FEDERAL RESERVE BOARD APPROVES FINAL RULES DEFINING WHEN SIGNIFICANT NONBANK FIRMS ARE "PREDOMINANTLY ENGAGED IN FINANCIAL ACTIVITIES"

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THIS ARTICLE DISCUSSES THE FEDERAL RESERVE BOARD'S RECENTLY PUBLISHED FINAL RULE SPECIFYING WHEN A FINANCIAL COMPANY IS "PREDOMINANTLY ENGAGED IN FINANCIAL ACTIVITIES" AND THE POTENTIAL EFFECTS OF THE RULE ON LARGE NONBANK FIRMS.

On April 3, the Federal Reserve Board ("Board") published a final rule ("Rule") specifying when a financial company that may be made subject to systemic regulation under Title I of the Dodd-Frank Wall Street Accountability and Consumer Protection Act ("Dodd-Frank Act") is "predominantly engaged in financial activities" for purposes of being designated for systemic regulation under the Dodd-Frank Act. The Rule is effective on May 6, 2013.

As discussed below, the net effect of the Rule would be to expand the types of activities that might qualify as financial activities for purposes of applying the "predominantly engaged" test, and thus broaden the population of large nonbank firms that might be designated as systemically important financial firms, under the Dodd-Frank Act. Accordingly, large nonbank financial firms should pay close attention to the Rule's requirements and its potential impact on them.

BACKGROUND

The authority of the Financial Stability Oversight Council (the "Council") to designate a firm as systemically important is limited to those firms that meet the definition of "nonbank financial company" under section 102(a)(4) of the Dodd-Frank Act. The term is limited to any firm "predominantly engaged in financial activities." In turn, section 102(b) charges the Board with defining the term "predominantly engaged in financial activities" through rulemaking, but is constrained by specific statutory requirements. Under section 102(a)(6), financial activities are those that are financial in nature under section 4(k) of the Bank Holding Company Act ("BHCA").[1] Under the same provision, a company is "predominantly" engaged in financial activities if one of two conditions exists: either (i) the annual gross revenues derived by the company and all of its subsidiaries from financial activities, as well as from the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated assets of the company.

In February 2011, the Board proposed regulations ("First NPR") that would apply both of the 85 percent tests to each of the past two calendar years. An institution that met either test in either of the two years would be regarded as being "predominantly" engaged in financial activities. This proposal provided no further explanation of "financial activity."

In April 2012, the Board revised the February 2011 proposal to address "financial activities" in greater detail,[2] in response to several comments on the First NPR concerning the applicability of the BHCA restrictions on the conduct of certain financial activities, particularly investment-related activities, by bank holding companies. The principal thrust of the Board's Second NPR was to define a financial activity as "any activity referenced in [BHCA] section 4(k)…without regard to conditions that were imposed on bank holding companies that do not define the activity itself." Conditions not applicable to the definition of "predominantly engaged" include those "that were imposed to ensure that the activity is conducted in a safe and sound manner, to prevent a financial holding company from controlling a commercial firm, or to comply with another provision of law."[3]

THE FINAL RULE

The Board's rule generally preserves the approach that it proposed in the Second NPR, namely, to define as a financial activity any BHCA section 4(k) activity without regard to any condition that were imposed on bank holding companies to conduct those activities. The Board, however, has slightly modified this approach in several instances. Highlights of the Rule are:

- *Applicability.* The Rule applies to "significant nonbank financial companies," which are defined as (i) nonbank financial companies that are supervised by the Board pursuant to Council designation, and (ii) nonbank financial companies with $50 billion or more in total worldwide consolidated assets as of the end of their most recently completed fiscal years. It also defines a "significant bank holding company" as any bank holding company (including a foreign banking organization treated as a bank holding company under section 8(a) of the International Banking Act) with $50 billion or more in consolidated assets. These definitions, however, apply solely for purposes of Dodd-Frank Act Title I and do not *per se* result in the imposition of any new regulatory requirements on covered financial institutions.
- *Financial Activities—in General.* The Rule includes within the defini-

tion of "financial activities" those activities that are financial in nature under BHCA section 4(k), which includes the full list of activities that are closely related to banking under BHCA section 4(c)(8) and Board Regulation Y.[4] The Rule also covers activities that are performed internally for a bank holding company.

