to complete processing.

§ 303.122 Processing.

(a) *Expedited processing.* A notice filed by an insured state bank seeking to commence or continue an activity under § 362.4(b)(3)(i), § 362.4(b)(5), or § 362.8(a)(2) of this chapter will be acknowledged in writing by the FDIC and will receive expedited processing, unless the applicant is notified in writing to the contrary and provided a basis for that decision. The FDIC may remove the notice from expedited processing for any of the reasons set forth in § 303.11(c)(2). Absent such removal, a notice processed under expedited processing is deemed approved 30 days after receipt of a complete notice by the FDIC (subject to extension for an additional 15 days upon written notice to the bank) or on such earlier date authorized by the FDIC in writing.

(b) *Standard processing for applications and notices that have been removed from expedited processing.* For an application filed by an insured state bank seeking to commence or continue an activity under § 362.3(a)(2)(iii)(A), § 362.3(b)(2)(i), § 362.3(b)(2)(ii)(A), § 362.3(b)(2)(ii)(C), § 362.4(b)(1), § 362.4(b)(2), § 362.4(b)(4), § 362.5(b)(2), § 362.8(a)(2), or § 362.8(b) of this chapter or for notices which are not processed pursuant to the expedited processing procedures, the FDIC will provide the insured state bank with written notification of the final action as soon as the decision is rendered. The FDIC will normally review and act in such cases within 60 days after receipt of a completed application or notice (subject to extension for an additional 30 days upon written notice to the bank), but failure of the FDIC to act prior to the expiration of these periods does not constitute approval.

§ 303.123 Delegations of authority.

(a) *Instruments having the character of debt securities.* Authority is delegated to the Director (DOS) to make determinations contemplated under §§ 362.2(h) and 362.3(b)(2)(iii)(B) of this chapter.

(b) *Other applications, notices, and actions.* The authority to review and act upon applications and notices filed pursuant to this subpart G and to take any other action authorized by this subpart G or subparts A and B of part 362 of this chapter is delegated to the Director (DOS), and except as limited by paragraph (a) of this section, to the Deputy Director and where confirmed in writing by the Director to an associate director and the appropriate regional director and deputy regional director.

3. Revise subpart H to read as follows:

Subpart H—Activities of Insured Savings Associations

Subpart H—Activities of Insured Savings Associations

§ 303.140 Scope.

This subpart sets forth procedures for complying with the notice and application requirements contained in subpart C of part 362 of this chapter, governing insured state savings associations and their service corporations engaging in activities which are not permissible for federal savings associations and their service corporations. This subpart also sets forth procedures for complying with the notice requirements contained in subpart D of part 362 of this chapter, governing insured savings associations which establish or engage in new activities through a subsidiary.

§ 303.141 Filing procedures.

(a) *Where to file.* All applications and notices required by subpart C or subpart D of part 362 of this chapter are to be in writing and filed with the appropriate regional director.

(b) *Contents of filing*—(1) *Filings generally.* A complete letter notice or letter application shall include the following information:

(i) A brief description of the activity and the manner in which it will be conducted;

(ii) The amount of the association's existing or proposed direct or indirect investment in the activity as well as calculations sufficient to indicate compliance with any specific capital ratio or investment percentage limitation detailed in subpart C or D of this chapter;

(iii) A copy of the association's business plan regarding the conduct of the activity;

(iv) A citation to the state statutory or regulatory authority for the conduct of the activity;

(v) A copy of the order or other document from the appropriate regulatory authority granting approval for the association to conduct the activity if such approval is necessary and has already been granted;

(vi) A brief description of the association's policy and practice with regard to any anticipated involvement in the activity by a director, executive officer or principal shareholder of the association or any related interest of such a person; and

(vii) A description of the association's expertise in the activity.

(2) [Reserved]

(3) *Copy of application or notice filed with another agency.* If an insured savings association has filed an application or notice with another federal or state regulatory authority which contains all of the information required by paragraph (b) (1) of this section, the insured state bank may submit a copy to the FDIC in lieu of a separate filing.

(4) *Additional information.* The appropriate regional director (DOS) may request additional information to complete processing.

§ 303.142 Processing.

(a) *Expedited processing.* A notice filed by an insured state savings association seeking to commence or continue an activity under § 362.11(b)(2)(i), § 362.12(b)(2)(i), or § 362.12(b)(4) of this chapter will be acknowledged in writing by the FDIC and will receive expedited processing, unless the applicant is notified in writing to the contrary and provided a basis for that decision. The FDIC may remove the notice from expedited processing for any of the reasons set forth in § 303.11(c)(2). Absent such removal, a notice processed under expedited processing is deemed approved 30 days after receipt of a complete notice by the FDIC (subject to extension for an additional 15 days upon written notice to the bank) or on such earlier date authorized by the FDIC in writing.

(b) *Standard processing for applications and notices that have been removed from expedited processing.* For an application filed by an insured state savings association seeking to commence or continue an activity under § 362.11(a)(2), § 362.11(b)(2), § 362.12(b)(1) of this chapter or for notices which are not processed pursuant to the expedited processing procedures, the FDIC will provide the insured state savings association with written notification of the final action as soon as the decision is rendered. The FDIC will normally review and act in such cases within 60 days after receipt of a completed application or notice (subject to extension for an additional 30 days upon written notice to the bank), but failure of the FDIC to act prior to the expiration of these periods does not constitute approval.

(c) *Notices of activities in excess of an amount permissible for a federal savings association; subsidiary notices.* Receipt of a notice filed by an insured state savings association as required by § 362.11(b)(3) or § 362.15 of this chapter will be acknowledged in writing by the appropriate regional director (DOS). The notice will be reviewed at the appropriate regional office, which will take such action as it deems necessary and appropriate.

§ 303.143 Delegations of authority.

(a) *Instruments having the character of debt securities.* Authority is delegated to the Director (DOS) to make determinations contemplated under §§ 362.2(h) and 362.3(b)(2)(iii)(B) of this chapter.

(b) *Other applications, notices, and actions.* The authority to review and act upon applications and notices filed pursuant to this subpart H and to take any other action authorized by this subpart H or subparts C and D of part 362 of this chapter is delegated to the Director (DOS), and except as limited by paragraph (a) of this section, to the Deputy Director and where confirmed in writing by the Director to an associate director and the appropriate regional director and deputy regional director.

PART 337—UNSAFE AND UNSOUND BANKING PRACTICES

4. The authority citation for part 337 continues to read as follows:

Authority: 12 U.S.C. 375a(4), 375b, 1816, 1818(a), 1818(b), 1819, 1820(d)(10), 1821(f), 1828(j)(2), 1831f, 1831f–1.

5. In § 337.4, a new paragraph (i) is added to read as follows:

§ 337.4 Securities activities of subsidiaries of insured nonmember banks; bank transactions with affiliated securities companies.

* * * * *

(i) *Coordination with part 362 of this chapter*—(1) *New subsidiary or affiliate relationships.* Beginning January 1, 1999, every insured state nonmember bank that establishes a new subsidiary relationship subject to the provisions of § 362.4(b)(4) or § 362.4(b)(5)(ii) of this chapter or a new affiliate relationship that is subject to § 362.8(b) of this chapter shall comply with § 362.4(b)(4), § 362.4(b)(5)(ii) or § 362.8(b) of this chapter, respectively, or to the extent the insured state nonmember bank's planned subsidiary or affiliate will not comply with all requirements thereunder, submit an application to the FDIC under § 362.4(b)(1) or § 362.8(b) of this chapter, respectively. This section shall not apply to such subsidiary or affiliate.

(2) *Existing insured state nonmember bank subsidiaries subject to § 362.4.* Applicable transition rules for insured state nonmember bank subsidiaries engaged, before January 1, 1999, in securities activities pursuant to this section and also subject to § 362.4 of this chapter are set out in § 362.5 of this chapter.

(3) *Continued effectiveness of this section.* Insured state nonmember banks establishing or holding subsidiaries or affiliates subject to this section, but not covered by § 362.4 or § 362.8 of this chapter, remain subject to the requirements of this section, except that to the extent such subsidiaries or affiliates engage only in activities permissible for a national bank directly, including such permissible activities that may require the subsidiary or affiliate to register as a securities broker, no notice under paragraph (d) of this section is required.

6. Part 362 is revised to read as follows:

PART 362—ACTIVITIES OF INSURED STATE BANKS AND INSURED SAVINGS ASSOCIATIONS

Subpart A—Activities of Insured State Banks

Sec.

Subpart B—Safety and Soundness Rules Governing Insured State Nonmember Banks

Subpart C—Activities of Insured State Savings Associations

Subpart D—Acquiring, Establishing, or Conducting New Activities Through a Subsidiary by an Insured Savings Association

Authority: 12 U.S.C. 1816, 1818, 1819(a)(Tenth), 1828(m), 1831a, 1831e.

Subpart A—Activities of Insured State Banks

§ 362.1 Purpose and scope.

(a) This subpart, along with the notice and application procedures in subpart G of part 303 of this chapter, implements the provisions of section 24 of the Federal Deposit Insurance Act (12 U.S.C. 1831a) that restrict and prohibit insured state banks and their subsidiaries from engaging in activities and investments that are not permissible for national banks and their subsidiaries. The phrase ''activity permissible for a national bank'' means any activity authorized for national banks under any statute including the National Bank Act (12 U.S.C. 21 *et seq.*), as well as activities recognized as permissible for a national bank in regulations, official circulars, bulletins, orders or written interpretations issued by the Office of the Comptroller of the Currency (OCC).

