

Summary of Federal Reserve Proposed Rule on Definitions Related to Nonbank Financial Companies and Interconnectedness of Systemically Important Firms

Yesterday, the Board of Governors of the Federal Reserve System (the “**Board**”) issued a Notice of Proposed Rulemaking and request for comment¹ regarding two aspects of the new Dodd-Frank systemic risk regime. The proposed rule sets forth suggested definitions of two sets of terms that appear in the systemic risk provisions of Title I of the Dodd-Frank Act—“predominantly engaged in financial activities” and “significant” nonbank financial company and bank holding company.

The first of these terms, “predominantly engaged in financial activities,” will be of most interest to companies that are concerned that they may be designated as systemic, including funds and companies whose activities are part commercial and part financial. Absent evasion, the Financial Stability Oversight Council (“**FSOC**”) may only designate as systemically important nonbank **financial** companies, and therefore companies that are not predominantly engaged in “financial activities” cannot be designated as systemically important. The proposed rule provides a framework by which firms whose activities place them at the cusp of being financial can assess whether their activities are “predominantly financial,” by reference to the Board’s historical practice and regulations. For those not familiar with the Board’s historical practice and regulation, the list of activities considered “financial in nature” under the Bank Holding Company Act (the “**BHC Act**”) is neither obvious nor intuitive. The list evolved piecemeal over the years and reflects both regulatory and statutory political and policy decisions made during those times. Thus, firms that are engaging in mixed commercial and financial activities, as commonly understood in business parlance, should review the list of activities currently considered financial in nature set forth in [Annex A](#).

The second set of terms, “significant nonbank financial company” and “significant bank holding company” are not, in our view, tied directly to systemic designation. Rather, the “significant” standard serves a different purpose that relates to the credit relationships of nonbank financial companies rather than their potential designation as systemic.

Comments on the proposed rule are due on or before March 30, 2011.

¹ Definitions of “Predominantly Engaged in Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company (released Feb. 8, 2011), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110208a1.pdf>.

“Predominantly Engaged” in Financial Activities

Under the Dodd-Frank Act, in order to be defined as a “nonbank financial company”² a company must be predominantly engaged in financial activities. The proposed rule clarifies what it means for a nonbanking company to be “predominantly engaged in financial activities” by incorporating the extensive list of activities that a financial holding company is permitted to engage in under the BHC Act. This list of activities is derived from Section 4(k) of the BHC Act and the Board’s Regulation Y, which distinguishes financial activities from commercial activities, and includes activities such as securities underwriting and dealing and insurance underwriting and brokerage, along with investment advisory activities among many other activities.³ Notably, the rule does not include those activities that are considered to be “incidental” or “complementary” to a financial activity, such as trading in physical commodities like oil, natural gas and agricultural products.

By its terms, the proposed rule states that a U.S. subsidiary of a bank holding company is excluded from the definition of a U.S. nonbank financial company, and that a non-U.S. subsidiary of a bank holding company or a non-U.S. bank that is treated as a bank holding company due to its U.S. banking presence is excluded from the definition of a foreign nonbank financial company.

The Board has indicated that the conditions imposed on financial holding companies when engaging in financial activities in Section 4(k) of the BHC Act and the Board’s Regulation Y – but no other legal authorities – must be considered when analyzing whether a potentially systemic nonbank firm meets the “predominantly engaged” test.

The proposed rule sets forth the time period at which the “predominantly engaged” test will be considered, which was absent in the statute itself. Typically the test will be applied after a company has completed the preparation of its year-end consolidated financial statements; however, the Board does maintain the ability to make a case-by-case determination at any time in exceptional circumstances. The proposed rule states that the test will be applied on a two-year look back basis – as a general matter, potentially systemic nonbanking companies will be required to have ***less than 85% of their total assets and gross revenues classified as financial assets and revenues for two consecutive years*** in order to avoid the definition of “nonbank financial company.”

Proposed Test to Determine Whether an Entity Is “Predominantly Engaged in Financial Activities”

- **85% Test.** The proposed rule provides that a potentially systemic nonbank company is predominantly engaged in financial activities if it meets the following test (the “85% Test”):
 - The consolidated annual gross ***financial*** revenues of the company in ***either*** of its two most recently completed fiscal years represent 85% or more of the company’s consolidated annual gross revenues in that fiscal year; ***or***
 - The consolidated total ***financial*** assets of the company as of the end of ***either*** of its two most recently completed fiscal years represent 85% or more of the company’s consolidated total assets as of the end of that fiscal year.

