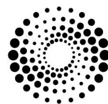
Regulation of Foreign Banks and Affiliates in the United States

7th Edition

Randall D. Guynn
Editor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Chapter 11

Foreign Banks as U.S. Financial Holding Companies[*]

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§ 11:1 Introduction

This Chapter discusses the expanded powers that a foreign bank or its parent (foreign banking organization or FBO) may exercise in the United States if it successfully elects to be treated

as a U.S. financial holding company (FHC). We first describe the restrictions imposed by the Bank Holding Company Act of 1956 (BHC Act) on an FBO's power to engage in nonbanking activities or make nonbanking investments in the United States if it owns or controls a U.S. bank or otherwise has or acquires a U.S. commercial banking presence[1] but does not qualify for or elect to be treated as an FHC. We then summarize the expanded powers that an FBO may exercise if it qualifies and elects to be treated as an FHC under the BHC Act. We next set forth the conditions and procedures for becoming an FHC including the minimum capital requirements that FHCs must meet. We then elaborate on an FHC's expanded powers, focusing on securities underwriting and dealing, insurance underwriting, merchant banking, insurance company portfolio investments, commodities, hedge funds, and real estate powers. We then discuss the streamlined notice and approval procedures available to FHCs, the consequences of becoming an FHC, and the consequences of failing to maintain the FHC conditions. Finally, we discuss certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) that affect the conditions for qualifying as an FHC or that impose limits on the expanded activities of an FHC, including the new capital requirements, the Volcker Rule, the Swaps Pushout Rule, and amendments to Section 23A of the Federal Reserve Act (FRA).[2]

In addition, as discussed in more detail in the Introduction to this book, in December 2012, the Federal Reserve Board issued a Proposed FBO Rule that would apply U.S. capital, liquidity, and other enhanced prudential standards to the U.S. operations of FBOs with total global consolidated assets of $50 billion or more (Large FBOs). The Proposed FBO Rule would require many Large

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[Section 11:1]

[1]We refer to any foreign bank with a branch, agency, or commercial lending company in the United States, or a foreign bank that controls an Edge company acquired after March 5, 1987, as a foreign bank with a "U.S. commercial banking presence." Such a foreign bank and any company that controls such a foreign bank is subject to the BHC Act and treated as if it were a BHC under Section 8(a) of the International Banking Act of 1978 (IBA), 12 U.S.C.A. § 3106(a).

[2]Dodd-Frank Act, Pub. L. No. 111-203, §§ 171, 608, 619, 716 (2010) (to be codified at 12 U.S.C.A. §§ 5371 (capital requirements), 1851 (the Volcker Rule), 15 U.S.C.A. § 8305 (the Swaps Pushout Rule), amending 12 U.S.C.A. § 371c (Section 23A of the FRA)). For a discussion of the new capital requirements, *see* § 11:3[3]. For a discussion of the amendments to Section 23A, *see* § 11:6[6]. For a discussion of the Volcker Rule, *see* § 11:8. For a discussion of the Swaps Pushout Rule, *see* § 11:9.

FBOs to create a separately capitalized top-tier U.S. intermediate holding company (IHC) that would hold all U.S. bank and nonbank subsidiaries. The IHC would be subject to U.S. capital, liquidity and other enhanced prudential standards, and the Federal Reserve Board, as the umbrella supervisor, could examine any IHC or subsidiary of an IHC. Although the Proposed FBO Rule does not address the FHC status of IHCs, if the top-tier FBO has made an FHC election, then it is likely the IHC subsidiary would also be required to become an FHC. U.S. branches and agencies of a Large FBO's foreign bank would not be required to be held underneath the IHC, but they would also be subject to liquidity, single counterparty credit limits and, in certain circumstances, asset maintenance requirements. Large FBOs not required to form an IHC would also be subject to certain of the new enhanced prudential standards.

§ 11:2 Legal framework

[1] Restrictions on U.S. Nonbanking Powers of FBOs

The BHC Act generally prohibits both a domestic bank holding company (BHC) and an FBO that controls a U.S. bank or otherwise has a U.S. commercial banking presence from owning or controlling any company other than a U.S. bank or from engaging in, or directly or indirectly owning or controlling any company engaged in, any activities that are not "so closely related to banking as to be a proper incident thereto."[3] These restrictions on the nonbanking activities and investments of an FBO reflect the traditional U.S. policy of separating banking and commerce.[4] They are implemented by the Board of Governors of the Federal

[Section 11:2]

[3]*See* 12 U.S.C.A. § 1843(a), (c)(8). The BHC Act also contains various narrow exemptions from this general prohibition, including exemptions that allow a BHC (i) to make noncontrolling investments for its own account or an investment fund controlled by it in up to 4.9% of any class of voting securities; (ii) to invest in a subsidiary that does not have any office or direct or indirect subsidiary or otherwise engage in any activities directly or indirectly in the United States other than those that are incidental to its foreign or international business; (iii) to hold investments as a fiduciary; or (iv) to furnish services to its subsidiaries. 12 U.S.C.A. § 1843(c)(1)(C), (c)(4), (c)(6), (c)(7), (c)(13); 12 C.F.R. § 225.144.

[4]This traditional policy is justified mainly on the grounds that the mixing of banking and commerce would lead to (i) conflicts of interest in the allocation of credit, (ii) potential increased risks to insured depository institutions and expansion of the federal deposit insurance safety net, (iii) undue concentration of economic power and therefore anticompetitive behavior, and (iv) the creation of conglomerates that would be too complex to manage or supervise because it is

Reserve System (the Federal Reserve Board) principally through its Regulation Y.[5]

[2] QFBO Exemptions

The potential extraterritorial impact of these activities restrictions, however, is limited in part by exemptions for "qualifying foreign banking organizations" (QFBOs), which are permitted to engage in any activity outside the United States and in certain activities in the United States, which, although more limited than is customary in many countries, are more varied than those permitted to domestic bank holding companies.[6] These exemp-

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not possible to have the skills necessary to manage or supervise both financial and commercial businesses in the same group. *See, e.g.*, Leach, The Mixing of Commerce and Banking, in Proceedings of The 43rd Annual Conference on Banking Structure and Competition, Federal Reserve Bank of Chicago, 13 (May 2007) (Proceedings); Fine, U.S. Households and the Mixing of Banking and Commerce, in Proceedings, 28; Tenhundfeld, Banking and Commerce: 1 + 1 = 0, in Proceedings, 33; Evanoff, Preface, in Proceedings. Perhaps the most ardent preservationist of this traditional policy is former Congressman James A. Leach, after whom the Gramm-Leach-Bliley Act of 1999 was named, who has described the mixing of commerce and banking in almost apocalyptic terms. Leach, The Mixing of Commerce and Banking, in Proceedings, 13, at 13 ("[T]here are few broad principles that could hurriedly be legislated, which could in shorter order change the fabric of American democracy as well as the economy, than adoption of a new radical approach to this issue [*i.e.*, mixing commerce and banking]."). Critics argue that (i) relaxing this traditional policy would (A) foster competition; (B) level the playing field between banks and other financial institutions like securities firms, insurance companies, and hedge funds that are not prevented from engaging in commerce or having commercial affiliates; and (C) reduce risk by allowing banking organizations to have greater diversification of assets and income flows; and (ii) (A) the highly competitive nature of the credit markets would prevent any potential adverse effects from any conflicts of interest in the allocation of credit and (B) provisions such as Section 23A and 23B of the FRA are sufficient to insulate insured depository institutions and the federal safety net from the risks of commercial affiliates. *See, e.g*., Wallison, *Thinking Ahead: Treasury Prepares to Lay Down a Marker for the Future (Part 1)*, Financial Services Outlook (American Enterprise Institute for Public Policy Research, Oct. 2007); Muckenfuss & Eager, The Separation of Banking and Commerce Revisited, *in* Proceedings, 39; Wall, Reichert & Liang, The Last Frontier: The Integration of Banking and Commerce in the U.S., *in* Proceedings, 67; Evanoff, Preface, *in* Proceedings.

[5] 12 C.F.R. Pt. 225.

[6] The qualifying foreign banking organization concept is found in Subpart B of the Federal Reserve Board's Regulation K, 12 C.F.R. Pt. 211, which implements in part the statutory exemptions from the BHC Act's coverage set forth in Sections 2(h)(2) and 4(c)(9) of the BHC Act. 12 U.S.C.A. § 1841(h)(2) and § 1843(c)(9). An analysis of the several statutory exemptions available to foreign banks is beyond the scope of this Chapter. *See* §§ 10:1 et seq. for a more extended discussion. To be a qualifying foreign banking organization, more than half of a

tions (the QFBO exemptions) fall into four general categories: (1) activities, and investments in other companies engaged in activities, conducted wholly outside the United States; (2) activities, and investments in other companies engaged in activities, conducted in the United States that are "incidental" to international or foreign business (such as would be permitted to Edge Act and agreement corporations established by U.S. banking organizations for their overseas activities);[7] (3) minority noncontrolling investments in foreign companies doing a majority of their business outside the United States and not engaged in securities underwriting or dealing; and (4) controlling investments in foreign companies doing a majority of their business outside the United States with any U.S. activities being limited to those which are nonfinancial in nature and related to nonfinancial businesses conducted abroad.[8]

[3] Expanded Powers of FHCs

The BHC Act was amended by the Gramm-Leach-Bliley Act of 1999 (the GLB Act) to permit bank holding companies, and FBOs that are otherwise subject to the BHC Act, to exercise certain expanded powers if they qualify for and elect to be treated as

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foreign institution's worldwide business (*excluding* the portion of such business attributable to U.S. banking operations) must be banking, and more than half of its worldwide banking business must be outside of the United States. 12 C.F.R. § 211.23(b). If, as a result of the acquisition of a very large U.S. subsidiary bank, more than half of a foreign acquirer's worldwide banking business was conducted in the United States, the acquirer would be treated as a domestic (rather than a foreign) BHC and could not be a QFBO.

[7] *See* 12 C.F.R. § 211.6.

[8] 12 C.F.R. § 211.23(f). In particular, the Federal Reserve Boards's regulations permit a foreign-chartered commercial subsidiary of a foreign BHC, indirectly through a domestic or foreign subsidiary, to engage in a broad range of commercial activities in the United States that are not permitted for a domestic BHC if it meets certain conditions, including that (1) a majority of its consolidated assets and revenues are located and derived from outside of the United States; (2) it does not engage, directly or indirectly, or have more than a 10% voting interest in, a company engaged in the business of underwriting, selling, or distributing securities in the United States (except to the extent permitted to domestic bank holding companies); and (3) it does not, without prior Federal Reserve Board approval, engage in activities in the United States that directly or through a majority-owned subsidiary consist of banking or financial operations (*e.g.*, insurance underwriting and real estate investment and brokerage activities) or "closely related to banking" activities covered by Section 4(c)(8) of the BHC Act. 12 C.F.R. § 211.23(f)(5).

financial holding companies.[9] In contrast to ordinary bank holding companies or FBOs, FHCs are not limited to owning and controlling banks and engaging in, or owning or controlling companies engaged in, activities that are "closely related to banking" or, in the case of QFBOs, certain additional activities and investments under the QFBO exemptions. Instead, FHCs may also engage in, or own or control any companies engaged in, any activity that is financial in nature, incidental to a financial activity, or complementary to a financial activity.[10] This category of financial and financial-related activities includes everything deemed to be "closely related to banking" and much more.[11] In particular, FHCs are permitted to make controlling and noncontrolling investments in companies engaged exclusively in financial activities or activities that are incidental to financial activities including securities underwriting and dealing, insurance underwriting, merchant banking, and insurance company portfolio investments.[12] FHCs are also permitted to engage in activities determined by the Federal Reserve Board to be complementary to a financial activity, which the Federal Reserve Board has determined on an FHC-by-FHC basis to include certain commodities trading and other activities.[13] They are also permitted to make controlling and noncontrolling investments in nonfinancial and mixed financial/nonfinancial companies including companies engaged in owning and managing real estate, subject to certain conditions, under the merchant banking power.[14]

These expanded powers, however, are subject to the Volcker Rule, including its conformance period, and, when it becomes effective, the Swaps Pushout Rule.[15] The Volcker Rule prohibits proprietary trading in most securities and other financial instru-

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[9]Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 to 1481 (1999). Although the GLB Act reduced the degree of separation between banking and commerce, it nevertheless reflects the U.S. policy of maintaining such separation.

[10]12 U.S.C.A. § 1843(k)(1).

[11]12 U.S.C.A. § 1843(k)(4), especially (k)(4)(F).

[12]12 U.S.C.A. § 1843(k)(4)(B) (insurance underwriting), (E) (securities underwriting and dealing), (H) (merchant banking), (I) (insurance company portfolio investments).

[13]*See, e.g.*, The Royal Bank of Scotland, 94 Fed. Res. Bull. C60 (2008) (certain energy commodities trading as a complement to energy derivatives trading); WellPoint, Inc., 93 Fed. Res. Bull. C133 (2007) (certain activities are complementary to the underwriting and selling of health insurance).

[14]12 U.S.C.A. § 1843(k)(4)(H) (merchant banking).

[15]Dodd-Frank Act, Pub. L. No. 111-203, §§ 619, 716 (2010) (to be codified at 12 U.S.C.A. § 1851 and 15 U.S.C.A. § 8305). The statutory Volcker Rule went

ments, as well as certain investments in and relationships with hedge funds and private equity funds, subject to certain exemptions. The Swaps Pushout Rule prohibits FBOs from engaging in swaps activities in any U.S. branch or agency that has access to a Federal Reserve Bank's discount window or in a U.S. insured depository institution affiliate. For a more complete discussion of the limits imposed by the Volcker Rule and the Swaps Pushout Rule on the expanded powers of an FHC, see §§ 11:8 and 11:9, respectively.

As of December 21, 2012, approximately 430 U.S. BHCs, four foreign holding companies of U.S. banks, and 40 FBOs (approximately 24% of those with a U.S. commercial banking presence) had successfully elected to be FHCs.[16]

The BHC Act includes a grandfathering provision that ex-

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into effect on July 21, 2012. Although the statute required the agencies responsible for implementing the Volcker Rule to issue final regulations within nine months of the FSOC Study's release or by October 18, 2011, the agencies proposed substantially identical implementing regulations in November 2011 (in the case of the Federal Reserve Board, the FDIC, the OCC and the SEC) and January 2012 (in the case of the CFTC). *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011); Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8,332 (Feb. 14, 2012). Although final regulations have not yet been issued, the Federal Reserve Board in April 2012 announced guidelines to clarify that banking entities must conform their activities, investments, relationships and transactions to the Volcker Rule by July 21, 2014, unless that period is extended. During this conformance period, "every banking entity . . . is expected to engage in good-faith efforts, . . . which will result in the conformance of all of its activities and investments . . . by no later than the end of the conformance period." Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 77 Fed. Reg. 33,949, 33,950 (June 8, 2012). For further discussion of the Volcker Rule and the Swaps Pushout Rule, *see* §§ 11:8 and 11:9, respectively.

[16] *See* Federal Reserve Board, Financial Holding Companies as of December 21, 2012, *available at* http://www.federalreserve.gov/bankinforeg/fhc.htm (last visited January 2, 2013), listing only the top-tier company in each organization:

Americas: Banco Bradesco, S.A. (Brazil); Banco do Brasil (Brazil); Banco Itaú; S.A. (Brazil); Bank of Montreal (Canada); The Bank of Nova Scotia (Canada); Canadian Imperial Bank of Commerce (Canada); National Bank of Canada (Canada); Royal Bank of Canada (Canada); The Toronto-Dominion Bank (Canada); and Banco Mercantil del Norte, S.A. (Mexico).

Asia: Mitsubishi UFJ Financial Group, Inc. (Japan); Mizuho Financial Group (Japan); The Norinchukin Bank (Japan); and ShinHan Financial Group (South Korea).

Australia: Australia and New Zealand Banking Group Limited, and National Australia Bank Limited.

empted certain companies that became bank holding companies or FBOs after November 12, 1999, from any of the activities restrictions contained in the BHC Act with respect to activities engaged in from November 12, 1999, until November 11, 2009, or, with the Federal Reserve Board's prior approval, for up to five additional years if certain conditions are satisfied.[17] It also includes a separate grandfathering provision that enables certain companies including FBOs (other than foreign banks) that become financial holding companies after November 12, 1999, to continue to engage in activities related to the trading, sale, or investment in commodities and commodities-related facilities if they were lawfully engaged in commodities activities as of September 30, 1997, and certain other conditions are satisfied.[18] Unlike the former grandfathering provision, the commodities grandfather provision does not contain a sunset date.

[4] Overlapping Sources of Authority

The expanded powers of an FHC, and the powers of a QFBO under the QFBO exemptions, include a number of overlapping sources of authority to engage in the same or similar powers. A QFBO that elects to be treated as an FHC is permitted to rely on whichever of these overlapping sources of authority gives it the broadest powers and is generally permitted to switch sources of

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Europe: KBC Bank NV (Belgium); Barclays PLC (England); HSBC Holdings PLC (England); Lloyds TSB Group, PLC (England); BNP Paribas (France); Crédit Agricole S.A. (France); Natixis (France); Société Générale (France); Bayerische Hypo- und Vereinsbank Aktiengesellschaft (Germany); Commerzbank AG (Germany); Deutsche Bank AG (Germany); DZ Bank AG (Germany); HSH Nordbank, A.G. (Germany); Landesbank Baden-Württemberg (Germany); The Governor and Company of The Bank of Ireland (Ireland); Unicredito Italiano S.P.A. (Italy); Rabobank Nederland (The Netherlands); DnB NOR ASA (Norway); Banco Santander Central Hispano, S.A. (Spain); The Royal Bank of Scotland Group PLC (Scotland); Skandinaviska Enskilda Banken AB (Sweden); Credit Suisse Group (Switzerland); and UBS AG (Switzerland).

Middle East: Bank Hapoalim (Israel).

Foreign holding companies of U.S. banks: Delta Investment Company (Cayman Islands), SNBNY Holdings Limited (Gibraltar), Caja de Ahorros y Monte de Piedad de Madrid (Spain), and Caja Madrid Cibeles S.A. (Spain).

The 40 FBOs that are FHCs represent approximately 24% of the approximately 164 FBOs that as of September 30, 2012, maintained, directly or indirectly, a branch, agency, or commercial lending company in the United States. *See* Federal Reserve Board, Structure Data for the U.S. Office of Foreign Banking Organizations by Country as of September 30, 2012, *available at* http://www.federalreserve.gov/releases/iba/201209/bycntry.htm (last visited January 2, 2013).

[17] 12 U.S.C.A. § 1843(n).

[18] 12 U.S.C.A. § 1843(o).

authority if it is in its advantage to do so as its circumstances or business objectives change.[19]

For example, Section 4(k)(4)(E) of the BHC Act permits an FHC to engage in securities underwriting, dealing, and market making without any geographic or other limitation,[20] subject to the Volcker Rule.[21] In contrast, Section 4(k)(4)(F) and (G) of the BHC Act, which incorporate by reference the power to engage in any activity that was determined as of a certain date to be closely related to banking or usual in connection with banking abroad, only permit securities underwriting and dealing subject to certain revenue, geographical, or other limitations,[22] subject to the Volcker Rule.[23] A QFBO that is an FHC is permitted to rely on the broadest source of authority for securities underwriting, dealing, and market making without regard to the geographic or other limitations in the overlapping, alternative sources of such authority.

Similarly, an FHC is permitted to make controlling and noncontrolling investments in nonfinancial companies or mixed financial/nonfinancial companies under Section 4(k)(4)(H) of the BHC Act, subject to the Volcker Rule,[24] and certain other conditions, including a maximum holding period, restrictions on involvement in the routine management or operation of portfolio companies, and compliance with certain reporting requirements.[25] In contrast, the QFBO exemptions permit a QFBO to make controlling and noncontrolling investments in foreign nonfinancial

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[19] *See* 66 Fed. Reg. 400, 406 (Jan. 3, 2001).

[20] 12 U.S.C.A. § 1843(k)(4)(E).

[21] *See* § 11:8.

[22] *See* 12 U.S.C.A. § 1843(k)(4)(F) to (G); 12 C.F.R. §§ 211.10(a)(13)-(14) (geographic limitations), 225.28(b)(8)(i) (limited to government securities); J.P. Morgan & Co., Incorporated, et al., 75 Fed. Res. Bull. 192, 195–97 (1989), *aff'd sub nom.* Securities Industries Ass'n v. Board of Governors of Federal Reserve System, 900 F.2d 360, Fed. Sec. L. Rep. (CCH) P 94999 (D.C. Cir. 1990); Citicorp, et al, 73 Fed. Res. Bull. 473 (1987), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of Federal Reserve System, 839 F.2d 47, Fed. Sec. L. Rep. (CCH) P 93615 (2d Cir. 1988) *as modified by* Modifications to Section 20 Orders, 75 Fed. Res. Bull. 751 (1989), and 10 Percent Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 48,953 (Sept. 17, 1996), and Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (Dec. 30, 1996) (revenue limits).

[23] *See* § 11:8.

[24] *See* § 11:8.

[25] *See* 12 U.S.C.A. § 1843(k)(4)(H); 12 C.F.R. Pt. 225, Subpt. J.

companies, subject to the Volcker Rule,[26] and a different set of conditions including that the foreign portfolio companies do a majority of their business outside the United States, are not engaged in securities underwriting or dealing, and, if controlled by the QFBO, have U.S. activities that are limited to those which are nonfinancial in nature and are related to nonfinancial businesses conducted by the QFBO or its affiliates abroad.[27] A QFBO that has elected to be treated as an FHC may find it preferable to rely on Section 4(k)(4)(H) of the BHC Act for most of its investments in U.S. or foreign nonfinancial companies or mixed financial/nonfinancial companies because the reporting requirements are less burdensome[28] or because of the greater leeway to invest in mixed financial/nonfinancial companies. In contrast, it may find the QFBO exemptions to be preferable for certain investments in foreign nonfinancial companies if it wishes to be involved in their routine management or operation or to hold them for more than the maximum holding period permitted by Section 4(k)(4)(H) and its implementing regulations. A QFBO that is an FHC is free to choose the best source of authority for its particular circumstances and business objectives or generally to switch sources of authority as circumstances or business objectives change.

[5] The Dodd-Frank Act

The Dodd-Frank Act is in the process of making the most significant reforms to the U.S. financial regulatory laws since the 1930s. Among other things, the SEC and CFTC are in the process of imposing mandatory registration, clearing, trading, and reporting requirements on certain FBOs engaged in over-the-counter derivatives transactions as mandated by the Dodd-Frank Act. In addition, the Federal Reserve Board is in the process of creating a new systemic risk regulatory regime that will impose enhanced prudential standards on FBOs that are considered to be systemically important and in December 2012 proposed a rule

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[26] *See* § 11:8.

[27] *See* 12 C.F.R. § 211.23(f)(5).

[28] *Compare* 12 C.F.R. § 225.87(b)(4) and Report of Changes in Organizational Structure, Form FR Y-10 (one-time post-transaction notice for large merchant banking investments only, showing name of portfolio company and size of investment) *with* 12 C.F.R. § 211.23(h) and Annual Report of Foreign Banking Organizations, Form FR Y-7 (annual reporting for all investments, showing name of portfolio, percentage of portfolio company's assets and revenues attributable to activities outside the United States, and, in the case of controlling investments, the types of activities engaged in within the United States).

outlining such a regime.[29]

The Federal Reserve Board's Proposed FBO Rule, discussed in the Introduction to this treatise, would, if adopted as released: (1) require foreign banking organizations with the largest U.S. operations to establish a top-tier U.S. intermediate holding company (IHC) over all U.S. bank and nonbank subsidiaries; (2) apply the same capital rules applicable to U.S. BHCs to U.S. IHCs; and (3) establish liquidity standards for the U.S. operations (including U.S. branches and agencies of foreign banks) of large foreign banking organizations.[30] The Proposed FBO Rule also establishes risk management, stress testing, and early remediation requirements. It requires a publicly-traded FBO with total global consolidated assets of $10 billion or more and any Large FBO to certify annually to the Federal Reserve Board that it maintains a U.S. risk committee to oversee the risk management practices of the FBO's combined U.S. operations.[31] It would subject an IHC to the Federal Reserve Board's stress test rules as if the IHC were a U.S. BHC and would subject Large FBOs to an early remediation framework with four levels of early remediation triggers. The Proposed FBO Rule would also extend certain enhanced prudential requirements of the Dodd-Frank Act to the U.S. Branch and Agency Network of Large FBOs, including single counterparty credit limits, liquidity requirements and, in certain circumstances, asset maintenance requirements.[32]

Although the Dodd-Frank Act will affect every FBO and its affiliates whether or not the FBO has a U.S. commercial banking presence, most of its provisions are not limited to FHCs, do not change the conditions for qualifying as an FHC, and do not impose limits on their expanded activities. Accordingly, a discussion of the full impact of the Dodd-Frank Act is beyond the scope

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[29] The enhanced prudential supervision will also apply to nonbank financial companies, including FBOs with no U.S. commercial banking presence, that are otherwise designated as systemically important by the Financial Stability Oversight Council (the FSOC).

[30] Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628 (Dec. 28, 2012); *see also* Governor Daniel K. Tarullo, Speech At the Yale School of Management Leaders Forum, New Haven, Connecticut (Nov. 28, 2012), *available at* http://federalreserve.gov/newsevents/speech/tarullo20121128a.htm.

[31] The Proposed FBO Rule includes additional risk management requirements for Large FBOs with combined U.S. assets of $50 billion or more, as discussed further in the Introduction to this book.

[32] For further detail on the Proposed FBO Rule, please refer to the Introduction to this book.

of this Chapter.[33] Instead, this Chapter limits its discussion of the Dodd-Frank Act to the key provisions that affect the conditions for qualifying as an FHC or that impose limits on the expanded powers of an FHC including the new capital requirements, the Volcker Rule, the Swaps Pushout Rule, and amendments to Section 23A of the FRA.[34]

§ 11:3 Conditions and procedures for becoming an FHC

[1] Conditions

To qualify as an FHC, an FBO must satisfy the following conditions:

- the FBO, if it is or controls a foreign bank with a U.S. commercial banking presence; all U.S. insured and uninsured depository institutions[35] controlled by the FBO; and all foreign banks with a U.S. commercial banking presence that are controlled by the FBO must be and remain well capitalized and well managed,[36] and, as a general matter, any FBO that is a foreign bank with a U.S. commercial

[33]For a discussion of the full potential impact of the Dodd-Frank Act on FBOs, *see* Randall Guynn, Mark Plotkin & Ralph Reisner, U.S. Regulation of Foreign and Domestic Banks: A Users Guide to Regulatory Reform under Dodd-Frank (2010).

[34]*See* § 11:3[3] for a discussion of the new capital requirements, § 11:6[6] for a discussion of the amendments to Section 23A of the FRA, § 11:8 for a discussion of the Volcker Rule, and § 11:9 for a discussion of the Swaps Pushout Rule.

[Section 11:3]

[35]The term "depository institution" is defined as "any bank or savings association," *see* 12 U.S.C.A. §§ 1841(n), 1813(c)(1), and includes both insured and uninsured depository institutions. As a result, any FBO that seeks to become an FHC must satisfy the well-capitalized requirements with respect to all of its U.S. depository institution subsidiaries whether insured or not and whether or not they would be treated as "banks" for purposes of the BHC Act. This would include any U.S. thrift subsidiaries and any Utah industrial bank subsidiaries. *See, e.g.*, MetLife, Inc., 87 Fed. Res. Bull. 268, at 269 n.6 & 270 n.15 (2001) (stating that, although a certain limited-purpose trust company subsidiary of the applicant MetLife was not a bank for purposes of the BHCA, it was nevertheless a "depository institution" under Section 3(c)(1) of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C.A. § 1813(c)(1), and therefore, MetLife in its election to be an FHC must certify that the trust company is well capitalized and well managed).

[36]12 U.S.C.A. § 1843(l)(1)(A) to (B); 12 C.F.R. §§ 225.81(b)(2), 225.90(a)(1) to (2). Before July 21, 2011, the BHC Act did not require a BHC to be well capitalized and well managed in order for the BHC to qualify as an FHC. Only its depository institution subsidiaries were required to satisfy those tests. Section 606 of the Dodd-Frank Act, however, amended the BHC Act to require

banking presence and all foreign banks with a U.S. commercial banking presence that are controlled by the FBO must be subject to comprehensive consolidated supervision (CCS) by their home-country supervisors;[37]

- it must have filed with the Federal Reserve Board a declaration of election to be an FHC and a certification that it meets the well-capitalized and well-managed conditions;[38] and
- all of its U.S. insured depository institution subsidiaries[39] must have achieved a rating of at least "satisfactory" under the Community Reinvestment Act of 1977[40] (the CRA) in the most recent examination of such institutions.[41]

The BHC Act's broad definition of control[42] can lead to surpris-

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the BHC itself to be well capitalized and well managed in order to qualify as an FHC. Section 606 applies to an FBO that controls a foreign bank with a U.S. commercial banking presence because under Section 8(a) of the IBA, such an FBO is subject to the BHC Act as if it were a BHC. *See* 12 U.S.C.A. § 3106(a). Section 606 became effective on July 21, 2011. The Federal Reserve Board has not yet proposed any regulations explaining how the amendments made by Section 606 will apply to FBOs.