(b) This subpart does not cover the following activities:

(1) Activities conducted other than ''as principal,'' defined for purposes of this subpart as activities conducted as agent for a customer, conducted in a brokerage, custodial, advisory, or administrative capacity, or conducted as trustee, or in any substantially similar capacity. For example, this subpart does not cover acting solely as agent for the sale of insurance, securities, real estate, or travel services; nor does it cover acting as trustee, providing personal financial planning advice, or safekeeping services;

(2) Interests in real estate in which the real property is used or intended in good faith to be used within a reasonable time by an insured state bank or its subsidiaries as offices or related facilities for the conduct of its business or future expansion of its business or used as public welfare investments of a type permissible for national banks; and

(3) Equity investments acquired in connection with debts previously contracted (DPC) if the insured state bank does not hold the property for speculation and takes only such actions as would be permissible for a national bank's DPC. The bank must dispose of the property within the shorter of the period set by federal law for national banks or the period allowed under state law. For real estate, national banks may not hold DPC for more than 10 years. For equity securities, national banks must generally divest DPC as soon as possible consistent with obtaining a reasonable return.

(c) A subsidiary of an insured state bank may not engage in real estate investment activities that are not permissible for a subsidiary of a national bank unless the bank does so through a subsidiary of which the bank is a majority owner, is in compliance with applicable capital standards, and the FDIC has determined that the activity poses no significant risk to the appropriate deposit insurance fund. This subpart provides standards for majority-owned subsidiaries of insured state banks engaging in real estate investment activities that are not permissible for a subsidiary of a national bank. Because of safety and soundness concerns relating to real estate investment activities, subpart B of this part reflects special rules for subsidiaries of insured state nonmember banks that engage in real estate investment activities of a type that are not permissible for a national bank, but may be otherwise permissible for a subsidiary of a national bank.

(d) The FDIC intends to allow insured state banks and their subsidiaries to undertake only safe and sound activities and investments that do not present significant risks to the deposit insurance funds and that are consistent with the purposes of federal deposit insurance and other applicable law. This subpart does not authorize any insured state bank to make investments or to conduct activities that are not authorized or that are prohibited by either state or federal law.

§ 362.2 Definitions.

For the purposes of this subpart, the following definitions will apply:

(a) *Bank, state bank, savings association, state savings association, depository institution, insured depository institution, insured state bank, federal savings association,* and *insured state nonmember bank* shall each have the same respective meaning contained in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(b) *Activity* means the conduct of business by a state-chartered depository institution, including acquiring or retaining an equity investment or other investment.

(c) *Change in control* means any transaction:

(1) By a state bank or its holding company for which a notice is required to be filed with the FDIC, or the Board of Governors of the Federal Reserve System (FRB), pursuant to section 7(j) of the Federal Deposit Insurance Act (12 U.S.C. 1817(j)) except a transaction that is presumed to be an acquisition of control under the FDIC's or FRB's regulations implementing section 7(j);

(2) As a result of which a state bank eligible for the exception described in § 362.3(a)(2)(iii) is acquired by or merged into a depository institution that is not eligible for the exception, or as a result of which its holding company is acquired by or merged into a holding company which controls one or more bank subsidiaries not eligible for the exception; or

(3) In which control of the state bank is acquired by a bank holding company in a transaction requiring FRB approval under section 3 of the Bank Holding Company Act (12 U.S.C. 1842), other than a one bank holding company formation in which all or substantially all of the shares of the holding company will be owned by persons who were shareholders of the bank.

(d) *Company* means any corporation, partnership, limited liability company, business trust, association, joint venture, pool, syndicate or other similar business organization.

(e) *Control* means the power to vote, directly or indirectly, 25 percent or more of any class of the voting securities of a company, the ability to control in any manner the election of a majority of a company's directors or trustees, or the ability to exercise a controlling influence over the management and policies of a company.

(f) *Convert its charter* means an insured state bank undergoes any transaction that causes the bank to operate under a different form of charter than it had as of December 19, 1991, except a change from mutual to stock form shall not be considered a charter conversion.

(g) *Equity investment* means an ownership interest in any company; any membership interest that includes a voting right in any company; any interest in real estate; any transaction which in substance falls into any of these categories even though it may be structured as some other form of business transaction; and includes an equity security. The term ''equity investment'' does not include any of the foregoing if the interest is taken as security for a loan.

(h) *Equity security* means any stock (other than adjustable rate preferred stock, money market (auction rate) preferred stock, or other newly developed instrument determined by the FDIC to have the character of debt securities), certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, or voting-trust certificate; any security immediately convertible at the option of the holder without payment of substantial additional consideration into such a security; any security carrying any warrant or right to subscribe to or purchase any such security; and any certificate of interest or participation in, temporary or interim certificate for, or receipt for any of the foregoing.

(i) *Extension of credit, executive officer, director, principal shareholder,* and *related interest* each has the same respective meaning as is applicable for the purposes of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b) and § 337.3 of this chapter.

(j) *Institution* shall have the same meaning as ''state-chartered depository institution.''

(k) *Majority-owned subsidiary* means any corporation in which the parent insured state bank owns a majority of the outstanding voting stock.

(l) *National securities exchange* means a securities exchange that is registered as a national securities exchange by the Securities and Exchange Commission pursuant to section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) and the National Market System, i.e., the top tier of the National Association of Securities Dealers Automated Quotation System.

(m) *Real estate investment activity* means any interest in real estate (other than as security for a loan) held directly or indirectly that is not permissible for a national bank.

(n) *Residents of the state* includes individuals living in the state, individuals employed in the state, any person to whom the company provided insurance as principal without interruption since such person resided in or was employed in the state, and companies or partnerships incorporated in, organized under the laws of, licensed to do business in, or having an office in the state.

(o) *Security* has the same meaning as it has in part 344 of this chapter.

(p) *Significant risk to the deposit insurance fund* shall be understood to be present whenever the FDIC determines there is a high probability that any insurance fund administered by the FDIC may suffer a loss. Such risk may be present either when an activity contributes or may contribute to the decline in condition of a particular state-chartered depository institution or when a type of activity is found by the FDIC to contribute or potentially contribute to the deterioration of the overall condition of the banking system.

(q) *State-chartered depository institution* means any state bank or state savings association insured by the FDIC.

(r) *Subsidiary* means any company controlled by an insured depository institution.

(s) *Tier one capital* has the same meaning as set forth in part 325 of this chapter for an insured state nonmember bank. For other state-chartered depository institutions, the term ''tier one capital'' has the same meaning as set forth in the capital regulations adopted by the appropriate federal banking agency.

(t) *Well-capitalized* has the same meaning set forth in part 325 of this chapter for an insured state nonmember bank. For other state-chartered depository institutions, the term ''well-capitalized'' has the same meaning as set forth in the capital regulations adopted by the appropriate federal banking agency.

§ 362.3 Activities of insured state banks.

(a) *Equity investments.* (1) *Prohibited equity investments.* No insured state bank may directly or indirectly acquire or retain as principal any equity investment of a type that is not permissible for a national bank unless one of the exceptions in paragraph (a)(2) of this section applies.

(2) *Exceptions.* (i) *Equity investment in majority-owned subsidiaries.* An insured state bank may acquire or retain an equity investment in a subsidiary of which the bank is a majority owner, provided that the subsidiary is engaging in activities that are allowed pursuant to the provisions of or by application under § 362.4(b).

(ii) *Investments in qualified housing projects.* An insured state bank may invest as a limited partner in a partnership, or as a noncontrolling interest holder of a limited liability company, the sole purpose of which is to invest in the acquisition, rehabilitation, or new construction of a qualified housing project, provided that the bank's aggregate investment (including legally binding commitments) does not exceed, when made, 2 percent of total assets as of the date of the bank's most recent consolidated report of condition prior to making the investment. For the purposes of this paragraph (a)(2)(ii), *Aggregate investment* means the total book value of the bank's investment in the real estate calculated in accordance with the instructions for the preparation of the consolidated report of condition. *Qualified housing project* means residential real estate intended to primarily benefit lower income persons throughout the period of the bank's investment including any project that has received an award of low income housing tax credits under section 42 of the Internal Revenue Code (26 U.S.C. 42) (such as a reservation or allocation of credits) from a state or local housing credit agency. A residential real estate project that does not qualify for the tax credit under section 42 of the Internal Revenue Code will qualify under this exception if 50 percent or more of the housing units are to be occupied by lower income persons. A project will be considered residential despite the fact that some portion of the total square footage of the project is utilized for commercial purposes, provided that such commercial use is not the primary purpose of the project. *Lower income* has the same meaning as ''low income'' and ''moderate income'' as defined for the purposes of § 345.12(n) (1) and (2) of this chapter.

(iii) *Grandfathered investments in common or preferred stock; shares of investment companies.* (A) *General.* An insured state bank that is located in a state which as of September 30, 1991, authorized investment in:

(*1*)(*i*) Common or preferred stock listed on a national securities exchange (listed stock); or

(*ii*) Shares of an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) (registered shares); and

(*2*) Which during the period beginning on September 30, 1990, and ending on November 26, 1991, made or maintained an investment in listed stock or registered shares, may retain whatever lawfully acquired listed stock or registered shares it held and may continue to acquire listed stock and/or registered shares, provided that the bank files a notice in accordance with section 24(f)(6) of the Federal Deposit Insurance Act in compliance with § 303.121 of this chapter and the FDIC processes the notice without objection under § 303.122 of this chapter. Approval will be granted only if the FDIC determines that acquiring or retaining the stock or shares does not pose a significant risk to the appropriate deposit insurance fund. Approval may be subject to whatever conditions or restrictions the FDIC determines are necessary or appropriate.

