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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

**Conditional Approval #755**  
**September 2006**

August 25, 2006

Martha A. Pampel, Esq.  
Deputy Regulatory Counsel  
HSBC – North America  
2700 Sanders Road  
Prospect Heights, IL 60070

Re: Application by HSBC Bank, N.A., Wilmington, Delaware, for its wholly-owned operating subsidiary to hold a limited equity interest in connection with investment management activities

Application Control Number: 2006-NE-08-0012

Dear Ms. Pampel:

This responds to the application filed by HSBC Bank, N.A., Wilmington, Delaware (the “Bank”), requesting approval for its wholly-owned operating subsidiary, HSBC Investment (USA) Inc. (“HSBCI”), to hold for limited periods of time a limited interest in a newly formed private investment fund for which it serves as investment manager. The Bank indicates that holding such a limited interest is convenient and useful in order for HSBCI to conduct its investment management business. Based upon the representations and commitments made by the Bank, and prior OCC precedent, the application is approved subject to the conditions described herein.<sup>1</sup>

**A. Background**

The Bank is a national bank. HSBCI is registered as an investment advisor under the Investment Advisers Act of 1940.<sup>2</sup> HSBCI provides investment advisory services, including portfolio

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<sup>1</sup> We note that the OCC has previously concluded that an operating subsidiary of a national bank may hold limited interests in private investment funds for which the operating subsidiary serves as investment manager. *See*, Conditional Approval No. 643 (June 16, 2004) (“Conditional Approval No. 643”); Conditional Approval No. 578 (February 27, 2003) (“Conditional Approval No. 578”); and Interpretive Letter No. 940 (May 24, 2002), *reprinted in* [2001-2002 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶81,465 (“Interpretive Letter No. 940”).

<sup>2</sup> 15 U.S.C. §§ 80b-1 to 80b-21.

management, to investment companies as well as institutional clients.

HSBCI will serve as the managing member and advisor for the HSBC Global Emerging Markets Equity Freestyle Fund (the “Fund”), a Delaware limited liability company.<sup>3</sup> The Fund will invest primarily in a concentrated long portfolio of emerging markets securities and other financial assets in which a national bank is ordinarily not permitted to invest.<sup>4</sup>

The Fund will be offered through a private placement only to U.S. persons and offshore affiliates of HSBCI that each meet the definitions of both accredited investors under the Securities Act of 1933 (the “1933 Act”)<sup>5</sup> and qualified purchasers under the Investment Company Act of 1940 (the “1940 Act”).<sup>6</sup> As such, the Fund will be exempt from registration under Regulation D of the 1933 Act and Section 3(c)(7) of the 1940 Act and will not be registered under either the 1933 Act or the 1940 Act. The Fund will be taxed as a partnership. Consistent with this tax treatment, all the losses, gains, fees, and expenses will be passed through to the Fund’s investors.

As managing member, HSBCI will be responsible for the overall management of the Fund, including various administrative duties and investment advisory services. The OCC previously approved these activities for national bank operating subsidiaries that were investment advisors and managers of private investment funds.<sup>7</sup>

HSBCI expects to designate an affiliate, HSBC Halbis Partners (UK) Limited (“Halbis Partners”), as subadvisor to the Fund. Halbis Partners, a registered investment adviser, will have day-to-day investment management responsibility for the Fund. The Bank represents that Halbis Partners has extensive experience in managing emerging market portfolios. Halbis Partners is not a subsidiary of HSBCI or the Bank. HSBCI will have the power to terminate the services of Halbis Partners.

For its management services, HSBCI will receive both a management fee and performance-based compensation. Such fees may be shared with Halbis Partners and other affiliates who provide services to the Fund. The management fee will be an annual fee, payable quarterly in arrears, equal to 1 percent of each capital account balance of the Fund. The fee for performance will be a

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<sup>3</sup> The Bank represents that the Fund will constitute an affiliate of HSBCI and the Bank for purposes of Sections 23A and 23B of the Federal Reserve Act.