[37] 12 U.S.C.A. § 1843(l)(3); 12 C.F.R. § 225.92(e). If a foreign bank is not subject to CCS, the Federal Reserve Board will not consider the foreign bank to be well capitalized and well managed for purposes of the BHC Act unless the Federal Reserve Board finds that the home country has made "significant progress" in establishing arrangements for CCS, and the "foreign bank is in strong financial condition as demonstrated, for example, by capital levels that significantly exceed the minimum levels that are required for a well capitalized determination and strong asset quality." 12 C.F.R. § 225.92(e)(2).

[38] 12 U.S.C.A. § 1843(l)(1)(C); 12 C.F.R. §§ 225.81(b)(3), 225.90(a)(2). The regulations require the FBO to make "an effective election" to be treated as an FHC.

[39] An insured depository institution is a depository institution, the deposits of which are insured by the Federal Deposit Insurance Corporation (FDIC). It includes a foreign bank with an FDIC-insured U.S. branch that is, or is controlled by, an FBO. 12 U.S.C.A. § 1813(c)(2), (h); 12 C.F.R. § 225.2(g).

[40] The CRA requires banks to help meet the credit needs of the low- and moderate-income neighborhoods of the local communities in which such banks are chartered. A bank's record of meeting community credit needs must be rated annually by the appropriate federal financial supervisory agency. *See* 12 U.S.C.A. §§ 2901 to 2907.

[41] 12 U.S.C.A. § 1843(l)(2); 12 C.F.R. §§ 225.82(c)(1), 225.92(c)(2).

[42] The BHC Act deems an investment to be controlling if the investor (i) acquires or controls 25% or more of any class of voting securities of another company, (ii) has the power to elect a majority of the board of directors or similar governing body of the company, or (iii) exercises a controlling influence over the management or policies of the company. 12 U.S.C.A. § 1841(a)(2). The Federal Reserve Board treats the first two alternatives as essentially conclusive

ing results in the application of the well-capitalized and well-managed requirements to minority-owned banks. For instance, it is possible for a foreign bank to be deemed to control another foreign bank for purposes of the BHC Act based on a stake in as low as 10% of the voting equity of the target bank yet have no actual control over the foreign bank. In its release accompanying its final FHC rules, the Federal Reserve Board stated that, in limited situations involving strategic minority investments, some relief from the well-capitalized and well-managed requirements may be justified but only "in limited circumstances where the foreign bank can clearly demonstrate that it has no ability to control the other foreign bank."[43]

[2] Election Procedures

The procedures for a foreign bank or any company controlling a foreign bank to make an FHC election are contained in Sections 225.90 to 225.92 of Regulation Y.[44] If a foreign bank or its parent controls a U.S. bank or BHC or is controlled by a BHC, it must also comply with the procedures set forth in Sections 225.81 to 225.82 of Regulation Y.[45]

The procedures for electing to be treated as an FHC are

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with almost no exceptions. The last alternative is very flexible and highly indeterminate, and its interpretation and application are dependent on all the facts and circumstances. The Federal Reserve Board staff will often deem an investor to have a controlling influence over another company whenever it has what most people would consider to be only a significant influence over the company. The Federal Reserve Board staff generally will not treat an investment in a nonbank company as "controlling" unless the investor acquires control of at least 15% of any class of voting securities or one-third of the total equity including voting securities, of the target, provided that no other control factors are present. 12 C.F.R. § 225.144. The Federal Reserve Board staff generally treats total equity as including voting securities, nonvoting securities, and subordinated debt. For a more detailed discussion of the Federal Reserve Board staff's application of the controlling influence test, *see* §§ 7:1 et seq.

[43] *See* 66 Fed. Reg. 400, 411 (Jan. 3, 2001). To date, the Federal Reserve Board's statement has not resulted in any such relief being granted. The Federal Reserve Board staff has not conceded that there is any room between its traditional interpretation of the "controlling influence" test in the BHC Act and the type of control that must be "clearly demonstrated" to be absent as a condition to obtaining the limited relief. As long as the traditional controlling influence test, rather than some sort of actual control test, is used for determining when limited relief is justified, the promise of limited relief is likely to remain unfulfilled. *See* Randall D. Guynn, Developments in Minority Investments, Regulatory Compliance Seminar, Institute of International Bankers (Nov. 22, 2005) (on file with the Davis Polk & Wardwell Library).

[44] 12 C.F.R. §§ 225.90 to 225.92.

[45] 12 C.F.R. § 225.81(c).

relatively simple. The company electing to be treated as an FHC must file a written declaration with the appropriate Federal Reserve Bank[46] stating the election, certifying that all the entities that must meet the well-capitalized and well-managed requirements satisfy those requirements (including whether any foreign bank is subject to CCS), providing certain capital information and, in the case of an FBO that is a BHC or that has or controls a foreign bank with an FDIC-insured branch, information about the CRA compliance record of the applicant's U.S. insured depository institution subsidiaries and insured branches.[47] An election to be an FHC is automatically effective on the 31st calendar day after the date that a complete declaration was filed with the appropriate Federal Reserve Bank unless the Federal Reserve Board notifies the applicant prior to that time that the election is ineffective or that the election is effective prior to such 31st day.[48] In the case of an election by a foreign bank or a company owning or controlling a foreign bank, the 30-day period may be extended by the Federal Reserve Board with the consent of such foreign bank or such company.[49]

The Federal Reserve Board will find an election ineffective if any of the entities that must meet the well-capitalized and well-managed requirements does not meet such requirements.[50] The Federal Reserve Board will also find an election ineffective if any U.S. insured depository institution controlled by the FBO or any U.S. insured branch of any foreign bank that is or is controlled by the FBO did not receive a rating of at least "satisfactory" under the CRA at its most recent examination.[51] Finally, the Federal Reserve Board may find the election ineffective if the Federal Reserve Board does not have sufficient information to determine whether the FBO or any of its foreign bank subsidiar-

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[46]The appropriate Federal Reserve Bank is determined pursuant to 12 C.F.R. § 225.3(b).

[47]12 C.F.R. § 225.91(a) and (b) and, in the case of an FBO that is or is controlled by a BHC, 12 C.F.R. § 225.82(a) to (d).

[48]12 C.F.R. § 225.92(a)(1), (b) and, in the case of an FBO that is or is controlled by a BHC, 12 C.F.R. § 225.82(e).

[49]12 C.F.R. § 225.92(a)(2).

[50]12 C.F.R. § 225.92(c)(1), (3) and, in the case of an FBO that is or is controlled by a BHC, 12 C.F.R. § 225.82(c)(2).

[51]12 C.F.R. §§ 225.82(c)(1), 225.92(c)(2). Special rules apply to the consideration of the CRA performance of recently acquired U.S. insured depository institutions. 12 C.F.R. §§ 225.82(d), 225.92(d).

ies making an election meets the election requirements.[52]

Because of the difficult issues relating to the well-capitalized and well-managed requirements that a foreign bank's election to be an FHC may raise, a foreign bank or its controlling company, before filing an election to be treated as an FHC, may file a request for a preclearance review of its qualifications to be treated as an FHC.[53] Regulation Y specifies two cases in which a preclearance process must be initiated.

- A foreign bank whose home country has not adopted risk-based capital standards consistent with the Basel Capital Accord (Basel I)[54] *must* obtain a determination from the Federal Reserve Board in the preclearance process that the foreign bank's capital is comparable to the capital that would be required of a U.S. bank owned by an FHC.[55]
- A foreign bank that has not been found, and that is chartered in a country where no bank from that country has been found, by the Federal Reserve Board to be subject to CCS by its home-country supervisor must use the preclearance process for a determination of its comprehensive supervision on a consolidated basis. In addition, a foreign bank or a company controlling a foreign bank may on its own initiate the preclearance process to have the Federal Reserve Board review the qualifications that it has to meet for an effective election to be an FHC.[56]
- A foreign bank whose home country has adopted risk-based

[52] 12 C.F.R. § 225.92(c)(4).

[53] 12 C.F.R. § 225.91(c).

[54] Basel Committee on Banking Supervision (Basel Committee), International Convergence of Capital Measurement and Capital Standards (July 1988). In June 1999, the Basel Committee announced a proposal for a new, more sophisticated capital accord. That proposal ultimately led to the adoption of a new capital accord in June 2006 (Basel II). Basel Committee, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version June 2006). In December 2010, the Basel Committee issued new international regulatory standards on bank capital adequacy and liquidity (Basel III). Basel Committee, Basel III: A global regulatory framework for more resilient banks and banking systems (Revised June 2011); Basel Committee, Basel III: International framework for liquidity risk measurement, standards and monitoring (Dec. 2010). It is not clear whether the Federal Reserve Board will require an applicant to use the preclearance process to obtain a capital comparability determination if the foreign bank's home country has replaced its risk-based capital standards under Basel I with risk-based capital standards under Basel II or Basel III.

[55] 12 C.F.R. § 225.90(b)(1) to (2).

[56] 12 C.F.R. § 225.91(c).

capital standards consistent with Basel I but that does not meet the capital standards that would be required of a U.S. bank owned by an FHC (either because it falls short of the required capital adequacy ratios under Basel I or because there is a question about the comparability of the foreign bank's capital to the capital that would be required of a U.S. bank owned by an FHC) may obtain a determination from the Federal Reserve Board in the preclearance process that the foreign bank's capital is otherwise comparable to the capital that would be required of a U.S. bank owned by an FHC.[57]

- The preclearance process may be used by a foreign bank or company controlling a foreign bank to request that the Federal Reserve Board review any of the other qualifications that must be met to make an effective election of the FHC status.[58] In particular, the question of whether the foreign bank is well managed could be subject to the preclearance process. For instance, the preclearance process may be used by a foreign bank that wishes to obtain FHC status but has not been assigned a combined U.S. banking assessment as part of the regular examination cycle and thus cannot determine whether it is well managed.[59]

The preclearance process helps the Federal Reserve Board to comply with the rule that FHC elections become effective on the 31st day after receipt of the election and avoids the need to extend the period with the consent of the electing foreign bank or the company controlling the foreign bank.[60] The preclearance process may be advantageous for a foreign bank because the Federal Reserve Board does not make a public announcement of the filing of a request for a preclearance review, and the records of the Federal Reserve Board relating to the preclearance process may be accorded confidential treatment.[61]

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[57] 12 C.F.R. § 225.90(b)(1)(ii) to (iii), (2).

[58] 12 C.F.R. § 225.91(c).

[59] *See* 66 Fed. Reg. 400, 409 (Jan. 3, 2001).

[60] *See* 12 C.F.R. § 225.92(a)(2).

[61] The Federal Reserve Board's staff takes the position that information relating to a preclearance process is a matter contained in or related to examination, operating, or condition reports prepared by or for the use of an agency responsible for the regulation or supervision of financial institutions and that therefore such information need not be made available to the public under the Freedom of Information Act, 5 U.S.C.A. § 552; 12 C.F.R. § 261.14(a)(8). It may

[3] Capital

[a] Current Requirements for Well-Capitalized Status

An FBO will satisfy the well-capitalized requirement to become an FHC only if the FBO, if it is or controls a foreign bank with a U.S. commercial banking presence; all of its U.S. insured and uninsured depository institution subsidiaries; and all foreign banks with a U.S. commercial banking presence that are controlled by it are well capitalized.[62] Section 4(*l*)(3) of the BHC Act[63] authorizes the Federal Reserve Board to develop capital standards for foreign banks with a U.S. commercial banking presence that are "comparable" to U.S. standards.[64] In exercising its authority under this provision with respect to foreign banks with a U.S. commercial banking presence, the Federal Reserve Board has determined that the well-capitalized requirement should be measured on the basis of the foreign bank's capital as a whole and not by the separate capital of any U.S. branch, agency, or commercial lending company.[65]

Regulation Y provides two methods[66] for determining whether a foreign bank will be considered well capitalized for purposes of electing to be treated as an FHC.[67]

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still be advisable for an FBO to request confidential treatment of its submissions in connection with a preclearance process pursuant to 12 C.F.R. § 261.15.

[62] 12 U.S.C.A. § 1843(*l*)(1)(A) to (B); 12 C.F.R. §§ 225.81(b)(2), 225.90(a)(1) to (2). Before July 21, 2011, the BHC Act did not require a BHC to be well capitalized and well managed in order for the BHC to qualify as an FHC. Only its depository institution subsidiaries were required to satisfy those tests. Section 606 of the Dodd-Frank Act, however, amended the BHC Act to require the BHC itself to be well capitalized and well managed in order to qualify as an FHC. Section 606 applies to an FBO that controls a foreign bank with a U.S. commercial banking presence because under Section 8(a) of the IBA, such an FBO is subject to the BHC Act as if it were a BHC. *See* 12 U.S.C.A. § 3106(a). Section 606 became effective on July 21, 2011. The Federal Reserve Board has not yet proposed any regulations explaining how the amendments made by Section 606 will apply to FBOs.

[63] Section 4(*l*)(3) of the BHC Act was not amended by the Dodd-Frank Act.

[64] 12 U.S.C.A. § 1843(*l*)(3). *Comparable* does not mean *identical* but means adjusted to the special circumstances of the foreign bank.

[65] *See* 12 C.F.R. § 225.2(r)(3)(ii).

[66] 12 C.F.R. §§ 225.2(r)(3)(i), 225.90(b).

[67] Under either method, the Federal Reserve Board's rules prevent it from considering a foreign bank to be well capitalized unless the foreign bank is either subject to CCS or the Federal Reserve Board has determined that its home country has made "significant progress" in establishing arrangements for CCS

The first method currently still relies on Basel I,[68] which U.S. bank regulators implemented through the issuance of the general

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and that the foreign bank is in strong financial condition. 12 C.F.R. § 225.92(e)(2). Strong financial condition may be demonstrated, for example, by capital levels that significantly exceed the minimum levels that are required for a well-capitalized determination and strong asset quality. 12 C.F.R. § 225.92(e)(2), § 225.92(e)(2)(ii). Despite the promise of this alternative standard, the Federal Reserve Board has not previously approved an FHC election based on a foreign bank's home-country supervisor making "significant progress" toward CCS. The Federal Reserve Board anticipates that a foreign bank that is not subject to CCS will be granted FHC status only in rare instances. Bank Holding Company Supervision Manual, § 3903.0. In contrast, the Federal Reserve Board has approved several applications by foreign banks to establish branches in the United States based on home-country supervisors "actively working toward" CCS. *See, e.g.,* ICICI Bank, 94 Fed. Res. Bull. C26 (2008); Randall Guynn, Emerging Trends and Key Developments in the Regulation and Supervision of Branches and Agencies of International Banks and in the Regulation of International Banks Themselves as Bank Holding Companies and Financial Holding Companies, Annual Regulatory Examination, Risk Management and Compliance Seminar, Institute of International Bankers (Oct. 30, 2007).

[68] *See* 12 C.F.R. Pt. 225, Apps. A, E (Federal Reserve Board); 12 C.F.R. Pt. 3 Apps. A, B (OCC); 12 C.F.R. Pt. 325 Apps. A, C (FDIC). Both the Federal Reserve Board and most bank regulators around the world define regulatory capital requirements for banking organizations based on a series of international capital accords known as the Basel Capital Accords. Basel I, which was adopted in 1988, is a risk-based capital framework established by the Basel Committee that defines the capital instruments and related accounting items that constitute regulatory capital (the numerator of the risk-based capital ratio), establishes a fairly rudimentary system for assigning risk weights to assets and exposures in order to calculate risk-weighted assets (the denominator of the risk-based capital ratio), and establishes minimum Tier 1 and total risk-based capital ratios. *See* Basel Committee, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (July 1988); Basel Committee, Amendment to the Capital Accord to Incorporate Market Risks (Jan. 1996, as modified Sept. 1997). Basel II, which was adopted by the Basel Committee in 2006, built upon Basel I and established a three-pillar capital framework that enhanced the risk-sensitivity of regulatory capital measurements by, among other things, permitting banks that receive supervisory approval to use internal models and methodologies to calculate risk-weighted assets. *See* Basel Committee, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version, June 2006). Basel III, adopted in December 2010, represents the Basel Committee's response to the recent financial crisis and is intended to enhance the resilience of the banking sector by, among other things, significantly increasing the quality and quantity of regulatory capital. Basel III also introduced a liquidity framework that centers around two quantitative measures of liquidity: the liquidity coverage ratio and the net stable funding ratio. In general, the Basel III capital and liquidity standards will be phased in over a multi-year period. *See* Basel Committee, Basel III: A global regulatory framework for more resilient banks and banking systems (Revised June 2011); Basel Committee, Basel III:

risk-based capital rules. Under this method, if the home country of the foreign bank has adopted risk-based capital standards that are consistent with Basel I, the foreign bank must maintain a Tier 1 risk-based capital ratio of at least 6% and a total risk-based capital ratio of at least 10% as calculated on the basis of home-country standards.[69] In addition, the Federal Reserve Board must determine that the foreign bank's capital is "comparable"[70] to the capital required for a U.S. bank that is owned by an FHC.[71]

The second method permits (1) a foreign bank whose home country has not adopted risk-based capital standards consistent with Basel I and (2) a foreign bank whose home country has adopted capital standards based on Basel I but that does not meet the 6% Tier 1 or 10% total risk-based capital ratios under the first method[72] to obtain from the Federal Reserve Board a determination that their capital is "otherwise comparable" to the capital that would be required of a U.S. bank owned by an FHC.[73] This Federal Reserve Board determination is made in a preclearance process.[74]

International framework for liquidity risk measurement, standards, and monitoring (Dec. 2010). *See also* §§ 3:1 et seq.

[69] 12 C.F.R. §§ 225.2(r)(3)(i)(A), 225.90(b)(1)(i) to (ii). Notably, this approach does not require the foreign bank to calculate its capital using U.S. bank capital standards.

[70] "Comparable" does not mean identical to U.S. standards.

[71] In making this determination, Regulation Y authorizes the Federal Reserve Board to consider a variety of factors including, among others, its composition of capital, Tier 1 capital to total assets leverage ratio, accounting standards, long-term debt ratings, reliance on government support to meet capital requirements, and whether it is subject to CCS. 12 C.F.R. § 225.90(b)(1)(iii). Although the Federal Reserve Board will consider an FBO's leverage ratio as part of this determination, it does not currently require a foreign bank to satisfy any specific Tier 1 leverage ratio. The release accompanying the final FHC rules states that the financial information necessary for the Federal Reserve Board's staff to compute a foreign bank's leverage ratio will be required as part of the certification process and ongoing reporting required of foreign FHCs. 66 Fed. Reg. 400, 408 n.18 (Jan. 3, 2001).

[72] 12 C.F.R. § 225.90(b) gives the foreign bank a choice between relying on the Basel I capital standards of its home country or using the preclearance process.

[73] 12 C.F.R. § 225.90(b)(2). Presumably, the factors to determine comparability of capital set forth in 12 C.F.R. § 225.92(e) apply to this determination.

[74] Before filing an election to be treated as an FHC, a foreign bank whose home country has not adopted risk-based capital standards consistent with Basel I or a company owning or controlling such foreign bank must file a request for a determination in the preclearance process that the foreign bank's capital is comparable to the capital that would be required of a U.S. bank owned by an

Many jurisdictions have adopted regulatory capital requirements based on Basel II,[75] and in certain cases, any Basel I-based transitional capital floors initially required by Basel II are no longer in effect or are expected to be phased out in the near term. For instance, in the European Union, Basel II was implemented by means of the European Capital Requirements Directive (CRD).[76] For FBOs that have begun operating under Basel II, the Federal Reserve Board "evaluate[s] the capital of the foreign banking organization as reported in compliance with [Basel II], while also taking into account a range of factors including compliance with [Basel II's] capital requirement floors linked to Basel I, where applicable."[77] The Federal Reserve Board has stated that it will continue to evaluate capital equivalency on a case-by-case

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FHC. If the home country of the foreign bank has adopted standards based on Basel I, the foreign bank may request a review of its capital qualification in the preclearance process. 12 C.F.R. §§ 225.90(b)(2), 225.91(c).

[75]International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version June 2006). *See* §§ 3:1 et seq.

[76]Capital Requirements Directive, Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 Relating to the Taking Up and Pursuit of the Business of Credit Institutions (recast) and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the Capital Adequacy of Investment Firms and Credit Institutions (recast). Under the CRD as implemented by member state law, European banks were required to start a "parallel run" in the first quarter of 2007, during which they not only continued to comply with Basel I but also calculated their capital under Basel II. Since its enactment, the CRD has been amended by two other directives, CRD II and CRD III. In July 2011, the European Commission proposed to strengthen regulation of the EU banking sector by replacing CRD III with a directive and a regulation that would, among other things, implement Basel III. Most of Basel III would be implemented through the proposed regulation except for the provisions on capital buffers that are part of the proposed directive. While EU member states must implement a directive into national law, a regulation is directly applicable without any further action on the part of the national authorities. *See* European Commission, Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (Jul. 2011); European Commission, Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (July 2011).

[77]Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor, 76 Fed. Reg. 37,620, 37,620 to 37,629 (June 28, 2011). *See also* Proposed Rule—Risk-Based Capital Standards: Establishment of a Risk-Based Capital Floor, 75 Fed. Reg. 82317, 82319 (Dec. 30, 2010).

basis taking into consideration, among other things, competitive equality between U.S. banking organizations and FBOs.[78]

Some foreign banks control intermediate bank holding companies that are organized in the United States (intermediate U.S. BHCs). Since 2001, an intermediate U.S. BHC controlled by a foreign bank FHC generally was not required to maintain any minimum capital ratios.[79] The Federal Reserve Board assumed that the foreign bank FHC had sufficient financial strength and

[78]In response to U.S. bank regulators' proposal to implement the Collins Amendment by establishing a permanent capital floor based on the general risk-based capital requirements (currently reflecting Basel I) for U.S. banking organizations operating under Basel II's advanced internal ratings-based approach for credit risk and advanced measurement approaches for operational risk as implemented in the United States (advanced approaches banking organizations), some commenters argued that FBOs that are not subject to Basel I capital floors in their home countries would have a competitive advantage over their U.S. counterparts. U.S. bank regulators agreed that such FBOs could theoretically operate with lower minimum risk-based capital requirements than a U.S. banking organization that is subject to the permanent capital floor and stated that they will take into account these competitive issues when evaluating the capital equivalency of FBOs. *See* Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor, 76 Fed. Reg. 37,620, 37,620-29 (June 28, 2011). In implementing the Collins Amendment's capital floor requirements, the Federal Reserve Board and the other banking agencies specifically acknowledged the problem of evaluating capital equivalency for FBOs in cases in which an FBO would not be subject to a Basel I floor in its home country and would thus no longer even produce financial information (i.e., risk-weighted assets) based on Basel I requirements. *See* 76 Fed. Reg. at 37,624. The Federal Reserve Board did not address this issue in its Proposed FBO Rule.

[79]Application of the Federal Reserve Board's Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations, SR Letter 01-1 (SUP) (Jan. 5, 2001). The Federal Reserve Board explained that in light of provisions in the Gramm-Leach-Bliley Act that permit a foreign bank to be an FHC, it is modifying its previous practice of applying its capital adequacy standards to the top-tier U.S. BHC owned by a foreign banking) organization. The supervisory letter, however, qualified its policy by stating that "[r]elying on the capital strength of the consolidated banking organization, as well as requiring all subsidiary banks to meet appropriate capital and management standards, is consistent with the [Federal Reserve Board's] supervisory assessment process for domestic [BHCs]. The [Federal Reserve Board] retains its supervisory authority to require any [BHC], including a U.S. BHC owned and controlled by a foreign bank that meets the FHC standards, to maintain higher capital levels where such levels are appropriate to ensure that its U.S. activities are operated in a safe and sound manner. This authority may be exercised as part of ongoing supervision or through the application process."

resources to support its banking activities in the United States.[80] This historic policy was reversed by the Dodd-Frank Act, which requires such intermediate U.S. BHCs to comply with U.S. capital requirements beginning on July 21, 2015.[81] In addition, the Federal Reserve Board's Proposed FBO Rule would require all foreign banking organizations to hold all U.S. bank and nonbank subsidiaries under a U.S. intermediate BHC referred to as an IHC. This IHC will be subject to all U.S. capital and liquidity standards, among other things, as discussed in the Introduction to this book.

[b] The Dodd-Frank Act

The Dodd-Frank Act[82] contains a number of provisions that require or permit U.S. bank regulators to adopt capital, leverage, and liquidity requirements for bank holding companies and FBOs.[83] In the absence of final rulemaking to implement these provisions, it is uncertain at this time precisely what impact these new capital-related requirements will have on the well-capitalized standard as applied to an FBO with a U.S. commercial banking presence.

A number of provisions in the Dodd-Frank Act, for which U.S. bank regulators have yet to issue implementing regulations, *may* affect whether an FBO with a U.S. commercial banking presence will be considered well capitalized. Until July 21, 2011, the BHC Act permitted a BHC to become an FHC if its depository institu-

[80]Application of the Federal Reserve Board's Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations, SR Letter 01-1 (SUP) (Jan. 5, 2001).

[81]*See* Dodd-Frank Act, Pub. L. No. 111-203, § 171 (2010) (codified at 12 U.S.C. § 5371).

[82]Enacted on July 21, 2010, the Dodd-Frank Act marks the greatest set of legislative changes to U.S. financial supervision since the 1930s. Many provisions of the Dodd-Frank Act were not effective immediately upon enactment and require extensive rulemaking and implementation by U.S. regulators. Following the enactment of the Dodd-Frank Act, U.S. regulators have entered an intense period of rulemaking. In many instances, the Dodd-Frank Act provides U.S. regulators with considerable rulemaking authority. *See* Davis Polk, Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act and accompanying Regulatory Implementation Slides (July 21, 2010) (link to slides appears on page i).

[83]U.S. bank regulators have indicated that they will carefully consider the relationships among these provisions and expressed the view that "all aspects of the [Dodd-Frank] Act should be implemented so as to avoid imposing conflicting or inconsistent regulatory capital requirements." Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor, 76 Fed. Reg. 37,620, 37,620 to 37,629 (June 28, 2011).

tion subsidiaries were well capitalized and well managed.[84] Effective July 21, 2011, however, Section 606 of the Dodd-Frank Act amended the BHC Act to require the BHC, not just its depository institution subsidiaries, to be well capitalized and well managed.[85] This provision applies to an FBO that is or controls a foreign bank with a U.S. commercial banking presence as well as any foreign banks controlled by the FBO because under Section 8(a) of the International Banking Act of 1978 (IBA), they are all subject to the BHC Act as if they were BHCs.[86] It is not clear, however, how the Federal Reserve Board will apply this provision to FBOs that are not themselves foreign banks. The Federal Reserve Board has not yet updated its rules for FBOs to implement Section 606.[87]

Furthermore, the Proposed FBO Rule would require foreign banks with large U.S. operations to create a separately capitalized top-tier U.S. intermediate holding company (IHC) that would sit on top of *all* of the foreign bank's U.S. bank and nonbank subsidiaries. Under the Proposed FBO Rule, the IHC would be required independently to meet U.S. capital and liquidity requirements as well as other enhanced prudential standards required by the Dodd-Frank Act. Although the Proposed FBO Rule is silent on how IHC subsidiaries of FBOs that are FHCs will meet the well-capitalized standard for purposes of FHC designation and does not refer to the well-capitalized standard in Regulation Y, one possible outcome is that all IHC subsidiaries of FBOs that are FHCs will become FHCs as well and be required to meet the well-capitalized standard in exactly the same way as a similarly situated U.S. BHC.[88]

[c] Impact of the Collins Amendment on Foreign Banking Organizations

The Collins Amendment in the Dodd-Frank Act imposes, over time, the minimum risk-based and leverage capital requirements applicable to U.S. insured depository institutions as a floor on U.S. BHCs, including U.S. intermediate bank holding companies

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[84] 12 U.S.C.A. § 1843(*l*)(1)(A) to (B).

[85] 12 U.S.C.A. § 1843(*l*)(1), *amended by* Dodd-Frank Act of 2010, Pub. L. No. 111-203, § 606 (2010) (amending § 1843(*l*)(1)).

[86] 12 U.S.C.A. § 3106(a).

[87] *See* 12 C.F.R. § 225.90(a)(1).