(B) *Loss of grandfather exception.* The exception for grandfathered investments under paragraph (a)(2)(iii)(A) of this section shall no longer apply if the bank converts its charter or the bank or its parent holding company undergoes a change in control. If any of these events occur, the bank may retain its existing investments unless directed by the FDIC or other applicable authority to divest the listed stock or registered shares.

(C) *Maximum permissible investment.* A bank's aggregate investment in listed stock and registered shares under paragraph (a)(2)(iii)(A) of this section shall in no event exceed, when made, 100 percent of the bank's tier one capital as measured on the bank's most recent consolidated report of condition (call report) prior to making any such investment. The lower of the bank's cost as determined in accordance with call report instructions or the market value of the listed stock and shares shall be used to determine compliance. The FDIC may determine when acting upon a notice filed in accordance with paragraph (a)(2)(iii)(A)(*2*) of this section that the permissible limit for any particular insured state bank is something less than 100 percent of tier one capital.

(iv) *Stock investment in insured depository institutions owned exclusively by other banks and savings associations.* An insured state bank may acquire or retain the stock of an insured depository institution if the insured depository institution engages only in activities permissible for national banks; the insured depository institution is subject to examination and regulation by a state bank supervisor; the voting stock is owned by 20 or more insured depository institutions, but no one institution owns more than 15 percent of the voting stock; and the insured depository institution's stock (other than directors' qualifying shares or shares held under or acquired through a plan established for the benefit of the officers and employees) is owned only by insured depository institutions.

(v) *Stock investment in insurance companies*—(A) *Stock of director and officer liability insurance company.* An insured state bank may acquire and retain up to 10 percent of the outstanding stock of a corporation that solely provides or reinsures directors', trustees', and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions.

(B) *Stock of savings bank life insurance company.* An insured state bank located in Massachusetts, New York, or Connecticut may own stock in a savings bank life insurance company, provided that the savings bank life insurance company provides written disclosures to purchasers or potential purchasers of life insurance policies, other insurance products, and annuities that are consistent with the disclosures described in the Interagency Statement on the Retail Sale of Nondeposit Investment Products (FIL–9–94,[1] February 17, 1994) or any successor requirement which indicates that the policies, products, and annuities are not FDIC insured deposits, are not guaranteed by the bank and are subject to investment risks, including possible loss of the principal amount invested.

(b) *Activities other than equity investments*—(1) *Prohibited activities.* An insured state bank may not directly or indirectly engage as principal in any activity, that is not an equity investment, and is of a type not permissible for a national bank unless one of the exceptions in paragraph (b)(2) of this section applies.

(2) *Exceptions*—(i) *Consent obtained through application.* An insured state bank that meets and continues to meet the applicable capital standards set by the appropriate federal banking agency may conduct activities prohibited by paragraph (b)(1) of this section if the bank obtains the FDIC's prior written consent. Consent will be given only if the FDIC determines that the activity poses no significant risk to the affected deposit insurance fund. Applications for consent should be filed in accordance with § 303.121 of this chapter and will be processed under § 303.122(b) of this chapter. Approvals granted under § 303.122(b) of this chapter may be made subject to any conditions or restrictions found by the FDIC to be necessary to protect the deposit insurance funds from risk, to prevent unsafe or unsound banking practices, and/or to ensure that the activity is consistent with the purposes of federal deposit insurance and other applicable law.

(ii) *Insurance underwriting*—(A) *Savings bank life insurance.* An insured state bank that is located in Massachusetts, New York or Connecticut may provide as principal savings bank life insurance through a department of the bank, provided that the department meets the core standards of paragraph (c) of this section or submits an application in compliance with § 303.121 of this chapter and the FDIC grants its consent under the procedures in § 303.122(b) of this chapter, and the department provides purchasers or potential purchasers of life insurance policies, other insurance products and annuities written disclosures that are consistent with the disclosures described in the Interagency Statement on the Retail Sale of Nondeposit Investment Products (FIL–9–94, February 17, 1994) and any successor requirement which indicates that the policies, products and annuities are not FDIC insured deposits, are not guaranteed by the bank, and are subject to investment risks, including the possible loss of the principal amount invested.

(B) *Federal crop insurance.* Any insured state bank that was providing insurance as principal on or before September 30, 1991, which was reinsured in whole or in part by the Federal Crop Insurance Corporation, may continue to do so.

(C) *Grandfathered insurance underwriting.* A well-capitalized insured state bank that on November 21, 1991, was lawfully providing insurance as principal through a department of the bank may continue to provide the same types of insurance as principal to the residents of the state or states in which the bank did so on such date provided that the bank's department meets the core standards of paragraph (c) of this section, or submits an application in compliance with § 303.121 of this chapter and the FDIC grants its consent under the procedures in § 303.122(b) of this chapter.

(iii) *Acquiring and retaining adjustable rate and money market preferred stock.* (A) An insured state bank's investment of up to 15 percent of the bank's tier one capital in adjustable rate preferred stock or money market (auction rate) preferred stock does not represent a significant risk to the deposit insurance funds. An insured state bank may conduct this activity without first obtaining the FDIC's consent, provided that the bank meets and continues to meet the applicable capital standards as prescribed by the appropriate federal banking agency. The fact that prior consent is not required by this subpart does not preclude the FDIC from taking any appropriate action with respect to the activities if the facts and circumstances warrant such action.

(B) An insured state bank may acquire or retain other instruments of a type determined by the FDIC to have the character of debt securities and not to represent a significant risk to the deposit insurance funds. Such instruments shall be included in the 15 percent of tier one capital limit imposed in paragraph (b)(2)(iii)(A) of this section. An insured state bank may conduct this activity without first obtaining the FDIC's consent, provided that the bank meets and continues to meet the applicable capital standards as prescribed by the appropriate federal banking agency. The fact that prior consent is not required by this subpart does not preclude the FDIC from taking any appropriate action with respect to

[1] Financial institution letters (FILs) are available in the FDIC Public Information Center, room 100, 801 17th Street, N.W., Washington, D.C. 20429.

the activities if the facts and circumstances warrant such action.

(c) *Core standards.* For any insured state bank to be eligible to conduct insurance activities listed in paragraph (b)(2)(ii)(A) or (C) of this section, the bank must conduct the activities in a department that meets the following core separation and operating standards:

(1) The department is physically distinct from the remainder of the bank;

(2) The department maintains separate accounting and other records;

(3) The department has assets, liabilities, obligations and expenses that are separate and distinct from those of the remainder of the bank;

(4) The department is subject to state statute that requires its obligations, liabilities and expenses be satisfied only with the assets of the department; and

(5) The department informs its customers that only the assets of the department may be used to satisfy the obligations of the department.

§ 362.4 Subsidiaries of insured state banks.

(a) *Prohibition.* A subsidiary of an insured state bank may not engage as principal in any activity that is not of a type permissible for a subsidiary of a national bank, unless it meets one of the exceptions in paragraph (b) of this section.

(b) *Exceptions*—(1) *Consent obtained through application.* A subsidiary of an insured state bank may conduct otherwise prohibited activities if the bank obtains the FDIC's prior written consent and the insured state bank meets and continues to meet the applicable capital standards set by the appropriate federal banking agency. Consent will be given only if the FDIC determines that the activity poses no significant risk to the affected deposit insurance fund. Applications for consent should be filed in accordance with § 303.121 of this chapter and will be processed under § 303.122(b) of this chapter. Approvals granted under § 303.122(b) of this chapter may be made subject to any conditions or restrictions found by the FDIC to be necessary to protect the deposit insurance funds from risk, to prevent unsafe or unsound banking practices, and/or to ensure that the activity is consistent with the purposes of federal deposit insurance and other applicable law.

(2) *Grandfathered insurance underwriting subsidiaries.* A subsidiary of an insured state bank may:

(i) Engage in grandfathered insurance underwriting if the insured state bank or its subsidiary on November 21, 1991, was lawfully providing insurance as principal. The subsidiary may continue to provide the same types of insurance as principal to the residents of the state or states in which the bank or subsidiary did so on such date provided that:

(A)(*1*) The bank meets the capital requirements of paragraph (e) of this section; and

(*2*) The subsidiary is an ''eligible subsidiary'' as described in paragraph (c)(2) of this section; or

(B) The bank submits an application in compliance with § 303.121 of this chapter and the FDIC grants its consent under the procedures in § 303.122(b) of this chapter.

(ii) Continue to provide as principal title insurance, provided the bank was required before June 1, 1991, to provide title insurance as a condition of the bank's initial chartering under state law and neither the bank nor its parent holding company undergoes a change in control.

(iii) May continue to provide as principal insurance which is reinsured in whole or in part by the Federal Crop Insurance Corporation if the subsidiary was engaged in the activity on or before September 30, 1991.