- *Activity Conditions—Part 1*. In many cases, the Board has not incorporated into this definition those activity conditions (financial or prudential) that are not part of the statutory authority for specified activity. This concept plays out in an interesting manner in several contexts. For example:
- *Merchant banking investments*. In the Board's view, the specific 10-year holding period for these investments specified by Regulation Y was not part of the statutory authority for this activity, and therefore is not made part of the "financial activity" definition as it pertains to merchant banking activities.
- *Credit activities*. The Board's regulations prohibit a bank holding company from owning, managing or developing, or sponsoring the development of, commercial real estate for which it is arranging financing. The Board concluded that these conditions are intended only to clarify that such activities were not authorized through the activity of arranging financing, and these conditions therefore do not appear in the Rule.
- *Futures commission merchant activities*. Board rules require futures commission merchant activities to be conducted through a separately-incorporated subsidiary, involve exchange-traded contracts, and not be guaranteed by the parent bank holding company. The Board treats these conditions as "prudential" conditions that are not part of the relevant "financial activity" definition for these activities.
- *Open-end investment company activities*. The Board has concluded that open-end investment companies are engaged in "financial activities" without regard to the prudential conditions that the Board has placed on bank holding companies engaged in such activities.
- *Activity Conditions—Part 2*. The old bromide that it is the exception that proves the rule, however, certainly manifests itself in this Rule. In turn, the Board has either (i) discarded statutory elements of a particular financial activity in defining it as such, or (ii) incorporated administrative conditions into the "financial activity" definition. This too plays itself out in interesting ways. For example:
- *Merchant banking investments, part 2*. The Board concluded that certain of the *statutory* conditions for merchant banking activities—the requirement that a financial holding company have a "securities affiliate," and that merchant banking investments not be held by a depository institution—were viewed as "not essential" elements of the financial nature of these activities and these conditions were not incorporated into the Rule.
- *Leasing activities*. The Board's regulations require that personal or real property leasing activities, among other things, must involve nonoperating leases with a term of at least 90 days. The Board states these conditions were created to distinguish between permitted financial, and impermissible nonfinancial, leasing activities, and therefore these conditions are included in the relevant part of the "financial activity" definition.
- *Financial calculations*. As required by the Dodd-Frank Act, a nonbank company will fall within the definition of a "significant nonbank financial company" if 85 percent or more of its consolidated assets or annual consolidated revenues relate to, or are derived from, financial activities. The Rule requires these calculations to be made for nonbank firms "in accordance with applicable accounting standards."
- *Unconsolidated Subsidiaries*. Investments in unconsolidated subsidiaries will be presumed to be made "in the course of conducting" a financial activity. This eliminates a prior proposed requirement that the nonbank financial firm determine whether such an unconsolidated company is itself "predominantly engaged" in financial activities.

UNDERSTANDING, AND IMPLICATIONS OF, THE FINAL RULE

In one respect, there is a certain logical consistency in the Board's (possibly) idiosyncratic definitions of "financial activities." First, the Board tries to distinguish between regulatory or administrative activity conditions that are prudential in nature, in contrast to those conditions that define the financial nature of the activity itself, and has excluded what it believes to be "prudential" conditions from the definition of a financial activity. Second, the Board has attempted to evaluate whether certain *statutory, regulatory, or administrative* activity conditions are "essential" in defining the permissible nature of an activity, and has included those conditions that it believes are essential within the financial activity definition, and excluded those conditions that the Board views as being nonessential in defining the activity.