[88] While the U.S. branches and agencies of a foreign bank would not be part of the IHC, they would be subject to certain additional measures, including liquidity requirements. For a detailed discussion of the Proposed FBO Rule, please refer to the Introduction to this book.

of FBOs, thrift holding companies, and systemically important nonbank financial companies.[89]

For intermediate U.S. bank holding companies of FBOs that have relied on the exemption from the Federal Reserve Board's capital adequacy guidelines under Supervision and Regulation Letter SR-01-1,[90] the U.S. minimum risk-based capital and leverage capital requirements and the other requirements of the Collins Amendment for debt or equity issued before May 19, 2010, will take effect beginning on July 21, 2015, which is five years after the enactment of the Dodd-Frank Act.[91] The Collins Amendment is immediately effective for hybrid debt or equity instruments issued by such intermediate bank holding companies on or after May 19, 2010.[92]

As a technical matter, the Collins Amendment also applies to the U.S. operations of FBOs with no U.S. commercial banking presence that are designated as systemically important by the FSOC. It is unclear, however, whether federal banking regulators will in fact extend the Collins Amendment, including its risk-based and leverage capital floor, to the U.S. operations of such FBOs. Section 165 of the Dodd-Frank Act grants the Federal Reserve Board authority to exempt systemically important nonbank financial companies (including FBOs with no U.S. commercial banking presence that are designated as systemically important) from the application of risk-based and leverage capital requirements.[93] In order to do so, the Federal Reserve Board must determine, in consultation with the FSOC, that the requirements are not appropriate for a company because of the company's activities or structure and must apply other standards that result in similarly stringent controls.[94] In December 2011, the Federal Reserve Board proposed enhanced prudential standards for U.S. systemically important financial companies, which would generally subject U.S. systemically important *nonbank* financial companies to risk-based and capital requirements that apply to

[89] *See* Dodd-Frank Act, Pub. L. No. 111-203, § 171 (2010) (codified at 12 U.S.C.A. § 5371). *See also* §§ 3:1 et seq.

[90] Application of the Federal Reserve Board's Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations, SR Letter 01-1 (SUP) (Jan. 5, 2001).

[91] 12 U.S.C.A. § 5371(b)(4)(E).

[92] 12 U.S.C.A. § 5371(b)(4)(A).

[93] Dodd-Frank Act, Pub. L. No. 111-203, § 165(b)(1)(A) (2010) (codified at 12 U.S.C.A. § 5365(b)(1)(A)).

[94] Dodd-Frank Act, Pub. L. No. 111-203, § 165(b)(1)(A) (2010) (codified at 12 U.S.C.A. § 5365(b)(1)(A)).

U.S. bank holding companies, subject to any case-by-case exceptions the Federal Reserve Board may grant. The Federal Reserve Board stated, however, that it will "thoroughly assess the business model, capital structure, and risk profile" of a nonbank financial company following its systemic designation by the FSOC to determine how the enhanced prudential standards should apply.[95] It remains to be seen whether the Federal Reserve Board will take a similar approach with respect to non-U.S. systemically important nonbank financial companies.

The Collins Amendment does not authorize U.S. bank regulators to establish minimum capital requirements for FBOs with a U.S. commercial banking presence on a consolidated group-wide basis.[96] As a result, an FBO whose home-country requirements no longer subject it to Basel I floors could theoretically operate with lower capital requirements than a U.S. banking organization that is subject to the permanent capital floor under the Collins Amendment.[97] The potential competitive equality issues arising from this discrepancy could be taken into account by the Federal Reserve Board when assessing whether an FBO's capital is "comparable" to the capital that would be required of a U.S. bank owned by an FHC.[98] This may present an issue for FBOs whose home-country requirements no longer subject them to Basel I floors.

[4] Management

As noted in Section 11:3[1], an FBO will satisfy the well-managed requirement to become an FHC only if the FBO, if it is or controls a foreign bank with a U.S. commercial banking presence; all of its U.S. insured and uninsured depository institution subsidiaries; and all foreign banks with a U.S. commercial bank-

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[95]*See* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, 597 (Jan. 5, 2012).

[96]However, as noted above, the Federal Reserve Board's Proposed FBO Rule would require foreign banks with large U.S. operations to create a separately capitalized top-tier U.S. IHC that would sit on top of *all* of the foreign bank's U.S. bank and nonbank subsidiaries. Under the proposal, the IHC would be required independently to meet U.S. capital and liquidity requirements as well as other enhanced prudential standards required by the Dodd-Frank Act.

[97]Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor, 76 Fed. Reg. 37,620, 37,620 to 37,629 (June 28, 2011).

[98]*See* Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor, 76 Fed. Reg. 37,620, 37,620 to 37,629 (June 28, 2011).

ing presence that are controlled by it are well managed.[99]

A U.S. insured and uninsured depository institution will be deemed to be well managed if it received a composite rating of at least "satisfactory" and, if such rating is given, a rating for management of at least "satisfactory" at its most recent state or federal examination.[100]

A foreign bank with a U.S. commercial banking presence will be deemed to be well managed if (i) its U.S. branches, agencies, and commercial lending company subsidiaries received a combined, composite assessment of at least "satisfactory" at their most recent examination; (ii) its home-country supervisor consents to the foreign bank expanding its activities in the United States to include activities permissible for an FHC; and (iii) its management otherwise meets standards comparable to those required of a U.S. bank owned by an FHC.[101] The consent of the home-country supervisor may be provided in writing or by arranging for the Federal Reserve Board to consult with the home-country supervisor.[102]

In case of new depository institutions that have not received an examination rating, the term *well managed* means that "the [Federal Reserve Board] has determined, after a review of the managerial and other resources of the depository institution . . .

[99] 12 U.S.C.A. § 1843(*l*)(1)(B); 12 C.F.R. §§ 225.81(b)(2), 225.90(a)(1). Before July 21, 2011, the BHC Act did not require a BHC to be well capitalized and well managed in order for the BHC to qualify as an FHC. Only its depository institution subsidiaries were required to satisfy those tests. Section 606 of the Dodd-Frank Act, however, amended the BHC Act to require the BHC itself to be well capitalized and well managed in order to qualify as an FHC. Section 606 applies to an FBO that controls a foreign bank with a U.S. commercial banking presence because under Section 8(a) of the IBA, such an FBO is subject to the BHC Act as if it were a BHC. *See* 12 U.S.C.A. § 3106(a). Section 606 became effective on July 21, 2011. The Federal Reserve Board has not yet proposed any regulations explaining how the amendments made by Section 606 will apply to FBOs; however, with the Proposed FBO Rule requiring the creation of a U.S. IHC, it can be expected that the U.S. IHC itself will be required to be well managed and well capitalized to qualify as an FHC.

[100] 12 C.F.R. § 225.2(s)(1). *See, e.g.*, Commercial Bank Examination Manual, § A.5020.1, Board of Governors of the Federal Reserve System (Apr. 2011).

[101] 12 C.F.R. § 225.90(c). *See, e.g.*, Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations, SR Letter 00-14 (SUP) (Oct. 23, 2000).

[102] *See* 66 Fed. Reg. 400, 409 (Jan. 3, 2001). The consultation is conducted so that the Federal Reserve Board can assure itself that the home-country supervisor considers the consolidated capital and management of the bank to satisfy its home-country standards and that the supervisor has no objections to the expansion.

that the . . . institution is well managed."[103] Although this provision does not expressly apply to new U.S. branches, agencies, or commercial lending company subsidiaries of foreign banks that have not received an examination assessment, the Federal Reserve Board has the discretion to employ the same flexible standard in determining whether the well-managed standard is satisfied.[104]

[5] Comprehensive Consolidated Supervision

As noted in Section 11:3[1], the Federal Reserve Board's own regulations prevent it from considering a foreign bank to be well capitalized and well managed unless the foreign bank is subject to "comprehensive supervision or regulation on a consolidated basis" in its home country, or the Federal Reserve Board determines that the foreign bank's home-country supervisor has made "significant progress" toward CCS, and the foreign bank is in strong financial condition.[105] A foreign bank may be considered to be subject to CCS if the Federal Reserve Board determines

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[103] 12 C.F.R. § 225.2(s)(1)(ii). *See also* Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations, SR Letter No. 00-14 (SUP) (Oct. 23, 2000).

[104] If a foreign bank that wishes to obtain FHC status has not been assigned a combined U.S. banking assessment as part of the regular examination cycle, the foreign bank should contact its responsible Federal Reserve bank or utilize the preclearance process. 12 C.F.R. § 225.91(c). A combined U.S. banking assessment may be assigned to a foreign bank as part of the FHC preclearance process. *See* 66 Fed. Reg. 400, 409 (Jan. 3, 2001).

[105] 12 C.F.R. § 225.92(e). Despite the promise of this alternative standard, the Federal Reserve Board has not previously approved an FHC election based on a foreign bank's home-country supervisor making "significant progress" toward CCS. In contrast, the Federal Reserve Board has approved several applications by foreign banks to establish branches in the U.S. based on home-country supervisors "actively working toward" CCS. *See, e.g.,* ICICI Bank, 94 Fed. Res. Bull. C26 (2008); China Merchants Bank, 94 Fed Res. Bull. C24 (2008); Industrial and Commercial Bank of China, Order Approving Establishment of a Branch (Aug. 5, 2008); Banco de Credito del Peru, 87 Fed. Res. Bull. 708 (2001). *See* Randall Guynn, Emerging Trends and Key Developments in the Regulation and Supervision of Branches and Agencies of International Banks and in the Regulation of International Banks Themselves as Bank Holding Companies and Financial Holding Companies, Annual Regulatory Examination, Risk Management and Compliance Seminar, Institute of International Bankers (Oct. 30, 2007). As discussed in §§ 7:1 et seq., the Federal Reserve Board has since granted China full CCS status. In May 2012, the Federal Reserve Board conferred CCS status on three large, state-owned Chinese banks, which at the time represented the first CCS determination with respect to a major country in nearly ten years. *See* Davis Polk, Federal Reserve's Comprehensive Consolidated Supervision Determination for Chinese Banks Has Broader Implications (May 11, 2012).

that the bank is supervised or regulated in such a manner that its home-country supervisor receives sufficient information on the worldwide operations of the foreign bank, including the relationship of the bank to its affiliates, to assess the foreign bank's overall financial condition and compliance with law and regulation.[106] The terms "comprehensive regulation" and "consolidated basis" are sufficiently broad to leave the Federal Reserve Board substantial latitude in determining whether to deem an FHC election as ineffective on the basis of insufficient home-country regulation.

In theory, the CCS requirement must be fulfilled on a bank-by-bank basis, not on a country-by-country basis. According to one staff member, however, "applicants chartered in the same country may rely on information previously submitted and considered by the Federal Reserve Board on consolidated supervision in that country. Subsequent applicants need only describe the extent to which the supervision system already evaluated applies to them and how, if at all, that system has changed since the Federal Reserve Board last considered it."[107] As a result, it is normally less difficult for the second bank from a particular country to work through the CCS requirement with the Federal Reserve Board.

A foreign bank that has not previously been determined by the Federal Reserve Board to be subject to CCS and that is chartered in a country where no other bank from that country has been determined by the Federal Reserve Board to be subject to CCS is *required* (not merely encouraged) to use the preclearance process,

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[106]The Federal Reserve Board considers, among other factors, the extent to which the home-country supervisor:

- Ensures that the foreign bank has adequate procedures for monitoring and controlling its activities worldwide;
- Obtains information on the condition of the foreign bank and its subsidiaries and offices outside the home country through regular reports of examination, audit reports, or otherwise;
- Obtains information on the dealings and relationship between the foreign bank and its affiliates, both foreign and domestic;
- Receives from the foreign bank financial reports that are consolidated on a worldwide basis or comparable information that permits analysis of the foreign bank's financial condition on a worldwide, consolidated basis; and
- Evaluates prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

12 C.F.R. § 211.24(c)(ii)(A) to (E).

[107]Misback, The Foreign Bank Supervision Enhancement Act of 1991, 79 Fed. Res. Bull. 1, 9 (1993); *see also, e.g.*, Bank Sinopac, 83 Fed. Res. Bull. 669, 669 (1997).

even if it otherwise meets the objective FHC criteria.[108]

There may be limited situations in which an exceptionally strong bank from a country that has not yet fully implemented CCS should be able to be considered for FHC status. The Federal Reserve Board may grant FHC status to a foreign bank that is not yet fully subject to CCS if the home-country supervisor has made "significant progress" in adopting and implementing arrangements for the comprehensive and consolidated supervision of its banks and if the foreign bank demonstrates significant financial strength, such as through levels of capital that significantly exceed the minimum levels required for a well-capitalized determination or through exceptional asset quality.[109] A foreign bank that is not subject to CCS may use the preclearance process to explain to the Federal Reserve Board why it should be granted FHC status. The Federal Reserve Board anticipates granting FHC status to foreign banks that are not subject to CCS only in rare instances.[110]

[6] Community Reinvestment Act

As noted in Section 11:3[1], if an FBO is a BHC, or has or controls a foreign bank with any insured branches, all of its FDIC-insured depository institution subsidiaries and insured branches must have achieved a rating of at least "satisfactory" under the CRA in the most recent examination of such institutions. Although the CRA requirement is not expressly part of the certification requirement, the Federal Reserve Board is prohibited from treating an FHC election as effective if the CRA requirement is not satisfied.[111] The Federal Reserve Board must use the 30-day period beginning on the date that the declaration of election to be an FHC is deemed to be complete to determine whether the CRA rating requirement is met.[112]

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[108] 12 C.F.R. § 225.91(c).

[109] 12 C.F.R. § 225.92(e)(2).

[110] *See* 66 Fed. Reg. 400, 411 (Jan. 3, 2001). To date, the Federal Reserve Board has not approved FHC status for any FBO that has not met the CCS standard based on the "significant progress" standard. *See* Randall Guynn, Emerging Trends and Key Developments in the Regulation and Supervision of Branches and Agencies of International Banks and in the Regulation of International Banks Themselves as Bank Holding Companies and Financial Holding Companies, Annual Regulatory Examination, Risk Management and Compliance Seminar, Institute of International Bankers (Oct. 30, 2007).

[111] 12 U.S.C.A. § 2906(b)(2)(B).

[112] 12 U.S.C.A. § 2903(c)(1)(B).

§ 11:4 Expanded powers of an FHC

As noted in Section 11:2[3], the BHC Act permits both bank holding companies and FBOs that are otherwise subject to the BHC Act to exercise certain expanded powers if they qualify for and elect to be treated as financial holding companies. In contrast to ordinary bank holding companies or FBOs, FHCs are not limited to owning and controlling banks and engaging in, or owning or controlling companies engaged in, activities that are "closely related to banking" or, in the case of QFBOs, certain additional activities and investments under the QFBO exemptions. Instead, FHCs may also engage in, or own or control any companies engaged in, any activity that is *financial in nature*, *incidental* to a financial activity, or *complementary* to a financial activity.[113] The authority to engage in these expanded activities is not limited to activities in the United States but rather extends to anywhere in the world, subject to the laws of the jurisdiction in which the activity is conducted.[114] Of course, electing FHC status does not prevent a QFBO from relying on the QFBO exemptions to engage in certain activities or make certain investments outside the United States that are not generally permissible even for FHCs.[115]

These expanded powers, however, are subject to the Volcker Rule, including its conformance period, and, when it becomes effective, the Swaps Pushout Rule.[116] The Volcker Rule prohibits proprietary trading in most securities and other financial instruments, as well as certain investments in and relationships with hedge funds and private equity funds, subject to certain exemptions. The Swaps Pushout Rule prohibits FBOs from engaging in swaps activities in any U.S. branch or agency that has access to a Federal Reserve Bank's discount window or in a U.S. insured depository institution affiliate. For a more complete

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[Section 11:4]

[113] 12 U.S.C.A. § 1843(k)(1).

[114] 12 C.F.R. § 225.85(b). The territorial limitations of 12 C.F.R. §§ 211.8 and 211.10 relating to investments by BHCs outside the United States do not apply to FHCs whether the activity is conducted in or out of the United States. *See* 66 Fed. Reg. 400, 406 n.14 (Jan. 3, 2001).

[115] *See* § 11:2[2]. For example, QFBOs are permitted to hold controlling interests in foreign commercial companies with only limited activities in the United States without complying with the conditions applicable to merchant banking or insurance company portfolio investments. *See* 12 C.F.R. § 211.23(f). For a more extended discussion of the QFBO exemptions, *see* §§ 10:1 et seq.

[116] Dodd-Frank Act, Pub. L. No. 111-203, §§ 619, 716 (2010) (to be codified at 12 U.S.C.A. § 1851 and 15 U.S.C.A. § 8305).

discussion of the limits imposed by the Volcker Rule and the Swaps Pushout Rule on the expanded powers of an FHC, see Sections 11:8 and 11:9, respectively.

[1] Financial Activities

The BHC Act defines financial activities as any activity that the Federal Reserve Board determines, by regulation or order in accordance with certain procedures, to be financial in nature.[117] It also lists certain activities that "shall be considered to be financial in nature" without any Federal Reserve Board action,[118] as well as certain activities that will be considered financial in nature only to the extent that the Federal Reserve Board specifies by regulation or order.[119] In essence, this statutory scheme creates a "laundry list" of activities that are automatically deemed to be financial in nature and a process by which the Federal Reserve Board may add to that list by regulation or order. The Federal Reserve Board's Regulation Y lists all of the activities considered to be financial in nature by this statutory scheme, as well as all of the activities that the Federal Reserve Board has thus far determined by regulation or order to be financial in nature or incidental to a financial activity.[120]

[a] Laundry List

The following activities are considered to be "financial in nature" without further Federal Reserve Board action:

- *Money and Securities*. Lending, exchanging, transferring, investing for others, or safeguarding money or securities (but not other assets except as described below).[121]
- *Insurance*. Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death or providing and issuing annuities and acting as principal, agent, or broker for purposes of the foregoing.[122]
- *Advisory Services*. Providing financial, investment, or eco-

[117] 12 U.S.C.A. § 1843(k)(1).

[118] 12 U.S.C.A. § 1843(k)(4).

[119] 12 U.S.C.A. § 1843(k)(5).

[120] 12 C.F.R. § 225.86.

[121] 12 U.S.C.A. § 1843(k)(4)(A).

[122] 12 U.S.C.A. § 1843(k)(4)(B). *See* Conference Report on S. 900 at 154 stating that the reference to "insuring, guaranteeing, or indemnifying against . . . illness" is meant to include activities commonly thought of as health insurance and that the reference is not meant to include the activity of directly providing health care on a basis other than to the extent that it may be incidental to the business of insurance. *Insurance* includes reinsurance. *See* 12 Fed. Reg. 400, 405 (Jan. 3, 2001).

nomic advisory services, including advising an investment company (as defined by the U.S. Investment Company Act of 1940 (the 1940 Act)).[123]

- *Securitization of Bank-Eligible Assets*. Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly.[124]
- *Securities Activities*. Underwriting, dealing in, or making a market in securities.[125]

The Federal Reserve Board has determined that the insurance activities permitted by § 4(k)(4)(B) of the BHC Act include insurance claims administration (*i.e.*, collecting and holding in trust insurance premiums, establishing an insurance claims paying account, adjusting insurance claims, negotiating with insureds concerning insurance claims, and paying and settling insurance claims) and risk management services in connection with insurance sales activities (*i.e.*, assessing the risks of a client and identifying the client's exposure to loss; designing programs, policies, and systems to reduce the client's risks; advising clients about risk management alternatives to insurance; and negotiating insurance coverage, deductibles, and premiums for an insurance client). Letter from J. Virgil Mattingly, General Counsel to the Federal Reserve Board, to Karol K. Sparks (July 10, 2002), Fed. Banking L. Rep. (CCH) ¶ 80-304 (Curr. Vol. 2002). Permitted insurance activities also include acting as a third-party administrator for an insurance company. *See* H.R. Rep. No. 106-74 pt. 1, at 122 (1999), 1999 WL 176905 (Leg. Hist.) at 116 ("Activities such as administering, marketing, advising or assisting with . . . claim administration or similar programs shall be deemed to be incidental to insurance activities as described in [Section 4(k)(4) of the BHC Act]."); Letter from J. Virgil Mattingly, General Counsel to the Federal Reserve Board, to Craig N. Landrum (July 10, 2002), Fed. Banking L. Rep. (CCH) ¶ 80-303 (Curr. Vol. 2002) (listing the services that are included in third-party administration).

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

[123] 12 U.S.C.A. § 1843(k)(4)(C).

[124] 12 U.S.C.A. § 1843(k)(4)(D).

[125] 12 U.S.C.A. § 1843(k)(4)(E). Unlike the securities underwriting and dealing powers that are deemed to be closely related to banking or usual in connection with banking abroad, these securities powers are not subject to revenue limits or firewalls other than Sections 23A and 23B of the FRA (including that intraday extensions of credit by banking entities to securities affiliates be on market terms), 12 C.F.R. § 225.4(g), or to any condition that they be exercised

- *Merchant Banking*. Acquiring controlling or noncontrolling interests in any company that is engaged in "any activity" other than an activity that is financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act provided that the FHC has a securities affiliate or both an insurance affiliate and an investment adviser affiliate and subject to certain conditions described more fully in Section 11:4[7].[126]
- *Insurance Company Portfolio Investments*. Acquiring controlling or noncontrolling interests in any company that is engaged in "any activity" other than an activity that is financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act provided that the interests are acquired and held by an insurance company affiliate and subject to certain other conditions described more fully in Section 11:4[8].[127]
- *Closely Related to Banking*. Any activity that the Federal Reserve Board had determined by order or regulation in effect on November 12, 1999, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto (subject to the same terms and conditions contained in such order or regulation unless modified by the Federal Reserve Board) including the activities that are listed in Sections 225.28 and 225.86(a)(2) of Regulation

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only outside the United States. *See, e.g*., J.P. Morgan & Co., Inc., et al., 75 Fed. Res. Bull. 192 (1989), *aff'd sub nom.* Securities Industries Ass'n v. Board of Governors of Federal Reserve System, 900 F.2d 360, Fed. Sec. L. Rep. (CCH) P 94999 (D.C. Cir. 1990); Citicorp, et al., 73 Fed. Res. Bull. 473 (1987), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of Federal Reserve System, 839 F.2d 47, Fed. Sec. L. Rep. (CCH) P 93615 (2d Cir. 1988) as modified by Modifications to Section 20 Orders, 75 Fed. Res. Bull. 751 (1989) (raising revenue limit from 5% to 10%), and 10 Percent Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 48,953 (1996) (adopting change in the manner in which interest earned on certain securities held by a company in an underwriting or dealing capacity are treated in determining whether the company is engaged principally in underwriting and dealing in securities for purposes of Section 20 of the Glass-Steagall Act); and Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (1996) (raising revenue limits from 10% to 25%); 12 C.F.R. § 211.10(a)(14), (15) (territorial conditions), § 225.200 (firewalls).

[126] 12 U.S.C.A. § 1843(k)(4)(H).

[127] 12 U.S.C.A. § 1843(k)(4)(I).

Y.[128] The activities listed in Section 225.28 of Regulation Y include the following:

- *Derivative Contracts*. Engaging as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether exchange-traded or over-the-counter, based on any rate, price, financial asset, nonfinancial asset, or group of assets, subject to certain conditions.[129]

- *Usual in Connection with Banking Abroad*. Any activity that the Federal Reserve Board has determined by regulation or interpretation to be usual in connection with the transaction of banking or other financial operations abroad, including the activities listed in Section 211.10(a) of Regulation K, without regard to any condition that otherwise requires any of these activities be conducted outside the United States.[130] These activities include the following:
  - *Mutual Funds*. Organizing, sponsoring, and managing a mutual fund so long as the fund does not exercise managerial control over the entities in which the fund invests, and the FHC reduces its ownership in the fund,

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[128] 12 U.S.C.A. § 1843(k)(4)(F); 12 C.F.R. §§ 225.28, 225.86(a)(2). For a discussion of the list of activities that are considered to be "closely related to banking," *see* §§ 10:1 et seq. Because Section 4(k)(4)(F) is limited to activities that the Federal Reserve Board had determined by order or regulation in effect on November 12, 1999, to be closely related to banking, the list is effectively frozen as of that date, *i.e.*, any activities subsequently added to the closely related to banking list will only be considered financial in nature if the Federal Reserve Board follows the procedures in Section 4(k).

While Section 4(k)(4)(F) of the BHC Act may have frozen the *categories* of closely related to banking activities that will be considered to be financial in nature, Section 4(k)(4)(F) permits the Federal Reserve Board to relax any conditions applicable to any previously permitted category of activity, even if relaxing the limitation has the effect of expanding the range of permissible activities within the overall category. Thus, the Federal Reserve Board has effectively expanded the range of principal activities with respect to commodity contracts that are considered to be closely related to banking by amending Section 225.28(b)(8)(ii)(B) of Regulation Y to eliminate the previous prohibitions on (i) taking or making delivery of title to commodities underlying commodity derivative contracts to the extent they are done on an instantaneous pass-through basis; and (ii) entering into commodity derivative contracts that do not require cash settlement or specifically provide for assignment, termination, or offset prior to delivery. *See* 68 Fed. Reg. 39,807 (July 3, 2003). The Federal Reserve Board has also effectively expanded the range of permissible data-processing activities by amending Section 225.28(b)(14) of Regulation Y to relax certain previously applicable limitations on data processing. *See* 68 Fed. Reg. 68,493 (Dec. 9, 2003).

[129] 12 C.F.R. § 225.28(b)(8)(ii).

[130] 12 U.S.C.A. § 1843(k)(4)(G); 12 C.F.R. §§ 211.5(d), 225.86(b).

if any, to less than 25% of the equity of the fund within one year of sponsoring the fund or such additional period as the Federal Reserve Board permits.[131]

- *Management Consulting*. Providing management consulting services, including with respect to nonfinancial matters, so long as the management consulting services are advisory and do not allow the FHC to control the person to which the services are provided.[132]
- *Travel Agency*. Operating a travel agency in connection with financial services offered by the FHC or others.[133]

The following activities are considered "financial in nature" solely to the extent, and subject to the conditions, that the Federal Reserve Board specifies by regulation:

- *Financial Assets Other than Money or Securities*. Lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities.
- *Asset Transfer Devices*. Providing any device or other instrumentality for transferring money or other financial assets.
- *Agency Activities*. Arranging, effecting, or facilitating financial transactions for the account of third parties but only to the extent that the Federal Reserve Board specifies by regulation or order that such activities are financial in nature.[134]

The Federal Reserve Board has specified by regulation that the activities listed above are financial in nature only when conducted pursuant to a specific determination by the Federal Reserve Board for a particular FHC.[135]

An FHC or other interested party may request an advisory opinion from the Federal Reserve Board about whether a proposed activity falls within the scope of an activity listed in Section 225.86 of Regulation Y as an activity that is financial in nature or incidental to a financial activity.[136]

The authority to engage in merchant banking and insurance company portfolio investments differs from the other financial activities in that they permit FHCs to control portfolio companies

[131] 12 C.F.R. §§ 225.86(b)(3), 211.10(a)(11).

[132] 12 C.F.R. §§ 225.86(b)(1), 211.10(a)(12).

[133] 12 C.F.R. §§ 225.86(b)(2), 211.10(a)(16).

[134] 12 U.S.C.A. § 1843(k)(5); 12 C.F.R. § 225.86(e).

[135] 12 C.F.R. § 225.86(e)(1), (2).

[136] 12 C.F.R. § 225.88(e).

that are engaged exclusively in nonfinancial activities or a mixture of financial and nonfinancial activities, subject to certain conditions, including maximum holding periods and restrictions on being routinely involved in the management or operation of such portfolio companies as more fully described in Sections 11:4[7] and 11:4[8].

[b] Additional Financial Activities

In addition to the "laundry list" of financial activities, the Federal Reserve Board has the authority to permit FHCs to engage in, or own or control companies engaged in, any other activity that the Federal Reserve Board determines by regulation or order to be financial in nature.

An FHC or other interested party[137] may request a determination from the Federal Reserve Board that an activity not listed in the BHC Act, or previously determined by the Federal Reserve Board to be a financial activity, is "financial in nature."[138] The Federal Reserve Board or the Secretary of the Treasury may also propose that an activity be considered financial in nature on its own initiative.[139]

Before declaring a new activity to be financial in nature, the Federal Reserve Board must notify and consult with the Secretary of the Treasury.[140] The Federal Reserve Board is prohibited from declaring any activity to be financial in nature if the Secretary of the Treasury objects.[141] The Federal Reserve Board must implement its approval of any proposal by the Secretary of the Treasury by amending its regulations subject to the ordinary public notice and comment requirements.[142] On any proposal from any other person, the Federal Reserve Board is permitted, but

[137] 12 C.F.R. § 225.88(a). A BHC that has not yet elected FHC status may file a request if its decision whether or not to seek FHC status depends on certain activities being considered to be financial in nature or incidental to a financial activity.

[138] 12 C.F.R. § 225.88(a).