(3) *Majority-owned subsidiaries' ownership of equity investments that represent a control interest in a company.* The FDIC has determined that investment in the following by a majority-owned subsidiary of an insured state bank does not represent a significant risk to the deposit insurance funds:

(i) Equity investment in a company engaged in real estate or securities activities authorized in paragraph (b)(5) of this section if the bank complies with the following restrictions and files a notice in compliance with § 303.121 of this chapter and the FDIC processes the notice without objection under § 303.122(a) of this chapter. The FDIC is not precluded from taking any appropriate action or imposing additional requirements with respect to the activity if the facts and circumstances warrant such action. If changes to the management or business plan of the company at any time result in material changes to the nature of the company's business or the manner in which its business is conducted, the insured state bank shall advise the appropriate regional director (DOS) in writing within 10 business days after such change. Investment under this paragraph is authorized if:

(A) The majority-owned subsidiary controls the company;

(B) The bank meets the core eligibility criteria of paragraph (c)(1) of this section;

(C) The majority-owned subsidiary meets the core eligibility criteria of paragraph (c)(2) of this section (including any modifications thereof applicable under paragraph (b)(5)(i) of this section), or the company is a corporation meeting such criteria;

(D) The bank's transactions with the majority-owned subsidiary, and the bank's transactions with the company, comply with the investment and transaction limits of paragraph (d) of this section;

(E) The bank complies with the capital requirements of paragraph (e) of this section with respect to the majority-owned subsidiary and the company; and

(F) To the extent the company is engaged in securities activities authorized by paragraph (b)(5)(ii) of this section, the bank and the company comply with the additional requirements therein as if the company were a majority-owned subsidiary.

(ii) Equity securities of a company engaged in the following activities, if the majority-owned subsidiary controls the company or the company is controlled by insured depository institutions, and the bank meets and continues to meet the applicable capital standards as prescribed by the appropriate federal banking agency. The FDIC consents that a majority-owned subsidiary may conduct such activity without first obtaining the FDIC's consent. The fact that prior consent is not required by this subpart does not preclude the FDIC from taking any appropriate action with respect to the activity if the facts and circumstances warrant such action:

(A) Any activity that is permissible for a national bank, including such permissible activities that may require the company to register as a securities broker;

(B) Acting as an insurance agency;

(C) Engaging in any activity permissible for an insured state bank under § 362.3(b)(2)(iii) to the same extent permissible for the insured bank thereunder, so long as instruments held under this paragraph (b)(3)(ii)(C), paragraph (b)(7) of this section, and § 362.3(b)(2)(iii) in the aggregate do not exceed the limit set by § 362.3(b)(2)(iii);

(D) Engaging in any activity permissible for a majority-owned subsidiary of an insured state bank under paragraph (b)(6) of this section to the same extent and manner permissible for the majority-owned subsidiary thereunder; and

(4) *Majority-owned subsidiary's ownership of certain securities that do not represent a control interest.* (i) *Grandfathered investments in common or preferred stock and shares of*

investment companies. Any insured state bank that has received approval to invest in common or preferred stock or shares of an investment company pursuant to § 362.3(a)(2)(iii) may conduct the approved investment activities through a majority-owned subsidiary of the bank without any additional approval from the FDIC provided that any conditions or restrictions imposed with regard to the approval granted under § 362.3(a)(2)(iii) are met.

(ii) *Bank stock.* An insured state bank may indirectly through a majority-owned subsidiary organized for such purpose invest in up to ten percent of the outstanding stock of another insured bank.

(5) *Majority-owned subsidiaries conducting real estate investment activities and securities underwriting.* The FDIC has determined that the following activities do not represent a significant risk to the deposit insurance funds, provided that the activities are conducted by a majority-owned subsidiary of an insured state bank in compliance with the core eligibility requirements listed in paragraph (c) of this section; any additional requirements listed in paragraph (b)(5) (i) or (ii) of this section; the bank complies with the investment and transaction limitations of paragraph (d) of this section; and the bank meets the capital requirements of paragraph (e) of this section. The FDIC consents that these listed activities may be conducted by a majority-owned subsidiary of an insured state bank if the bank files a notice in compliance with § 303.121 of this chapter and the FDIC processes the notice without objection under § 303.122(a) of this chapter. The FDIC is not precluded from taking any appropriate action or imposing additional requirements with respect to the activities if the facts and circumstances warrant such action. If changes to the management or business plan of the majority-owned subsidiary at any time result in material changes to the nature of the majority-owned subsidiary's business or the manner in which its business is conducted, the insured state bank shall advise the appropriate regional director (DOS) in writing within 10 business days after such change. Such a majority-owned subsidiary may:

(i) *Real estate investment activities.* Engage in real estate investment activities. However, the requirements of paragraph (c)(2) (ii), (v), (vi), and (xi) of this section need not be met if the bank's investment in the equity securities of the subsidiary does not exceed 2 percent of the bank's tier one capital; the bank has only one subsidiary engaging in real estate investment activities; and the bank's total investment in the subsidiary does not include any extensions of credit from the bank to the subsidiary, any debt instruments issued by the subsidiary, or any other transaction originated by the bank that is used to benefit the subsidiary.

(ii) *Securities activities.* Engage in the public sale, distribution or underwriting of securities that are not permissible for a national bank under section 16 of the Banking Act of 1933 (12 U.S.C. 24 Seventh), provided that the following additional conditions are, and continue to be, met:

(A) The state-chartered depository institution adopts policies and procedures, including appropriate limits on exposure, to govern the institution's participation in financing transactions underwritten or arranged by an underwriting majority-owned subsidiary;

(B) The state-chartered depository institution may not express an opinion on the value or the advisability of the purchase or sale of securities underwritten or dealt in by a majority-owned subsidiary unless the state-chartered depository institution notifies the customer that the majority-owned subsidiary is underwriting or distributing the security;

(C) The majority-owned subsidiary is registered with the Securities and Exchange Commission, is a member in good standing with the appropriate self-regulatory organization, and promptly informs the appropriate regional director (DOS) in writing of any material actions taken against the majority-owned subsidiary or any of its employees by the state, the appropriate self-regulatory organizations or the Securities and Exchange Commission; and

(D) The state-chartered depository institution does not knowingly purchase as principal or fiduciary during the existence of any underwriting or selling syndicate any securities underwritten by the majority-owned subsidiary unless the purchase is approved by the state-chartered depository institution's board of directors before the securities are initially offered for sale to the public.

(6) *Real estate leasing.* A majority-owned subsidiary of an insured state bank acting as lessor under a real property lease which is the equivalent of a financing transaction, meeting the lease criteria of paragraph (b)(6)(i) of this section and the underlying real estate requirements of paragraph (b)(6)(ii) of this section, does not represent a significant risk to the deposit insurance funds. A majority-owned subsidiary may conduct this activity without first obtaining the FDIC's consent, provided that the bank meets and continues to meet the applicable capital standards as prescribed by the appropriate federal banking agency. The fact that prior consent is not required by this subpart does not preclude the FDIC from taking any appropriate action with respect to the activity if the facts and circumstances warrant such action.

(i) *Lease criteria*—(A) *Capital lease.* The lease must qualify as a capital lease as to the lessor under generally accepted accounting principles.

(B) *Nonoperating basis.* The bank and the majority-owned subsidiary shall not, directly or indirectly, provide or be obligated to provide servicing, repair, or maintenance to the property, except that the lease may include provisions permitting the subsidiary to protect the value of the leased property in the event of a change in circumstances that increases the subsidiary's exposure to loss, or the subsidiary may take reasonable and appropriate action to salvage or protect the value of the leased property in such circumstances.

(ii) *Underlying real property requirements*—(A) *Acquisition.* The majority-owned subsidiary may acquire specific real estate to be leased only after the subsidiary has entered into:

(*1*) A lease meeting the requirements of paragraph (b)(6)(i) of this section;

(*2*) A legally binding written commitment to enter into such a lease; or

(*3*) A legally binding written agreement that indemnifies the subsidiary against loss in connection with its acquisition of the property.

(B) *Improvements.* Any expenditures by the majority-owned subsidiary to make reasonable repairs, renovations, and improvements necessary to render the property suitable to the lessee shall not exceed 25 percent of the majority-owned subsidiary's full investment in the real estate.

(C) *Divestiture.* At the expiration of the initial lease (including any renewals or extensions thereof), the majority-owned subsidiary shall, as soon as practicable but in any event no less than two years, either:

(*1*) Re-lease the property under a lease meeting the requirement of paragraph (b)(6)(i)(B) of this section; or

(*2*) Divest itself of all interest in the property.

(7) *Acquiring and retaining adjustable rate and money market preferred stock and similar instruments.* The FDIC has determined it does not present a significant risk to the deposit insurance

funds for a majority-owned subsidiary of an insured state bank to engage in any activity permissible for an insured state bank under § 362.3(b)(2)(iii), so long as instruments held under this paragraph, paragraph (b)(3)(ii)(C) of this section, and § 362.3(b)(2)(iii) in the aggregate do not exceed the limit set by § 362.3(b)(2)(iii). A majority-owned subsidiary may conduct this activity without first obtaining the FDIC's consent, provided that the bank meets and continues to meet the applicable capital standards as prescribed by the appropriate federal banking agency. The fact that prior consent is not required by this subpart does not preclude the FDIC from taking any appropriate action with respect to the activity if the facts and circumstances warrant such action.

(c) *Core eligibility requirements.* If specifically required by this part or by FDIC order, any state-chartered depository institution that wishes to be eligible and continue to be eligible to conduct as principal activities through a subsidiary that are not permissible for a subsidiary of a national bank must be an ''eligible depository institution'' and the subsidiary must be an ''eligible subsidiary''.