That being said, the logical consistency of the Board's "in" and "out" determinations may not be readily apparent to the nonbank financial firm community that is not deeply experienced in federal bank activities regulation. There appears, however, to be a more prosaic consistency in the Board's interpretations of "financial activity" in the Rule, and that is to expand the activities that may be treated as Dodd-Frank Act financial activities beyond the BHCA's existing legal boundaries. With few exceptions, the Board's application of its "prudential" exclusion principles, and its "essential" inclusion principles, seems to have resulted in a process where the Board, when faced with multiple possible treatments of specific financial activities as "financial activities," has elected the interpretation which results in a broader definition of "financial activity." In turn, that means that more activities will be included as financial activities in the asset and revenue calculations necessary to determine whether a nonbank firm is "predominantly engaged" in financial activities.

The investment management community in particular may want to focus carefully on the Board's treatment of open-end investment company (mutual fund) and other investment fund activities. In its discussion accompanying this particular aspect of the Rule, the Board says outright that "it is clear that open-end investment companies including money market mutual funds, as well as closed-end investment companies, engage in financial activities as defined in section 4(k) of the [BHCA]." Such an assertion cannot be encouraging to the members of the investment funds community, whether they are mutual funds, money market funds, ETFs, private equity funds, or hedge funds, that are hoping to avoid a systemic financial firm designation by the Council.

The Board's Rule has no direct applicability outside of Dodd-Frank Act Title I and is of significant practical relevance to those large nonbank firms ($50 billion or more of assets) that must assess whether they fall within the statutory definition of a nonbank financial firm and thus may be subject to Council designation as a systemically significant firm. Because a bank holding company needs only meet the $50 billion threshold to be considered a "significant bank holding company" without reference to its financial activities, the financial activities definition appears to be of little relevance to bank holding companies for Dodd-Frank Act Title I purposes, with the possible exception of the credit exposure reports required by Dodd-Frank Act section 165(d)(2) for exposures between systemically important banks and "significant nonbank financial companies."

Moreover, bank holding and other financial companies that fall within the systemically significant designation hopefully need not be concerned about the ripple effects of the Rule outside of Title I, because there should be none. We use the word "should" immediately above, however, with one cautionary note. For purposes of the application of certain swaps trading and clearing requirements under Title VII of the Dodd-Frank Act, nonbank companies will want to closely consider whether this guidance affects their ability to qualify for the "end user" exception from clearing requirements. An entity that is a "financial entity" would not be an end-user. In turn, "financial entity" for this purpose is defined as a person "predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the [BHCA]." The construction of this definition, which is similar but not identical to that used in Title I, is the joint responsibility of the Securities and Exchange Commission and the Commodity Futures Trading Commission, and not the Board, but it remains to be seen whether the Board's Rule may have an impact on the construction and application of the financial entity prong of the end user definition.

In sum, the Board's action is important primarily because, under the Dodd-Frank Act, the Council's process for designating nonbank financial firms can be applied only by reference to the Board's rules on the meaning of "predominantly engaged in financial activities." Indeed, as a matter of law, that rulemaking must be completed before the Council can make a final designation of a nonbank financial firm as systemically important.[5] Although the Council previously suggested that final Board rules were not needed to make systemic designations of nonbank financial companies, with the Rule's adoption that view has become moot, inasmuch as the Council thus far has not designated any nonbank firms for Title I regulatory purposes and (presumably) will not do so prior to the May 6 effective date of the Rule. Further, whatever the merits or demerits of the Rule may be, they no longer are open for substantive discussion at the rulemaking level. Because the Rule is final, large nonbank financial firms of all stripes now need to review the financial activity definitions on an activity-by-activity basis and proceed accordingly. ■

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1 12 U.S.C. § 1843(k). An activity may be regarded as financial either by statute, regulation, or administrative order.

2 77 Fed. Reg. 21494 (Apr. 10, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-04-10/pdf/2012-515.pdf.

3 *Id.* at 21495.

4 12 C.F.R. § § 225.28(b), 225.86.

5 S. Rep. No. 111-176 (Apr. 30, 2010).