[139] 12 U.S.C.A. § 1843(k)(2)(A)(i), (B)(i); 66 Fed. Reg. 400, 407 (Jan. 3, 2001).

[140] 12 U.S.C.A. § 1843(k)(2)(A)(i); 12 C.F.R. § 225.88(c).

[141] 12 U.S.C.A. § 1843(k)(2)(A)(ii). The Secretary of the Treasury must respond to a notice within 30 days, and the Federal Reserve Board will endeavor to make a decision on the request within 60 calendar days following the completion of the consultative process with the Secretary of the Treasury and any public comment period. 12 C.F.R. § 225.88(d).

[142] 12 U.S.C.A. § 1843(k)(2)(B)(ii).

not required, to request public comment on the proposal.[143]

In determining whether an activity is financial in nature, the Federal Reserve Board is required to take into account the following factors:

- the purposes of the BHC Act and the GLB Act;
- changes or reasonably expected changes in the marketplace in which FHCs compete;
- changes or reasonably expected changes in the technology for delivering financial services; and
- whether the proposed activity is necessary or appropriate to allow an FHC and its affiliates to compete effectively with any company seeking to provide financial services in the United States, efficiently deliver information and services that are financial in nature through the use of technological means, and offer customers any available or emerging technological means for using financial services or for the document imaging of data.[144]

To date, neither the Federal Reserve Board nor the Secretary of the Treasury has proposed to add any activity to the list of activities considered financial in nature.

[2] Incidental Activities

Similar to the definition of financial activities, the BHC Act defines activities that are incidental to a financial activity as any activity that the Federal Reserve Board determines, by regulation or order in accordance with certain procedures described more fully below, to be incidental to a financial activity.[145] As noted in Section 11:4[1][a], an FHC or other interested party may request an advisory opinion from the Federal Reserve Board about whether a proposed activity falls within the scope of an activity listed in Section 225.86 of Regulation Y as an activity that is financial in nature or incidental to a financial activity.[146] The procedures for finding a new activity to be incidental to a financial activity are identical to the procedures for finding a new activity to be financial in nature. As a result, the Federal Reserve Board has tended to treat both categories as a single category for purposes of Regulation Y.[147]

The Federal Reserve Board has determined that acting as a

[143] *See* 66 Fed. Reg. 400, 407 (Jan. 3, 2001).

[144] 12 U.S.C.A. § 1843(k)(3)(D).

[145] 12 U.S.C.A. § 1843(k)(1).

[146] 12 C.F.R. § 225.88(e).

[147] *See* 12 C.F.R. § 225.86.

"finder" is incidental to financial activities.[148] A finder is an intermediary that brings together one or more buyers and sellers of any product or service for transactions that the parties negotiate and consummate themselves.[149] Among the sorts of activities that fall within this category are hosting electronic markets on Internet Web sites that bring buyers and sellers together to effect transactions that they negotiate and consummate themselves.[150]

On January 3, 2001, the Federal Reserve Board and the Secretary of the Treasury jointly proposed that real estate brokerage and real estate management be treated as incidental to a financial activity.[151] Although the agencies have not formally withdrawn their joint proposal, they have effectively abandoned it in the face of substantial opposition to the proposal mainly from a host of independent real estate brokers.

Although real estate investment, brokerage, and management have not been determined to be financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act, an FHC may underwrite, deal, and make markets in securities of *companies* engaged in such activities and make controlling and noncontrolling investments in them pursuant to, and subject to the conditions and limitations of, the merchant banking and insurance company portfolio investment powers as discussed more fully in Section 11:4[11]. These expanded powers, however, are subject to the Volcker Rule.[152]

[3] Complementary Activities

Similar to the definitions of financial and incidental activities, the BHC Act defines activities that are complementary to a financial activity as any activity that the Federal Reserve Board determines, by regulation or order, to be both (i) complementary to a financial activity and (ii) not a substantial risk to the safety

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[148] 65 Fed. Reg. 80,735 (Dec. 22, 2000).

[149] 12 C.F.R. § 225.86(d)(1). *See* 65 Fed. Reg. 47,696 (Aug. 3, 2000) (proposed rule on finders); 65 Fed. Reg. 80,735 (Dec. 22, 2000) (final rule on finders); 66 Fed. Reg. 19,081 (Apr. 13, 2001) (technical amendments restoring finders rule that had been inadvertently dropped from Section 225.86 of Regulation Y). *See* Williams and Gillespie, Jr., The Impact of Technology on Banking: The Effect and Implications of "Deconstruction" of Banking Functions, 5 N.C. Banking Inst. 135, 150–56 (2001) for a discussion of the activity of banks acting as finders.

[150] 12 C.F.R. § 225.86(d)(ii).

[151] 66 Fed. Reg. 307 (Jan. 3, 2001).

[152] *See* § 11:8.

or soundness of depository institutions or the financial system generally.[153] Unlike the procedures for adding activities to the list of financial or incidental activities, the Federal Reserve Board is not required to notify or consult with the Secretary of the Treasury about whether a particular activity is complementary to a financial activity.

An FHC that seeks to engage in, or acquire more than 5% of the outstanding shares of any class of voting securities of a company engaged in, an activity that the FHC believes to be complementary to a financial activity must obtain prior approval from the Federal Reserve Board by filing a notice in accordance with Section 4(j) of the BHC Act.[154] In deciding whether to approve such a notice, the Federal Reserve Board will consider whether the proposed activity (i) is complementary to a financial activity, (ii) would pose a substantial risk to the safety and soundness of any depository institutions or the financial system generally, and (iii) would produce public benefits that outweigh its potential adverse effects.[155] The Federal Reserve Board has observed that its power to designate certain activities as complementary to an FHC's financial activities "was intended to permit the Federal Reserve to authorize an FHC to engage, to a limited extent, in activities that appear to be commercial if a meaningful connection exists between the proposed commercial activity and the FHC's financial activities and the proposed commercial activity would not pose undue risks to the safety and soundness of the FHC's affiliated depository institutions or the financial system."[156]

The Federal Reserve Board has exercised its authority to find two types of activities to be complementary to financial activities. In a series of orders, the Federal Reserve Board has found that certain commodities trading activities, energy management services, and energy tolling arrangements are complementary to the financial activity of trading in commodities futures, forwards, and other contracts.[157] The Federal Reserve Board has also found that certain disease management and mail-order pharmacy services are complementary to the financial activity of underwriting

[153] 12 U.S.C.A. § 1843(k)(1).

[154] 12 C.F.R. § 225.89(a).

[155] 12 C.F.R. § 225.89.

[156] 68 Fed. Reg. 68,493 (Dec. 9, 2003).

[157] *See, e.g.*, Citigroup, 89 Fed. Res. Bull. 508 (2003) (commodities trading); Fortis S.A./N.V., 94 Fed. Res. Bull. C20 (2008) (energy management); The Royal Bank of Scotland Group plc, 94 Fed. Res. Bull. C60 (2008) (energy tolling).

and selling health insurance.[158] In approving these applications, the Federal Reserve Board has imposed a number of conditions designed to limit the potential safety and soundness risks of the complementary activities and to ensure that the proposed activities would produce public benefits that outweighed any potential adverse effects. These conditions have typically included limits on the market value of assets acquired as part of the complementary activities, requirements that the assets be reasonably liquid, and conditions designed to preserve the separation of banking and commerce.

[4] Exclusivity Requirement

In general, an FHC is not permitted to acquire or retain the shares of any company in reliance on Section 4(k)(1) of the BHC Act unless the company is *exclusively* engaged in activities that are financial in nature or incidental to a financial activity.[159] If an FHC acquires shares of any company that is engaged exclusively in nonfinancial activities or a mixture of financial and nonfinancial activities, the FHC must obtain a determination that the nonfinancial activities are complementary to a financial activity or rely on the merchant banking power, the insurance company portfolio investments authority, the securities underwriting or dealing power, the QFBO exemptions, Section 4(c)(6) or 4(c)(7) of the BHC Act, or some other source of authority that specifically permits FHCs to acquire shares of companies engaged in

[158] Wellpoint, Inc., 93 Fed. Res. Bull. C133 (2007). The *Wellpoint* order was issued in the context of an application by Wellpoint to the FDIC to obtain deposit insurance for a newly chartered Utah industrial bank. Although Wellpoint was not a BHC or otherwise subject to the BHC Act at the time of the Federal Reserve Board's determination, and would not become a BHC by virtue of acquiring the Utah industrial bank, *see* 12 U.S.C.A. § 1841(c)(2)(H) (industrial banks excluded from the term "bank" for purposes of the BHC Act), Wellpoint requested the determination because it had filed its application with the FDIC during an FDIC-imposed moratorium that prohibited approval of any such applications except by applicants engaged exclusively in activities that were permissible for an FHC. *See* Moratorium on Certain Industrial Bank Applications and Notices, 72 Fed. Reg. 5290 (Feb. 5, 2007).

[159] *See* 12 C.F.R. § 225.85(a); 66 Fed. Reg. 400, 404 (Jan. 3, 2001). The regulation and release distinguish complementary activities from other permissible activities, but this is because they are referring to them in the context of post-transaction notice requirements, which do not apply to complementary activities, which must be preapproved. *See*, *e.g.*, 66 Fed. Reg. 404, n.9. *See* 12 C.F.R. § 225.85(a)(2), which makes it clear that companies otherwise required to engage exclusively in activities that are financial in nature, incidental to a financial activity, or otherwise permissible under Section 4(c) of the BHC Act are, nevertheless, permitted to engage in complementary activities despite the general-exclusivity requirement.

nonfinancial or a mixture of financial and nonfinancial activities, subject to the conditions of such other source of authority.

There is one exception to this general rule. An FHC may acquire and retain the shares of any company engaged in mixed financial and nonfinancial activities if the following conditions are satisfied:

- it is "substantially engaged" in financial activities, meaning at least 85% of the company's consolidated total annual gross revenues is derived from, and at least 85% of the company's consolidated total assets is attributable to, the conduct of activities that are financial in nature, incidental to a financial activity, or otherwise permissible under Section 4(c) of the BHC Act;
- the FHC complies with the post-transaction notice requirements applicable to such transactions; and
- the FHC causes the company to conform, terminate, or divest any nonconforming activities within two years of the company's acquisition by the FHC.[160]

[5] Securities Underwriting and Dealing

As noted in Section 11:4[1][a], securities underwriting, dealing, and market making are listed financial activities.[161] As a result, an FBO that is an FHC may engage in, or own or control a subsidiary exclusively engaged in, such securities activities, as well as any other activities that are financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permissible under Section 4 of the BHC Act. These powers, however, are subject to the Volcker Rule, including its prohibition on proprietary trading, compliance provisions and conformance period.[162]

Because any company engaged in securities underwriting, dealing, and market-making in the United States must also be registered as a broker-dealer with, and will be subject to the supervision and regulation of, the Securities and Exchange Commission (SEC),[163] an FBO will virtually always engage in those securities activities in the United States through a separately

[160] 12 C.F.R. § 225.85(a)(3).

[161] 12 U.S.C.A. § 1843(k)(4)(E).

[162] *See* § 11:8.

[163] 15 U.S.C.A. § 78o; *see also* 12 C.F.R. § 218 (Federal Reserve Board rules jointly issued with the Securities and Exchange Commission (SEC) implementing exceptions for banks from the definition of "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934 (Exchange Act)); Exemptions for Banks

incorporated subsidiary.

The power to engage in securities underwriting, dealing, and market-making pursuant to Section 4(k)(4)(E) of the BHC Act extends to all types of securities, including debt and equity securities, by all types of issuers including banks, companies engaged in financial activities, and companies engaged in nonfinancial activities. Unlike the more limited underwriting and dealing powers that are permissible Sections 4(c)(8) and (13) of the BHC Act,[164] the power granted by Section 4(k)(4)(E) of the BHC Act is not subject to revenue, geographical, or other limitations.[165]

Although there is nothing in the statute or regulations expressly imposing any maximum holding period on securities acquired by an FHC as a securities underwriter, dealer, or market maker pursuant to Section 4(k)(4)(E) of the BHC Act, implicit in the notion of underwriting securities is that the securities are acquired with a bona fide intent to resell them as promptly as possible rather than to hold them for investment purposes. Similarly, dealing and market-making in securities is generally understood to be the practice of holding oneself out to the public as willing to buy or sell securities in specified volumes at specified prices and therefore typically results in the securities being turned over on a regular basis rather than being held for investment. In general, the Federal Reserve Board would likely expect securities acquired pursuant to this power to be disposed of or turned over within a relatively short period of time, typi-

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under Section 3(a)(5) of the Exchange Act and Related Rules, Release No. 34-56502 (Sept. 24, 2007) (rules implemented by the SEC only regarding the bank exemptions from the definition of "dealer"). State and federal broker-dealer registration and change-in-control requirements, as well as state and federal regulation and supervision of broker-dealers, is beyond the scope of this Chapter.

[164] 12 U.S.C.A. § 1843(c)(8), (13); J.P. Morgan & Co., Incorporated, et al., 75 Fed. Res. Bull. 192 (1989), *aff'd sub nom.* Securities Industries Ass'n v. Board of Governors of Federal Reserve System, 900 F.2d 360, Fed. Sec. L. Rep. (CCH) P 94999 (D.C. Cir. 1990); Citicorp, et al., 73 Fed. Res. Bull. 473 (1987), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of Federal Reserve System, 839 F.2d 47, Fed. Sec. L. Rep. (CCH) P 93615 (2d Cir. 1988) *as modified by* the Modifications to Section 20 Orders, 75 Fed. Res. Bull. 751 (1989), and 10 Percent Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 48,953 (1996), and Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (1996) (revenue limits); 12 C.F.R. § 211.10(a)(14) and (15) (geographical limits).

[165] *See* 66 Fed. Reg. 400, 406 (Jan. 3, 2001).

cally within 30 to 60 days.[166] If an FHC or its securities affiliate decides to hold securities for investment purposes, instead of for bona fide underwriting, dealing, or market-making purposes, or finds itself with securities that it cannot resell on a reasonable basis for more than 90 to 180 days despite bona fide efforts to do so, the FHC would likely need to find another source of authority to continue holding such securities such as the merchant banking power.

[6] Insurance Underwriting

Underwriting life, health, property, and casualty and other types of insurance is also a listed financial activity.[167] As a result, an FBO that is an FHC may engage in, or own or control a subsidiary exclusively engaged in, such insurance underwriting activities, as well as any other activities that are financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permissible under Section 4 of the BHC Act. In addition, the Federal Reserve Board has determined that certain disease management and mail-order pharmacy services are complementary to the financial activity of underwriting and selling health insurance, subject to certain conditions.[168] Because complementary activities are only permissible if specifically permitted for a specific FHC, any other FHC would be required to obtain its own approval from the Federal Reserve Board before commencing to engage in those activities.

The Federal Reserve Board will not necessarily treat all of the activities of an insurance affiliate as permissible insurance or

[166] *See, e.g.*, 12 C.F.R. § 211.10(a)(15)(iv)(C) (treating securities acquired pursuant to an underwriting commitment as an investment if held for more than 90 days); 12 U.S.C.A. § 1841(a)(5)(B) (exempting acquisitions of bank and BHC securities from the prior approval requirements of Section 3 of the BHC Act if acquired in connection with an underwriting of such securities but only if the shares are held "for such period of time as will permit the sale thereof on a reasonable basis"). J.P. Morgan & Co., Incorporated, et al., 75 Fed. Res. Bull. 192 (1989), *aff'd sub nom.* Securities Industries Ass'n v. Board of Governors of Federal Reserve System, 900 F.2d 360, Fed. Sec. L. Rep. (CCH) P 94999 (D.C. Cir. 1990); Citicorp, et al., 73 Fed. Res. Bull. 473 (1987), *aff'd sub nom*. Securities Industry Ass'n v. Board of Governors of Federal Reserve System, 839 F.2d 47, Fed. Sec. L. Rep. (CCH) P 93615 (2d Cir. 1988) *as modified* by Modifications to Section 20 Orders, 75 Fed. Res. Bull. 751 (1989), and 10 Percent Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 48,953 (1996), and Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (1996) (revenue limits).

[167] 12 U.S.C.A. § 1843(k)(4)(B).

[168] Wellpoint, Inc., 93 Fed. Res. Bull. C133 (2007).

other financial activities despite the broad wording of Section 4(k)(4)(B) of the BHC Act. Insurance companies are not generally subject to the same activities and investment restrictions as FHCs. As a result, they are free to engage in certain activities that may not fall within any of the activities listed as financial in nature or incidental to a financial activity or otherwise permissible under Section 4 of the BHC Act. Unless the Federal Reserve Board determines that any such nonfinancial activities are complementary to a financial activity, an FBO may be precluded from acquiring or maintaining more than 5% of the voting shares of an insurance company unless the nonfinancial activities are terminated or transferred to a separate company that can be held under, and subject to the conditions of, the merchant banking power or the insurance company portfolio investments authority.

Although the regulation of insurance companies is almost exclusively a matter of state law in the United States,[169] federal law preempts state antiaffiliation laws that would otherwise prevent or restrict affiliations between depository institutions (including foreign banks with a U.S. commercial banking presence) and insurance companies other than prior approval, information collection, capital maintenance or restoration, or similar requirements that do not discriminate against depository institutions (including foreign banks with a U.S. commercial banking presence).[170] Federal law also preempts state laws that would otherwise regulate the insurance activities of a depository institution (including a foreign bank with a U.S. commercial banking presence) or its affiliates that are otherwise permitted by federal law in a manner that discriminates against the depository institution or its affiliates.[171] Finally, federal law preempts state law that would otherwise interfere with the ability of an insurer or its affiliates to acquire a depository institution (including a foreign bank with a U.S. commercial banking presence) or to elect to become an FHC[172] or limit the amount of an insurer's assets that may be invested in the voting securities of a depository institution or any company that controls such an institution.[173] The state of an insurer's domicile may, however, limit the amount of an insurer's assets that may be invested in the voting securi-

[169]State insurance licensing and change-in-control requirements, as well as state regulation and supervision of insurance companies, are beyond the scope of this Chapter.

[170]15 U.S.C.A. § 6701(c), (g)(3).

[171]15 U.S.C.A. § 6701(e).

[172]15 U.S.C.A. § 6715(1).

[173]15 U.S.C.A. § 6715(2).

ties of a depository institution or a company controlling such an institution to an amount that is not less than 5% of the insurer's admitted assets.[174]

[7] Merchant Banking

Section 4(k)(4)(H) of the BHC Act permits an FHC to make controlling and noncontrolling investments in the shares, assets, or other ownership interests of a company or other entity that is engaged in "any activity" that is not financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act,[175] subject to the following conditions:

- the investment is not made or held by a U.S. depository institution (including any FDIC-insured U.S. branch of a foreign bank) or by a subsidiary of a U.S. depository institution;[176]
- the investment is made as part of a bona fide underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment;[177]
- the FHC has (i) a registered securities affiliate or (ii) both (A) an insurance company affiliate that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities and (B) a registered investment adviser affiliate that provides advice to an insurance company;[178]
- the investment is held only for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the merchant banking investment activities;[179] and
- the FHC does not routinely manage or operate the company in which the investment is made except as may be neces-

[174] 15 U.S.C.A. § 6715(2). *See, e.g.*, N.Y. Ins. Law § 1301 (McKinney) for definitions of admitted assets.

[175] 12 U.S.C.A. § 1843(k)(4)(H); 12 C.F.R. § 225.177(c).

[176] 12 U.S.C.A. § 1843(k)(4)(H)(i); 12 C.F.R. § 225.170(d).

[177] 12 U.S.C.A. § 1843(k)(4)(H)(ii); 12 C.F.R. § 225.170(b).

[178] 12 U.S.C.A. § 1843(k)(4)(H)(ii); 12 C.F.R. § 225.170(f). It suffices if a bank has a separate and identifiable department or division that is registered as a municipal securities dealer. 12 C.F.R. § 225.170(f)(1)(ii).

[179] 12 U.S.C.A. § 1843(k)(4)(H)(iii); 12 C.F.R. § 225.172(a).

sary or required to obtain a reasonable return on investment upon resale or disposition.[180]

The merchant banking power overlaps with several other sources of authority for investments in nonfinancial companies including the securities underwriting, dealing, and market-making power contained in Section 4(k)(4)(E) of the BHC Act; the insurance company portfolio investment power contained in Section 4(k)(4)(I); investments made under Sections 4(c)(6) and (7); and investments made under Section 4(c)(13), the QFBO exemptions, and Regulation K. To the extent that any of these provisions overlap, they are alternative sources of authority for the same investments but with different conditions and limitations. An FHC is free to choose whichever source of authority gives it the most flexibility with the least burden under any particular circumstances.[181]

To the extent that investments under the merchant banking power are made through hedge funds and private equity funds, both the merchant banking power and these alternative sources of authority are subject to the Volcker Rule, including its restrictions on investments in or through, and certain relationships with, hedge funds and private equity funds, and subject to its conformance period.[182]

[a] Nonfinancial or Mixed Financial/Nonfinancial

The merchant banking authority permits an FHC to make investments in any company or other entity that is engaged in *any activity* that is not financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act. This includes companies that are engaged exclusively in nonfinancial activities, as well as companies that are engaged in mixed financial and nonfinancial activities. Neither the statute nor the implementing regulations impose any minimum percentage or other threshold on the amount of nonfinancial activities in which a company or other entity must engage in order to be an eligible merchant banking investment. Thus, unless a company or other entity is engaged *exclusively* in activities that are financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act, it is an eligible merchant banking investment, subject to the condi-

[180] 12 U.S.C.A. § 1843(k)(4)(H)(iv); 12 C.F.R. § 225.171(a).

[181] 66 Fed. Reg. 8466, 8469 (Jan. 31, 2001).

[182] *See* § 11:8.

tions and limitations of such investments.

If a company or other entity is engaged exclusively in activities that are permissible by Section 4 of the BHC Act, the investment is permissible under Section 4(k)(1) of the BHC Act, but it is not an eligible merchant banking investment.[183] If a company is engaged in a mixture of financial and nonfinancial activities, but is substantially engaged in financial activities (meaning that its financial activities, activities that are incidental to a financial activity, and activities permissible under Section 4(c) of the BHC Act account for at least 85% of the company's assets and revenues), the FHC has a choice in making any investment in the company. The FHC is permitted to make the investment under the merchant banking power, subject to the conditions and limitations of that power, or it may make the investment under Section 4(k)(1), subject to the requirement that it terminate any nonconforming activities, or obtain a determination from the Federal Reserve Board that the nonconforming activities are complementary to a financial activity, within two years of making the investment.[184] An FHC might choose the second authority if it wanted to be involved in the routine management or operation of the company or hold the investment for more than the maximum holding period for a merchant banking investment.

[b] Bona Fide Investment Banking Activity

The BHC Act requires merchant banking investments to be made as part of a bona fide underwriting or merchant- or investment-banking activity.[185] The Federal Reserve Board has stated that "this requirement was intended to distinguish between merchant banking investments that . . . are made for purposes of resale or other disposition, and investments that are made for purposes of allowing the [FHC] to engage in the nonfinancial activities conducted by the portfolio company."[186] It "preserves the financial nature of merchant banking investment activities and helps further the . . . purpose of maintaining the separation of banking and commerce."[187] The Federal Reserve Board has said that it will monitor compliance with the bona fide requirement through the supervisory process to make sure that the merchant banking power is not used by an FHC to become "impermissibly involved in nonfinancial activities, such as real

[183] 66 Fed. Reg. 8466, 8468 to 8469 (Jan. 31, 2001).

[184] *See* 12 C.F.R. § 225.85(a)(3).

[185] 12 U.S.C.A. § 1843(k)(4)(H)(ii); 12 C.F.R. § 225.170(b).

[186] 66 Fed. Reg. 8,466, 8,469 (Jan. 31, 2001).

[187] 66 Fed. Reg. 8,466, 8,469 (Jan. 31, 2001).

estate investment or development."[188] Although the bona fide requirement does not prohibit an FHC from making investments in real estate investment or management companies or from concentrating its investments in any other particular sector, the Federal Reserve Board might scrutinize an FHC's compliance with the bona fide requirement if it makes merchant banking investments only in real estate investment or development companies.[189]

[c] Portfolio Company Requirement

Although the statute does not make any distinction between investments in the shares or assets of a company, the Federal Reserve Board's implementing regulations prohibit an FHC from making investments in assets unless the following conditions are satisfied:

- The assets are held by or promptly transferred to a portfolio company;
- The portfolio company maintains policies, books and records, accounts, and other indicia of corporate, partnership, or limited liability organization and operation that are separate from the FHC and limit the legal liability of the FHC for obligations of the portfolio company; and
- The portfolio company has management that is separate from the FHC to the extent required by the restriction on routine management or operation of the portfolio company.[190]

[d] No Routine Management or Operation

The statute provides that an FHC may not "routinely manage or operate" any company acquired under the merchant banking power "except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition."[191] This restriction does not prevent an FHC from controlling up to 100% of the board of directors or similar governing body of a portfolio company as long as the portfolio company employs officers and employees responsible for routinely managing and operating the company, and the board does not participate in routine management or operation of the company, even if the board has the

[188] 66 Fed. Reg. 8,466, 8,469 (Jan. 31, 2001).

[189] *See* 66 Fed. Reg. 8,466, 8,469 (Jan. 31, 2001). Real estate investment and development are not financial activities. *See* 66 Fed. Reg. 8466, 8469 (Jan. 31, 2001); 65 Fed. Reg. 16,460, 16,463 (Mar. 28, 2000) (interim rule).

[190] 12 C.F.R. § 225.170(e).

[191] 12 U.S.C.A. § 1843(k)(4)(H)(iv); *see also* 12 C.F.R. § 225.171(a).

authority to do so under applicable corporate law.[192]

An FHC is deemed to be engaged in the routine management or operation of a portfolio company if any of the following exist:

- Any director, officer, or employee of the FHC or any of its securities, depository institution, merchant banking, small business investment corporation, or certain other equity investing subsidiaries serves as, or has the responsibilities of, an executive officer of the portfolio company;[193]
- Any executive officer of the FHC or any of its securities, depository institution, merchant banking, small business investment corporation, or certain other equity-investment subsidiaries serves as, or has the responsibilities of, an officer or employee of the portfolio company; or
- Negative covenants restricting the portfolio company's ability to make routine business decisions, such as entering into transactions in the ordinary course of business.[194]

An FHC is presumed, subject to rebuttal, to be engaged in the routine management or operation of a portfolio company if any of the following exist:

- Any director, officer, or employee of the FHC serves as, or has the responsibilities of, a nonexecutive officer or employee of the portfolio company; or
- Any officer or employee of the portfolio company is supervised by any director, officer, or employee of the FHC (other than in that individual's capacity as a director of the portfolio company).[195]

The following arrangements are not considered routine management or operation of a portfolio company:

- Negative covenants limited to restricting the portfolio company's ability to take actions on matters that are not in

[192] 12 C.F.R. § 225.171(d)(1).

[193] The term "executive officer" is defined by 12 C.F.R. § 225.177(d) as "any person who participates or has the authority to participate (other than in the capacity as a director) in major policymaking functions of the company, whether or not the officer has an official title, the title designates the officer as an assistant, or the officer serves without salary or other compensation."

[194] 12 C.F.R. § 225.171(b)(1).

[195] 12 C.F.R. § 225.171(b)(2).

the ordinary course of business—that is, actions that customarily require board or shareholder action;[196]

- Providing financial, investment, and management consulting advice in a manner consistent with and subject to any restrictions on routine management or operations;[197]
- Providing underwriting and private placement services to a portfolio company in connection with the portfolio company's securities;[198] or
- Meeting with officers or employees of the portfolio company to monitor or provide advice in connection with the portfolio company's performance or activities.[199]

Notwithstanding the general prohibition on routine management or operation of portfolio companies, an FHC (other than any U.S. depository institution subsidiary or the U.S. branch or agency of a foreign bank) is permitted to engage in the routine management or operations of a portfolio company on a temporary basis if necessary or required to obtain a reasonable return on the investment in the portfolio company upon resale or other disposition.[200] An FHC may routinely manage or operate a portfolio company only for the period of time as may be necessary to address the cause of the FHC's involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or otherwise to obtain a reasonable return upon the resale or other disposition of the investment.[201] However, an FHC may not routinely manage or operate a portfolio company for a period greater than nine months without prior written notice to the Federal Reserve Board.[202] An FHC must maintain and make available to the Federal Reserve Board upon request a written record describing its involvement in routinely managing or operating a portfolio company.[203]

[e] Minority Investments and Veto Rights

The restriction on routine management or operation of a portfolio company applies to both majority and minority

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[196] 12 C.F.R. § 225.171(d)(2). *See also* Letter from J. Virgil Mattingly, General Counsel of the Federal Reserve Board, to Peter T. Grauer, Credit Suisse First Boston (Dec. 21, 2001).