(1) A state-chartered depository institution is an ''eligible depository institution'' if it:

(i) Has been chartered and operating for three or more years, unless the appropriate regional director (DOS) finds that the state-chartered depository institution is owned by an established, well-capitalized, well-managed holding company or is managed by seasoned management;

(ii) Has an FDIC-assigned composite rating of 1 or 2 assigned under the Uniform Financial Institutions Rating System (UFIRS) (or such other comparable rating system as may be adopted in the future) as a result of its most recent federal or state examination for which the FDIC assigned a rating;

(iii) Received a rating of 1 or 2 under the ''management'' component of the UFIRS as assigned by the institution's appropriate federal banking agency;

(iv) Has a satisfactory or better Community Reinvestment Act rating at its most recent examination conducted by the institution's appropriate federal banking agency;

(v) Has a compliance rating of 1 or 2 at its most recent examination conducted by the institution's appropriate federal banking agency; and

(vi) Is not subject to a cease and desist order, consent order, prompt corrective action directive, formal or informal written agreement, or other administrative agreement with its appropriate federal banking agency or chartering authority.

(2) A subsidiary of a state-chartered depository institution is an ''eligible subsidiary'' if it:

(i) Meets applicable statutory or regulatory capital requirements and has sufficient operating capital in light of the normal obligations that are reasonably foreseeable for a business of its size and character within the industry;

(ii) Is physically separate and distinct in its operations from the operations of the state-chartered depository institution, provided that this requirement shall not be construed to prohibit the state-chartered depository institution and its subsidiary from sharing the same facility if the area where the subsidiary conducts business with the public is clearly distinct from the area where customers of the state-chartered depository institution conduct business with the institution. The extent of the separation will vary according to the type and frequency of customer contact;

(iii) Maintains separate accounting and other business records;

(iv) Observes separate business entity formalities such as separate board of directors' meetings;

(v) Has a chief executive officer of the subsidiary who is not an employee of the institution;

(vi) Has a majority of its board of directors who are neither directors nor officers of the state-chartered depository institution;

(vii) Conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the state-chartered depository institution and that the state-chartered depository institution is not responsible for and does not guarantee the obligations of the subsidiary;

(viii) Has only one business purpose within the types described in paragraphs (b)(2) and (b)(5) of this section;

(ix) Has a current written business plan that is appropriate to the type and scope of business conducted by the subsidiary;

(x) Has qualified management and employees for the type of activity contemplated, including all required licenses and memberships, and complies with industry standards; and

(xi) Establishes policies and procedures to ensure adequate computer, audit and accounting systems, internal risk management controls, and has necessary operational and managerial infrastructure to implement the business plan.

(d) *Investment and transaction limits*—(1) *General.* If specifically required by this part or FDIC order, the following conditions and restrictions apply to an insured state bank and its subsidiaries that engage in and wish to continue to engage in activities which are not permissible for a national bank subsidiary.

(2) *Investment limits*—(i) *Aggregate investment in subsidiaries.* An insured state bank's aggregate investment in all subsidiaries conducting activities subject to this paragraph (d) shall not exceed 20 percent of the insured state bank's tier one capital.

(ii) *Definition of investment.* (A) For purposes of this paragraph (d), the term ''investment'' means:

(*1*) Any extension of credit to the subsidiary by the insured state bank;

(*2*) Any debt securities, as such term is defined in part 344 of this chapter, issued by the subsidiary held by the insured state bank;

(*3*) The acceptance by the insured state bank of securities issued by the subsidiary as collateral for an extension of credit to any person or company; and

(*4*) Any extensions of credit by the insured state bank to any third party for the purpose of making a direct investment in the subsidiary, making any investment in which the subsidiary has an interest, or which is used for the benefit of, or transferred to, the subsidiary.

(B) For the purposes of this paragraph (d), the term ''investment'' does not include:

(*1*) Extensions of credit by the insured state bank to finance sales of assets by the subsidiary which do not involve more than the normal degree of risk of repayment and are extended on terms that are substantially similar to those prevailing at the time for comparable transactions with or involving unaffiliated persons or companies;

(*2*) An extension of credit by the insured state bank to the subsidiary that is fully collateralized by government securities, as such term is defined in § 344.3 of this chapter; or

(*3*) An extension of credit by the insured state bank to the subsidiary that is fully collateralized by a segregated deposit in the insured state bank.

(3) *Transaction requirements*—(i) *Arm's length transaction requirement.* With the exception of giving the subsidiary immediate credit for uncollected items received in the ordinary course of business, an insured state bank may not carry out any of the following transactions with a subsidiary subject to this paragraph (d) unless the

transaction is on terms and conditions that are substantially the same as those prevailing at the time for comparable transactions with unaffiliated parties:

(A) Make an investment in the subsidiary;

(B) Purchase from or sell to the subsidiary any assets (including securities);

(C) Enter into a contract, lease, or other type of agreement with the subsidiary;

(D) Pay compensation to a majority-owned subsidiary or any person or company who has an interest in the subsidiary; or

(E) Engage in any such transaction in which the proceeds thereof are used for the benefit of, or are transferred to, the subsidiary.

(ii) *Prohibition on purchase of low quality assets.* An insured state bank is prohibited from purchasing a low quality asset from a subsidiary subject to this paragraph (d). For purposes of this subsection, ''low quality asset'' means:

(A) An asset classified as ''substandard'', ''doubtful'', or ''loss'' or treated as ''other assets especially mentioned'' in the most recent report of examination of the bank;

(B) An asset in a nonaccrual status;

(C) An asset on which principal or interest payments are more than 30 days past due; or

(D) An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

(iii) *Insider transaction restriction.* Neither the insured state bank nor the subsidiary subject to this paragraph (d) may enter into any transaction (exclusive of those covered by § 337.3 of this chapter) with the bank's executive officers, directors, principal shareholders or related interests of such persons which relate to the subsidiary's activities unless:

(A) The transactions are on terms and conditions that are substantially the same as those prevailing at the time for comparable transactions with persons not affiliated with the insured state bank; or

(B) The transactions are pursuant to a benefit or compensation program that is widely available to employees of the bank, and that does not give preference to the bank's executive officers, directors, principal shareholders or related interests of such persons over other bank employees.

(iv) *Anti-tying restriction.* Neither the insured state bank nor the majority-owned subsidiary may require a customer to either buy any product or use any service from the other as a condition of entering into a transaction.

(4) *Collateralization requirements.* (i) An insured state bank is prohibited from making an investment in a subsidiary subject to this paragraph (d) unless such transaction is fully-collateralized at the time the transaction is entered into. No insured state bank may accept a low quality asset as collateral. An extension of credit is fully collateralized if it is secured at the time of the transaction by collateral having a market value equal to at least:

(A) 100 percent of the amount of the transaction if the collateral is composed of:

(*1*) Obligations of the United States or its agencies;

(*2*) Obligations fully guaranteed by the United States or its agencies as to principal and interest;

(*3*) Notes, drafts, bills of exchange or bankers acceptances that are eligible for rediscount or purchase by the Federal Reserve Bank; or

(*4*) A segregated, earmarked deposit account with the insured state bank;

(B) 110 percent of the amount of the transaction if the collateral is composed of obligations of any state or political subdivision of any state;

(C) 120 percent of the amount of the transaction if the collateral is composed of other debt instruments, including receivables; or

(D) 130 percent of the amount of the transaction if the collateral is composed of stock, leases, or other real or personal property.

(ii) An insured state bank may not release collateral prior to proportional payment of the extension of credit; however, collateral may be substituted if there is no diminution of collateral coverage.

(5) *Investment and transaction limits extended to insured state bank subsidiaries.* For purposes of applying paragraphs (d)(2) through (d)(4) of this section, any reference to ''insured state bank'' means the insured state bank and any subsidiaries of the insured state bank which are not themselves subject under this part or FDIC order to the restrictions of this paragraph (d).

(e) *Capital requirements.* If specifically required by this part or by FDIC order, any insured state bank that wishes to conduct or continue to conduct as principal activities through a subsidiary that are not permissible for a subsidiary of a national bank must:

(1) Be well-capitalized after deducting from its tier one capital the investment in equity securities of the subsidiary as well as the bank's pro rata share of any retained earnings of the subsidiary;

(2) Reflect this deduction on the appropriate schedule of the bank's consolidated report of income and condition; and

(3) Use such regulatory capital amount for the purposes of the bank's assessment risk classification under part 327 of this chapter and its categorization as a ''well-capitalized'', an ''adequately capitalized'', an ''undercapitalized'', or a ''significantly undercapitalized'' institution as defined in § 325.103(b) of this chapter, provided that the capital deduction shall not be used for purposes of determining whether the bank is ''critically undercapitalized'' under part 325 of this chapter.

§ 362.5 Approvals previously granted.

(a) *FDIC consent by order or notice.* An insured state bank that previously filed an application or notice under part 362 in effect prior to January 1, 1999 (see 12 CFR part 362 revised as of January 1, 1998), and obtained the FDIC's consent to engage in an activity or to acquire or retain a majority-owned subsidiary engaging as principal in an activity or acquiring and retaining any investment that is prohibited under this subpart may continue that activity or retain that investment without seeking the FDIC's consent, provided that the insured state bank and its subsidiary, if applicable, continue to meet the conditions and restrictions of the approval. An insured state bank which was granted approval based on conditions which differ from the requirements of § 362.4(c)(2), (d) and (e) will be considered to meet the conditions and restrictions of the approval relating to being an eligible subsidiary, meeting investment and transactions limits, and meeting capital requirements if the insured state bank and subsidiary meet the requirements of § 362.4(c)(2), (d) and (e). If the majority-owned subsidiary is engaged in real estate investment activities not exceeding 2 percent of the tier one capital of a bank and meeting the other conditions of § 362.4(b)(5)(i), the majority-owned subsidiary's compliance with § 362.4(c)(2) under the preceding sentence may be pursuant to the modifications authorized by § 362.4(b)(5)(i). Once an insured state bank elects to comply with § 362.4 (c)(2), (d), and (e), it may not revert to the corresponding provisions of the approval order.

