CLIENT UPDATE

FEDERAL RESERVE ADOPTS KEY DODD-FRANK ACT DEFINITIONS

DEFINING THE TERMS "PREDOMINANTLY ENGAGED IN FINANCIAL ACTIVITIES" AND "SIGNIFICANT" NONBANK FINANCIAL AND BANK HOLDING COMPANIES

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On April 3, 2013, the Federal Reserve Board ("FRB") issued a final rule (the "Final Rule") establishing requirements for determining when a company is "predominantly engaged in financial activities." In the Final Rule, the FRB defines "financial activities" broadly and, notably, makes clear that the activities of mutual funds, private equity funds, hedge funds and other pooled investment vehicles are financial activities. The definitions adopted by the FRB are important because a firm that is "predominantly engaged in financial activities" *may* be considered by the Financial Stability Oversight Council ("FSOC") for potential designation as a systemically important financial institution ("SIFI") under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Firms designated as SIFIs will be subject to enhanced regulatory scrutiny by the FRB. Additionally, the FSOC may issue recommendations to apply new or heightened regulatory standards to a financial activity or practice conducted by companies that are "predominantly engaged in financial activities."

The Final Rule also defines "significant nonbank financial company" and "significant bank holding company" generally to include nonbank financial companies and bank holding companies with $50 billion or more in total consolidated assets (measured according to applicable accounting standards). Although these definitions do *not* bear directly on whether a company may be designated as a SIFI by the FSOC, they are important for two other reasons: *First*, under the Dodd-Frank Act, SIFIs and bank holding companies with more than

$50 billion in total consolidated assets will be required to file reports with the FRB regarding their credit exposures to "significant" nonbank financial and bank holding companies. *Second*, in deciding whether an entity should be designated as a SIFI, the FSOC will consider the interconnectedness and relationships between the entity and "significant" nonbank financial and bank holding companies. Thus, an entity that is a significant nonbank financial company may have its relationships with SIFIs, and likely with other significant nonbank financial and bank holding companies, subject to regulatory scrutiny.

The Final Rule, which becomes effective on May 6, 2013, represents the culmination of a multi-year rulemaking process, which began with a proposed rule on February 11, 2011 (the "First Proposal")[1] and a supplementary rulemaking on April 2, 2012 (the "Supplementary Proposal").[2] With the adoption of the Final Rule, the FSOC can move forward with its SIFI designation process. It is widely expected that the FSOC may make its first designations sometime this summer.

BACKGROUND

Under the Dodd-Frank Act, a company may only be designated a SIFI if it is a "nonbank financial company" whose material financial distress or whose scope, size and scale of activities could pose a threat to the financial stability of the United States. A nonbank financial company is defined as an entity "predominantly engaged in financial activities." Under the Dodd-Frank Act, a company is "predominantly engaged" in financial activities if either (i) its annual revenues derived from financial activities represent 85% or more of its consolidated annual gross revenues; or (ii) its assets related to financial activities represent 85% or more of its total consolidated assets.[3]

The FRB is given rulemaking authority for establishing the requirements for determining if a company is "predominantly engaged in financial activities." The Dodd-Frank Act also gives the FRB responsibility for defining "significant nonbank financial company" and "significant bank holding company," which are not defined by the Dodd-Frank Act.[4]

The First Proposal addressed both sets of definitions. Of particular note, the proposed rule interpreted the term "financial activities" as activities considered "financial in nature" under section 4(k) of the Bank Holding Company Act ("BHC Act"), 12 U.S.C. § 1843(k). In response, the FRB received a number of comments that various activities, including many

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[1] 76 Fed. Reg. 7731 (Feb. 11, 2011).

[2] 77 Fed. Reg. 21494 (Apr. 10, 2012).

[3] Dodd-Frank Act § 102(a)(6).

[4] *Id.* at § 102(a)(7) and (b).

investment fund activities, are restricted for bank and financial holding companies under the BHC Act and, thus, should not be considered financial activities in this Dodd-Frank Act rulemaking.