<sup>4</sup> The Fund will not invest in real estate or tangible personal property.

<sup>5</sup> 15 U.S.C. §§ 77a to 77aa. To qualify as an accredited investor under the 1933 Act, an individual must have income for two years of at least \$200,000 (\$300,000 when combined with spouse), or \$1,000,000 in net worth. Rule 501(a) of Regulation D under the 1933 Act (17 C.F.R. § 230.501(a)).

<sup>6</sup> 15 U.S.C. §§ 80a-1 to 80a-64. Qualified purchasers under the 1940 Act are natural persons and certain trusts who have at least \$5,000,000 in investments and an institutional investor that has at least \$25,000,000 in investments, in each case net of any debt incurred to acquire such investments. 15 U.S.C. § 80a-2(a)(51)(A). The Bank represents that the minimum initial capital contribution to the Fund by an investor is generally \$250,000.

<sup>7</sup> See, Conditional Approval No. 643; Conditional Approval No. 578; and Interpretive Letter No. 940.

percentage of the profits of the Fund above a certain hurdle rate. The OCC has previously confirmed that an investment advisor owned by a national bank may structure its management fee and performance-based compensation in this way.<sup>8</sup>

The Bank represents that it is advantageous to U.S. investors in the Fund if HSBCI's compensation for performance is paid as a share of profits, rather than as a fee. To receive a share of the profits, HSBCI needs to hold an interest in the Fund.<sup>9</sup> This interest will be in the form of a \$1,000 managing member capital contribution to the Fund ("Managing Member Interest"). As the owner of the Managing Member Interest in the Fund, HSBCI would not participate in all the gains and losses of the Fund, but only in the gains equal to the performance fee to which HSBCI is entitled as investment manager. HSBCI will receive performance-based compensation as an allocation to its capital account in the Fund.

Performance compensation can be a substantial percentage of the Fund's returns. The Bank represents that individual investors, trusts, and investors taxed as partnerships (that in turn have individual or trust investors) prefer that investment funds structure performance compensation as an allocation to the investment manager's equity account rather than as a fee. Under U.S. tax law, individual investors must report as income their proportionate share of the gross amount of an investment fund's income and gains *before* deducting investment-related fees and expenses paid by the investment fund. The limit placed by the U.S. tax laws on the deductibility of these fees and expenses may preclude high-income individuals from deducting their full proportionate share of the fees and expenses of the investment funds. The Bank represents that if the investment manager is paid in the form of a profit allocation, rather than through a performance fee, the amount so paid is not treated as income to investors who are not recipients of the allocation.

For these reasons, the Bank represents that it is an industry practice for investment advisors and managers of certain types of investment funds to receive performance-related compensation as a profit allocation. The OCC has previously recognized this industry practice with respect to similar private investment funds.<sup>10</sup> The similar funds are structured to provide payments for advisory services as fund allocations rather than as fees to maximize tax efficiency for investors. The Bank represents that if HSBCI is not able to structure its performance-based compensation using an allocation of income and gains to its equity account, the Fund would be significantly disadvantaged in competing for investors' business. HSBCI's Managing Member Interest is necessary to enable it to receive its performance-based compensation as a profit allocation.

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<sup>8</sup> *Id.*

<sup>9</sup> The Bank represents that it also needs to hold an interest in the Fund to address potential investors' concerns that HSBCI's interest is aligned with those of investors in the Fund.

<sup>10</sup> *See*, Conditional Approval No. 643; Conditional Approval No. 578; Interpretive Letter No. 940; and Interpretive Letter No. 897 (October 23, 2000), *reprinted in* [2000-2001 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81-416 ("Interpretive Letter No. 897").