(b) *Approvals by regulation*—(1) *Securities underwriting.* If an insured state nonmember bank engages in securities activities covered by § 362.4(b)(5)(ii), and prior to January 1, 1999, engaged in securities activities under and in compliance with the restrictions of § 337.4 (b) through (c), § 337.4(e), or § 337.4(h) of this chapter, having filed the required notice under § 337.4(d) of this chapter, the insured state bank may continue those activities if the bank and its majority-owned subsidiaries comply with the restrictions set forth in §§ 362.4(b)(5)(ii) and 362.4 (c), (d), and (e) by January 1, 2000. During the one-year period of transition between January 1, 1999, and January 1, 2000, the bank and its majority-owned subsidiary must meet the restrictions set forth in § 337.4 of this chapter until the requirements of §§ 362.4(b)(5)(ii) and 362.4 (c), (d) and (e) are met. If the bank will not meet these requirements, the bank must obtain the FDIC's consent to continue those activities under § 362.4(b)(1).

(2) *Grandfathered insurance underwriting.* An insured state bank which is directly providing insurance as principal pursuant to § 362.4(c)(2)(i) in effect prior to January 1, 1999 (see 12 CFR part 362 revised as of January 1, 1998), may continue that activity if it complies with the provisions of § 362.3(b)(2)(ii)(C) by April 1, 1999. An insured state bank indirectly providing insurance as principal through a subsidiary pursuant to § 362.3(b)(7) in effect prior to January 1, 1999 (see 12 CFR part 362 revised as of January 1, 1998), may continue that activity if it complies with the provisions of § 362.4(b)(2)(i) by April 1, 1999. During the ninety-day period of transition between January 1, 1999 and April 1, 1999, the bank and its majority-owned subsidiary must meet the restrictions set forth in § 362.4(c)(2)(i) or § 362.3(b)(7) in effect prior to January 1, 1999 (see 12 CFR part 362 revised as of January 1, 1998), as applicable, until the requirements of § 362.3(b)(2)(ii)(C) or § 362.4(b)(2)(i) are met. If the insured state bank or its subsidiary will not meet these requirements, as applicable, the insured state bank must submit an application in compliance with § 303.121 of this chapter and obtain the FDIC's consent in accordance with § 303.122(b) of this chapter.

(3) *Stock of certain corporations.* An insured state bank owning indirectly through a majority-owned subsidiary stock of a corporation that engages solely in activities permissible for a bank service corporation pursuant to § 362.4(c)(3)(iv)(C) in effect prior to January 1, 1999 (see 12 CFR part 362 revised as of January 1, 1998), or stock of a corporation which engages solely in activities which are not ''as principal'' pursuant to § 362.4(c)(3)(iv)(D) in effect prior to January 1, 1999 (see 12 CFR part 362 revised as of January 1, 1998), may continue that activity if it complies with the provisions of § 362.4(b)(3) by April 1, 1999. During the ninety-day period of transition between January 1, 1999 and April 1, 1999, the bank and its majority-owned subsidiary must meet the restrictions set forth in § 362.4(c)(3)(iv)(C) or § 362.4(c)(3)(iv)(D) in effect prior to January 1, 1999 (see 12 CFR part 362 revised as of January 1, 1998), as applicable, until the requirements of § 362.4(b)(3) are met. If the insured state bank or its subsidiary will not meet these requirements, as applicable, the insured state bank must apply for the FDIC's consent under § 362.4(b)(1).

(4) [Reserved]

(5) [Reserved]

(6) *Adjustable rate or money market preferred stock.* An insured state bank owning adjustable rate or money market (auction rate) preferred stock pursuant to § 362.4(c)(3)(v) in effect prior to January 1, 1999 (see 12 CFR part 362 revised as of January 1, 1998), in excess of the amount limit in § 362.3(b)(2)(iii) may continue to hold any overlimit shares of such stock acquired before January 1, 1999, until redeemed or repurchased by the issuer, but such stock shall be included as part of the amount limit in § 362.3(b)(2)(iii) when determining whether the bank may acquire new stock thereunder.

(c) *Charter conversions.* (1) An insured state bank that has converted its charter from an insured state savings association may continue activities through a majority-owned subsidiary that were permissible prior to the time it converted its charter only if the insured state bank receives the FDIC's consent. Except as provided in paragraph (c)(2) of this section, the insured state bank should apply under § 362.4(b)(1), submit any notice required under § 362.4(b) (4) or (5), or comply with the provisions of § 362.4(b) (3), (6), or (7) if applicable, to continue the activity.

(2) *Exception for prior consent.* If the FDIC had granted consent to the savings association under section 28 of the Federal Deposit Insurance Act (12 U.S.C. 1831(e)) prior to the time the savings association converted its charter, the insured state bank may continue the activities without providing notice or making application to the FDIC, provided that the bank and its subsidiary as applicable are in compliance with:

(i) The terms of the FDIC approval order; and

(ii) The provisions of § 362.4(c)(2), (d), and (e) regarding operating as an ''eligible subsidiary'', ''investment and transaction limits'', and ''capital requirements'.

(3) *Divestiture.* An insured state bank that does not receive FDIC consent shall divest of the nonconforming investment as soon as practical but in no event later than two years from the date of charter conversion.

Subpart B—Safety and Soundness Rules Governing Insured State Nonmember Banks

§ 362.6 Purpose and scope.

This subpart, along with the notice and application procedures in subpart G of part 303 of this chapter apply to certain banking practices that may have adverse effects on the safety and soundness of insured state nonmember banks. The FDIC intends to allow insured state nonmember banks and their subsidiaries to undertake only safe and sound activities and investments that would not present a significant risk to the deposit insurance fund and that are consistent with the purposes of federal deposit insurance and other law. The following standards shall apply for insured state nonmember banks to conduct real estate investment activities through a subsidiary if those activities are permissible for a national bank subsidiary but are not permissible for the national bank parent itself. Additionally, the following standards shall apply to affiliates of insured state nonmember banks that are not affiliated with a bank holding company if those affiliates engage in the public sale, distribution or underwriting of stocks, bonds, debentures, notes or other securities.

§ 362.7 Definitions.

For the purposes of this subpart, the following definitions apply:

(a) *Affiliate* shall mean any company that directly or indirectly, through one or more intermediaries, controls or is under common control with an insured state nonmember bank, but does not include a subsidiary of an insured state nonmember bank.

(b) *Activity, company, control, equity security, insured state nonmember bank, real estate investment activity, security,* and *subsidiary* have the same meaning as provided in subpart A of this part.

§ 362.8 Restrictions on activities of insured state nonmember banks.

(a) *Real estate investment activities by subsidiaries of insured state nonmember banks.* The FDIC has found that real estate investment activities may have adverse effects on the safety and soundness of insured state nonmember banks. Notwithstanding any interpretations, orders, circulars or official bulletins issued by the Office of the Comptroller of the Currency regarding activities permissible for subsidiaries of a national bank that are not permissible for the parent national bank itself under 12 CFR 5.34(f), insured state nonmember banks may not establish or acquire a subsidiary that engages in such real estate investment activities unless the insured state nonmember bank:

(1) Has an approval previously granted by the FDIC and continues to meet the conditions and restrictions of the approval; or

(2) Meets the requirements for engaging in real estate investment activities as set forth in § 362.4(b)(5), and submits a corresponding notice in compliance with § 303.121 of this chapter and the FDIC processes the notice without objection under § 303.122(a) of this chapter; or submits an application in compliance with § 303.121 of this chapter and the FDIC grants its consent under the procedure in § 303.122(b) of this chapter.

(b) *Affiliation with securities companies.* The FDIC has found that an unrestricted affiliation between an insured state nonmember bank and a securities company may have adverse effects on the safety and soundness of insured state nonmember banks. An insured state nonmember bank which is affiliated with a company that is not treated as a bank holding company pursuant to section 4(f) of the Bank Holding Company Act (12 U.S.C. 1843(f)) is prohibited from becoming or remaining affiliated with any company that directly engages in the public sale, distribution or underwriting of stocks, bonds, debentures, notes, or other securities which is not permissible for a national bank unless it submits an application in compliance with § 303.121 of this chapter and the FDIC grants its consent under the procedure in § 303.122(b) of this chapter, or:

(1) The securities business of the affiliate is physically separate and distinct in its operations from the operations of the bank, provided that this requirement shall not be construed to prohibit the bank and its affiliate from sharing the same facility if the area where the affiliate conducts retail sales activity with the public is physically distinct from the routine deposit taking area of the bank;

(2) The affiliate has a chief executive officer who is not an employee of the bank;

(3) A majority of the affiliate's board of directors are not directors, officers, or employees of the bank;

(4) The affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and the state-chartered depository institution is not responsible for and does not guarantee the obligations of the affiliate;

(5) The bank adopts policies and procedures, including appropriate limits on exposure, to govern its participation in financing transactions underwritten by an underwriting affiliate;

(6) The bank does not express an opinion on the value or the advisability of the purchase or sale of securities underwritten or dealt in by an affiliate unless it notifies the customer that the entity underwriting, making a market, distributing or dealing in the securities is an affiliate of the bank;

(7) The bank does not purchase as principal or fiduciary during the existence of any underwriting or selling syndicate any securities underwritten by the affiliate unless the purchase is approved by the bank's board of directors before the securities are initially offered for sale to the public;

(8) The bank does not condition any extension of credit to any company on the requirement that the company contract with, or agree to contract with, the bank's affiliate to underwrite or distribute the company's securities;

(9) The bank does not condition any extension of credit or the offering of any service to any person or company on the requirement that the person or company purchase any security underwritten or distributed by the affiliate; and

(10) The bank complies with the investment and transaction limitations of § 362.4(d). For the purposes of applying these restrictions, references to the term ''subsidiary'' in § 362.4(d)(2), (3), and (4) shall be deemed to refer to the affiliate. For the purposes of applying these limitations, the term ''investment'' as defined in § 362.4(d)(2)(ii) shall also include any equity securities of the affiliate held by the insured state bank.

