Client Update

Banking Agencies Issue Dodd-Frank Act Section 620 Report

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On September 8, 2016, the Federal Reserve and other federal banking agencies issued a report describing the activities in which "banking entities" may engage under federal and state law, indicating the negative effects those activities may have on the safety and soundness of the U.S. banking system, and recommending how to address any risks. Many of the recommendations are sweeping and very well may portend an ongoing policy debate, which could lead to changes that have significant consequences for the financial system, regulated institutions and the economy.

If implemented, the recommendations would make fundamental changes to the federal bank regulatory framework, perhaps in some cases at least as significant as many of the Dodd-Frank Act's reforms. Because the Federal Reserve suggests legislative changes to implement its recommendations, those recommendations may be less likely to come fully into force than the administrative changes recommended by the FDIC and OCC, although the Federal Reserve also has significant authority as a prudential regulator to pursue objectives even in the absence of legislative action. Below we provide key takeaways and observations, background on section 620's legislative history and its relation to the Volcker Rule and a summary of the recommendations made in the report.

KEY TAKEAWAYS AND OBSERVATIONS

The following are key takeaways and observations:

- With regard to merchant banking authority, the report both (1) recommends Congress repeal merchant banking authority and (2) states that the Federal Reserve is considering regulatory measures that would limit the safety and soundness risks of merchant banking investments.
- The Federal Reserve also recommends that Congress repeal the statutory exemptions for: (1) owners of industrial loan companies ("ILCs") to operate

outside of the regulatory and supervisory framework applicable to other corporate owners of insured depository institutions, and (2) grandfathered unitary savings and loan holding companies ("GUSLHCs") from the ownership and activities restrictions applicable to all other savings and loan holding companies ("SLHCs").

- The Federal Reserve also alludes to the potential use of authority provided by Dodd-Frank Act section 626 to require GUSLHCs to implement an intermediate holding company ("IHC") structure. As foreign banking organizations have experienced over the last couple of years as a result of the Federal Reserve's enhanced prudential standards requirements, the imposition of an IHC structure can have significant consequences for an organization.
- The agencies did not seek public comment before issuing the report or ask for comment on the report's findings and scope. This approach, which is not explained or justified, is at odds with how other reports mandated by the Dodd-Frank Act have been handled by various regulatory agencies.[1]
- The report's recommendations are likely to spur a policy debate over the coming months and potentially years. Because the report is delivered to Congress and the Financial Stability Oversight Council ("FSOC"), there very well may be future hearings and other activity on Capitol Hill and consideration by the FSOC and its member agencies (including the Treasury Department) of the report, its findings and the implications of its recommendations.

SECTION 620 AND THE VOLCKER RULE

Section 620 of the Dodd-Frank Act mandates that the federal banking agencies study the activities and investments that banking entities may engage in under state and federal law. In conducting the study, the agencies are required to consider (1) the types of permissible activities and investments of banking entities, (2) the risks, including financial, operational, managerial, or reputational associated with or presented as a result of such activities or investments and (3) the risk mitigation activities undertaken by banking entities with regard to

1 *See, e.g.*, FSOC, Recommendations Regarding Modifications to the Concentration Limit on Large Financial Companies, 76 Fed. Reg. 6756 (Feb. 8, 2011) (requesting comment on the concentration limit study); Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds, 75 Fed. Reg. 61,758 (Oct. 6, 2010) (requesting comment on the Volcker Rule study). *See also* Securities and Exchange Commission, Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, 75 Fed. Reg. 44,996 (July 30, 2010) (requesting comment on the fiduciary duty study).

such risks. Notably, the statute does not expressly require that the agencies consider the benefits of such activities or the costs or other potential consequences of any recommendations.

Section 620 is closely related to the Volcker Rule, which, as section 619, is the immediately preceding statutory provision. The two provisions were introduced together by the same legislative sponsors, and Senate floor discussions indicate that the section 620 report was intended, by its sponsors, to "dovetail" with the Volcker Rule and to address activities that are not implicated or restricted by the Volcker Rule.[2] The relationship between section 620 and the Volcker Rule also is evident from the fact that those provisions are the only sections of the Dodd-Frank Act that use the term "banking entity," which is a broad term that, with limited exceptions, includes insured depository institutions, foreign banks with a U.S. presence and all affiliates of such entities.

FEDERAL RESERVE RECOMMENDATIONS

The Federal Reserve's section of the report makes recommendations with respect to financial holding companies ("FHCs"), bank holding companies, GUSLHCs and ILCs and their owners.

Review of Permissible Activities and Investments

The Federal Reserve focuses its review on the activities and investments authorized pursuant to the Gramm-Leach-Bliley Act, which expanded permissible activities and investments to include activities that are financial in nature, like securities underwriting and dealing, insurance underwriting and agency activities and merchant banking activities. The Federal Reserve also focuses on exemptions under federal law that allow owners and affiliates of certain insured depository institutions to operate without regard to otherwise applicable restrictions on activities and investments, as we describe in more detail below.

Recommendations

In the report, the Federal Reserve recommends statutory changes—which require congressional action—to eliminate special statutory powers and exemptions that permit firms to conduct certain activities and hold certain investments.

First, the Federal Reserve recommends Congress repeal the authority of FHCs to engage in merchant banking activities. Under merchant banking authority,

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2 *See* 156 CONG. REC. S5899 (daily ed. July 14, 2010) (statement of Sen. Merkley).