[197] 12 C.F.R. § 225.171(d)(3)(i).

[198] 12 C.F.R. § 225.171(d)(3)(ii).

[199] 12 C.F.R. § 225.171(d)(3)(iii).

[200] 12 U.S.C.A. § 1843(k)(4)(H)(iii); 12 C.F.R. § 225.171(e).

[201] 12 C.F.R. § 225.171(e)(2).

[202] 12 C.F.R. § 225.171(e)(3).

[203] 12 C.F.R. § 225.171(e)(4).

investments. Its chief impact on minority investments is to limit the negative covenants, or "veto" rights, that an FHC may have over certain corporate actions. Such negative covenants must be limited to matters that are not in the ordinary course of business—that is, matters that customarily require board or shareholder action. The negative covenants may not extend to matters that constitute routine management or operations. The Federal Reserve Board has issued an interpretive letter with a list of examples of matters over which negative covenants are permissible, consistent with the restriction on routine management or operations.[204]

[f] Limited Holding Period

The Federal Reserve Board has interpreted the requirement that a merchant banking investment be limited to "a period of time to enable the sale or disposition thereof on a reasonable basis"[205] as meaning that an FHC generally may hold a merchant banking investment for a maximum of 10 years except that a merchant banking investment held through a qualified private equity fund may be held for the duration of the fund (which may not exceed 15 years).[206] Investments made through a qualified private equity fund, however, are subject to the Volcker Rule, including its restrictions on investments in or through, and certain relationships with, hedge funds and private equity funds, subject to its conformance period.[207]

If an FHC, a controlled qualified private equity fund, or any other affiliate of the FHC acquires an investment in a portfolio company from an affiliate that was previously held under the merchant banking rule or any other provision of the Federal banking laws that imposes a limited holding period, the acquiring company must tack onto its holding period the amount of time that such affiliate has held such investment for purposes of determining the acquiring company's compliance with the applicable maximum holding period under the merchant banking

[204] Letter from J. Virgil Mattingly, General Counsel of the Federal Reserve Board, to Peter T. Grauer, Credit Suisse First Boston (Dec. 21, 2001), which sets forth examples of negative covenants that an FHC may enter into with a portfolio company without being deemed to be engaged in the routine management or operation of the portfolio company. *See also* 12 C.F.R. § 225.171(d)(2).

[205] 12 U.S.C.A. § 1843(k)(4)(H)(iii).

[206] 12 C.F.R. §§ 225.172(b)(1), 225.173(c)(1).

[207] *See* § 11:8.

power.[208] In unusual circumstances, an FHC may seek Federal Reserve Board approval to hold an interest in a portfolio company in excess of the applicable maximum holding period.[209] However, an FBO that holds a merchant banking investment in excess of the applicable maximum holding period must abide by any restrictions that the Federal Reserve Board may impose in connection with granting approval of the extension of the holding period.[210]

[g] Qualified Private Equity Funds

FHCs are permitted to make merchant banking investments through private equity funds, which are generally structured as limited partnerships or other investment vehicles that pool the FHC's capital with capital provided by third-party investors. These third-party investors typically are institutional investors such as other investment companies, pension funds, endowments, financial institutions or corporations, and sophisticated individual investors with high net worth. In most instances, the FHC is the sponsor or advisor to the fund and has a general partnership or similar interest in the fund.

Investments made through a qualified private equity fund, however, are subject to the Volcker Rule, including its restrictions on investments in or through, and certain relationships with, hedge funds and private equity funds, and subject to its conformance period.[211]

Under the merchant banking rule, an investment in a private equity fund qualifies for a longer holding period if the fund satisfies the following conditions:

- It was formed for the purpose of and is engaged exclusively in the business of investing in shares, assets, and ownership interests of financial and nonfinancial companies for resale or other disposition;
- It is not an operating company;
- The FHC and its directors, officers, employees, and principal

[208] 12 C.F.R. §§ 225.172(b)(2), (3), 225.173(c)(3).

[209] 12 C.F.R. §§ 225.172(b)(4), (5), 225.173(c)(2).

[210] 12 C.F.R. §§ 225.172(b)(6)(ii), 225.173(c)(2).

[211] *See* § 11:8.

shareholders do not hold, own, or control more than 25% of the total equity of the fund;[212]

- The fund has a maximum term of not more than 15 years; and
- It is not formed or operated for the purpose of making investments inconsistent with the merchant banking power or evading the limitations on merchant banking investments.[213]

An FHC is permitted to make both controlling and noncontrolling investments in qualified private equity funds. Regulation Y defines situations in which an FHC is considered to control a qualified private equity fund.[214] An FHC is deemed to control a qualified private equity fund if the FHC, including any director, officer, employee, or principal shareholder of the FHC:

- serves as general partner, managing member, or trustee of the private equity fund;
- owns or controls 25% or more of any class of voting shares or similar interests in the fund;[215]
- in any manner selects, controls, or constitutes a majority of the directors, trustees, or management of the fund; or
- owns or controls more than 5% of any class of voting shares or similar interests in the private equity fund and is the investment adviser to the fund.[216]

If an FHC is deemed to control a qualified private equity fund, the FHC will be deemed to control the fund's investments in portfolio companies. As a result, the FHC will be responsible for ensuring that the qualified private equity fund complies with the prohibition against routine management or operation of portfolio companies and the maximum holding period. In contrast, if an FHC has a noncontrolling interest in a qualified private equity fund, the investments of the private equity fund are not attributable to the FHC; such a qualified private equity fund may routinely manage or operate its portfolio companies and hold its investments in portfolio companies indefinitely without causing

[212]Subject to a conformance period, the Volcker Rule prohibits an FHC from owning, as principal, an ownership interest in a private equity fund except pursuant to certain permitted activity exemptions. *See* § 11:8.

[213]12 C.F.R. § 225.173(a).

[214]12 C.F.R. § 225.173(d)(4).

[215]Subject to a conformance period, the Volcker Rule prohibits an FHC from owning, as principal, an ownership interest in a private equity fund except pursuant to certain permitted activity exemptions. *See* § 11:8.

[216]12 C.F.R. § 225.173(d)(4).

the FHC to be in violation of the BHC Act, subject to the Volcker Rule.[217]

An FHC's controlling or noncontrolling investment in a qualified private equity fund (in contrast to any investments in portfolio companies attributable to the FHC by virtue of controlling a qualified private equity fund) is, by definition, an investment in a company that is engaged exclusively in activities that are financial in nature. As a result, an FHC may routinely manage or operate a qualified private equity fund.[218] In contrast, both the FHC and any qualified private equity fund that is controlled by the FHC must comply with the limits on routine management or operation and on maximum holding periods with respect to any investments by the qualified private equity fund in portfolio companies.

An FHC is also permitted to make controlling investments in private equity funds that do not satisfy the conditions of qualified private equity funds, subject to the Volcker Rule.[219] If the investment is a controlling one in a nonqualified private equity fund (*e.g.*, a fund such as a hedge fund formed as a company with unlimited life) that is otherwise exclusively engaged in activities that are financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act, the only consequence is that the FHC must comply with the 10-year maximum holding period and the restrictions on routine management or operation of portfolio companies as if the portfolio investments were made directly by the FHC. If the investment is a controlling or noncontrolling one in a nonqualified private equity fund that engages in any activity not permitted by Section 4 of the BHC Act, then the FHC must treat its investment in the private equity fund itself as a merchant banking investment in a portfolio company, subject to the maximum holding period and restriction on routine management or operation at the level of the private equity fund itself or under some other source of authority other than Section 4(k)(1)

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[217] *See* § 11:8.

[218] As noted in this Section, to the extent that routine management or operation of a private equity fund requires that an FHC "sponsor" the fund, the FHC must comply with one of the Volcker Rule's permitted activity exemptions, such as the asset management exemption. The Volcker Rule does not place any limits on serving strictly as investment adviser to a private equity fund, although doing so triggers a prohibition on certain transactions between the investment adviser or any of its affiliates, on the one hand, and the fund, on the other hand. *See* 12 U.S.C.A. § 1851(f)(1).

[219] *See* § 11:8.

of the BHC Act. Finally, if the investment is a noncontrolling one in a nonqualified private equity fund (*e.g.*, a hedge fund formed as an unlimited life company) that is otherwise exclusively engaged in activities that are financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act, the investment will be permissible under Section 4(k)(1), and the merchant banking limitations will not be applicable either at the level of the private equity fund or its portfolio companies,[220] subject to the Volcker Rule.[221]

[h] After-the-Fact Notice Requirements

An FHC is required to provide the Federal Reserve Board with notice within 30 days after the closing of any merchant banking investment in which the FHC directly or indirectly acquires more than 5% of the shares, assets, or other ownership interests of a portfolio company if the aggregate acquisition cost of such investment exceeds the lesser of 5% of the FHC's Tier 1 capital and $200 million.[222] It is also required to provide any notice that the Federal Reserve Board otherwise deems to be necessary in the exercise of its supervisory authority.[223] Otherwise, an FHC is generally not required to obtain prior approval for, or otherwise provide before- or after-the-fact notice of, any merchant banking investment except as described in Section 11:5[2]. If an after-the-fact notice is required, the notice is provided on Form FR Y-10.

[i] Risk Management, Record-Keeping, and Reporting

An FHC, including a private equity fund controlled by an FHC, that makes merchant banking investments must establish and maintain policies, procedures, records, and systems reasonably designed to conduct, monitor, and manage such investments and the risks associated with such investments in a safe and sound manner.[224] In addition, the Division of Banking Supervision and Regulation of the Federal Reserve Board has issued a supervisory letter entitled Supervisory Guidance on Equity Investment and

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[220] *See* 66 Fed. Reg. 8466, 8477 (Jan. 31, 2001), which is not entirely consistent with the description in the text, which is based on the plain language and purposes of Section 4(k) of the BHC Act.

[221] *See* § 11:8.

[222] 12 C.F.R. § 225.87(b)(4)(i).

[223] 12 C.F.R. § 225.87(b)(4)(iii).

[224] 12 C.F.R. § 225.175(a)(1).

Merchant Banking Activities (the Guidance Letter).[225] The Guidance Letter describes in detail the internal controls and risk management policies, procedures, and systems that the Federal Reserve Board expects bank holding companies engaged in equity investment activities to have and to maintain in order to conduct such activities in a safe and sound manner. The Guidance Letter notes that foreign banks should incorporate the basic principles set forth in the Guidance Letter into their U.S. operations with appropriate adaptation to reflect the fact that those operations are an integral part of a foreign bank, which should be managing its risks on a consolidated basis and that the bank is subject to overall supervision by its home-country authorities.[226]

The risk management, record-keeping and reporting requirements of Regulation Y and the Guidance Letter are summarized in the following Section (these requirements will likely be updated after final regulations implementing the Volcker Rule are issued).

[i] Internal Risk Management Requirements

FHCs engaged in merchant banking investment activities are required to establish policies, procedures, and systems and maintain records reasonably designed to:

- Monitor and assess the carrying value, market value, and performance of each investment and such values of the FHC's aggregate merchant banking investment portfolio;
- Identify and manage the market, credit, concentration, and other risks associated with merchant banking investments;
- Identify, monitor, and assess the terms, amounts, and risks arising from transactions and relationships (including contingent fees or contingent interests) between the FHC and the portfolio companies;
- Ensure the maintenance of corporate separateness between the FHC and the portfolio companies in order to protect the FHC and its depository institution subsidiaries from legal liability for the operations conducted and financial obligations of any of the portfolio companies; and
- Ensure compliance with Subpart J (Merchant Banking Investments) of Regulation Y and other provisions of law

[225] SR Letter No. 00-9 (SPE) (June 22, 2000).

[226] SR Letter No. 00-9 (SPE), Attachment, at 3 (June 22, 2000).

governing transactions and relationships between the FHC and portfolio companies.[227]

In addition, the Guidance Letter recommends that FHCs implement "sound management practices."[228] These practices include:

- *Oversight*: Active oversight by the FHC's board of directors and senior management. The board should approve portfolio objectives and investment strategies and policies, limits on aggregate investment and exposure amounts, types of investments, and diversification-related aspects of equity investments. The board should actively monitor the performance and risk profile of the equity investment business in light of its established objectives, strategies, and policies. The board should ensure that there is an effective management structure for conducting the institution's equity activities, including adequate systems for measuring, monitoring, controlling, and reporting on the risks of equity investments, and should specify lines of authority and responsibility for acquisition and sales of investments.[229]

Senior management must ensure that there are adequate policies, procedures, and management information systems for managing equity investment activities on a day-to-day and longer-term basis and that there is competent staff.[230]

- Management of the Investment Process:
  - *Policies and Limits*: The FHC must have effective policies that: (i) govern the types and amounts of investments that may be made; (ii) provide guidelines on appropriate holding periods for different types of investments; (iii) establish parameters for portfolio diversification;[231] (iv) govern compensation arrangements, including coinvestment structures and sales of portfolio company interests by employees of the FHC;[232] (v) govern the terms and conditions of employee loans and sales of participants' interests prior to the release of the lien securing such loans in connection with key employees'

[227] 12 C.F.R. § 225.175(a)(1).

[228] *See* SR Letter No. 00-9 (SPE), Attachment, at 3 (June 22, 2000).

[229] *See* SR Letter No. 00-9 (SPE), Attachment, at 4–5 (June 22, 2000).

[230] *See* SR Letter No. 00-9 (SPE), Attachment, at 5 (June 22, 2000).

[231] *See* SR Letter No. 00-9 (SPE), Attachment, at 5 (June 22, 2000).

[232] *See* SR Letter No. 00-9 (SPE), Attachment, at 6 (June 22, 2000).

coinvestments;[233] and (vi) limit the legal liability of the FHC and its affiliates for the financial obligations and liabilities of the portfolio companies.[234]

- *Procedures*: The FHC must have procedures for assessing, approving, and reviewing investments based upon the size, nature, and risk profile of an investment. These include: (i) analytical assessments of investment opportunities and formal approval process; (ii) internal risk rating for equity investments; (iii) periodic and timely review of the FHC's equity investments; (iv) valuation accounting policies and procedures; (v) exit strategies; (vi) policies and procedures to govern the sale, exchange, or other disposition of the FHC's investments; (vii) internal methods for allocating economic capital based on the risk inherent in the investment activities; and (viii) terms and conditions of employee loans and sales of participants' interests prior to the release of the liens securing such loans in connection with key employees' coinvestments.[235]

- *Control System*: The FHC must have an adequate system of internal controls, with appropriate checks and balances and clear audit trails, that focuses on all of the elements of the investment management process including: (i) the appropriateness of existing policies and procedures; (ii) the adherence to policies and procedures; (iii) the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting; (iv) departures from policies and procedures; and (v) compliance with all federal laws and regulations applicable to an FHC's investment activities (in particular, compliance with the prohibition on impermissible control over equity investments and compliance with restrictions on cross-marketing between depository institutions and portfolio companies of FHCs).[236]

The policies and procedures described above are expected to be at the top-tier FHC level and applied by it on a consolidated basis to its subsidiaries. Accordingly, any subsidiary of an FHC should be informed of the policies and procedures that it would be expected to follow when engaged in merchant banking invest-

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[233] *See* SR Letter No. 00-9 (SPE), Attachment, at 12 (June 22, 2000).

[234] *See* SR Letter No. 00-9 (SPE), Attachment, at 14 (June 22, 2000).

[235] *See* SR Letter No. 00-9 (SPE), Attachment, at 6–10, 12 (June 22, 2000).

[236] *See* SR Letter No. 00-9 (SPE), Attachment, at 10–11 (June 22, 2000).

ments, including reporting requirements to the parent FHC.

[ii] Record-Keeping Requirements

Regulation Y requires FHCs to keep records designed to conduct, monitor, and manage the investment activities and the risks associated with such investments in a safe and sound manner.[237]

The Guidance Letter recommends the following record-keeping measures:[238]

- documentation of key elements of the investment process, including initial due diligence, approval reviews, valuation, and disposition;
- documentation of board-approved objectives, strategies, policies, and procedures;[239]
- records of transactions between an FHC and companies held under the merchant banking investment authority, specifically documentation of transactions that are not on market terms;
- documentation of incentive arrangements in connection with controlling or advising a fund, including the carrying value and market value of the arrangement and amounts that may be payable based on future asset performance; and
- documentation of the legal separation between the FHC and the portfolio company.[240]

[iii] Reporting Requirements

Upon request by the Federal Reserve Board or the appropriate Federal Reserve Bank, an FHC must make the policies, procedures, and records maintained with respect to its merchant banking investments available to the Federal Reserve Board or the Federal Reserve Bank.[241] Furthermore, an FHC must provide reports to the appropriate Federal Reserve Bank in such format and at such times as the Federal Reserve Board may prescribe.[242]

[237] 12 C.F.R. § 225.175(a)(1).

[238] *See* SR Letter No. 00-9 (SPE), Attachment, at 11 (June 22, 2000).

[239] *See* SR Letter No. 00-9 (SPE), Attachment, at 4, 11 (June 22, 2000).

[240] *See* SR Letter No. 00-9 (SPE), Attachment, at 11 (June 22, 2000).

[241] 12 C.F.R. § 225.175(a)(2).

[242] 12 C.F.R. § 225.175(b).

[iv] Disclosure of Merchant-Banking Investment Activities

The Guidance Letter recommends that FHCs adequately disclose to the public relevant information that is necessary for the markets to assess the risk profiles and performance of their merchant banking investment activities. FHCs are encouraged to disclose information relating to:

- The size of their merchant banking investment portfolios;
- The types and nature of their merchant banking investments such as direct/indirect, domestic/international, public/private, and equity/debt with conversion rights;
- The initial cost, carrying value, and fair value of investments and, where applicable, comparisons to publicly quoted share values of portfolio companies;
- The accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices;
- The realized gains and losses arising from sales and unrealized gains and losses; and
- Any insights regarding the potential performance of equity investments under alternative market conditions.[243]

[v] Institutions Lending to or Engaging in Other Transactions with Portfolio Companies

Additional risk management issues may arise when a U.S. insured depository institution subsidiary of an FHC or the U.S. branch or agency of a foreign bank lends to or has other business relationships with: (i) a company in which the FHC or an affiliate has invested (*i.e.*, a portfolio company); (ii) the general partner or manager of a private equity fund that has also invested in a portfolio company; or (iii) a private equity-financed company in which the FHC does not hold a direct or indirect ownership interest but that is an investment or portfolio company of a general partner or fund manager with which the FHC has other investments. Given their potentially higher than normal risk attributes, FHCs should devote special attention to ensuring that the terms and conditions of such lending relationships are at arm's length and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivatives transactions with or guaranteed by portfolio

[243] *See* SR Letter No. 00-9 (SPE), Attachment, at 12–13 (June 22, 2000).

companies and general partners.[244]

Where a U.S. insured depository institution subsidiary of an FHC, or the U.S. branch or agency of a foreign bank, lends to a private equity-financed company in which the FHC has no equity interest but where the borrowing company is a portfolio investment of private equity fund managers or general partners with which the FHC may have other private equity-related relationships, care must be taken to ensure that the extension of credit is conducted on reasonable terms.[245]

[vi] Private Equity and Other Funds

If an FHC controls a private equity fund or other fund that makes merchant banking investments, the FHC must ensure that the fund has established the types of policies, procedures, and systems and maintains the types of records described in Regulation Y for making and monitoring the fund's merchant banking investments, or, alternatively, the FHC may ensure that the fund is subject to the FHC's merchant banking policies, procedures, and systems.[246] These requirements do not apply if the FHC does not control the fund.[247] These requirements will likely be updated after the federal regulators have finalized regulations implementing the Volcker Rule.

[vii] Federal Reserve Board Review of Risk Management Policies

The Federal Reserve Board has announced that it generally will conduct a review of the investment and risk management

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[244] *See* SR Letter No. 00-9 (SPE), Attachment, at 13 (June 22, 2000). Lending and other business transactions between an insured depository institution and a portfolio company that meets the definition of an affiliate must be negotiated on an arm's-length basis in accordance with Section 23B of the FRA, 12 U.S.C.A. § 371c-1. *See* § 11:6[6]. The FHC should have systems and policies in place to monitor transactions between the FHC, or a nondepository institution subsidiary of the FHC, and a portfolio company. (These transactions are not typically governed by Section 23B.) An FHC should assure that the risks of these transactions, including exposures of the FHC on a consolidated basis to a single portfolio company, are reasonably limited and that all transactions are on reasonable terms, with special attention paid to transactions that are not on market terms. *See* SR Letter No. 00-9 (SPE), Attachment, at 13 (June 22, 2000). Also, the Dodd-Frank Act amended Sections 23A and 23B of the FRA to include additional limitations on transactions with advised or managed funds. *See* §§ 6:1 et seq. for a detailed discussion of these restrictions.

[245] *See* SR Letter No. 00-9 (SPE), Attachment, at 13 (June 22, 2000).

[246] 12 C.F.R. § 225.175(a)(1) applies to private equity funds controlled by an FHC.

[247] *See* 66 Fed. Reg. 8466, 8479 (Jan. 31, 2001).

policies, procedures, and systems of an FHC that makes merchant banking investments within a short period after the FHC commences the activity. The review may be conducted off-site or on-site, depending on the expected level and complexity of the FHC's merchant banking investments and the FHC's previous experience in making equity investments under other legal authorities.[248]

[j] Enhanced Capital Requirements

Domestic FHCs are subject to the Federal Reserve Board's enhanced capital requirements for merchant banking investments and must deduct from their core capital a specified percentage based on the adjusted carrying value of all nonfinancial equity investments calculated on a consolidated basis, including merchant banking investments. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the FHC increases as a percentage of Tier 1 capital.[249] Although these enhanced capital requirements do not apply to foreign banks, which are subject to home-country capital requirements, they may be imposed on U.S. IHCs to the extent that merchant banking investments are held under the IHC, if the Federal Reserve Board's Proposed FBO Rule is finalized as proposed.

[k] Cross-Marketing Restrictions

The BHC Act imposes cross-marketing restrictions on any U.S. depository institution controlled by an FHC with respect to the FHC's merchant banking activities.[250] The main purpose of the cross-marketing restrictions is to ensure an appropriate separation between banking and commerce.[251] The Federal Reserve Board has extended these restrictions to the U.S. branches and agencies of foreign banks.[252]

As implemented by the Federal Reserve Board, these cross-marketing restrictions prohibit any U.S. depository institution controlled by an FHC, any of the depository institution's subsid-

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[248] *See* 66 Fed. Reg. 8466, 8479 (Jan. 31, 2001).

[249] 12 C.F.R. Pt. 225, App. A, § II.B.5; *see also* 67 Fed. Reg. 3784 (Jan. 25, 2002).

[250] 12 U.S.C.A. § 1843(n)(5)(A).

[251] *See* H.R. Rep. No. 106-74 pt. 1, at 122 to 123 (1999); 66 Fed. Reg. 8,466, 8,480 (Jan. 31, 2001).

[252] 12 C.F.R. § 225.177(b) (definition of depository institution includes the U.S. branches and agencies of a foreign bank for purposes of the merchant banking power).

iaries with certain exceptions,[253] and any U.S. branch or agency of a foreign bank from:

- offering or marketing, directly or through any arrangement, any product or service of any company if more than 5% of the company's voting shares, assets, or other ownership interests are owned or controlled by the FHC under Section 4(k)(4)(H) of the BHC Act; or
- allowing any product or service of the depository institution, including any product or service of a subsidiary of the depository institution, to be offered or marketed, directly or through any arrangement, by or through any company if more than 5% of the company's voting shares, assets, or other ownership interests are owned or controlled by the FHC under Section 4(k)(4)(H) of the BHC Act.[254]

These cross-marketing restrictions apply to both a company engaged in merchant banking activities and the portfolio companies of such a company held under the merchant banking power.[255]

The cross-marketing restrictions generally apply to a private equity fund and its portfolio investments. However, they do not apply to the portfolio companies of a private equity fund that is not controlled by the FHC;[256] nor do they apply to the sale, offer, or marketing of any limited partnership or other interest in a private equity fund whether or not it is controlled by the FHC.[257]

The cross-marketing restrictions do not apply to the marketing of products and services by a U.S. depository institution, its subsidiaries, or the U.S. branch or agency of a foreign bank—such as deposits, loans, and advisory services—to a merchant banking affiliate or its portfolio companies so long as the merchant banking affiliate or its portfolio companies do not market those products or services to their customers or others.[258] Nor do the cross-marketing restrictions apply to the purchasing of products or services—such as data processing—by a U.S. depository institution, its subsidiaries, or the U.S. branch or agency of a foreign bank from a merchant banking affiliate or its portfolio companies

[253] 12 C.F.R. § 225.176(a)(1), (2) (for example, financial subsidiaries of national banks are excluded from the covered subsidiaries).

[254] 12 C.F.R. § 225.176(a)(1).

[255] *See* 12 U.S.C.A. § 1843(n)(5).

[256] 12 C.F.R. § 225.176(a)(3)(i).

[257] 12 C.F.R. § 225.176(a)(3)(ii).

[258] *See* 66 Fed. Reg. 8466, 8481 (Jan. 31, 2001).

provided that the institution does not, directly or indirectly or through arrangements, market the merchant banking company or portfolio company's products or services to the institution's customers or others. Likewise, the cross-marketing restrictions do not prohibit a U.S. depository institution, its subsidiary, or the U.S. branch or agency of a foreign bank from engaging in cross-marketing activities with a company that is a coinvestor with the FHC in a merchant banking company or portfolio company so long as those activities do not involve products or services of the merchant banking company or portfolio company.[259]

[8] Insurance Company Portfolio Investments

Section 4(k)(4)(I) of the BHC Act permits an FHC to make controlling and noncontrolling investments in the shares, assets, or other ownership interests of a company or other entity that is engaged in "any activity" that is not financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act, subject to the following conditions:

- the investment is not made or held by a U.S. depository institution (including any FDIC-insured U.S. branch of a foreign bank) or by a subsidiary of a U.S. depository institution;
- the shares, assets, or other ownership interests are acquired and held by an insurance company affiliate that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities;
- such shares, assets, or other ownership interests represent an investment made in the ordinary course of business of such insurance company in accordance with relevant state law governing such investments; and
- the FHC does not routinely manage or operate the company in which the investment is made except as may be necessary or required to obtain a reasonable return on investment.[260]

Insurance companies typically make these types of investments to invest the funds received from policyholders. The investment of funds, in particular funds received from policyholders and funds generated by investments, is an essential and inherent

[259] *See* 66 Fed. Reg. 8466, 8481 and n.28.

[260] 12 U.S.C.A. § 1843(k)(4)(I).

part of the insurance business. The Federal Reserve Board recognized in the *Citicorp/Travelers* Order that, as an integral part of their insurance business, insurance underwriting companies invest the insurance premiums that they collect in a variety of investments.[261]

The insurance company portfolio investment power is similar to the merchant banking power in several respects described more fully in Section 11:4[8][a] to 11:4[8][i]. Its chief differences are that there is no maximum holding period on portfolio investments made pursuant to the insurance company portfolio investment power, and it is not sufficient for the FHC to have insurance company and investment adviser affiliates in order to rely on this power. Instead, investments actually have to be made and held by an insurance company affiliate that is predominantly engaged in certain insurance activities, and the investments must be made in the ordinary course of its insurance business in accordance with state or other applicable law.

Like the merchant banking power, the insurance company portfolio investment power overlaps with several other sources of authority for investments in nonfinancial companies, including the securities underwriting, dealing, and market making power contained in Section 4(k)(4)(E) of the BHC Act; the merchant banking power contained in Section 4(k)(4)(H); investments made under Sections 4(c)(6) and (7); and investments made under Section 4(c)(13), the QFBO exemptions, and Regulation K. To the extent that any of these provisions overlap, they are alternative sources of authority for the same investments but with different conditions and limitations. An FHC is free to choose whichever source of authority gives it the most flexibility with the least burden under any particular circumstances.

The insurance company portfolio investment power and alternative sources of authority, however, are subject to the Volcker Rule, including its restrictions on investments in or through, and certain relationships with, hedge funds and private equity funds, and subject to its conformance period.[262]

[a] Nonfinancial or Mixed Financial/Nonfinancial

Like the merchant banking authority, the insurance company portfolio investment power permits an FHC to make investments

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[261] Travelers Group Inc., Citicorp, 84 Fed. Res. Bull. 985, 988 n.18 (1998) ("As an integral part of their insurance business, the Travelers insurance underwriting subsidiaries invest insurance premiums they collect in a variety of investments.").

[262] *See* § 11:8.

in any company or other entity that is engaged in *any activity* that is not financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act. This includes companies that are engaged exclusively in nonfinancial companies, as well as companies that are engaged in mixed financial and nonfinancial activities. The BHC Act does not impose any minimum percentage or other threshold on the amount of nonfinancial activities in which a portfolio company or other entity must engage in order to be an eligible insurance company portfolio investment. Thus, unless a company or other entity is engaged *exclusively* in activities that are financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act, it is an eligible insurance company portfolio investment, subject to the conditions and limitations of such investments.