HSBCI's ownership interest in the Fund would be limited. HSBCI will not make any out-of-pocket investments in the Fund. The Bank has represented that under the terms of the instrument governing the Fund HSBCI will not participate in any losses suffered by the Fund. HSBCI will account for the Managing Member Interest under the equity method of accounting. HSBCI's loss exposure from an accounting perspective will be limited to the amount of profit allocation it expects to receive as compensation. The Bank represents that HSBCI will maintain the Managing Member Interest in the Fund only while HSBCI provides investment management services to the Fund. HSBCI will withdraw its profit allocation immediately.<sup>11</sup>

## **B. Analysis**

Section 5.34(e) of the OCC's operating subsidiary regulation provides that "a national bank may conduct in an operating subsidiary activities that are permissible for a national bank to engage in directly either as part of, or incidental to, the business of banking, as determined by the OCC, or otherwise under other statutory authority."<sup>12</sup> The OCC has long held that a national bank may provide investment management services as part of the business of banking authorized under 12 U.S.C. § 24(Seventh) and pursuant to their fiduciary powers under 12 U.S.C. § 92a.<sup>13</sup> HSBCI currently engages in the authorized activities of acting as an investment advisor to investment companies and receiving compensation for such services. Holding the Managing Member Interest is an alternative means to receive payment of incentive compensation for advisory services, and is therefore incidental to permissible investment advisory activities.

The authority of an operating subsidiary of a national bank to hold limited interests in advised funds, subject to certain conditions, was confirmed by the OCC in Conditional Approval No. 578.<sup>14</sup> In that approval, the OCC permitted an operating subsidiary to own similar limited interests in investment funds the operating subsidiary managed, reasoning that such ownership is directly related to, and an integral part of, the subsidiary's activity of providing bank-permissible investment management and administrative services to certain private investment funds.<sup>15</sup> The

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<sup>11</sup> HSBCI will have a standing request for redemption of all equity allocations from the Fund. HSBCI will receive the redemption proceeds on or about the same business day that the Fund determines the final amount of each allocation. Because HSBCI will in effect withdraw all profit allocations immediately, the amount of HSBCI's interest in the Fund as a practical matter would, consistent with Interpretive Letter No. 897, never exceed 24.99 percent of the total equity of the Fund.

<sup>12</sup> 12 C.F.R. § 5.34(e)(1).

<sup>13</sup> See, e.g., Interpretive Letter No. 897; Interpretive Letter No. 851 (December 8, 1999) *reprinted in* [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,308; Interpretive Letter No. 871 (October 14, 1999) *reprinted in* [1999-2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,365; Conditional Approval Letter No. 164 (December 9, 1994); Interpretive Letter No. 648 (May 4, 1994) *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,557; Interpretive Letter No. 647 (April 15, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,558; Interpretive Letter No. 622 (April 9, 1993) *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,557; and Interpretive Letter No. 403 (December 9, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,627.

<sup>14</sup> See also, Conditional Approval No. 643; and Interpretive Letter No. 940.

<sup>15</sup> The OCC also concluded that holding limited interests is not prohibited by 12 U.S.C. § 24(Seventh).

purpose of holding the interests was to enable the operating subsidiary to act as an investment manager to the types of investment funds in which this form of ownership by the investment manager is convenient and useful—indeed necessary. The interests in the investment funds were not passive or speculative investments on the operating subsidiary’s part. The investments were made solely to enable the operating subsidiary to provide investment management services as conducted by its competitors in the investment management industry. The OCC found that, as a practical matter, in order to offer the funds it managed, the operating subsidiary had to structure its compensation to hold the investments in this limited manner. Among other conditions, the OCC required that the interests may be held under these circumstances only when, and for so long as, the operating subsidiary is providing investment management services.

In the instant proposal, consistent with the OCC’s determination in Conditional Approval No. 578, HSBCI’s ownership of the Managing Member Interest in the Fund it advises will be restricted to a context where the holding is integral to facilitating a recognized bank-permissible activity and therefore such holdings are permissible as an incident to the bank-permissible investment management activities. The Bank represents that HSBCI receiving the Managing Member Interest enables HSBCI to engage in permissible banking activities and act as investment manager for an investment fund that, in practice, requires the manager to take an equity interest. The Bank further represents that investors in the Fund require the manager to structure the payment of performance fees in this fashion. In this connection, the Bank states that this investment permits HSBCI to offer a fund that provides investors with a tax treatment comparable to that of investors in other, similar funds. The Bank represents that HSBCI would be unable to offer this Fund on a competitive basis unless HSBCI makes the investment.