Subpart C—Activities of Insured State Savings Associations

§ 362.9 Purpose and scope.

(a) This subpart, along with the notice and application procedures in subpart H of part 303 of this chapter, implements the provisions of section 28 of the Federal Deposit Insurance Act (12 U.S.C. 1831e) that restrict and prohibit insured state savings associations and their service corporations from engaging in activities and investments of a type that are not permissible for federal savings associations and their service corporations. The phrase ''activity permissible for a federal savings association'' means any activity authorized for federal savings associations under any statute including the Home Owners' Loan Act (HOLA, 12 U.S.C. 1464 *et seq.*), as well as activities recognized as permissible for a federal savings association in regulations, official thrift bulletins, orders or written interpretations issued by the Office of Thrift Supervision (OTS), or its predecessor, the Federal Home Loan Bank Board.

(b) This subpart does not cover the following activities:

(1) Activities conducted by the insured state savings association other than ''as principal'', defined for purposes of this subpart as activities conducted as agent for a customer, conducted in a brokerage, custodial, advisory, or administrative capacity, or conducted as trustee, or in any substantially similar capacity. For example, this subpart does not cover acting solely as agent for the sale of insurance, securities, real estate, or travel services; nor does it cover acting as trustee, providing personal financial planning advice, or safekeeping services.

(2) Interests in real estate in which the real property is used or intended in good faith to be used within a reasonable time by an insured savings association or its service corporations as offices or related facilities for the conduct of its business or future expansion of its business or used as public welfare investments of a type and in an amount permissible for federal savings associations.

(3) Equity investments acquired in connection with debts previously contracted (DPC) if the insured savings association or its service corporation takes only such actions as would be permissible for a federal savings association's or its service corporation's DPC holdings.

(c) The FDIC intends to allow insured state savings associations and their service corporations to undertake only safe and sound activities and investments that do not present significant risks to the deposit insurance funds and that are consistent with the purposes of federal deposit insurance and other applicable law. This subpart does not authorize any insured state savings association to make investments or conduct activities that are not authorized or that are prohibited by either federal or state law.

§ 362.10 Definitions.

For the purposes of this subpart, the definitions provided in § 362.2 apply. Additionally, the following definitions apply to this subpart:

(a) *Affiliate* shall mean any company that directly or indirectly, through one or more intermediaries, controls or is under common control with an insured state savings association.

(b) *Corporate debt securities not of investment grade* means any corporate debt security that when acquired was not rated among the four highest rating categories by at least one nationally recognized statistical rating organization. The term shall not include any obligation issued or guaranteed by a corporation that may be held by a federal savings association without limitation as to percentage of assets under subparagraphs (D), (E), or (F) of section 5(c)(1) of HOLA (12 U.S.C. 1464(c)(1) (D), (E), (F)).

(c) *Insured state savings association* means any state-chartered savings association insured by the FDIC.

(d) *Qualified affiliate* means, in the case of a stock insured state savings association, an affiliate other than a subsidiary or an insured depository institution. In the case of a mutual savings association, ''qualified affiliate'' means a subsidiary other than an insured depository institution provided that all of the savings association's investments in, and extensions of credit to, the subsidiary are deducted from the savings association's capital.

(e) *Service corporation* means any corporation the capital stock of which is available for purchase by savings associations.

§ 362.11 Activities of insured state savings associations.

(a) *Equity investments*—(1) *Prohibited investments.* No insured state savings association may directly acquire or retain as principal any equity investment of a type, or in an amount, that is not permissible for a federal savings association unless the exception in paragraph (a)(2) of this section applies.

(2) *Exception: Equity investment in service corporations.* An insured state savings association that is and continues to be in compliance with the applicable capital standards as prescribed by the appropriate federal banking agency may acquire or retain an equity investment in a service corporation:

(i) Not permissible for a federal savings association to the extent the service corporation is engaging in activities that are allowed pursuant to the provisions of or an application under § 362.12(b); or

(ii) Of a type permissible for a federal savings association, but in an amount exceeding the investment limits applicable to federal savings associations, if the insured state savings association obtains the FDIC's prior consent. Consent will be given only if the FDIC determines that the amount of the investment in a service corporation engaged in such activities does not present a significant risk to the affected deposit insurance fund. Applications should be filed in accordance with § 303.141 of this chapter and will be processed under § 303.142(b) of this chapter. Approvals granted under § 303.142(b) of this chapter may be made subject to any conditions or restrictions found by the FDIC to be necessary to protect the deposit insurance funds from significant risk, to prevent unsafe or unsound practices, and/or to ensure that the activity is consistent with the purposes of federal deposit insurance and other applicable law.

(b) *Activities other than equity investments*—(1) *Prohibited activities.* An insured state savings association may not directly engage as principal in any activity, that is not an equity investment, of a type not permissible for a federal savings association, and an insured state savings association shall not make nonresidential real property loans in an amount exceeding that described in section 5(c)(2)(B) of HOLA (12 U.S.C. 1464(c)(2)(B)), unless one of the exceptions in paragraph (b)(2) of this section applies. This section shall not be read to require the divestiture of any asset (including a nonresidential real estate loan), if the asset was acquired prior to August 9, 1989; however, any activity conducted with such asset must be conducted in accordance with this subpart. After August 9, 1989, an insured state savings association directly or through a subsidiary (other than, in the case of a mutual savings association, a subsidiary that is a qualified affiliate), may not acquire or retain any corporate debt securities not of investment grade.

(2) *Exceptions*—(i) *Consent obtained through application.* An insured state savings association that meets and continues to meet the applicable capital standards set by the appropriate federal banking agency may directly conduct activities prohibited by paragraph (b)(1) of this section if the savings association obtains the FDIC's prior consent. Consent will be given only if the FDIC determines that conducting the activity designated poses no significant risk to the affected deposit insurance fund. Applications should be filed in accordance with § 303.141 of this chapter and will be processed under § 303.142(b) of this chapter. Approvals granted under § 303.142(b) of this chapter may be made subject to any conditions or restrictions found by the FDIC to be necessary to protect the deposit insurance funds from significant risk, to prevent unsafe or unsound practices, and/or to ensure that the activity is consistent with the purposes of federal deposit insurance and other applicable law.

(ii) *Nonresidential realty loans permissible for a federal savings association conducted in an amount not permissible.* An insured state savings association that meets and continues to meet the applicable capital standards set by the appropriate federal banking agency may make nonresidential real property loans in an amount exceeding the amount described in section 5(c)(2)(B) of HOLA, if the savings association files a notice in compliance with § 303.141 of this chapter and the FDIC processes the notice without objection under § 303.142(a) of this chapter. Consent will be given only if the FDIC determines that engaging in such lending in the amount designated poses no significant risk to the affected deposit insurance fund.

(iii) *Acquiring and retaining adjustable rate and money market preferred stock.* (A) An insured state savings association's investment of up to 15 percent of the association's tier one capital in adjustable rate preferred stock or money market (auction rate) preferred stock does not represent a significant risk to the deposit insurance funds. An insured state savings association may conduct this activity without first obtaining the FDIC's consent, provided that the association meets and continues to meet the applicable capital standards as prescribed by the appropriate federal banking agency. The fact that prior consent is not required by this subpart does not preclude the FDIC from taking any appropriate action with respect to the activities if the facts and circumstances warrant such action.

(B) An insured state savings association may acquire or retain other instruments of a type determined by the FDIC to have the character of debt securities and not to represent a significant risk to the deposit insurance funds. Such instruments shall be included in the 15 percent of tier one capital limit imposed in paragraph (b)(2)(iii)(A) of this section. An insured state savings association may conduct this activity without first obtaining the FDIC's consent, provided that the association meets and continues to meet the applicable capital standards as prescribed by the appropriate federal banking agency. The fact that prior consent is not required by this subpart does not preclude the FDIC from taking any appropriate action with respect to the activities if the facts and circumstances warrant such action.

(3) *Activities permissible for a federal savings association conducted in an amount not permissible.* Except as provided in paragraph (b)(2)(ii) of this section, an insured state savings association may engage as principal in any activity, which is not an equity investment of a type permissible for a federal savings association, in an amount in excess of that permissible for a federal savings association, if the savings association meets and continues to meet the applicable capital standards set by the appropriate federal banking agency, the institution has advised the appropriate regional director (DOS) under the procedure in § 303.142(c) of this chapter within thirty days before engaging in the activity, and the FDIC has not advised the insured state savings association that conducting the activity in the amount indicated poses a significant risk to the affected deposit insurance fund. This section shall not be read to require the divestiture of any asset if the asset was acquired prior to August 9, 1989; however, any activity conducted with such asset must be conducted in accordance with this subpart.

