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Securities Holding Companies – Registration Rules Proposed by Federal Reserve

By Dwight Smith

This past Friday, the Federal Reserve Board (“FRB”) proposed a new Regulation OO for the registration of companies that control registered brokers or dealers as securities holding companies (“SHCs”).¹ Registration would not be required or necessary for companies that are already supervised on a consolidated basis by the FRB. The proposal itself is procedural, but it would require a detailed submission. The FRB projects that five companies are likely to register. FRB supervision of these companies will be comprehensive, and the enhanced prudential standards for systemically important financial institutions are likely to influence this supervision. Now would be the time for potential registrants to assess the impact of FRB oversight.

INSTITUTIONS COVERED

Section 618 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) establishes a new regime at the FRB for the supervision of SHCs.² The program is available only for those SHCs that are not nonbank financial companies that have been designated as systemically important by the Financial Stability Oversight Council, an insured bank or savings association or an affiliate of one, a foreign banking organization, a foreign bank that controls an Edge Act corporation, or any company subject to comprehensive consolidated regulation by a foreign supervisory.

Entry into the program technically is not automatic or required. Rather, it is available for SHCs that are required by a foreign regulator or a provision of foreign law to be subject to comprehensive consolidated supervision. Registration is the only realistic option in the event of such a requirement. The FRB anticipates that five companies will register for the SHC supervision program.

REGISTRATION PROCESS

The FRB will develop a new form, modeled on the current FR Y-3F for bank holding company registration. An SHC will file the form with the appropriate Federal Reserve Bank. On the 45th calendar day after the submission of the form, the registration will become effective. The preamble to the proposed rule sets forth nine pieces of information that the new form will require:

- An organization chart showing all subsidiaries.
- The name, asset size, general activities, place of incorporation, and ownership share held by the securities holding company for each of the SHC’s direct and indirect subsidiaries that comprise 1% or more of the SHC’s worldwide consolidated assets.

¹ See 76 Fed. Reg. 54717 (Sept. 2, 2011).

² See 12 U.S.C. § 1850a.

Client Alert.

- A list of all persons in the upstream chain of ownership of the SHC who, directly or indirectly, own 5% or more of the voting shares of the SHC. The form also would call for information on voting agreements or other mechanisms that exist among shareholders for the exercise of control over the SHC.
- For senior officers and directors with decision-making authority for the SHC, the biographical portion of the Interagency Biographical and Financial Report. The preamble is explicit that the financial portion would not be required.
- Copies of the most recent quarterly and annual reports prepared for shareholders, if any, for the SHC and certain subsidiaries.
- Income statement, balance sheets, and audited GAAP statements and any other financial statements submitted to the SHC's current consolidated supervisor, if any. The statement would be on both a consolidated and a parent-only basis, showing separately each principal source of revenue and expense, through the end of the most recent fiscal quarter and the past two fiscal years.
- A description of the methods used by the SHC to monitor and control its operations, including those of its domestic and foreign subsidiaries and offices (e.g., through internal reports and internal audits).
- A description of the bank regulatory system that exists in the home country of any of the SHC's foreign bank subsidiaries. This description would be detailed, including information on (i) the scope and frequency of on-site examinations, (ii) off-site monitoring, (iii) the role of external auditors, (iv) rules on transactions with affiliates, (v) other applicable prudential requirements, (vi) the remedial authority of the home-country supervisor, (vii) any prior approval requirements, and (viii) the regulatory capital framework.
- A description of any other regulatory capital framework to which the SHC is subject.

SUPERVISION REGIME

Section 618 and the FRB's SHC supervision program follow the unsuccessful and now-discontinued Consolidated Supervised Entities program (the "CSE Program") of the Securities and Exchange Commission ("SEC").³ In 1999, section 231 of the Gramm-Leach-Bliley Act authorized certain broker-dealer holding companies to register with the SEC as supervised investment bank holding companies ("SIBHCs"). SIBHCs were subject to limited examination and supervision by the SEC through the CSE Program. SIBHC status was voluntary and was designed for broker-dealer holding companies that needed to demonstrate comprehensive consolidated supervision in order to operate abroad. Over time, five firms were overseen through the CSE program: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. Two of the firms have, of course, disappeared, and the other three now are already regulated by the FRB through its supervision of bank holding companies.

Section 618 sets forth a far more robust supervision and examination regime than the CSE Program. The FRB will replace the SEC as the comprehensive consolidated supervisor. Registered SHCs will be subject to the same provisions of the Bank Holding Company Act ("BHCA") as a bank holding company with one exception: the limitations on activities or investments not closely related to banking or otherwise not permitted under section 4(c) do not apply to SHCs. The FRB will prescribe capital and other risk management standards for SHCs. These standards will reflect the requirements that now apply to BHCs, modified to reflect differences in operations. In addition (and in contrast to the SEC's powers under the CSE Program), the FRB has full examination authority over an SHC and its affiliates. The only limitation is that the FRB rely to the fullest extent possible on reports of examination prepared by other federal or state regulators with respect

³ The SEC ended the CSE Program in September 2008. Section 617 of Dodd-Frank repealed the statutory basis for the program.

Client Alert.

to any functionally regulated entities.

THE TRICKLE DOWN OF SYSTEMIC RISK REGULATION

Section 618 is one of several statutory extensions of the FRB's powers that are intended to address some of the sources of the financial crisis. Indeed, before Dodd-Frank, the FRB had no authority to regulate holding companies of brokers or dealers that did not also control a bank. Even when the FRB had the power to regulate bank holding companies with a broker or dealer subsidiary, it had very limited authority to examine such a subsidiary or other functionally regulated subsidiaries. Section 618 gives the FRB greater examination and supervision authority, and, as a result, every registered SHC will be subject to a more sweeping FRB oversight regime than even the largest financial holding companies were before Dodd-Frank and the financial crisis.

The section 618 regime thus occupies a middle ground between the stringent regulatory structure for systemically important financial institutions and the pre-Dodd-Frank framework for any bank holding company engaged in broker or dealer activities. Given the position of section 618, it is fair to say that the FRB will look not only to pre-Dodd-Frank standards but also to the enhanced prudential standards for systemically risky institutions. Indeed, since the existing Bank Holding Company Act standards by definition are designed to cover only bank holding companies (and not nonbank holding companies) and because the only standards specifically geared to broker and dealer activities that the FRB will be familiar with will be the enhanced prudential standards, those standards may well be the starting point for development of the section 618 standards. Accordingly, a registered SHC should be prepared for standards that are considerably more stringent than those to which they have become accustomed.

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