

calendar year up to the date of declaration. Particularly because the clear Congressional purpose would otherwise be largely defeated, it is concluded that this is the correct interpretation and that, consequently, the declaration by the member State bank, without the Board's approval, of a dividend in the amount of \$20,000 would be in violation of the applicable statutes, since the amount of that dividend would exceed "the total of (the bank's) net profits of that year combined with its retained net profits of the preceding two years."

(12 U.S.C. 60)

[33 FR 9866, July 10, 1968. Redesignated at 55 FR 52987, Dec. 26, 1990]

**§208.128 Commodity- or equity-linked transactions.**

(a) State-chartered banks that are members of the Federal Reserve System are required to obtain the approval of the Board under Regulation H (Membership of State Banking Institutions in the Federal Reserve System) before permitting any change to be made in the general character of their business or in the scope of the corporate powers they exercised at the time of admission to membership. The Board has considered whether engaging in transactions linked to commodity or equity security prices or indices would represent a change in the general character of the business of a state member bank.

(b) Banking organizations have developed a number of commodity- or equity-linked transactions in which a portion of the return is linked to the price of a particular commodity or equity security or to an index of such prices. These transactions have been offered in a variety of forms, including commodity-indexed deposits, loans, debt issues, and derivative products, such as forwards, options, and swaps. In these transactions, the interest, principal, or both, or payment streams in the case of swaps, are linked to the price of a commodity. In addition, banks are also entering into exchange-traded commodity or stock-index futures and options in order to hedge the exposure inherent in these transactions. These types of transactions have been linked to a variety of commodities, including gold, oil, alu-

minum, and copper, as well as individual securities and stock indices.

(c) With the exception of gold, silver, and, in some cases, platinum, banks are not empowered to purchase or hold the commodities or equity securities that underlie these transactions. Although commodity-linked transactions settle only in cash, they effectively expose banks to commodity or equity market price risks. Thus, linking payments to commodities or equities may present risks with which banks generally are not familiar, and the inability of the bank to purchase the commodity or equity security to which a transaction is linked may increase the difficulty of hedging the exposure created by such transactions.

(d) The Board has determined that engaging in transactions linked to commodities or securities that a state member bank does not have the authority to purchase and hold directly should generally be considered a change in the character of the bank's business unless the transactions are entered into on a perfectly matched basis.<sup>1</sup> State member banks that wish to engage in commodity- or equity-linked transactions that are considered to be a change in the general character of their business should obtain Board approval before initiating these transactions or, in the case of activities commenced prior to the adoption of this interpretation, to continue such activities. Applications to continue such activities should be submitted on or before February 3, 1992.

(e) Transactions linked to securities or monetary metals that a state member bank is authorized to purchase and

<sup>1</sup>The term *perfectly matched*, as used in this interpretation refers to transactions that are entered into on a matched basis, that is, offsetting transactions where the counterparties for both transactions have been found before the bank enters into either transaction and the transactions are consummated on the same day. Offsetting transactions include transactions that have a price differential to provide the bank with its usual and customary fee or commission for its services. The exemption from prior approval for perfectly matched transactions would include mirror image equity swaps executed by a state member bank with any affiliate that is authorized under Regulation K to engage in equity swaps.

hold directly will not be considered to be a change in the general nature of the bank's business, and approval will not be required.<sup>2</sup> Additionally, approval will not be required for a state member bank to offer loan or deposit contracts in which only the interest portion of the return is linked to a commodity or security even if the bank is not authorized to hold the commodity or security.

(f) Applications to engage in commodity-related activities should outline the types of transactions and scope of activities that the bank plans to undertake. The application also should demonstrate that the bank has the expertise to engage in such transactions and has developed adequate policies and controls to govern the conduct of these activities and to monitor the associated risks.

(g) Recent revisions to Regulation K (International Banking Operations) permit bank holding company subsidiaries, Edge and agreement corporations, and member banks to act as principal or agent outside of the United States in swap transactions, subject to any limitations applicable to state member banks under Regulation H. Banking organizations that wish to engage in swap transactions based on commodities that the organizations do not have the authority to purchase directly, therefore, must submit applications under Regulation K in order to engage in such transactions. Because Regulation K provides separate authority to engage outside of the United States in swap transactions based on equity securities or indices, approval of these transactions is not required.

[56 FR 63407, Dec. 4, 1991]

**§ 208.129 Obligations concerning institutional customers.**

(a) As a result of broadened authority provided by the Government Securities Act Amendments of 1993 (15 U.S.C. 78o-3 and 78o-5), the Board is adopting sales practice rules for the government secu-

<sup>2</sup>Gold and silver are the only commodities that banks generally have authority to purchase. In states where banks have authority to deal in platinum, transactions linked to platinum will not be considered a change in the general nature of the business of a bank.

rities market, a market with a particularly broad institutional component. Accordingly, the Board believes it is appropriate to provide further guidance to banks on their suitability obligations when making recommendations to institutional customers.

(b) The Board's Suitability Rule, § 208.25(d), is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct. Banks' responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. Banks are expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer.

(c) In recommending to a customer the purchase, sale, or exchange of any government security, the bank shall have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by the customer as to the customer's other security holdings and financial situation and needs.

(d) The interpretation in this section concerns only the manner in which a bank determines that a recommendation is suitable for a particular institutional customer. The manner in which a bank fulfills this suitability obligation will vary, depending on the nature of the customer and the specific transaction. Accordingly, the interpretation in this section deals only with guidance regarding how a bank may fulfill customer-specific suitability obligations under § 208.25(d).<sup>1</sup>

(e) While it is difficult to define in advance the scope of a bank's suitability obligation with respect to a specific institutional customer transaction recommended by a bank, the

<sup>1</sup>The interpretation in this section does not address the obligation related to suitability that requires that a bank have " \* \* \* a 'reasonable basis' to believe that the recommendation could be suitable for at least some customers." *In the Matter of the Application of F.J. Kaufman and Company of Virginia and Frederick J. Kaufman, Jr.*, 50 SEC 164 (1989).