After considering these comments, the FRB clarified in the Supplementary Proposal that any activity authorized as "financial in nature" under section 4(k) is a financial activity regardless of conditions imposed, so long as those conditions do not define the activity. In effect, the Supplementary Proposal sought to sever the term "financial activity" from safety-and-soundness and other conditions and limits imposed on bank and financial holding companies in carrying out those activities under the BHC Act.

THE FINAL RULE

Under the Final Rule, a company is "predominantly engaged in financial activities" if 85% or more of its assets or revenues are derived from financial activities, and a company may be considered a "significant nonbank financial company" or "significant bank holding company" if it meets the $50 billion asset test, as described further below.

Predominantly Engaged in Financial Activities

Financial Activities. "Financial activities" are defined by reference to BHC Act section 4(k), as in the FRB's proposals. A list of financial activities is included in an Appendix to this Client Update.

Like the Supplementary Proposal, activities are considered "financial in nature" without regard for whether the activities are conducted in accordance with prudential conditions imposed by the FRB under the BHC Act. The net result is a broad definition of the term "financial activities," providing the FSOC with a wide reach for designating firms as SIFIs.

As noted above, a particular point of comment in the proposed rulemakings was whether open-end investment companies are engaged in financial activities under BHC Act section 4(k). In the preamble to the Final Rule, the FRB seeks to dispel ambiguity on this point, stating that "it is clear that open-end investment companies, such as mutual funds including money market funds, as well as closed-end investment companies, engage in financial activities." The FRB states that, although the fund activities of a bank holding company are subject to various limits, these prudential conditions do "not negate the fact" that mutual funds are engaged in financial activities.

Elsewhere as well, the FRB follows this approach of viewing BHC Act conditions and limits on bank holding company activities as prudential; therefore, whether an activity is

conducted in compliance with, or outside of, those conditions or limits does not affect whether the activity is financial for purposes of Title I of the Dodd-Frank Act. For instance, the BHC Act permits financial holding companies to engage in so-called "merchant banking activities" and, thereby, to acquire shares and other ownership interests in companies and funds for appreciation and ultimate resale. Under the BHC Act, financial holding company merchant banking activities are subject to numerous limits, including a limit on how long investments may be held (generally, 10 years) and a limit on "routinely managing" a portfolio company. The FRB does not include either limit in the Final Rule, noting that hedge funds, private equity funds and other pooled investment vehicles do not abide by such restrictions. Instead, the FRB adopts a presumption that, when a firm holds an investment only for the period permitted for financial holding companies and without engaging in routine management of the portfolio company, the firm is engaged in merchant banking and, thus, a financial activity.

To the same end, although the BHC Act requires futures activities of bank holding companies to be conducted through a separately incorporated subsidiary, to involve exchange-traded contracts and to not include a parent bank holding company guarantee, none of these restrictions are included in the Final Rule. Thus, a firm that engages in futures activities, whether or not the firm comports those activities to the above requirements, will be engaged in a financial activity for purposes of the Final Rule. The Final Rule does, however, generally take the view that financial derivatives transactions require cash settlement (in order to distinguish between commercial derivatives activities involving physically settled derivatives contracts and financial derivatives activities).

Finally, under the Final Rule, the definition of financial activities includes all activities that are determined to be "financial in nature," regardless of where in a company an activity is conducted and regardless of whether the activity is conducted "on an internal or inter-affiliate basis or with a third-party."

<u>Predominantly Engaged</u>. The Final Rule adopts three alternative tests pursuant to which a firm may be considered to be "predominantly engaged" in a financial activity:

- *<u>Revenue Test</u>*. A firm is considered predominantly engaged if, in either of the two prior fiscal years, its year-end gross financial revenues represent at least 85% of its year-end gross revenues.
- *<u>Asset Test</u>*. A firm is considered predominantly engaged if, in either of the two prior fiscal years, its year-end financial assets represent at least 85% of its year-end total assets.

- *Discretionary Test*. A firm may be deemed predominantly engaged if, in the FRB or the FSOC's judgment, based on all facts and circumstances, the firm is engaged in financial activities using either the revenue or asset tests, without a two-year limitation.