### **C. Conclusion**

Accordingly, HSBCI holding the Managing Member Interest as described by the Bank is permissible subject to the conditions in this letter. As indicated above, the Bank has the authority to conduct in HSBCI activities that the Bank could engage in directly. The investment management services provided by HSBCI are part of the business of banking as authorized under 12 U.S.C. §§ 24(Seventh) and 92a. Holding the Managing Member Interest is an integral component of the investment management services provided by HSBCI. The OCC previously has found that, as a practical matter, in order to offer certain types of funds, national banks and their operating subsidiaries must structure their compensation in this way.<sup>16</sup> Thus, consistent with OCC precedents for both national banks and their operating subsidiaries, holding the Managing Member Interest is a proper incident to these bank-permissible investment management activities.<sup>17</sup>

Based upon a review of the information you provided, including the representations and commitments made in your letter, and for the reasons discussed above, we conclude that HSBCI may receive the Managing Member Interest in the Fund, subject to the following conditions:

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<sup>16</sup> See, Conditional Approval No. 643; Conditional Approval No. 578; and Interpretive Letter No. 940.

<sup>17</sup> *Id.*

- (1) Prior to HSBCI receiving the Managing Member Interest in the Fund, the Bank shall adopt and implement an appropriate risk management process, acceptable to the OCC Examiner-in-Charge, to monitor this interest. The risk management process shall be comprehensive and shall include:
  - (i) Adoption and implementation of a conflict of interest policy addressing all inherent conflicts associated with HSBCI's holding of the Managing Member Interest in the Fund; and
  - (ii) Adoption and implementation of risk management policies and procedures for monitoring the Managing Member Interest in the Fund and the risks associated with this interest, taking into account relevant factors noted in OCC guidance (e.g., OCC Banking Circular 277 (BC-277 - October 1993), Supplemental Guidance 1 to BC-277 (January 1999) and the Handbook for National Bank Examiners, *Risk Management of Financial Derivatives* (January 1997)).
  - (iii) The Bank shall provide the OCC with copies of the policies and procedures described in (i) and (ii) prior to HSBCI receiving the Managing Member Interest in the Fund.
- (2) The Bank, through HSBCI, shall not receive a Managing Member Interest in funds other than funds that invest in securities and financial instruments, and shall not invest in any fund that holds real estate or tangible personal property.
- (3) The Bank shall make reports and other information readily available to OCC supervisory staff as necessary for the OCC to determine compliance with these conditions.
- (4) The Bank shall account for HSBCI's Managing Member Interest in the Fund under the equity method of accounting.
- (5) The Bank, through HSBCI, shall hold the Managing Member Interest in the Fund only when, and only for so long as, HSBCI is providing investment management services to the Fund.
- (6) The Bank shall provide its Examiner-in-Charge ten days notice before HSBCI receives an interest in any fund in addition to the interest it already holds in the Fund.

The conditions of this approval are conditions imposed in writing by the agency in connection with the granting of an application or other request within the meaning of 12 U.S.C. § 1818. As such, the conditions are enforceable under 12 U.S.C. § 1818.

This approval, and the activities and communications by OCC employees in connection with the filing, do not constitute a contract, express or implied, or any other obligation binding upon the OCC, the United States, any agency or entity of the United States, or any officer or employee of the United States, and do not affect the ability of the OCC to exercise its supervisory, regulatory and examination authorities under applicable laws and regulations. The foregoing may not be waived or modified by any employee or agent of the OCC or the United States. In the event of

questions, please contact Ramah Chansen, Senior Licensing Analyst, at (202) 874-5060 or by e-mail: [largebanks@occ.treas.gov](mailto:largebanks@occ.treas.gov).

Sincerely,

*Lawrence E. Beard*

Lawrence E. Beard  
Deputy Comptroller, Licensing