If a company or other entity is engaged exclusively in activities that are permissible under Section 4 of the BHC Act, the investment is permissible under Section 4(k)(1) of the BHC Act, but it is not an eligible insurance company portfolio investment. If a company is engaged in a mixture of financial and nonfinancial activities, but is substantially engaged in financial activities (meaning that its financial activities, activities that are incidental to a financial activity, and activities permissible under Section 4(c) of the BHC Act account for at least 85% of the company's assets and revenues), the FHC has a choice in making any investment in the company. The FHC is permitted to make the investment under the insurance company portfolio investment power, subject to the conditions and limitations of that power; or it may make the investment under Section 4(k)(1), subject to the requirement that it terminate any nonconforming activities; or obtain a determination from the Federal Reserve Board that the nonconforming activities are complementary to a financial activity within two years of making the investment.[263] An FHC might choose the second authority if it wanted to be involved in the routine management or operation of the company.

[b] Ordinary Course Under State Law

The BHC Act requires that any insurance company portfolio investments be made in the ordinary course of business of the insurance company in accordance with state law governing such

[263] *See* 12 C.F.R. § 225.85(a)(3).

investments.[264] If the insurance company is organized under foreign law or doing business under foreign law, this requirement is presumably met if the portfolio investments are made in the ordinary course of business of the insurance company in accordance with applicable foreign law. Like the bona fide investment banking requirement under the merchant banking power, this requirement was intended to distinguish between insurance company portfolio investments made for investment purposes and more strategic investments that are made for purposes of allowing the FHC to engage in the nonfinancial activities conducted by the portfolio company.[265] It preserves the financial nature of insurance company portfolio investment activities and helps further the purpose of maintaining an appropriate separation between banking and commerce.[266] Presumably, the Federal Reserve Board will monitor compliance with this requirement through the supervisory process to make sure that the insurance company portfolio investment power is not used by an FHC to become impermissibly involved in nonfinancial activities as it does with merchant banking investments.[267] Although the ordinary-course-under-state- (or other applicable) law requirement does not prohibit an FHC from making investments in real estate investment or management companies or from concentrating its investments in any other particular sector, the Federal Reserve Board might scrutinize an FHC's compliance with the ordinary-course-under-state- (or other applicable) law requirement if it makes insurance company portfolio investments only in real estate investment or development companies.[268]

[c] Portfolio Company Requirement

Although the BHC Act does not make any distinction between investments in the shares or assets of a company, and the Federal Reserve Board has not promulgated any regulations for insurance company portfolio investments similar to its merchant banking regulations, the Federal Reserve Board would likely interpret Section 4(k)(4)(I) to prohibit an FHC from making investments in assets unless the following conditions are satisfied as it does for merchant banking investments:

[264] 12 U.S.C.A. § 1843(k)(4)(I)(iii).

[265] *See* 66 Fed. Reg. 8466, 8469 (Jan. 31, 2001).

[266] *See* 66 Fed. Reg. 8466, 8469 (Jan. 31, 2001).

[267] *See* 66 Fed. Reg. 8466, 8469 (Jan. 31, 2001).

[268] *See* 66 Fed. Reg. 8466, 8469 (Jan. 31, 2001). Real estate investment and development are not financial activities. *See* 66 Fed. Reg. 8466, 8469 (Jan. 31, 2001); 65 Fed. Reg. 16,460, 16,463 (Mar. 28, 2000) (interim rule).

- The assets are held by or promptly transferred to a portfolio company;
- The portfolio company maintains policies, books and records, accounts, and other indicia of corporate, partnership, or limited liability organization and operation that are separate from the FHC and limit the legal liability of the FHC for obligations of the portfolio company; and
- The portfolio company has management that is separate from the FHC to the extent required by the restriction on routine management or operation of the portfolio company.[269]

[d] No Routine Management or Operation

The statute provides that an FHC may not "routinely manage or operate" any company acquired under the insurance company portfolio investments authority power except as may be necessary or required to obtain a reasonable return on investment.[270] This restriction does not prevent an FHC from controlling up to 100% of the board of directors or similar governing body of a portfolio company as long as the portfolio company employs officers and employees responsible for routinely managing and operating the company, and the board does not participate in routine management or operation of the company.[271]

Although the Federal Reserve Board has not promulgated any rules for insurance company portfolio investments similar to the rules implementing the merchant banking power, the Federal Reserve Board is likely to follow the same rules in determining whether an FHC is deemed to be engaged in the routine management or operation of a portfolio company held under the insurance company portfolio investment power and when and to what extent it may be temporarily involved in routinely managing or operating a portfolio company.[272]

[e] Minority Investments and Veto Rights

The restriction on routine management applies to both majority and minority investments. Its chief impact on minority investments is to limit the negative covenants, or "veto" rights, that an FHC may have over certain corporate actions. Such negative covenants must be limited to matters that are not in the ordinary

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[269] *See* 12 C.F.R. § 225.170(e).

[270] 12 U.S.C.A. § 1843(k)(4)(I)(iv).

[271] *See* 12 C.F.R. § 225.171(d)(1).

[272] *See* § 11:4[7][d].

course of business—that is, matters that customarily require board or shareholder action. The negative covenants may not extend to matters that constitute routine management or operations. The Federal Reserve Board has issued an interpretive letter with a list of examples of matters over which negative covenants are permissible, consistent with the restriction on routine management and operations.[273] Although this letter was issued in the context of merchant banking investments, the Federal Reserve Board is likely to apply the same guidelines to negative covenants obtained in connection with minority investments made pursuant to the insurance company portfolio investment power.

[f] After-the-Fact Notice Requirements

As with merchant banking investments, an FHC is required to provide the Federal Reserve Board with notice within 30 days after consummating any insurance company portfolio investment in which the FHC directly or indirectly acquires more than 5% of the shares, assets, or other ownership interests of a portfolio company if the aggregate acquisition cost of such investment exceeds the lesser of 5% of the FHC's Tier 1 capital and $200 million.[274] It is also required to provide any notice that the Federal Reserve Board otherwise deems to be necessary in the exercise of its supervisory authority.[275] Otherwise, an FHC is generally not required to obtain prior approval for, or otherwise provide before- or after-the-fact notice of, any insurance company portfolio investment except as described in Section 11:5[2]. If an after-the-fact notice is required, the notice is provided on Federal Reserve Board Form FR Y-10.

[g] Risk Management, Record-Keeping, and Reporting

As with FHCs that make merchant banking investments, an FHC that makes insurance company portfolio investments must establish and maintain policies, procedures, records, and systems reasonably designed to conduct, monitor, and manage such investments and the risks associated with such investments in a safe and sound manner in accordance with the Supervisory Guid-

[273] 12 C.F.R. § 225.171(d)(2). *See* Letter from J. Virgil Mattingly, General Counsel of the Federal Reserve Board, to Peter T. Grauer, Credit Suisse First Boston (Dec. 21, 2001), which sets forth examples of negative covenants that an FHC may enter into with a portfolio company without being deemed to be engaged in the routine management or operation of the portfolio company.

[274] 12 C.F.R. § 225.87(b)(4)(ii).

[275] 12 C.F.R. § 225.87(b)(4)(iii).

ance on Equity Investment and Merchant Banking Activities (the Guidance Letter).[276] The Guidance Letter describes in detail the internal controls and risk management policies, procedures, and systems that the Federal Reserve Board expects bank holding companies engaged in equity investment activities to have and to maintain in order to conduct such activities in a safe and sound manner. The Guidance Letter notes that foreign banks should incorporate the basic principles set forth in the Guidance Letter into their U.S. operations with appropriate adaptation to reflect the fact that those operations are an integral part of a foreign bank, which should be managing its risks on a consolidated basis and that the bank is subject to overall supervision by its home-country authorities.[277]

[h] Enhanced Capital Requirements

Domestic FHCs are subject to the Federal Reserve Board's enhanced capital requirements for insurance company portfolio investments, as described in Section 11:4[7][j].[278] Although these enhanced capital requirements do not apply to FBOs, which are subject to home-country capital requirements, they may be imposed on U.S. IHCs to the extent that insurance company portfolio investments are held under the IHC, if the Federal Reserve Board's Proposed FBO Rule is finalized as proposed.

[i] Cross-Marketing Restrictions

As with merchant banking investments, the BHC Act imposes cross-marketing restrictions on any U.S. depository institution controlled by an FHC with respect to the FHC's insurance company portfolio investments.[279] The Federal Reserve Board has extended these restrictions to the U.S. branches and agencies of foreign banks.[280]

As implemented by the Federal Reserve Board, these cross-marketing restrictions prohibit any U.S. depository institution controlled by an FHC, any of the depository institution's subsid-

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[276] SR Letter No. 00-9 (SPE) (June 22, 2000).

[277] SR Letter No. 00-9 (SPE), Attachment, at 3 (June 22, 2000). For a summary of the guidelines contained in the Guidance Letter, *see* § 11:4[7][i].

[278] 12 C.F.R. Pt. 225, App. A, § II.B.5.

[279] 12 U.S.C.A. § 1843(n)(5)(A).

[280] 12 C.F.R. § 225.177(b) (definition of depository institution includes the U.S. branches and agencies of a foreign bank for purposes of the merchant banking power).

iaries with certain exceptions,[281] and any U.S. branch or agency of a foreign bank from:

- offering or marketing, directly or through any arrangement, any product or service of any company if more than 5% of the company's voting shares, assets, or other ownership interests are owned or controlled by the FHC under Section 4(k)(4)(I) of the BHC Act; or
- allowing any product or service of the depository institution, including any product or service of a subsidiary of the depository institution, to be offered or marketed, directly or through any arrangement, by or through any company if more than 5% of the company's voting shares, assets, or other ownership interests are owned or controlled by the FHC under Section 4(k)(4)(I) of the BHC Act.[282]

These cross-marketing restrictions apply to both a company engaged in insurance company portfolio investments and the portfolio companies of such a company held under Section 4(h)(4)(I).[283]

The cross-marketing restrictions do not apply to any arrangement with a company owned or controlled under insurance company portfolio investment power for the marketing of products or services through statement inserts or Internet Web sites if the arrangement does not violate the anti-tying rule applicable to banking products and services,[284] and the Federal Reserve Board determines that the arrangement is in the public interest, does not undermine the separation of banking and commerce, and is consistent with the safety and soundness of depository institutions.[285]

The cross-marketing restrictions do not apply to the marketing of products and services by a U.S. depository institution, its subsidiaries, or the U.S. branch or agency of a foreign bank—such as deposits, loans, and advisory services—to an affiliate or its portfolio companies so long as the insurance company portfolio investments affiliate or its portfolio companies do not market

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[281] 12 C.F.R. § 225.176(a)(1), (2) (for example, financial subsidiaries of national banks are excluded from the covered subsidiaries).

[282] 12 C.F.R. § 225.176(a)(1).

[283] *See* 12 U.S.C.A. § 1843(n)(5).

[284] *See* 12 U.S.C.A. § 1972.

[285] 12 U.S.C.A. § 1843(n)(5)(B).

those products or services to their customers or others;[286] nor do the cross-marketing restrictions apply to the purchasing of products or services—such as data processing—by a U.S. depository institution, its subsidiaries, or the U.S. branch or agency of a foreign bank from an insurance company portfolio investments affiliate or its portfolio companies, provided that the institution does not, directly or indirectly or through arrangements, market the insurance company portfolio investments affiliate's or portfolio company's products or services to the institution's customers or others. Likewise, the cross-marketing restrictions do not prohibit a U.S. depository institution, its subsidiary, or the U.S. branch or agency of a foreign bank from engaging in cross-marketing activities with a company that is a co-investor with the FHC in an insurance company portfolio investments affiliate or portfolio company so long as those activities do not involve products or services of the insurance company portfolio investments affiliate or portfolio company.[287]

[9] Commodities

[a] Generally

The BHC Act generally treats trading in commodity derivatives contracts as a financial activity. It therefore grants FHCs authority to trade in a broad range of forward contracts, options, futures, options on futures, swaps, and similar contracts, whether exchange-traded or over-the-counter, based on any rate, price, financial asset, nonfinancial asset, or group of assets, subject to certain conditions.[288] Similarly, the Office of the Comptroller of the Currency (the OCC) generally treats commodity derivatives trading as a permissible banking activity for national banks.[289] This means that FBOs have considerable scope to engage in such commodity derivatives trading as a permissible banking activity through their U.S. branches or agencies (or the U.S. branches or agencies of their subsidiary foreign banks) or as a financial activity through their non-U.S. offices or nonbank affiliates,[290] subject to the swaps pushout provision of the Dodd-Frank Act when that

[286] *See* 66 Fed. Reg. 8466, 8481 (Dec. 31, 2001).

[287] *See* 66 Fed. Reg. 8466, 8481 and n.28.

[288] 12 C.F.R. § 225.28(b)(8)(ii).

[289] OCC Interpretive Letter No. 1040 (Sept. 15, 2005); OCC Interpretive Letter No. 1025 (Apr. 6, 2005); OCC Interpretive Letter No. 962 (Apr. 21, 2003).

[290] *See* 12 C.F.R. § 225.28(b)(8)(ii).

provision becomes effective.[291]

Although trading in commodity derivative contracts is a permissible financial activity for FHCs, trading in the underlying physical commodities or engaging in certain other commodity-related activities is not considered to be financial in nature or incidental to a financial activity. The Federal Reserve Board has determined in a series of orders, however, that certain commodity trading activities, energy management services, and energy tolling arrangements are complementary to the financial activity of trading in commodity derivatives.

In an order issued to Citigroup in 2003, the Federal Reserve Board determined that taking and making physical delivery of, or storing, oil, natural gas, agricultural products, and other nonfinancial commodities were complementary to the financial activity of trading in commodity derivatives.[292] The Federal Reserve Board gave several reasons why such commodity trading activities were complementary to commodity derivatives trading. First, they flowed from permissible existing financial activities, allowing FHCs to take an otherwise permissible commodity derivatives contract to physical settlement rather than terminating, assigning, offsetting, or otherwise cash-settling the contract. Second, they would make FHCs more competitive with non-FHCs, which are not subject to any limitations on taking or making physical delivery of commodity contracts. Third, they would allow FHCs to provide a full range of commodity-related services to their customers more efficiently. Fourth, by enabling FHCs to gain experience in the markets for physical commodities, they would improve the FHCs' understanding of the commodity derivatives market.[293]

In order to limit the potential safety and soundness risks of Citigroup's commodity-trading activities, and to ensure that the proposed activities would produce public benefits that outweighed any potential adverse effects, the Federal Reserve Board imposed a number of conditions on Citigroup's exercise of commodity trading activities, including the following:[294]

- *Market Value Limit*. The market value of any commodities

[291] *See* § 11:9.

[292] Citigroup, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 89 Fed. Res. Bull. 508 (2003).

[293] *See* Citigroup, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 89 Fed. Res. Bull. 508 (2003).

[294] *See* Citigroup, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 89 Fed. Res. Bull. 508 (2003).

acquired and held by Citigroup must not exceed 5% of its consolidated Tier 1 capital;

- *Reporting Requirement*. Citigroup must notify the Federal Reserve Bank of New York if the market value of commodities held by it as a result of the commodity trading activities were to exceed 4% of its Tier 1 capital;
- *Related Contract Approval Requirement*. Citigroup may take and make physical delivery only of physical commodities for which derivative contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission (the CFTC) unless specifically excluded or approved by the Federal Reserve Board;
- *Limits to Control Nonfinancial Risks*. To minimize nonfinancial risks, such as storage risk, transportation risk, and legal and environmental risk, Citigroup would not be authorized to: (i) own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities; or (ii) process, refine, or otherwise alter commodities; instead, Citigroup would be expected to use storage and transportation facilities owned and operated by third parties; and
- *Compliance with Laws*. Citigroup would be expected to conduct its commodity trading activities in compliance with the general securities, commodities, and energy laws.

The Federal Reserve Board has subsequently granted permission to engage in commodity trading activities to other FHCs, including foreign banks, subject to essentially the same conditions set forth above.[295] In the case of a foreign bank, the Federal Reserve Board has made it clear that Tier 1 capital means the Tier 1 capital of the entire foreign bank as calculated under home-country capital standards.[296]

The Federal Reserve Board has subsequently expanded the range of commodities activities that are considered complementary to commodity derivatives transactions to include (i) energy management services for owners of power generation facilities[297]

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[295] *See, e.g.*, UBS AG, 90 Fed. Res. Bull. 215 (2004); Barclays Bank PLC, 90 Fed. Res. Bull. 511 (2004); Deutsche Bank AG, 92 Fed. Res. Bull. C54 (2006); JPMorgan Chase & Co., 92 Fed. Res. Bull. C57 (2006); Société Générale, 92 Fed. Res. Bull. C113 (2006).

[296] *See, e.g.*, UBS AG, 90 Fed. Res. Bull. 215, 216 (2004).

[297] *See, e.g.*, Fortis S.A./N.V., 94 Fed. Res. Bull. C20 (2008).

and (ii) physically settled energy tolling arrangements.[298] It has also determined that commodity trading activities include entering into long-term electricity supply contracts with large industrial and commercial customers.[299]

The Federal Reserve Board has also relaxed certain of the conditions imposed on commodity trading activities. In particular, it has relaxed the requirement that trading in commodities be limited to commodities for which derivative contracts have been approved for trading on a U.S. futures exchange by the CFTC. Instead, it has permitted trading in nickel because although contracts for nickel have not been approved for trading on a U.S. futures exchange by the CFTC, contracts for nickel are widely and actively traded on the London Metal Exchange, a major non-U.S. exchange that the CFTC has determined to be subject to a regulatory structure comparable to that administered by the CFTC. The Federal Reserve Board has also permitted trading in certain natural gas liquids, oil products, and petrochemicals even though contracts for those commodities have not been approved for trading on a U.S. futures exchange or on a major non-U.S. exchange because such commodities are (i) fungible and (ii) traded in a sufficiently liquid market through brokers on alternative trading platforms.[300]

The Federal Reserve Board has also relaxed the condition that commodities being traded not be physically altered. The Federal Reserve Board has permitted an FHC to engage third parties to refine, blend, or otherwise alter commodities for which it is permitted to take and make physical delivery provided that both the commodity input and the resulting altered commodity are permissible commodities under the Federal Reserve Board's decisions, and the FHC will not have exclusive rights to use the alteration facility.[301]

[298]The Royal Bank of Scotland Group plc, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 94 Fed. Res. Bull. C60, C66 (2008). An energy tolling agreement is an agreement to pay the owner of a power plant a fixed periodic payment that compensates the owner for its fixed and fuel costs in exchange for the right to all or part of the plant's power output. The plant owner retains control over the day-to-day operations of the plant and physical plant assets.

[299]The Royal Bank of Scotland Group plc, 94 Fed. Res. Bull. C60, C61–62 (2008).

[300]The Royal Bank of Scotland Group plc, 94 Fed. Res. Bull. C60, C62–63 (2008).

[301]The Royal Bank of Scotland Group plc, 94 Fed. Res. Bull. C60, C64 (2008).

[b] Grandfathered Commodities Activities

The BHC Act also includes a grandfathering provision that authorizes any company, including an FBO, that becomes an FHC after November 12, 1999, to continue to engage in activities related to the trading, sale, or investment in commodities and commodities-related facilities if the following conditions are satisfied:

- The company was *not* a BHC or *foreign bank* as of November 12, 1999;
- The company "lawfully was engaged, directly or indirectly, in any of such activities as of September 30, 1997, in the United States";
- The aggregate consolidated assets of the company attributable to commodities or commodities-related activities that are not otherwise permitted to be held by an FHC must not at any time exceed 5% of the company's total consolidated assets or such higher percentage that the Federal Reserve Board may permit; and
- The company does not permit:
  - any company, the shares of which it owns or controls pursuant to the commodities grandfathering provision of the BHC Act, to offer or market any product or service of an affiliated U.S. depository institution; or
  - any affiliated U.S. depository institution to offer or market any product or service of any company, the shares of which area owned or controlled by it pursuant to the commodities grandfathering provision of the BHC Act.

[10] Hedge Funds

An FHC is permitted to make controlling and noncontrolling investments in any hedge fund provided that the hedge fund is exclusively engaged in activities that are financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act. Investments in and certain relationships with hedge funds, however, are subject to the restrictions of the Volcker Rule, subject to its conformance period.[302]

If an investment in a hedge fund is a controlling investment, the FHC will be deemed to control the portfolio investments of the hedge fund, and the FHC will need a separate source of authority to control such portfolio investments. If the hedge fund's portfolio investments are limited to noncontrolling investments

[302] *See* § 11:8.

in less than 5% of any class of voting securities of its portfolio companies, which can be the case with certain traditional hedge funds that limit their investments to long and short positions in small percentages of large publicly traded companies, the FHC may be able to rely on Section 4(c)(6) of the BHC Act as the authority for holding the hedge fund's portfolio investments. In computing its compliance with the 5% limit of Section 4(c)(6), the FHC will need to aggregate all of its direct and indirect investments in the voting securities of each portfolio company, including investments held through the controlled hedge fund.

An FHC may also rely on the merchant banking power as a source of authority for holding any portfolio companies of a controlled hedge fund, but if it does so, it must assure itself by contractual arrangement or otherwise that the hedge fund will comply with the conditions of the merchant banking power, including the restrictions on routine management or operation of the portfolio companies and the maximum holding period.[303] This may be a serious issue if the FHC is deemed to control the hedge fund under the Federal Reserve Board's control rules but does not have actual control over the management or policies of the hedge fund.[304] If the hedge fund is organized as a corporation with unlimited life, instead of as a partnership or other entity with a maximum life of 15 years, it will not be able to satisfy the conditions for being a qualified private equity fund, so the maximum holding period for its portfolio investments will be 10 years rather than 15 years.

If an FHC is unable to assure itself that a hedge fund will comply with the conditions of the merchant banking power, it may still invest in the hedge fund under Section 4(k)(1) if the hedge fund is engaged exclusively in activities permitted by Section 4 of the BHC Act, but it will need to structure the investment as a noncontrolling investment in order to avoid having the hedge fund's portfolio investments attributed to it.

If a hedge fund is not exclusively engaged in activities that are permissible under Section 4 of the BHC Act, an FHC may nevertheless invest in it under, but subject to the conditions of, the merchant banking power or the insurance company portfolio

[303] Any such investment must also be made in compliance with the Volcker Rule.

[304] For a discussion of the Federal Reserve Board's control rules, *see* §§ 7:1 et seq.

investment power.[305] These conditions include the maximum holding period and the restrictions on routinely managing or operating the hedge fund.

[11] Real Estate

As noted in Section 11:4[2], in 2001, the Federal Reserve Board and the Secretary of the Treasury jointly proposed that real estate brokerage and real estate management be treated as incidental to a financial activity.[306] Although the agencies have not formally withdrawn their joint proposal, they have effectively abandoned it in the face of substantial public opposition to the proposal mainly from a host of independent real estate brokers.

Although real estate investment, development, brokerage, and management have not been determined to be financial in nature, incidental to a financial activity, complementary to a financial activity, or otherwise permitted by Section 4 of the BHC Act, a QFBO that is an FHC may (i) underwrite, deal, and make markets in securities of companies engaged in such activities, (ii) make controlling and noncontrolling investments in them pursuant to, and subject to the conditions and limitations of, the merchant banking and insurance company portfolio investment powers or the QFBO exemptions, or (iii) make noncontrolling investments in them pursuant to Section 4(c)(6) or (7) of the BHC Act.

The most important restriction on using the merchant banking or insurance company portfolio investment powers to make such investments is the restriction on using these powers to make investments in real estate assets as opposed to companies holding such assets. Under the merchant banking regulations, which apply directly to investments made under the merchant banking power and by analogy to investments made under the insurance company portfolio investment power, an FHC may not make investments in real estate assets unless the following conditions are satisfied:

- The assets are held by or promptly transferred to a portfolio company;
- The portfolio company maintains policies, books and records, accounts, and other indicia of corporate, partnership, or limited liability organization and operation that are separate from the FHC and limit the legal liability of the FHC for obligations of the portfolio company; and

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[305] Any such investment must also be made in compliance with the Volcker Rule.

[306] *See* 66 Fed. Reg. 307 (Jan. 3, 2001).

- The portfolio company has management that is separate from the FHC to the extent required by the restriction on routine management or operation of the portfolio company.[307]

To the extent that real estate investments are made through a private equity fund or hedge fund as defined by the Volcker Rule, an FHC's power to make such investments is subject to the Volcker Rule, including its conformance period.[308]

§ 11:5 Streamlined notice and approval procedures

If an FBO becomes an FHC, not only does it become eligible to exercise an expanded range of nonbanking powers, but it also enjoys streamlined procedures for commencing nonbanking activities and making nonbanking investments except for certain large transactions.

[1] General Rule: No Prior Application or Notice

Except as described in Section 11:5[2], FHCs generally are not subject to the prior approval requirements in Section 4 of the BHC Act that otherwise apply to the direct or indirect nonbanking activities of FBOs that control a U.S. bank or otherwise have a U.S. commercial banking presence so long as the nonbanking activities are financial in nature or incidental to a financial activity.[309] Thus, an FHC generally is not required to file an application for prior approval by the Federal Reserve Board or give prior notice to the Federal Reserve Board to (i) engage in, or make a controlling or noncontrolling investment in a company that is exclusively or substantially engaged in, financial activities or activities that are incidental to financial activities; or (ii) acquire a controlling or noncontrolling interest in a company pursuant to the FHC's securities underwriting, dealing, and market making; merchant banking; or insurance company portfolio

[307] *See* 12 C.F.R. § 225.170(e).

[308] *See* § 11:8.

[Section 11:5]

[309] *Compare* 12 C.F.R. § 225.24(a) (prior notice and approval requirements generally applicable to nonbanking activities and investments by FBOs that control a U.S. bank or otherwise have a U.S. commercial banking presence, including activities determined to be closely related to banking under Section 4(c)(8) of the BHC Act) *with* 12 C.F.R. § 225.85(a)(2) and (3) (no prior notice or approvals required for an FHC to engage in, or acquire control of any company exclusively or, subject to certain conditions, substantially engaged in, any activity that is financial in nature or incidental to a financial activity, including any activities determined to be closely related to banking under Section 4(c)(8) of the BHC Act).

investment powers.[310]

[2] Exceptions to the No Prior Application or Notice Requirement

There are seven exceptions to the general rule, described in Section 11:5[1], that no prior approval or notice is required for an FHC to commence nonbanking activities or make nonbanking investments under Section 4 of the BHC Act:

- **Complementary Activities**. An FHC must obtain prior approval from the Federal Reserve Board before commencing, or acquiring 5% or more of any class of voting securities of any company engaged in, any activities that are complementary to a financial activity[311] except for any company substantially engaged in financial activities or activities incidental to a financial activity; or pursuant to the FHC's power to engage in securities underwriting, dealing, or market making; or to make merchant banking or insurance company portfolio investments.[312]
- **Savings Association or Savings and Loan Holding Companies**. An FHC must obtain Federal Reserve Board approval prior to acquiring control of more than 5% of the shares of any class of voting securities of a savings association or a savings and loan holding company.[313]
- **Supervisory Discretion**. The Federal Reserve Board, in the exercise of its supervisory authority, may require an FHC to provide notice to or obtain approval from the Federal Reserve Board prior to engaging in any activity or acquiring shares or control of any company engaged in a financial or nonfinancial activity.[314]
- **New Closely Related to Banking Activities**. An FHC must give prior notice before engaging in activities on the basis of Section 4(c) of the BHC Act that have not been determined to be financial in nature or incidental to a

[310] 12 U.S.C.A. § 1843(k)(6)(B); 12 C.F.R. § 225.85(a)(1).

[311] *See* 12 C.F.R. § 225.89(a).

[312] 12 U.S.C.A. § 1843(k)(4)(B), (E), (H), (I); 12 C.F.R. §§ 225.85(a)(1), (3), 225.86(c).

[313] 12 U.S.C.A. § 1843(k)(6); 12 C.F.R. § 225.85(c)(1). Federal Reserve Board approval must be obtained in accordance with Section 4(j) of the BHC Act, 12 U.S.C.A. § 1843(j).