The Final Rule permits the use of U.S. GAAP, IFRS or other appropriate accounting standards for the relevant calculations, if the entity uses that system in its ordinary financial reporting. Under the discretionary test, the FSOC or FRB may permit the use of other accounting systems (such as statutory accounting principles).

The Final Rule adopts a "rule of construction" for applying the revenue and asset tests to unconsolidated entities. Under the Final Rule, an investment in an unconsolidated entity is "presumed to be made in the course of conducting a financial activity set forth in section 4(k)." This approach eliminates a requirement in the First Proposal that an investor look through a portfolio company to determine whether that firm's activities are predominantly financial. Instead, now investors (such as hedge funds, private equity funds and other pooled investment vehicles) will be presumed to be engaged in the financial activity of merchant banking.

"Significant" Nonbank Financial and Bank Holding Companies

The Final Rule defines the terms "significant nonbank financial company" and "significant bank holding company." The former term includes a nonbank financial company with $50 billion or more in total consolidated assets as of the end of its most recently completed fiscal year. The latter term includes a bank holding company and any company treated like a bank holding company in the United States (i.e., a foreign banking organization with U.S. banking presence) that had $50 billion or more in total world-wide consolidated assets as of the end of the last calendar year.

Several commenters had suggested that the FRB exclude certain assets from the calculation of a nonbank financial company's total consolidated assets, despite the inclusion of such assets on a company's balance sheet under GAAP or other applicable accounting standards. In particular, commenters urged the FRB to exclude managed and investment fund assets when calculating the total assets of a fund manager or adviser in situations in which accounting standards provide for the consolidation of such assets of the manager or adviser's balance sheets. The FRB expressly declined, suggesting that GAAP, IFRS and other applicable accounting standards "provide[] a reliable, uniform ... and simple approach" that can be applied with the least burden.

In adopting the Final Rule, the FRB also clarified that "significant" companies under the above tests are not required to report their status to the FRB. The FRB further reiterated

that a nonbank company that meets the "significant" test would not automatically be subject to enhanced supervision under the Dodd-Frank Act.

CONCLUSION

The Final Rule establishes a number of key definitions for purposes of Title I of the Dodd-Frank Act. The Final Rule does not, by itself, designate any firms for added supervision or regulation. Instead, the Final Rule clarifies the range and type of firms (those "predominantly engaged in financial activities") that potentially may be reviewed for SIFI designation by the FSOC and to whose activities the FSOC could potentially recommend new or heightened regulatory standards. The Final Rule also clarifies which firms are "significant" nonbank financial and bank holding companies; large bank holding companies and SIFIs will need to report to the FRB on their counterparty credit exposures to such "significant" companies.

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Please do not hesitate to contact us with any questions.

April 9, 2013

Appendix:
List of Financial Activities[5]

- Lending, exchanging, transferring, investing for others and safeguarding money or securities
- Insurance activities
- Financial, investment and economic advisory services
- Issuing or selling instruments representing interests in pools of bank-permissible assets
- Underwriting, dealing and market making
- Merchant banking
- Insurance company portfolio investments
- Lending, exchanging, transferring, investing for others, safeguarding financial assets other than money or securities and other activities
- Financial activities that are closely related to banking
    - Extending credit and servicing loans
    - Activities related to extending credit
    - Leasing
    - Operating nonbank depository institutions
    - Trust company functions
    - Financial and investment advisory activities
    - Agency transactional services for customer investments
    - Investment transactions as principal
    - Management consulting and counseling activities
    - Courier services and printing and selling MICR-encoded items
    - Insurance agency and underwriting
    - Community development activities
    - Money orders, savings bonds and traveler's checks
    - Data processing

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[5] The FRB acknowledges that this list includes "overlapping and redundant activities." The FRB indicates that such redundancies have not been eliminated "to ensure completeness."

- Mutual fund administrative services
- Owning shares of a securities exchange
- Certification services
- Providing employment histories
- Check-cashing and wire-transmission services
- Postage, vehicle registration and public transportation services
- Real estate abstracting

▪ Financial activities that are usual in connection with banking or other financial operations abroad

- Management consulting services
- Travel agency
- Mutual fund activities
- Commercial banking activities