² Under the Dodd-Frank Act, a “U.S. nonbank financial company” does not include any entity that is a bank holding company, a Farm Credit System institution, a national securities exchange (or parent thereof), clearing agency (or parent thereof, unless the parent is a bank holding company), a security-based swap execution facility, or security-based swap data repository registered with the SEC, or a board of trade designated as a contract market (or parent thereof), or a derivatives clearing organization (or parent thereof, unless the parent is a bank holding company), a swap execution facility, or a swap data repository registered with the CFTC. The term “foreign nonbank financial company” does not include a bank holding company or a company that is regulated in the U.S. as though it were a bank holding company.

³ Please see Annex A to this memorandum.

- **Financial Assets and Revenues.** The rule proves that *financial* assets or revenues are those revenues derived from, or assets related to:
 - activities that are “financial in nature”, or
 - the ownership, control or activities of an insured depository institution or any subsidiary of an insured depository institution.
- **“Financial in Nature” Definition.** The crucial part of the 85% Test will be determining what assets and revenues to include in the calculation. Here, the Board indicates that potentially systemic nonbank companies must focus their attention on the activities considered to be financial in nature under section 4(k) of the BHC Act and Regulation Y, as distinguished from commercial activities, and thus permitted for financial holding companies. This includes activities such as securities underwriting, dealing and market-making and engaging in financial and investment advisory activities. It also includes underwriting or acting as an agent or broker for insurance, including property and casualty, life, health, disability or accident insurance. A list of activities that are currently designated as financial activities is included in Annex A to this memorandum.
- **Only Financial in Nature.** For purposes of the 85% Test, financial activities include only those activities that are financial in nature under Section 4(k) of the BHC Act and Regulation Y and do not include those activities that are considered to be “incidental” or “complementary” to financial activities, such as trading in certain physical commodities. Another example of a complementary activity is the provision of disease management and mail-order pharmacy services by an insurance company. Such examples may prove helpful for some companies in determining whether any of their ancillary activities fall outside the financial side of the financial/commercial divide.
- **No Additional Conditions Beyond Section 4(k) and Regulation Y.** The release accompanying the proposed rule specifically indicates that the Board will not seek to alter the conditions that currently apply to a financial holding company under section 4(k) of the BHC Act or Regulation Y in order for an activity to be considered financial in nature. For example, although the Dodd-Frank Act’s Volcker Rule prohibits “proprietary trading” by financial holding companies, that activity is nonetheless still financial in nature for purposes of the 85% Test if conducted in accordance with section 4(k) of the BHC Act and Regulation Y. Therefore, a potentially systemic nonbank firm cannot exclude assets and revenues from proprietary trading on the grounds that it is prohibited by the Volcker Rule. At the same time, such a firm should consider the conditions to financial activities specified by the Board and Regulation Y when applying the 85% Test.
- **No Impact of Other BHC Act Provisions.** The proposed rule states that an activity will be “financial in nature” if it is financial under Section 4(k) and Regulation Y, even though it is independently permissible under other BHC Act provisions. This means that a potentially systemic nonbank firm cannot exclude assets and revenues from less than 5% voting equity investments that otherwise comply with Section 4(k) and Regulation Y on the grounds that such investments are exempt under 4(c)(6) of the BHC Act.⁴ Similarly, a non-U.S. nonbank firm cannot exclude assets and revenues from insurance activities that otherwise comply with Section 4(k) and Regulation Y because they would be considered held outside the U.S. and exempt under Section 4(c)(9) of the BHC Act.

⁴ Such an equity investment could, however, potentially qualify for the *de minimis* exception described below.

- **Requesting a Determination.** If there remains some doubt as to whether an activity should be considered to be financial in nature, a potentially systemic nonbank company can request the Board to make a determination.

Calculating the 85% Test

- **Two-Year Look Back.** The Dodd-Frank Act itself does not specify a time frame for the Board to consider when making its determination of whether an entity is predominantly engaged in financial activities; however, the proposed test accounts for temporary declines in financial assets or revenues by basing the test on a company's annual financial revenue in, or financial assets at the end of, either of its two most recent fiscal years. Therefore, a nonbank company must fail to meet the 85% Test for two consecutive years in order to be excluded from the definition of nonbank financial company.
- **Accounting Standard.** The accounting standard used to calculate a company's revenues and assets must be the standard, either U.S. GAAP or IFRS, used by the company in the ordinary course to prepare its year-end consolidated financial statements. With the Board's approval, a foreign company may use a different set of accounting standards if it does not currently prepare its year-end financial statements under U.S. GAAP or IFRS.