[314] 12 C.F.R. § 225.85(c)(2). The Federal Reserve Board may impose such a requirement in accordance with its authority pursuant to 12 C.F.R. § 225.82(g) (residual supervisory authority over FHCs) or 12 C.F.R. § 225.83(d) (limitations during period of noncompliance with FHC conditions).

financial activity if Section 4(c) of the BHC Act or Regulation Y requires such prior notice.[315]

- **Acquisitions of Voting Shares in Certain Large Nonbanking Companies by Systemically Important FHCs**. Section 163 of the Dodd-Frank Act requires systemically important FHCs ($50 billion or more in total consolidated assets) to provide prior notice to the Federal Reserve Board before acquiring control of any voting shares of any nonbanking company that is engaged in activities that are financial in nature, incidental to a financial activity, or complementary to a financial activity and that has $10 billion or more of consolidated assets. In approving such an activity, the Federal Reserve Board must consider whether the acquisition would result in greater or more concentrated risks to global or U.S. financial stability or the U.S. economy.[316]
  - There is an exception from this prior notice requirement for acquisitions of shares under Section 4(c) including investments in less than 5% of the voting shares of a company or pursuant to the FHC's underwriting, dealing, and market-making powers under Section 4(k)(4)(E) of the BHC Act.
- **Acquisitions of Large Nonbanking Companies**. Section 604 of the Dodd-Frank Act amended the BHC Act, effective July 21, 2011, to require all FHCs to provide prior notice to the Federal Reserve Board before acquiring any nonbanking company engaged in activities pursuant to Section 4(k)(4) of the BHC Act or any implementing regulations in a transaction in which the total consolidated assets to be acquired by the FHC exceed $10 billion.[317]
  - There is no express exception from this prior notice requirement. However, it appears to be limited to acquisitions of control of a covered company. If so, then investments in less than 5% of the voting shares of any

[315] *See, e.g.*, 12 U.S.C.A. § 1843(c)(13), (14); 87 Fed. Res. Bull. 683 (2001). In addition, an FBO that controls a U.S. bank or otherwise has a U.S. commercial banking presence, whether or not it is an FHC, must receive prior approval from the Federal Reserve Board under Section 3 of the BHC Act before acquiring 5% or more of the shares of any class of voting securities of a BHC (including an FBO that controls a U.S. bank) or a U.S. bank. 12 U.S.C.A. § 1842(a)(3); 12 C.F.R. § 225.11(c)(1), (f).

[316] Dodd-Frank Act, Pub. L. No. 111-203, § 163(b)(1) to (2) (2010) (to be codified at 12 U.S.C.A. § 5363(b)(1) to (2)).

[317] 12 U.S.C.A. § 1843(k)(6)(B), *amended by* Dodd-Frank Act, Pub. L. No. 111-203, § 604(e), 124 Stat. 1376, 1601 to 1602 (2010).

> company and any other noncontrolling investment in the company would be exempt from this prior notice requirement.

In addition, Section 622 of the Dodd-Frank Act imposes a flat prohibition on any FHC merging with or acquiring another company if the transaction would result in the FHC controlling more than 10% of all consolidated financial liabilities in the United States. There is an exception from this prohibition for the acquisition of any bank "in default or in danger of default" in and FDIC-assisted transaction if the acquisition "would result only in a *de minimis* increase" in the FHC's liabilities, and the FHC received prior, written consent from the Federal Reserve Board.[318]

[3] Post-transaction Notices

An FHC is generally required to notify the appropriate Federal Reserve Bank in writing within 30 calendar days after (i) commencing any financial activity or an activity that is incidental to a financial activity or (ii) consummating the acquisition of a controlling interest in a company that is engaged in any financial activities or any activities incidental to financial activities.[319] Once an FHC has given notice that it is engaged in a particular activity, it is not required to give any further notice if it commences the same activity *de novo* in any subsidiary.[320]

Similarly, once an FHC has given notice that it has commenced exercising securities underwriting, dealing, or market making; merchant banking; or insurance company portfolio investment powers, it is not required to give any further notice when it acquires an interest in a company pursuant to the exercise of those powers, with one exception.[321] An FHC is required to give after-the-fact notice within 30 days after consummating any merchant banking or insurance company portfolio investment in which the FHC directly or indirectly acquires more than 5% of the shares, assets, or other ownership interests of a portfolio company if the aggregate acquisition cost of such investment

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[318] Dodd-Frank Act, Pub. L. No. 111-203, § 622(b) to (c) (2010) (to be codified at 12 U.S.C.A. § 1852(b) to (c)). The FSOC conducted a study on how to effectively implement § 622 and made recommendations in the Federal Register on February 8, 2011. *See* 76 Fed. Reg. 6,756 (Feb. 8, 2011). The Federal Reserve Board was supposed to implement rules nine months after completion of the FSOC's study, 76 Fed. Reg. at 6,757, but as of December 15, 2012, had not done so.

[319] 12 C.F.R. § 225.87(a), (b)(1).

[320] 12 C.F.R. § 225.87(b)(2).

[321] 12 C.F.R. § 225.87(b)(3).

exceeds the lesser of 5% of the FHC's Tier 1 capital and $200 million.[322] It is also required to provide notice for any merchant banking or insurance company portfolio investment if the Federal Reserve Board otherwise deems it to be necessary in the exercise of its supervisory authority.[323]

If an FHC acquires a controlling interest in, for instance, a broker-dealer, a company engaged in making merchant banking investments, or an insurance company, a post-transaction notice is necessary. Even if the FHC has previously notified the Federal Reserve Board that it has commenced securities underwriting, dealing, and market making activities; merchant banking activities; or insurance activities, the FHC is still required to give a posttransaction notice in connection with a new acquisition (as opposed to *de novo* commencement) of a broker-dealer, a company engaged in merchant banking activities, or an insurance company.

[4] Hart-Scott-Rodino Act

If an FHC makes an acquisition of a company engaged in financial activities or makes an acquisition in exercise of its financial activities investment authority (*i.e.*, the merchant banking investment authority or the insurance company portfolio investment authority) of a company engaged in nonfinancial activities, it may be necessary to file a premerger notification under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act).[324]

The HSR Act is a procedural statute intended to give the U.S. antitrust enforcement authorities advance notice of certain mergers and acquisitions so that the enforcement authorities may detect and prevent transactions that may violate the U.S. antitrust laws before they are consummated. The HSR Act prohibits acquisitions of substantial amounts of voting securities and assets unless (1) a premerger notification is filed with both the Federal Trade Commission (FTC) and the Assistant Attorney General in charge of the Antitrust Division of the Department of Justice (DOJ) and (2) a waiting period subsequent to those filings has expired.

The HSR Act provides that no premerger notification is necessary for any transactions that require approval of the Federal

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[322] 12 C.F.R. § 225.87(b)(4)(i), (ii).

[323] 12 C.F.R. § 225.87(b)(4)(iii).

[324] 15 U.S.C.A. § 18a.

Reserve Board under Section 3 or Section 4 of the BHC Act.[325] However, a premerger notification under the HSR Act would be required in connection with most acquisitions under Section 4(k) of the BHC Act, including any portion of a transaction that is governed by Section 4(k), since those acquisitions (or portions of transactions) would not require prior Federal Reserve Board approval but only posttransaction notice.[326] In addition, Sections 163 and 604(e) of the Dodd-Frank Act expressly require premerger notifications under the HSR Act for transactions that require prior notice pursuant to those provisions.[327]

For instance, if the acquired company is a U.S. bank or BHC engaged, directly or indirectly, in (i) banking, (ii) financial activities under Section 4(k) of the BHC Act, and (iii) complementary activities, the acquiror would be required to file both a notice with the Federal Reserve Board (for the portion of the transaction relating to the complementary activities and the acquisition of the bank) and an HSR Act premerger notification with the FTC and the DOJ (for the portion of the transaction that involves financial activities subject to Section 4(k) of the BHC Act.)[328] As stated in Section 11:5[1], and subject to the exemption stated in Section 11:5[2], financial activities subject to Section 4(k) of the BHC Act do not require prior notice to or approval by the Federal Reserve Board, and hence, the acquisition of a company engaged

[325] 15 U.S.C.A. § 18a(c)(7), (8). For example, the acquisition of 5% or more of any U.S. bank or thrift, or any bank or thrift-holding company, by an FBO that controls a U.S. bank or otherwise has a U.S. commercial banking presence, regardless of whether it is an FHC, would require prior Federal Reserve Board approval and therefore be exempt from the premerger notification requirement of the HSR Act.

[326] 15 U.S.C.A. § 18a(c)(7), (8).

[327] 12 U.S.C.A. § 1843(k)(6)(B), *amended by* Dodd-Frank Act, Pub. L. No. 111-203, § 604(e) (2010); Dodd-Frank Act, Pub. L. No. 111-203, § 163(b)(5) (2010) (to be codified at 12 U.S.C.A. § 1563(b)(5)).

[328] *See* 15 U.S.C.A. § 18a(c)(7), (8). In order to avoid an HSR Act premerger notification in connection with the acquisition of a BHC that has subsidiaries engaged in financial activities, some practitioners file a prior notice under Section 4(j) of the BHC Act, 12 U.S.C.A. § 1843(j), for such financial activities that fall within the limitations of § 4(c)(8) of the BHC Act, 12 U.S.C.A. § 1843 (c)(8), 12 C.F.R. § 225.28. The Federal Reserve Board accepts this approach. *See* Royal Bank of Canada, Rock Merger Subsidiary, Inc. (Centura Banks, Inc.), 87 Fed. Res. Bull. 467 (2001) (Royal Bank, an FHC, filed an application under Section 3 of the BHC Act, 12 U.S.C.A. § 1842, to acquire Centura Bank, Inc. and under Sections 4(c)(8) and (j) of the BHC Act, 12 U.S.C.A. § 1843(c)(8) and (j), to acquire the nonbanking subsidiaries of Centura and thereby engage in extending credit and servicing loans. The Federal Reserve Board considered the competitive effect of the proposed acquisition of the nonbanking subsidiaries of Centura.).

in financial activities requires notification under the HSR Act. By contrast, complementary activities are subject to Section 4(k) of the BHC Act but require prior Federal Reserve Board approval under Section 4(j) of the BHC Act; therefore, a notification under the HSR Act is not required.

§ 11:6 Potential adverse consequences

The main consequences of becoming an FHC are the advantages of expanded nonbanking powers and streamlined procedures for exercising nonbanking powers. There are no apparent adverse regulatory consequences associated with becoming an FHC (*i.e.*, no change in applicable supervisors, no perceptible change in the level of supervision for any member of the FBO's group, no decrease in powers, no increased procedural burden for banking or nonbanking acquisitions or activities, no increased reporting requirements) except for the following:

[1] Additional Costs

One potential adverse consequence of becoming an FHC is the additional cost of making an FHC election and ensuring that the FBO continues to satisfy the well-capitalized and well-managed conditions of maintaining FHC status.

[2] New Quarterly Reports

Another potential adverse consequence is that foreign banks that are FBOs or controlled by FBOs are required to provide consolidated regulatory capital information to the Federal Reserve Board on a quarterly basis, instead of only annually, in order to show their continued compliance with the well-capitalized condition. Such information is provided on Form FR Y-7Q.

[3] New Self-Reporting Obligations

An FBO that becomes an FHC is required to notify the Federal Reserve Board promptly if it (in the case of an FBO that is a foreign bank with a U.S. commercial banking presence) or any foreign bank with a U.S. commercial banking presence or any U.S. depository institution controlled by it fails to satisfy the well-capitalized or well-managed conditions. Failure to comply with this new self-reporting obligation can result in an enforcement action or civil or criminal penalties.

[4] Potential Loss of FHC Powers

An FBO that becomes an FHC will be exposed to the adverse impact of losing its FHC status, and its ability to exercise the related expanded powers in the United States, if it ever fails to satisfy the well-capitalized or well-managed conditions and is un-

able to cure those deficiencies during a specified cure period. As discussed more fully in Section 11:7[1], an FHC generally has 180 days to cure any deficiencies (subject to extensions for good cause) before its FHC status may be revoked. The cost and reputational harm to the FBO of having to contract its U.S. operations so that they are permissible for a non-FHC after it has invested time and money in exercising any of the expanded powers could be significant.

[5] Limit Certain Options

In addition, the potential loss of the FBO's FHC status may deter it from making certain otherwise attractive investments. For example, suppose an FBO was interested in making a strategic minority investment in a foreign bank with a U.S. commercial banking presence or with a plan to establish a U.S. commercial banking presence. Under such circumstances, the FBO would risk losing its FHC status if the foreign bank were not well capitalized or well managed unless the FBO could structure the investment as a noncontrolling one for BHC Act purposes or cause the target bank to become well capitalized and well managed. However, because of the Federal Reserve Board's very low standard for what constitutes control,[329] the FBO might be deemed to control the foreign bank for purposes of the BHC Act without having the actual control to cause the target bank to become well capitalized or well managed. Thus, the FBO might be forced to choose between the otherwise attractive investment and preserving its FHC status.

[6] Sections 23A and 23B of the Federal Reserve Act

Sections 23A and 23B of the FRA insulate U.S. insured depository institutions from the risks of their nonbanking affiliates by imposing quantitative limits, collateral requirements and market terms requirements on certain transactions between insured depository institutions and most of their nonbanking affiliates.[330] In general, Sections 23A and 23B do not apply to the U.S. branches or agencies of foreign banks.

If a foreign bank or any company controlling a foreign bank elects to become an FHC, however, Sections 23A and 23B will apply as a matter of "competitive equality" to any "covered transaction" between the U.S. branches, agencies, and commercial lending company subsidiaries of the foreign bank, as if they were

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[Section 11:6]

[329] *See* §§ 7:1 et seq.

[330] 12 U.S.C.A. §§ 371c, 371c-1; 12 C.F.R. Pt. 223.

respectively members of the Federal Reserve System (member banks), and any of its affiliates that is also:

- engaged in insurance underwriting pursuant to Section 4(k)(4)(B) of the BHC Act;
- engaged in securities underwriting, dealing, or market making pursuant to Section 4(k)(4)(E) of the BHC Act;
- engaged in merchant banking activities pursuant to Section 4(k)(4)(H) of the BHC Act (but only to the extent that the proceeds of the transaction are used for the purpose of funding the affiliate's merchant banking activities);
- engaged in insurance company portfolio investments pursuant to Section 4(k)(4)(I) of the BHC Act;
- engaged in any other activity designated by the Federal Reserve Board;
- a portfolio company controlled by the foreign bank or an affiliate of the foreign bank or a company that would be an affiliate of the U.S. branch, agency, or commercial lending company subsidiary of the foreign bank if such branch, agency, or commercial lending company subsidiary were a member bank; or
- any subsidiary of any of the foregoing.[331]

Sections 23A and 23B of the FRA impose specific quantitative, qualitative, collateral, and arm's-length terms requirements on loans, other extensions of credit, asset purchases and other "covered transactions" that expose a member bank to the credit risks of its affiliates. In general, the term "affiliate" is defined for purposes of Sections 23A and 23B as any company that controls or is under common control with the member bank (or foreign bank, where applicable), as well as any company controlled by the member bank that is itself a bank or a "financial subsidiary" of the member bank.[332] A company is generally deemed to have "control" over another company if the company (i) owns, controls, or has the power to vote 25% or more of any class of voting securities of the other company; (ii) controls in any manner the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of the other company; or (iii) exercises a controlling influence over the management or policies of the other company.[333] Covered transactions with depository institutions that control, are controlled by, or are under common control with, a member bank (in each instance, assum-

[331] 12 C.F.R. §§ 223.61, 225.176(b)(6).

[332] *See* 12 C.F.R. § 223.2.

[333] *See* §§ 7:1 et seq.

ing control of 80% or more of voting securities) are generally exempt from quantitative limits and collateral requirements.

Prior to the effectiveness of the Dodd-Frank amendments to Section 23A, covered transactions included: (1) any loan or extension of credit to an affiliate; (2) any purchase of, or investment in, securities issued by an affiliate; (3) any purchases of assets, including assets subject to an agreement to repurchase from an affiliate, unless specifically exempted by the Federal Reserve Board; (4) any transaction in which the covered BHC accepts securities issued by an affiliate as collateral for a loan or extension of credit to any entity; and (5) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.[334]

The Dodd-Frank Act amended Section 23A of the FRA, effective July 21, 2012, in a number of ways, including:

- Expanding the scope of "covered transactions" to include credit exposure on derivatives transactions, credit exposure resulting from securities borrowing and lending transactions, and credit exposure arising from the acceptance of affiliate-issued debt obligations (other than securities) as collateral for a loan or extension of credit.
- Requiring that collateral requirements be satisfied on a continuous basis rather than only at the time that the transaction is entered into and in instances that collateral is retired or amortized as currently permitted.
- Expanding the range of covered transactions subject to the collateral requirement to include the new covered transactions described above, as well as credit exposure on repurchase agreements.
- Providing that debt obligations issued by an affiliate will no longer be eligible to satisfy the Section 23A collateral requirements.[335]
- Expanding the definition of "affiliate" to include any "investment fund" for which a member bank or its affiliate is an investment adviser.

There is also a rebuttable presumption that an FHC controls a portfolio company held under the merchant banking or insurance company portfolio investment powers for purposes of Sections 23A and 23B of the FRA if the FHC owns or controls, directly or indirectly, 15% or more of the equity capital of the portfolio

[334] 12 U.S.C.A. § 371c(b)(7).

[335] Dodd-Frank Act, Pub. L. No. 111-203, § 608 (2010) (*amending* 12 U.S.C.A. § 371c).

company.[336] Thus, unless the presumption is rebutted, any such portfolio company will be treated as an affiliate of the FHC, and any U.S. insured depository institution or U.S. branch, agency, or commercial lending company subsidiary of any foreign bank that is, or is controlled by, the FHC for purposes of Sections 23A and 23B of the FRA.

This presumption of control will be deemed rebutted if any of the following is true:

- No director, officer, or employee of the FHC serves as a director, trustee, or general partner (or individual exercising similar functions) of the portfolio company;
- A person that is not affiliated or associated with the FHC owns or controls a greater percentage of the equity capital of the portfolio company than is owned or controlled by the FHC, and no more than one officer or employee of the FHC serves as a director or trustee (or individual exercising similar functions) of the portfolio company; or
- A person that is not affiliated or associated with the holding company owns or controls more than 50% of the voting shares of the portfolio company, and officers and employees of the FHC do not constitute a majority of the directors or trustees (or individuals exercising similar functions) of the portfolio company.[337]

In addition, FHCs may seek to rebut the presumption of control by submitting evidence to the Federal Reserve Board.[338]

[7] Loss of Grandfathered Securities Affiliates

If a foreign bank or other foreign company covered by Section 8(a) of the IBA[339] is engaged in grandfathered activities under Section 8(c) of the IBA[340] and those activities are financial activi-

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[336] 12 U.S.C.A. § 371c(b)(11); 12 C.F.R. § 223.2(a)(9).

[337] 12 C.F.R. §§ 223.2(a)(9)(iii), 225.176(b)(3). In each of these situations, the FHC is assumed to own more than 15% of the total equity of the portfolio company (thereby triggering the statutory presumption) and less than 25% of any class of voting securities of the portfolio company (as such, not meeting the statutory definition of control). *See* 66 Fed. Reg. 8466, 8481 (Jan. 31, 2001).

[338] 12 U.S.C.A. § 371c(b)(11) ("unless the company or shareholder provides information acceptable to the Federal Reserve to rebut this presumption of control"); 12 C.F.R. §§ 223.2(a)(9)(ii), 225.176(b)(2).

[339] 12 U.S.C.A. § 3106(a).

[340] 12 U.S.C.A. § 3106(c). A foreign bank that, prior to the enactment of the IBA in 1978, was engaged in activities that were permitted at that time but

ties or complementary activities,[341] it will lose such grandfather rights upon filing an election to be an FHC.[342] For example, a foreign bank with a grandfathered securities underwriting subsidiary that elects to be an FHC is no longer permitted to rely on the grandfather authority under Section 8(c) of the IBA but must rely on Section 4(k)(4)(E) of the BHC Act for the securities underwriting activities of its subsidiary.[343]

§ 11:7 Failure to maintain FHC conditions

[1] 4(m) Letter

If the Federal Reserve Board finds that an FBO that elected to be treated as an FHC fails to satisfy the well-capitalized or well-managed conditions, Section 4(m) of the BHC Act requires the Federal Reserve Board to send the FHC a written notice (a 4(m) letter) to the effect that the FHC is no longer in compliance with one or both of these conditions.[344] Within 45 days after the receipt of a 4(m) letter, the FHC must enter into an agreement with the Federal Reserve Board (a cure agreement) setting forth the specific actions that the FHC will take to bring itself back into compliance with the well-capitalized and well-managed conditions and the schedule for achieving that objective.[345] The FHC will have 180 days to bring itself back into compliance, subject to extensions for one or more additional 180-day periods for good cause (the cure period).[346] The 4(m) letter and cure agreement will be treated by the Federal Reserve Board as confidential

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prohibited after the enactment of the IBA was, under § 8(c) of the IBA, allowed to continue these activities (grandfathered activities).

[341] 12 U.S.C.A. § 3106(c)(3)(A) refers to "any activity that the [Federal Reserve Board] has determined to be permissible for [FHCs]" under Section 4(k) of the BHC Act, 12 U.S.C.A. § 1843(k).

[342] 12 U.S.C.A. § 3106(c)(3)(A). *See* 12 U.S.C.A. § 1843(*l*)(1)(C) (filing of declaration of election). Although the IBA provides that the foreign bank or other foreign company covered by Section 8(a) of the IBA, 12 U.S.C.A. § 3106(a), loses its grandfather rights upon filing a declaration to be an FHC, the meaning probably is that there must have been an effective election to be an FHC.

[343] 12 U.S.C.A. § 1843(k)(4)(E).

[Section 11:7]

[344] 12 U.S.C.A. § 1843(m)(1); 12 C.F.R. § 225.93(a). Section 4(m)(1) of the BHC Act requires such Federal Reserve Board notice only with respect to FHCs that are engaged, directly or indirectly, in any activity under Section 4(k), (n), or (o) of the BHC Act other than activities that are permissible for a BHC under Section 4(c)(8) of the BHC Act.

[345] 12 U.S.C.A. § 1843(m)(2); 12 C.F.R. § 225.93(c).

[346] 12 U.S.C.A. § 1843(m)(4).

supervisory information that will not be disclosed to the public unless the FHC believes that it is obligated to do so under the securities laws because the receipt of the 4(m) letter and any related restrictions on its U.S. activities and investments is material to investors under the particular circumstances of the situation.

This situation may arise in the context of an acquisition of a U.S. insured depository institution. For example, if a foreign FHC acquires a U.S. bank in troubled condition (i.e., with a composite CAMELS rating of 4 or 5 or subject to a cease and desist order or written agreement to improve the financial condition of the bank), with the intention of recapitalizing it and operating it as a stand-alone bank subsidiary, for as long as the bank remains in troubled condition, the foreign FHC will generally not satisfy the requirement for each of its institutions to be well-capitalized and well-managed.[347]

[2] Restrictions During Cure Period

During the cure period, the FBO and its affiliates may not commence any additional activity in the United States or acquire control or shares of any company under Section 4(k) of the BHC Act without the prior approval of the Federal Reserve Board, unless the Federal Reserve Board provides otherwise,[348] and will be subject to any other limitations or conditions on the conduct of their U.S. activities as the Federal Reserve Board finds appropriate and consistent with the purposes of the BHC Act.[349]

[3] Failure to Correct

If the FBO fails to correct the condition within 180 days after receipt of the 4(m) letter from the Federal Reserve Board, or such longer period as the Federal Reserve Board may permit, the FHC will have to choose between terminating any activities that are permissible only for an FHC or divesting any U.S. depository institution affiliate and any other U.S. commercial banking presence.[350] To date, the Federal Reserve Board has not ordered any FBO to choose between its FHC powers and its U.S. commercial banking presence for failing to comply with the well-

[347] *See, e.g.*, 12 C.F.R. § 6.4(b)(1)(iv) (OCC definition of "well-capitalized" excludes bank subject to any written agreement, order or capital directive to meet and maintain a specific capital level for any capital measure.); 12 C.F.R. § 325.103(b)(1)(iv) (FDIC definition of "well capitalized").

[348] 12 C.F.R. § 225.93(d)(2).

[349] 12 C.F.R. § 225.93(d)(1).

[350] 12 U.S.C.A. § 1843(m)(4); 12 C.F.R. § 225.93(e).

capitalized and well-managed requirements.

[4] CRA Maintenance Requirement

Section 4(m) does not apply to a situation in which a U.S. insured depository institution or insured U.S. branch of a foreign bank that is, or is controlled by, an FBO receives a rating of less than "satisfactory" at its most recent CRA examination. Instead, the FHC simply may not (a) commence any new activity under Section 4(k) of the BHC Act or (b) directly or indirectly acquire control of any company engaged in any activity under Section 4(k) of the BHC Act.[351]

However, new investments made in the ordinary course of engaging in the merchant banking authority or in the ordinary course of the insurance company portfolio investment authority are not prohibited if the FHC, directly or indirectly, was already engaged in such activities prior to the time that an insured depository institution controlled by the FHC or an insured branch received a CRA rating below "satisfactory."[352] Thus, an FHC or an existing merchant banking or insurance subsidiary of an FHC may continue to make investments under the merchant banking authority and the insurance company portfolio investment authority if it was engaged in such financial activities prior to the less-than-satisfactory rating.[353] Similarly, a securities subsidiary of such an FHC may continue to underwrite, deal, and make a market in securities.

The prohibition that applies in case of a failure to maintain a satisfactory CRA rating does not prevent an FHC from commencing any additional activity or acquiring control of a company engaged in any activity under Section 4(c) of the BHC Act[354] if the FHC complies with the applicable notice, approval, and other requirements.[355]

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[351] 12 U.S.C.A. § 1843(*l*)(2); 12 C.F.R. §§ 225.84(a)(1), 225.94. The Federal Reserve Board reads the language to apply only when an insured depository institution receives a less-than-satisfactory CRA rating while it is under the control of the FHC. It does not apply immediately after an FHC has acquired a poorly rated depository institution. If the depository institution does not achieve at least a satisfactory CRA rating at its first CRA examination following the acquisition, the prohibitions apply to the FHC. *See* 66 Fed. Reg. 400, 404 (Jan. 3, 2001).

[352] *See* 12 U.S.C.A. § 1843(*l*)(2)(B); 12 C.F.R. §§ 225.84(b), 225.94.

[353] 12 U.S.C.A. § 1843(*l*)(2)(B).

[354] 12 U.S.C.A. § 1843(c).

[355] 12 C.F.R. § 225.84(b)(2).

§ 11:8 Volcker Rule

[1] General

Section 619 of the Dodd-Frank Act, popularly known as the "Volcker Rule,"[356] amends the BHC Act[357] to prohibit any "banking entity"[358] from engaging in proprietary trading or sponsoring or investing in a "hedge fund" or "private equity fund,"[359] subject to certain exceptions for permitted activities and a conformance period.[360] The Volcker Rule's prohibitions and other restrictions will affect the U.S. activities of FBOs that engage in the prohibited or restricted activities as well as certain of their non-U.S. activities. The statutory text of the Volcker Rule became effective on July 21, 2012, although final implementing regulations have yet to be issued.

On January 18, 2011, the FSOC, whose members include the heads of the same agencies tasked with implementation of the Volcker Rule, released the results of a statutorily mandated study on the implementation of the Volcker Rule (the FSOC Study).[361] Although the statute required the agencies responsible for implementing the Volcker Rule[362] to issue final regulations within nine months of the FSOC Study's release or by October 18, 2011,

[Section 11:8]

[356]Former Federal Reserve Board Chairman Paul Volcker, although not formally involved in the Dodd-Frank Act legislative process, was among the leading advocates for imposing restrictions on proprietary trading and private funds activities by banks and their affiliates in the Act.

[357]The Volcker Rule adds a new Section 13 to the BHC Act. Dodd-Frank Act, Pub. L. No. 111-203, § 619 (2010) (to be codified at 12 U.S.C.A. § 1851).

[358]The statute defines "banking entity" as "any insured depository institution (as defined in Section 3 of the FDI Act (12 U.S.C.A. [§] 1813)), any company that controls an insured depository institution, or that is treated as a BHC for purposes of Section 8 of the IBA, and any affiliate or subsidiary of any such entity," not including certain institutions that function solely in a trust or fiduciary capacity, under certain conditions. 12 U.S.C.A. § 1851(h)(1). Under Section 8 of the IBA, a foreign bank with a U.S. commercial banking presence, and any company deemed to control such a foreign bank, is treated as a BHC. 12 U.S.C.A. § 3106(a).

[359]For a definition of these terms, *see* § 11:8[3].

[360]12 U.S.C.A. § 1851(a).