§ 362.12 Service corporations of insured state savings associations.

(a) *Prohibition.* A service corporation of an insured state savings association may not engage in any activity that is not permissible for a service corporation of a federal savings association, unless it meets one of the exceptions in paragraph (b) of this section.

(b) *Exceptions*—(1) *Consent obtained through application.* A service corporation of an insured state savings association may conduct activities prohibited by paragraph (a) of this section if the savings association obtains the FDIC's prior written consent and the insured state savings association meets and continues to meet the applicable capital standards set by the appropriate federal banking agency. Consent will be given only if the FDIC determines that the activity poses no significant risk to the affected deposit insurance fund. Applications for consent should be filed in accordance with § 303.141 of this chapter and will be processed under § 303.142(b) of this chapter. Approvals granted under § 303.142(b) of this chapter may be made subject to any conditions or restrictions found by the FDIC to be necessary to protect the deposit insurance funds from risk, to prevent unsafe or unsound banking practices, and/or to ensure that the activity is consistent with the purposes of federal deposit insurance and other applicable law.

(2) *Service corporations conducting unrestricted activities.* The FDIC has determined that the following activities do not represent a significant risk to the deposit insurance funds:

(i) A service corporation of an insured state savings association may acquire and retain equity securities of a company engaged in securities activities authorized in paragraph (b)(4) of this section if the bank complies with the following restrictions and files a notice in compliance with § 303.141 of this chapter and the FDIC processes the notice without objection under § 303.142(a) of this chapter. The FDIC is not precluded from taking any appropriate action or imposing additional requirements with respect to the activity if the facts and circumstances warrant such action. If changes to the management or business plan of the company at any time result in material changes to the nature of the company's business or the manner in which its business is conducted, the insured state savings association shall advise the appropriate regional director (DOS) in writing within 10 business days after such change. Investment under this paragraph is authorized if:

(A) The service corporation controls the company;

(B) The savings association meets the core eligibility criteria of § 362.4(c)(1);

(C) The service corporation meets the core eligibility criteria of § 362.4(c)(2) (with references to the term ''subsidiary'' deemed to refer to the service corporation), or the company is a corporation meeting such criteria;

(D) The savings association's transactions with the service corporation comply with the investment and transaction limits of paragraph (c) of this section, and the savings association's transactions with the company comply with such limits as if it were a service corporation;

(E) The savings association complies with the capital requirements of paragraph (d) of this section with respect to the service corporation and the company; and

(F) The savings association and the company comply with the additional requirements of § 362.4(b)(5)(ii) (with references to the term ''majority-owned subsidiary'' deemed to refer to the company).

(ii) A service corporation of an insured state savings association may acquire and retain equity securities of a company engaged in the following activities, if the service corporation controls the company or the company is controlled by insured depository institutions, and the association continues to meet the applicable capital standards as prescribed by the appropriate federal banking agency. The FDIC consents that such activity may be conducted by a service corporation of an insured state savings association without first obtaining the FDIC's consent. The fact that prior consent is not required by this subpart does not preclude the FDIC from taking any appropriate action with respect to the activities if the facts and circumstances warrant such action.

(A) *Equity securities of a company that engages in permissible activities.* A service corporation may own the equity securities of a company that engages in any activity permissible for a federal savings association.

(B) *Equity securities of a company that acquires and retains adjustable-rate and money market preferred stock.* A service corporation may own the equity securities of a company that engages in any activity permissible for an insured state savings association under § 362.11(b)(2)(iii) so long as instruments held under this paragraph (b)(2)(ii)(B), paragraph (b)(2)(iv) of this section, and § 362.11(b)(2)(iii) in the aggregate do not exceed the limit set by § 362.11(b)(2)(iii).

(C) *Equity securities of a company acting as an insurance agency.* A service corporation may own the equity securities of a company that acts as an insurance agency.

(iii) *Activities that are not conducted ''as principal''.* A service corporation controlled by the insured state savings association may engage in activities which are not conducted ''as principal'' such as acting as an agent for a customer, acting in a brokerage, custodial, advisory, or administrative capacity, or acting as trustee, or in any substantially similar capacity.

(iv) *Acquiring and retaining adjustable-rate and money market preferred stock.* A service corporation may engage in any activity permissible for an insured state savings association under § 362.11(b)(2)(iii) so long as instruments held under this paragraph (b)(2)(iv), paragraph (b)(2)(ii)(B) of this section, and § 362.11(b)(2)(iii) in the aggregate do not exceed the limit set by § 362.11(b)(2)(iii).

(3) [Reserved]

(4) *Service corporations conducting securities underwriting.* The FDIC has determined that it does not represent a significant risk to the deposit insurance funds for a service corporation to engage in the public sale, distribution or underwriting of securities provided that the activity is conducted by a service corporation of an insured state savings association in compliance with the core eligibility requirements listed in

§ 362.4(c); any additional requirements listed in § 362.4(b)(5)(ii); the savings association complies with the investment and transaction limitations of paragraph (c) of this section; and the savings association meets the capital requirements of paragraph (d) of this section. The FDIC consents that these listed activities may be conducted by a service corporation of an insured state savings association if the savings association files a notice in compliance with § 303.141 of this chapter and the FDIC processes the notice without objection under § 303.142(a) of this chapter. The FDIC is not precluded from taking any appropriate action or imposing additional requirements with respect to the activities if the facts and circumstances warrant such action. If changes to the management or business plan of the service corporation at any time result in material changes to the nature of the service corporation's business or the manner in which its business is conducted, the insured state savings association shall advise the appropriate regional director (DOS) in writing within 10 business days after such change. For purposes of applying § 362.4 (b)(5)(ii) and (c) to this paragraph (b)(4), references to the terms ''subsidiary'' and ''majority-owned subsidiary'' in §§ 362.4(b)(5)(ii) and (c) shall be deemed to refer to the service corporation. For the purposes of applying § 362.4(c), references to the term ''eligible subsidiary'' in § 362.4(c) shall be deemed to refer to the eligible service corporation.

(c) Investment and transaction limits. The restrictions detailed in § 362.4(d) apply to transactions between an insured state savings association and any service corporation engaging in activities which are not permissible for a service corporation of a federal savings association if specifically required by this part or FDIC order. For purposes of applying the investment limits in § 362.4(d)(2), the term ''investment'' includes only those items described in § 362.4(d)(2)(ii)(A) (*3*) and (*4*). For purposes of applying § 362.4(d) (2), (3), and (4) to this paragraph (c), references to the terms ''insured state bank'' and ''subsidiary'' in § 362.4(d)(2), (3), and (4), shall be deemed to refer, respectively, to the insured state savings association and the service corporation. For purposes of applying § 362.4(d)(5), references to the terms ''insured state bank'' and ''subsidiary'' in § 362.4(d)(5) shall be deemed to refer, respectively, to the insured state savings association and the service corporations or subsidiaries.

(d) *Capital requirements.* If specifically required by this part or by FDIC order, an insured state savings association that wishes to conduct as principal activities through a service corporation which are not permissible for a service corporation of a federal savings association must:

(1) Be well-capitalized after deducting from its capital any investment in the service corporation, both equity and debt.

(2) Use such regulatory capital amount for the purposes of the insured state savings association's assessment risk classification under part 327 of this chapter.

§ 362.13 Approvals previously granted.

FDIC consent by order or notice. An insured state savings association that previously filed an application and obtained the FDIC's consent to engage in an activity or to acquire or retain an investment in a service corporation engaging as principal in an activity or acquiring and retaining any investment that is prohibited under this subpart may continue that activity or retain that investment without seeking the FDIC's consent, provided the insured state savings association and the service corporation, if applicable, continue to meet the conditions and restrictions of approval. An insured state savings association which was granted approval based on conditions which differ from the requirements of §§ 362.4(c)(2) and 362.12 (c) and (d) will be considered to meet the conditions and restrictions of the approval if the insured state savings association and any applicable service corporation meet the requirements of §§ 362.4(c)(2) and 362.12 (c) and (d). For the purposes of applying § 362.4(c)(2), references to the terms ''eligible subsidiary'' and ''subsidiary'' in § 362.4(c)(2) shall be deemed to refer, respectively, to the eligible service corporation and the service corporation.

Subpart D—Acquiring, Establishing, or Conducting New Activities Through a Subsidiary by an Insured Savings Association

§ 362.14 Purpose and scope.

This subpart implements section 18(m) of the Federal Deposit Insurance Act (12 U.S.C. 1828(m)) which requires that prior notice be given the FDIC when an insured savings association establishes or acquires a subsidiary or engages in any new activity in a subsidiary. For the purposes of this subpart, the term ''subsidiary'' does not include any insured depository institution as that term is defined in the Federal Deposit Insurance Act. Unless otherwise indicated, the definitions provided in § 362.2 apply to this subpart.

§ 362.15 Acquiring or establishing a subsidiary; conducting new activities through a subsidiary.

No state or federal insured savings association may establish or acquire a subsidiary, or conduct any new activity through a subsidiary, unless it files a notice in compliance with § 303.142(c) of this chapter at least 30 days prior to establishment of the subsidiary or commencement of the activity and the FDIC does not object to the notice. This requirement does not apply to any federal savings bank that was chartered prior to October 15, 1982, as a savings bank under state law or any savings association that acquired its principal assets from such an institution.

By order of the Board of Directors.

Dated at Washington, D.C. this 5th day of November, 1998.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

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