Rules of Construction for Unconsolidated Investments

The rule sets forth two rules of construction that will be of interest to private equity firms, hedge funds and other nonbank commercial companies that make substantial unconsolidated non-controlling minority investments.

- **Look-Through to Investee Companies That Are Predominantly Engaged in Financial Activities.** If the unconsolidated investee company is itself predominantly engaged in financial activities, determined by applying the 85% Test, then all assets related to, and all revenues derived from, such investment ***must*** be included in the nonbanking company's 85% Test calculation. This look-through will complicate the calculation of the test for funds and other companies that generally make noncontrolling unconsolidated investments.
- **De Minimis Investments.** A nonbanking company ***may*** exclude from the 85% Test assets and revenues related to certain minority investments, regardless of the activity of the investee company, but ***only*** up to 5% of its annual gross financial revenues or total financial assets. The minority investment must meet the following criteria in order to be eligible for the exclusion:
 - the company must own less than 5% of any class of voting shares of the investee company;
 - the company must own less than 25% of the total equity of the investee company;
 - the company must not consolidate the financial statements of the investee company;
 - the company's investment is not held in connection with the conduct of a financial activity (such as for example, investment advisory services or merchant banking activities conforming to Section 4(k) and Regulation Y); and
 - the investee company is not a bank, bank holding company, broker-dealer, insurance company or other SEC or CFTC regulated financial institution as enumerated in the rule.

Because of the relative narrowness of these criteria, we believe that this exclusion will not be helpful to most nonbank firms.

Board Flexibility

- **Case by Case Determination by Board.** The Board preserves its right based on all facts and circumstances to determine that a company is predominantly engaged in financial activities by applying the 85% Test itself at any point in time. This provision is designed to give the Board flexibility to act quickly and designate a company as a nonbank financial company during the course of the year, in particular, if changes in the activities or financial condition of a company would affect the systemic risk designation of such company. The Board indicates in the proposed rule that this case by case review would be used rarely and only when justified by the circumstances.
- **Anti-Evasion Provisions.** The FSOC maintains the ability to designate as systemically important any company that structures itself in such a way to evade the application of Title I of Dodd-Frank and poses a risk to the financial stability of the United States, such as by “slightly alter[ing] the manner in which the company conducts an activity” so that the activity does not comply with Section 4(k) and Regulation Y.
- **FDIC to Issue Separate Rule for Definition of “Financial Company” Under Title II.** The Board notes in its release that the definition included in its proposed rule applies to the systemic designation provisions of Title I of the Dodd-Frank Act, and that the FDIC will be promulgating regulations regarding the definition of “financial company” for purpose of Title II’s Orderly Liquidation Authority.

“Significant” Bank Holding Companies and Nonbank Financial Companies

Proposed Definition

- The release also defines the terms “significant bank holding company” and “significant nonbank financial company” to include the following:
 - Any nonbank financial company designated as systemically important, *i.e.*, designated by the FSOC for stricter Board supervision; and
 - Any bank holding company or nonbank financial company with at least \$50 billion in total consolidated assets.
- Both U.S. and non-U.S. bank holding companies and nonbank financial companies may be “significant.”
- **“Significant” is not synonymous with systemically important.⁵**
 - With respect to bank holding companies, \$50 billion in total consolidated assets is the automatic threshold for both. Thus a “significant bank holding company” is systemically important, *i.e.*, subject to stricter Board supervision, and vice versa.
 - A “significant” nonbank financial company, however, is not necessarily systemically important.

⁵ “Systemically important” refers to firms subject to stricter Board supervision under the Dodd-Frank Act: bank holding companies with at least \$50 billion in total consolidated assets, and nonbank financial companies designated by the FSOC.

Application

- We read the terms “significant bank holding company” and “significant nonbank financial company” as directly related to credit exposure reporting and only indirectly related to the designation of nonbank financial companies as systemically important. We believe that the definition of these terms will have little effect on the actual designation process. **Rather, the key application of these terms is to enable Board and FDIC analysis of the extent to which systemically important firms are interconnected to other firms in the financial sector.**
- The terms apply explicitly to only two provisions in the systemic risk regime:
 - **Credit Exposure Reporting.** Systemically important firms will be required to report “the nature and extent to which the company has credit exposure to other significant nonbank financial companies and significant bank holding companies” and “the nature and extent to which other significant nonbank financial companies have credit exposure to that company.” This may also play a role in Board and FDIC review of resolution plans that systemically important firms are required to submit.
 - The core idea here is that the Board and FDIC will connect the credit exposure of systemically important firms to the wider universe of “significant” bank holding companies and nonbank financial companies. In other words, a “significant” company is a category that includes **both** systemically important companies and a lesser category of significant companies.
 - **Designation Criteria.** Title I of the Dodd-Frank Act contains a long, open-ended list of criteria the FSOC must consider when deciding whether to designate a nonbank financial company as systemically important. One criterion is “the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies.”
 - A nonbank financial company’s exposure to any “significant” bank holding company or nonbank financial company will be considered as part of the interconnectedness factor for designation. What this means as a practical matter is that when the FSOC considers whether a nonbank financial company is interconnected to the financial sector, it will consider its relationships with both systemically important companies and the lesser category of significant companies.
 - The proposed rule’s use of a \$50 billion threshold echoes a well-known concept in the statute (bank holding companies with at least \$50 billion in total consolidated assets are automatically subject to increased Board supervision).
 - Interconnectedness and size, although important, are only two parts of a broad, open-ended litany of criteria that the FSOC may supplement as it deems appropriate.