[361]Fin. Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (Jan. 18, 2011) (FSOC Study), *available at* http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[362]Although the Federal Reserve Board generally has exclusive authority to implement the BHC Act, of which the Volcker Rule is one part, the statute

the agencies proposed substantially identical implementing regulations in November 2011 (in the case of the Federal Reserve Board, the FDIC, the OCC and the SEC) and January 2012 (in the case of the CFTC). The Federal Reserve Board issued final conformance rules, for which it alone was responsible under the statute, in February 2011.[363] The Federal Reserve Board also issued guidance regarding the initial two-year conformance period in April 2012.[364] What is currently known about the Volcker Rule's restrictions on proprietary trading and sponsorship of and investment in hedge funds and private equity funds, and the potential impact of these prohibitions on FBOs, is therefore based on the statutory text of the Volcker Rule, the FSOC Study, the proposed implementing regulations, the Federal Reserve Board's conformance period guidance, and other banking law provisions, regulations, and Federal Reserve Board interpretations with which the prohibitions may interact. The following discussion summarizes the key terms of the Volcker Rule as set forth in the statutory text, but generally does not attempt to summarize the proposed regulations, which have been the subject of extensive comment by the industry and other stakeholders, and which may change substantially in the final rulemaking.

Before describing how the statutory text of the Volcker Rule will limit certain of the otherwise permissible expanded powers of an FHC, it is useful to describe what it does not affect. The statute does not affect an FHC's authority to make investments pursuant to the merchant banking authority, insurance company portfolio investment authority, or other investment powers contained in the BHC Act, unless the investments are made through a "hedge fund" or "private equity fund" as those terms are currently defined by the statute and will, in the future, be further clarified in the regulations. In particular, merchant banking investments made directly by a BHC or through a subsidiary or affiliate that is not a hedge fund or private equity fund are not

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provides that the Volcker Rule will be implemented in a coordinated rulemaking process by the Federal Reserve Board, the OCC, the FDIC, the SEC, and the CFTC. 12 U.S.C.A. § 1851(b)(2)(B).

[363] 12 C.F.R. Pt. 225, subpt. K. *See* Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265, 8265 to 8278 (Feb. 14, 2011). For a discussion of the conformance rules, *see* § 11:8[7].

[364] Press Release, Board of Governors of the Federal Reserve System (Apr. 19, 2012), http://www.federalreserve.gov/newsevents/press/bcreg/20120419a.htm. This guidance was published in the Federal Register on June 8, 2012. *See* 77 Fed. Reg. 33,949.

subject to the limitations of the Volcker Rule.[365] The Volcker Rule also permits an FHC and its affiliates to continue to engage in the "permitted activities" of underwriting, hedging and market making, subject to certain statutory conditions which are expected to be further clarified in the regulations.

[2] Prohibition on Proprietary Trading

The final contours of the prohibition on proprietary trading are not yet known because the rulemaking process is not yet complete.

The statutory text of the Volcker Rule contains a basic definition of proprietary trading[366] that was further developed in the proposed regulations. Under the proposed regulations, "proprietary trading" is defined very broadly to encompass "stand-alone" or "walled off" proprietary trading operations that existed within many U.S. banking entities prior to passage of the Dodd-Frank Act, as well as any principal trading for a "trading account."[367] Certain activities are excluded from the definition of "trading account," and the final regulatory definitions of these activities will be crucial in determining the actual scope and impact of the proprietary trading prohibition. Permitted activity exemptions include:

- trading in U.S. government, agency, state, municipal, and government-sponsored enterprise instruments;[368]
- trading "in connection with underwriting or market-making-related activities";

[365] For further discussion, *see* § 11:4[10].

[366] "The term 'proprietary trading' . . . means engaging as a principal for the trading account of the banking entity . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the [SEC], and the [CFTC] may, by rule . . . determine." 12 U.S.C.A. § 1851(h)(4).

[367] "Trading account" is defined in the statute as "any account used for acquiring or taking positions in the securities and instruments described in [the definition of 'proprietary trading'] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate Federal banking agencies, the [SEC], and the [CFTC] may, by rule . . . determine." 12 U.S.C.A. § 1851(h)(6). The proposed regulations expand the scope of "trading account."

[368] 12 U.S.C.A. § 1851(d)(1)(A). The permitted activity does not extend to similar instruments issued by foreign governments.

- "[r]isk-mitigating hedging activities";[369]
- trading "on behalf of customers";[370]
- investments in certain small business investment companies, public welfare investments, or qualified rehabilitation expenditures;[371]
- trading by a regulated insurance company or its affiliate solely for the general account of the regulated insurance company in compliance with applicable insurance company investment laws;[372]
- such other activity as the agencies determine "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States";[373] and
- as discussed in Section 11:8[5], certain offshore trading activities by non-U.S. entities.[374]

Permitted activities may not include, however, any activity that would "involve or result in a material conflict of interest . . . between the banking entity and its clients, customers, or counterparties"; "result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies"; or pose a threat to U.S. financial stability or the safety and soundness of the banking entity.[375] In addition, the agencies may impose additional capital requirements and quantitative limitations, including diversification requirements, if deemed appropriate to protect the safety and soundness of banking entities engaged in activities excepted from the proprietary trading prohibition.[376] The Volcker Rule also contains a general anti-evasion provision.[377]

Compliance with the Volcker Rule's prohibition on proprietary trading will require that banking entities institute new compliance policies and procedures, reporting protocols, internal controls and record-keeping practices.

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[369] 12 U.S.C.A. § 1851(d)(1)(C).

[370] 12 U.S.C.A. § 1851(d)(1)(D).

[371] 12 U.S.C.A. § 1851(d)(1)(E).

[372] 12 U.S.C.A. § 1851(d)(1)(F).

[373] 12 U.S.C.A. § 1851(d)(1)(J).

[374] 12 U.S.C.A. § 1851(d)(1)(H).

[375] 12 U.S.C.A. § 1851(d)(2)(A).

[376] 12 U.S.C.A. § 1851(d)(3).

[377] 12 U.S.C.A. § 1851(e)(2).

[3] Prohibition on Certain Relationships with Hedge Funds and Private Equity Funds

The Volcker Rule also prohibits a banking entity from "sponsor-[ing]" or "acquir[ing] or retain[ing] any equity, partnership or other ownership interest" in any "hedge fund" or "private equity fund," subject to certain exceptions and a conformance period.

The term "sponsor"[378] is defined in the statutory text as:

- "[T]o serve as a general partner, managing member, or trustee" of a hedge fund or private equity fund;
- "[I]n any manner to select or control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees or management" of a hedge fund or private equity fund; or
- "[T]o share with a [hedge fund or private equity] fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name."

The terms "hedge fund" and "private equity fund" are both defined in the statutory text as any issuer that would be an investment company, as defined in the 1940 Act "but for" Section 3(c)(1) or (7) of that Act, or "such similar funds" as the agencies may affirmatively designate by rule.[379] This definition is very broad. The exemptions under Sections 3(c)(1) and (7) of the 1940 Act can be used to exempt any entity from the definition of "investment company" regardless of how it invests or what it invests in, so long as certain limits on the number or financial characteristics of its investors are satisfied. These exemptions are therefore frequently relied upon by entities that have none of the attributes of traditional hedge funds or private equity funds.[380] The overbreadth of the statutory definition was not corrected in the proposed regulations, which in fact expanded the scope of entities captured.

Subject to the same limitations on permitted activities described in the discussion of proprietary trading above, and any

[378] 12 U.S.C.A. § 1851(h)(5). The proposed regulations expand the scope of this definition.

[379] 12 U.S.C.A. § 1851(h)(2); Investment Company Act of 1940 § 3(c)(1), (7), 15 U.S.C.A. § 80a-3.

[380] Certain legislators appear to have recognized this. Rep. Frank (D-MA) and Rep. Himes (D-CT) sought in a colloquy in the legislative record to clarify that the Volcker Rule is intended to prohibit investments in "traditional" hedge funds and private equity funds and not "subsidiaries or joint ventures that are used to hold other investments." 156 Cong. Rec. H5226 (daily ed. June 30, 2010).

additional restrictions or limitations that the agencies determine to impose, the Volcker Rule excludes from the ban on sponsoring or investing in hedge funds or private equity funds all of the permitted activities listed above under proprietary trading other than those that clearly relate solely to proprietary trading.

The Volcker Rule also establishes an asset management exemption that permits a banking entity to "organiz[e] and offer[]" a hedge fund or private equity fund, including to sponsor and make *de minimis* coinvestments in such a fund, if all of the following conditions are met:

- "[T]he banking entity provides *bona fide* trust, fiduciary, or investment advisory services";
- "[T]he fund is organized and offered only in connection with the provision of [such services] and only to persons that are customers of such services of the banking entity";
- "[T]he banking entity does not acquire or retain an equity interest, partnership interest, or other ownership interest in the fund[]"[381] except for certain *de minimis* coinvestments, which must meet the following conditions:
    - Although the banking entity may make an initial seed investment in up to 100% of the total ownership interests of a fund, the banking entity must "actively seek unaffiliated investors to reduce or dilute" its investment to not more than 3% of the total ownership interests of the fund within one year after the fund's establishment (with the possibility of a two-year extension); and
    - The investment must be "immaterial to the banking entity" but in no case may the aggregate of all of the banking entity's permitted *de minimis* investments in hedge funds or private equity funds exceed 3% of the Tier 1 capital of the banking entity;[382]
- The banking entity complies with the "Super 23A" and 23B restrictions on transactions with such funds, as described in Section 11:8[4];
- "[T]he banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or

[381] 12 U.S.C.A. § 1851(d)(1)(G).

[382] 12 U.S.C.A. § 1851(d)(4). Note that the Volcker Rule prohibits any acquisition by a banking entity of an ownership interest in a hedge fund or private equity fund except pursuant to a permitted activity, such as in connection with the asset management exemption or the exemption for certain risk-mitigating hedging activities.

performance" of the fund (*e.g.*, bail out the fund) or of any fund in which such fund invests;

- The banking entity does not share with the fund "for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name";
- "[N]o director or employee of the banking entity takes or retains an equity interest, partnership interest, or other ownership interest" in the fund "except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services" to the fund; and
- "[T]he banking entity discloses to prospective and actual investors in the fund, in writing, that any losses in [the] fund are borne solely by investors in the fund and not by the banking entity, and otherwise complies with any additional rules" that the agencies may issue that are designed to ensure that such losses are so borne.[383]

[4] Limitations on Certain Transactions with Sponsored, Advised, Managed, or Organized and Offered Hedge Funds and Private Equity Funds

The Volcker Rule prohibits any banking entity that serves, directly or indirectly, as the investment manager or investment adviser of a hedge fund or private equity fund, or that organizes and offers or sponsors such a fund pursuant to the asset management exemption, and any affiliate of such banking entity, from entering into a "covered transaction" as defined in Section 23A of the FRA with any such fund, or any hedge fund or private equity fund controlled by such fund, as if the banking entity or an affiliate, other than the fund, were a member bank and the fund were its affiliate.[384] In addition, any transactions between any such banking entity and any such fund will be subject to Section 23B of the FRA as if the banking entity were a member bank, and the fund were its affiliate.[385]

This prohibition is commonly referred to as "Super 23A" to distinguish it from regular Section 23A of the FRA. Unlike Super

[383] 12 U.S.C.A. § 1851(d)(1)(G). The proposed regulations hew closely to the terms of the exemption as set forth in the statutory text.

[384] *See* § 11:6[6]. The proposed regulations expanded the scope of relationships that trigger Super 23A.

[385] Section 23B requires that many transactions, including any "covered transaction" under Section 23A, between a bank and an affiliate be conducted on market terms. 12 U.S.C.A. § 371c-1(a). For more information on 23B, *see* § 11:6[6].

23A, regular 23A only applies to covered transactions between an insured depository institution and its affiliates, whereas Super 23A applies to covered transactions between any banking entity (including a BHC, an FBO, and any of their subsidiaries or affiliates) and any sponsored or advised covered fund. In addition, Super 23A imposes an absolute ban on any covered transactions that fall within its scope, whereas regular 23A generally imposes only certain numerical limitations and collateral requirements on covered transactions within its scope.[386]

The Volcker Rule provides that the Federal Reserve Board may grant an exemption from the Super 23A prohibition for purposes of permitting a banking entity to enter into any "prime brokerage transaction," which is undefined in the statutory text but presumably will be defined by regulation, with any hedge fund or private equity fund *in which* a hedge fund or private equity fund sponsored or advised by such banking entity[387] has taken an equity, partnership, or other ownership interest if:

- The banking entity is in compliance with each of the conditions set forth in the asset management exemption described above;
- The CEO or equivalent officer of the banking entity certifies in writing annually that the antibailout condition of the asset management exemption is satisfied; and
- The Federal Reserve Board has determined that such transaction is consistent with the safe and sound operation and condition of the banking entity.[388]

[5] Application to FBOs and Extraterritorial Application

Although the Volcker Rule's prohibitions and restrictions will clearly impact the U.S. proprietary trading and private funds activities of FBOs, in the absence of final implementing regulations, it is difficult to predict to what degree the Volcker Rule's prohibitions and restrictions will affect such activities engaged in by FBOs outside the United States.

The statutory text of the Volcker Rule specifically permits FBOs

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[386]For a detailed discussion of regular Section 23A, *see* § 6:2.

[387]Presumably, the omission of "organized and offered" in the 23B provision, in light of its inclusion in the Super 23A provision, is a drafting oversight.

[388]12 U.S.C.A. § 1851(f)(3).

to engage in proprietary trading "pursuant to" Section 4(c)(9)[389] or (13)[390] of the BHC Act, *provided* that the trading occurs "solely outside" the United States.[391] Likewise, the statutory text specifically permits sponsorship of and investments in hedge funds and private equity funds conducted by a banking entity pursuant to the Section 4(c)(9) or (13) exemptions "solely outside" the United States *provided* that "no ownership interest in such hedge fund or private equity fund is offered for sale or sold" to a U.S. resident.[392] In both cases, the banking entity also must not be "directly or indirectly controlled" by a banking entity organized under U.S. federal or state law.[393]

The proposed regulations defined "solely outside" the United States fairly narrowly. The extraterritorial impact of the Volcker Rule must be read in light of a variety of sources, including the U.S. Supreme Court's decision in Morrison v. National Australia Bank Ltd.,[394] the principles of national treatment, competitive equality and comparable home-country standards, Sections 2(h)(2) and 4(c)(9) of the BHC Act, and the express exemptions for offshore activities in the Volcker Rule itself. It is not clear whether the agencies will ultimately interpret the offshore activities exemptions merely to be consistent with the general presumption against extraterritorial application in *Morrison* or whether the agencies will interpret them as providing the sort of "clearly expressed" "affirmative intention" of extraterritorial application required by *Morrison*, subject only to the specific exemption for proprietary trading that occurs "solely outside" the United States and for sponsoring or investing "solely outside" the United States in hedge funds or private equity funds that are not offered to U.S. residents. The former interpretation seems more consis-

[389] 12 U.S.C.A. § 1843(c)(9); *see* §§ 10:1 et seq. for a full discussion of this provision.

[390] 12 U.S.C.A. § 1843(c)(13); *see* §§ 10:1 et seq. for a full discussion of this provision.

[391] 12 U.S.C.A. § 1851(d)(1)(H).

[392] 12 U.S.C.A. § 1851(d)(1)(I).

[393] 12 U.S.C.A. § 1851(d)(1)(H) to (I).

[394] In Morrison, the U.S. Supreme Court overruled decades of lower court case law by holding that federal legislation is presumed to apply only within the territory of the United States unless the legislation "clearly express[s]" an "affirmative intention" by Congress that it have extraterritorial application. 130 S. Ct. 2869, 2877 (2010).

tent with certain statements in the legislative record,[395] but in any event, FBOs will face the potentially significant compliance burden of ensuring that any permitted activities remain outside the extraterritorial reach of the Volcker Rule.

[6] Additional Limitations

The agencies may also impose additional capital requirements and quantitative limitations if deemed necessary to protect the safety and soundness of banking entities engaged in such activities.

[7] Conformance Period

The Volcker Rule provides for a two-year general conformance period, beginning on July 21, 2012, during which banking entities in existence as of July 21, 2010 must bring their activities and investments into compliance with the Volcker Rule's prohibitions and restrictions.[396] Banking entities may apply to the Federal Reserve Board for up to three one-year extensions of the conformance period and for one up to five-year extension for certain investments in illiquid funds.[397] The Federal Reserve Board issued final rules implementing the conformance period provisions of the Volcker Rule in February 2011.[398] The final rule release makes clear that the conformance period applies to all

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[395] *See* Statement by Sen. Hagan, 156 Cong. Rec. S5889-90 (daily ed. July 15, 2010) ("Finally, [the offshore exemption for funds activity] permits certain banking entities to operate hedge and private equity funds outside of the United States provided that no ownership interest in any hedge or private equity fund is offered for sale or sold to a U.S. resident. For consistency's sake, I would expect that, apart from the U.S. marketing restrictions, these provisions will be applied by the regulators in conformity with and incorporating the Federal Reserve Board's current precedents, rulings, positions, and practices under Sections 4(c)(9) and 4(c)(13) of the BHC Act so as to provide greater certainty and utilize the established legal framework for funds operated by bank holding companies outside of the United States."); Colloquy Between Sens. Merkley and Levin, 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (the exemption seeks "to maintain a level playing field by prohibiting a foreign bank from improperly offering its hedge fund and private equity funds services to U.S. persons when such offering could not be made in the United States").

[396] 12 U.S.C.A. § 1851(c)(2); 12 C.F.R. § 225.181(a). Companies that become banking entities after July 21, 2010, will be entitled to a conformance period equal to the longer of the two-year general conformance period and two years after the date on which they became banking entities, plus extensions. 12 C.F.R. § 225.181(a)(2) to (3).

[397] 12 C.F.R. § 225.181(a)(3), (b).

[398] 12 C.F.R. Pt. 225, Subpt. K. *See* Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (Feb. 14, 2011).

covered activities, investments, and relationships, *e.g.*, proprietary trading, investments in hedge funds and private equity funds, and "covered transactions" with advised or sponsored funds.[399] Neither the release nor the rules makes any explicit distinction between U.S. and non-U.S. banking entities.[400] The Federal Reserve Board also released conformance period guidance in April 2012 confirming that banking entities would have until Ju1y 21, 2014, or such later date as the Federal Reserve Board may specify, to conform their activities, investments and relationships.

The rules and the release make clear that a banking entity must apply for each extension separately,[401] at least 180 days prior to the expiration of the relevant conformance period or already-granted extension period.[402] The Federal Reserve Board will consider applications for extensions in light of "all the facts and circumstances related to the activity, investment, or fund, including, to the extent relevant," certain criteria identified in the rules.[403] In addition, the Federal Reserve Board may impose conditions on extensions deemed "necessary or appropriate to protect the safety and soundness of the banking entity or the financial stability of the United States, address material conflicts of interest or other unsound banking practices, or otherwise further the purposes of [the Volcker Rule]."[404] Although the rules provide for the possibility of one up to five-year extended conformance period for investments in illiquid funds, as required by the statutory text, the rules define the scope of eligible investments quite narrowly.[405] A risk exists that banking entities will be required to unwind illiquid investments at steep discounts to fair value.[406] The Federal Reserve Board indicated in the final rule release that it "expects to review the final rule after completion of the interagency rulemaking process . . . to determine whether modifications or adjustments to the rule are appropriate in light

[399] 76 Fed. Reg. 8265, 8267.

[400] 76 Fed. Reg. 8265 at 8266 ("[T]he final rule does not address several topics suggested by commenters—such as, for example, the general application of the Volcker Rule to banking entities that are . . . foreign entities.").

[401] 76 Fed. Reg. 8265 at 8267.

[402] The application must address reasons why the extension should be granted and give a detailed explanation of the banking entity's plan for divestment or conformance. 12 C.F.R. § 225.181(c)(1) to (2).

[403] 12 C.F.R. § 225.181(d).

[404] 12 C.F.R. § 225.181(e).

[405] *See* 12 C.F.R. §§ 225.180(g) to (i), 225.181(b)(2) to (3).

[406] 12 C.F.R. § 225.181(e)(1).

of final rules adopted under that section."[407]

§ 11:9 Swaps Pushout Rule

When it becomes effective,[408] Section 716 of the Dodd-Frank Act (the Swaps Pushout Rule) will prohibit certain types of "Federal assistance" from being provided to swap dealers and major swap participants, referred to as "swaps entities."[409] Section 716 is called the Swaps Pushout Rule because it will require any swaps entity that receives federal assistance, including the U.S. branches, agencies, or insured depository institution subsidiaries of a foreign bank, to terminate or push any prohibited swaps activities into an affiliate to continue being eligible for federal assistance.

The term "federal assistance" is broadly defined as "the use of

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[407] 76 Fed. Reg. 8265, 8266.

[Section 11:9]

[408] The Swaps Pushout Rule will become effective on July 16, 2013. *See* OCC, Federal Reserve Board and FDIC, Guidance on the Effective Date of Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg. 27,456, (May 10, 2012). Insured depository institutions are eligible for up to an additional two-year transition period, plus the possibility of a discretionary one-year extension. There does not appear to be a similar transition period for uninsured branches and agencies of foreign banks. As of January 3, 2013, the OCC had issued guidance establishing the conditions and procedures for federally chartered insured depository institutions seeking additional transition periods for the conformance of their swaps activities to the Swaps Pushout Rule. Transition Period under Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 78 Fed. Reg. 1,306 (Jan. 8, 2013). The remaining federal banking regulators have indicated that they intend to issue similar proposals. *See* 77 Fed. Reg. at 27,457 n.13.

[409] For ease of presentation, the term "swap" will be used in this Chapter to refer to both "swaps" and "security-based swaps," the term "swap dealers" will be used in this Chapter to refer to both "swap dealers" and "security-based swap dealers," and the term "major swap participant" will be used in this Chapter to refer to both "major swap participants" and "major security-based swap participants." In general, a "swap dealer" is any person who: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) is commonly known as a dealer or market maker in swaps. However, an insured depository institution is not considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer. In general, a major swap participant is a person who is not a swap dealer and (i) who maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC and SEC, excluding positions held for hedging or mitigating commercial risk; or (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets.

any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under Section 13(3)(A) of the FRA or FDIC insurance or guarantees for the purpose of:

- making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;
- purchasing the assets of any swaps entity;
- guaranteeing any loan or debt issuance of any swaps entity; or
- entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity."

Although most U.S. branches and agencies of foreign banks are no longer eligible for FDIC deposit insurance, they do have access to a Federal Reserve Bank's discount window. The Swaps Pushout Rule will therefore require such branches and agencies to push any prohibited swaps activities into a separate affiliate that does not have access to the discount window as a condition for the U.S. branches and agencies to have continued access to the discount window. Pushing swaps activities into an affiliate involves a number of costs; for example, the "pushout affiliate" would need to be separately capitalized and funded, and trades with existing customers would need to be separately documented. If the Federal Reserve Board treats the U.S. and non-U.S. branches of foreign banks as separate entities for purposes of the Swaps Pushout Rule, as such branches have traditionally been treated for purposes of many other U.S. banking laws and doctrines,[410] foreign banks should also be able to comply with the Swaps Pushout Rule by moving any prohibited swaps activities into non-U.S. branches or to U.S. branches that do not have access to a Federal Reserve Bank's discount window.

A major flaw of the Swaps Pushout Rule is that many of its key provisions, including exemptions and grandfathering provisions, apply only to insured depository institutions and therefore by their terms do not apply to most branches and agencies of foreign banks that have access to a Federal Reserve Bank's discount window given that almost no branch or agency is an insured de-

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[410] *See* Cleary Gottlieb, Davis Polk, and Sullivan & Cromwell, White Paper on the Separate Entity Doctrine as Applied to the U.S. Branches of Foreign Headquartered (Non-U.S.) Banks (April 18, 2012).

pository institution or even eligible for FDIC deposit insurance.[411] The Swaps Pushout Rule includes an express exemption for insured depository institutions that limit their swaps dealing activities to the following activities:

- swaps that are used for hedging or similar risk mitigation directly related to the insured depository institution's activities; or
- swaps involving rates or reference assets that are permissible for investment by a national bank under the portion of the National Bank Act contained in 12 U.S.C.A. § 24 (Seventh), other than uncleared credit default swaps.[412]

In addition, the Swaps Pushout Rule provides that an insured depository institution is not considered to be a "swaps entity," and therefore is not required to push out its swaps activities, if it is merely a major swap participant and not a swap dealer. This means, for example, that an insured depository institution subsidiary of a foreign bank is permitted to maintain a substantial position in swaps whereas an uninsured branch or agency of the foreign bank that has access to a Federal Reserve Bank's discount window is prohibited from maintaining a substantial position in swaps, excluding positions held for hedging. Furthermore, such uninsured branch or agency may be required to push out swaps that were entered into prior to the effectiveness of the Swaps Pushout Rule into an affiliate. This is because the grandfathering provision in the Swaps Pushout Rule appears to apply only to insured depository institutions. As a result, to the extent that foreign banks use their branches and agencies that have access to a Federal Reserve Bank's discount window as swaps booking entities, existing swaps may need to be rebooked into a separate entity to preclude the foreign bank from being deemed a major

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[411] As of September 30, 2012, there were approximately 182 uninsured state and federally licensed branches of foreign banks; 46 uninsured state and federally licensed agencies of foreign banks; and 10 grandfathered insured state and federally licensed branches of foreign banks. *See* Federal Reserve, Structure and Share Data for U.S. Banking Offices of Foreign Entities (Sept. 2012), *available at* http://www.federalreserve.gov/releases/iba/201209/bytype.htm.

[412] The National Bank Act (NBA) permits national banks to invest in a wide range of assets, including loans; promissory notes; drafts; bills of exchange; other extensions of credit; foreign currency; coins; bullion, which includes gold, silver, and certain other precious metals; U.S. government and agency securities; certain investment shares in investment companies as long as the assets held by the investment companies are themselves bank permissible; and debt securities that are considered investment securities. In addition, the OCC has the power to interpret the NBA to allow other instruments to be permissible investments. The NBA expressly prohibits national banks from dealing in equity securities.

swap participant. This would require renegotiation and documentation of swaps agreements and capitalization of the new booking entity among other costs.

The omission of uninsured branches and agencies of foreign banks from the exemptions for insured depository institutions was clearly an oversight. Senator Blanche Lincoln, the sponsor of the Swaps Pushout Rule, issued a floor statement urging the regulators to extend the exemptions to the branches and agencies of foreign banks.[413] However, regulators have so far not done so. While many, including Senator Christopher Dodd,[414] believed that this oversight would be fixed through a technical amendment to the Dodd-Frank Act, to date, this has not occurred.

In February 2012, the House Financial Services Committee approved an amended version of a bill (H.R. 1838)[415] that would amend key aspects of the Swaps Pushout Rule, including by expressly extending the exemptions available to insured depository institutions to uninsured U.S. branches and agencies of non-U.S. banks. The bill would also significantly expand the types of swap activities that a U.S. depository institution would be permitted to engage in directly without having to push those activities out to an affiliate, and would limit the extraterritorial application of the Swaps Pushout Rule by providing that it will not apply to any activity conducted outside the United States with a non-U.S. counterparty by a non-U.S. swap dealer or major swap participant. To date, there has been no further action on this bill.

Thus, although the differential treatment of U.S. banks and the U.S. branches and agencies of foreign banks is widely viewed as a drafting error, the Swaps Pushout Rule may have the unintended consequence of requiring some foreign banks to reorganize their U.S. swaps activities to a greater extent than U.S. banks. At the same time, foreign banks may have an advantage with respect to their swaps activities outside of the United States, depending on whether U.S. regulators decide to extend the Swaps Pushout Rule to the foreign branches and agencies of U.S. banks. In addition, because no other jurisdiction has adopted a regulation comparable to the Swaps Pushout Rule, foreign banks will be able to continue to engage in swap dealing activities from what is typically the most well-capitalized entity

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[413] Statement of Senator Blanche Lincoln, 156 Cong. Rec. S5904 (daily ed. July 15, 2010).

[414] Statement of Senator Christopher Dodd, 111 Cong. Rec. S 5903 to 5904 (2010).

[415] H.R. 1838, 112th Cong. (2012).

in the corporate structure—the bank itself.

§ 11:10 Conclusion

In sum, an FBO may become an FHC if it satisfies the well-capitalized and well-managed conditions and if it has or controls a U.S. insured depository institution or an insured U.S. branch, the CRA condition. If the FBO makes an effective election to become an FHC, the FBO is permitted to engage in an expanded range of activities, including insurance underwriting, securities underwriting and dealing, merchant banking, and insurance company portfolio investments, subject to the Volcker Rule and the Swaps Pushout Rule when that provision of the Dodd-Frank Act becomes effective. The main consequences of becoming an FHC are the advantages of these expanded powers and certain streamlined procedures for commencing such activities and acquiring new companies engaged in such activities. If an FBO fails to satisfy the well-capitalized and well-managed conditions and is unable to cure these deficiencies during a cure period of 180 days, plus such additional time as the Federal Reserve Board may allow, it can be forced to terminate its expanded activities or its U.S. commercial banking presence. To date, the Federal Reserve Board has not required any FBO to make this choice.