FHCs may invest in nonfinancial companies. Such authority, the Federal Reserve states, exposes firms to legal liability for the operations of a portfolio company. The report does not appear to provide any empirical justification for this assertion and does not cite prior loss history as evidencing this concern.

Second, the Federal Reserve recommends the repeal of the grandfathered authority for certain FHCs to engage in commodities activities under section 4(o) of the Bank Holding Company Act. These activities include the storage, transportation and extraction of commodities. The Federal Reserve expressed concern that such activities may expose firms to liability arising from environmental disasters, raise competitive concerns and also undercut the general separation of banking and commerce.

Finally, this section of the report recommends Congress repeal (1) the exemption that permits corporate owners of ILCs to operate outside of the regulatory and supervisory framework applicable to other corporate owners of insured depository institutions and (2) the exemption for GUSLHCs from the activities and ownership restrictions applicable to all other SLHCs. The Federal Reserve stated that these exemptions foster an unfair and uneven competitive playing field and undermine the policy of separating banking from commerce. These recommendations have a history in the recent reform process. Specifically, the elimination of these exemptions also was suggested by the Treasury Department in its 2009 financial regulatory reform proposal, which preceded the Dodd-Frank Act.[3] In explaining the proposal, the Treasury Department said the "policy of separating banking from commerce should be re-affirmed and strengthened."[4]

The Federal Reserve suggests a several-year conformance period for these organizations to adjust to being treated for activities purposes effectively as BHCs. However, particularly if Congress repeals these exemptions and merchant banking authority, it would seem that the insurers and other corporate institutions relying on these grandfathered exemptions effectively would have a choice of either disposing of their depository institution subsidiaries or undergoing significant changes to the rest of their consolidated structures and operations.

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3 *See* U.S. Department of Treasury, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (June 17, 2009), *available at* https://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf.

4 *Id.* at 12.

OCC RECOMMENDATIONS

The OCC's section of the report makes recommendations with respect to national banks and federal savings associations.

Review of Permissible Activities and Investments

The OCC focuses its review on certain activities and investments that the agency determined warrant "special focus": derivatives, physical commodities, securities and structured products.

Recommendations

Unlike the Federal Reserve, the OCC does not recommend any legislative action in the report, but, instead, identifies areas of potential enhancement to its prudential regulatory scheme and precedents that merited reconsideration or clarification. By virtue of federal law generally limiting the activities and activities of insured state banks to those permissible for national banks, many of the OCC's recommendations also will be relevant to state banks.

As to its actions, the OCC plans to clarify minimum prudential standards applicable to national banks engaged in certain swap dealing activities. It is also reviewing the risks to federal banking entities posed by memberships in clearinghouses, especially those with rules that do not cap members' liability, in order to consider whether guidance on membership in those clearinghouses is appropriate. The latter change is particularly noteworthy given the strong capital and exposure limit benefits that the federal banking agencies and the Basel Committee have provided to encourage banks to use central counterparties.

With regard to physical commodities, the OCC already implemented its report recommendation to clarify regulatory limits on physical hedging, and concurrently with the release of the section 620 report, it issued a notice of proposed rulemaking to address national banks and federal savings associations' authority to hold and trade copper.[5]

Further, the OCC stated that it plans to update its investment security regulations (12 CFR 1, 12 CFR 160) to incorporate the limitations imposed by the Volcker Rule (so as to ensure that it is clear that the investment regulations do not in any way supersede the Volcker Rule).

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[5] *See* OCC Bulletin 2015-35, "Quantitative Limits on Physical Commodity Transactions" (Aug. 4, 2015); "Industrial and Commercial Metals," Docket ID OCC-2016-0022.

Finally, with regard to structured products, the OCC plans to propose guidance or a rulemaking to address the potential risks posed by concentrations in mark-to-model assets and liabilities. The OCC also is planning to propose a rule that prohibits national banks and federal savings associations from holding certain types of asset-backed securities (which may be backed by bank-impermissible assets) as Type III securities. The OCC is concerned that the Type III provisions currently permit a national bank to hold asset-backed securities with underlying instruments that the bank could not hold directly.

FDIC RECOMMENDATIONS

The FDIC's section of the report makes recommendations with respect to insured state-chartered banks that are not members of the Federal Reserve System and insured state-chartered savings associations.

Review of Permissible Activities and Investments

FDIC-regulated state banks and savings associations are permitted to seek FDIC approval to conduct certain activities as principal that are permissible under state law but have not been determined to be permissible for a national bank. To draft the report, the FDIC reviewed 430 of these filings, the majority of which were requests to engage in various real estate-related activities and investments. A sizeable portion of other filings dealt with equity-related activities and investments associated with mineral rights.

Recommendations

Like the OCC, the FDIC does not recommend any legislative action. Instead, the FDIC identifies potential areas for enhancement, reconsideration and clarification. In particular, the FDIC plans to:

- review activities related to investments in other financial institutions and other equity investments to evaluate the interaction of existing FDIC regulations under part 362 with other more recent regulatory and statutory rules, in order to determine whether changes to part 362 are necessary; and
- determine whether the prudential conditions and standards under which the FDIC evaluates part 362 filings with respect to mineral rights, commodities, or other non-traditional activities need to be clarified and enhanced.

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Please do not hesitate to contact us with any questions.