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Activities That Are Financial in Nature

- Extending credit; brokering and servicing loans
- Activities related to extending credit:
 - Real estate and personal property appraising
 - Arranging commercial real estate equity financing
 - Check-guaranty services
 - Collection agency services
 - Credit bureau services
 - Loan asset management, servicing, and collection activities
 - Acquiring debt that is in default at the time of acquisition, subject to certain conditions
 - Real estate settlement servicing
- Leasing personal or real property on a non-operating basis, or acting as agent, broker, or adviser in leasing such property, subject to certain conditions
- Operating a non-bank depository institution, including an industrial bank, Morris Plan bank or industrial loan company, or a savings association, subject to certain conditions
- Trust company services
- Providing banking-related courier services
- Issuing money orders and similar consumer-type payment instruments and traveler's checks and selling U.S. savings bonds
- Providing check cashing and wire transmission services
- Providing notary public services in connection with offering banking services
- Financing, investment and advisory activities related to community development
- Securities underwriting, dealing and market-making
- Securities brokerage (including riskless principal and private placement activities, and related securities credit and custodial services)
- Lending, exchanging, transferring or safeguarding securities
- Acting as investment or financial advisor to any person, including serving as investment advisor to a registered investment company
- Furnishing general economic information and advice, general economic statistical forecasting services, and industry studies
- Providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, financing transactions and similar transactions, and conducting financial feasibility studies

- Providing information, statistical forecasting, and advice with respect to foreign currency transactions, commodities, swaps and other derivative transactions
- Private equity investing, subject to certain conditions
- Principal investing in non-financial companies in the ordinary course of an insurance company's business, subject to certain conditions
- Securitizing assets permissible for a bank to hold directly
- Sponsoring, organizing and managing a closed-end fund
- Sponsoring, organizing and managing a mutual fund, subject to certain conditions
- Providing administrative and other services to mutual funds
- Being the general partner or managing member of a hedge fund or private equity fund, subject to certain conditions
- Engaging as principal or acting as agent in foreign currency spot, forward, futures, options and options on futures transactions, subject to certain conditions
- Engaging as principal or acting as agent in swap and other derivative contracts based on any rate, price, financial asset, nonfinancial asset, or group of assets, or index of assets, including futures, options, and options on futures contracts based on commodities or stock, bond or commodity indices, subject to certain conditions
- Acting as a futures commission merchant, subject to certain conditions
- Engaging as a principal or acting as agent in trades in traditional bank permissible commodities (gold, silver, platinum, palladium and copper)
- Acting as a commodity pool operator for private investment funds organized as commodity pools, subject to certain conditions
- Insurance agency activities (including annuity sales)
- Insurance underwriting (including annuities and reinsurance)
- Performing claims-administration activities
- Acting as a third party administrator for an insurance company
- Providing educational courses, and instructional materials to consumers on individual financial management matters
- Providing tax-planning and tax-preparation services to any person
- Management consulting activities, as long as the activities are advisory in nature and do not result in control of the companies advised
- Employee benefits consulting and career counseling services, subject to certain conditions
- Operating a travel agency in connection with financial services
- Providing data processing and data transmission services, facilities (including data processing and data transmission hardware, software, documentation, or operating personnel), databases, advice, and access thereto, as long as total annual revenues from the processing, storage and transmission of data that are not financial, banking or economic do not exceed 49 percent of the company's total annual revenues from all data processing, storage and transmission, and subject to certain other conditions

- Owning shares of a securities exchange
- Acting as a certification authority for digital signatures and authenticating the identity of persons conducting financial and nonfinancial transactions
- Providing employment histories to third parties for use in making credit decisions and to depository institutions and their affiliates for use in the ordinary course of business
- Real estate title abstracting