CADWALADER

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

One World Financial Center, New York, NY 10281
Tel 212 504 6000 Fax 212 504 6666
www.cadwalader.com

Clients&FriendsMemo

Some Concerns with the Regulation of Large Non-Bank Holding Companies

June 3, 2010

The Wall Street Reform and Consumer Protection Act of 2009[1] (the "**House bill**") and the Restoring American Financial Stability Act of 2010 (the "**Senate bill**"[2]; and together with the House bill, the "**Legislation**") both contain a requirement that large financial firms that do not own banks ("**NonBHCs**") should be regulated as if they were bank holding companies ("**BHCs**").[3] A NonBHC that is deemed to require regulation (a "**Regulated NonBHC**") would be subject to, among other things: (i) restrictions as to the activities in which the Regulated NonBHC could engage; and (ii) capital requirements. As a practical matter, these restrictions would (i) disadvantage a Regulated NonBHC as compared to its competitors; and (ii) subject the Regulated NonBHC to costs and operational burdens that could cause it to exit existing lines of business and potentially render it unable to compete with unregulated competitors.

Legislation which subjects firms to burdens of this type should be the subject of significant discussion. Nonetheless, this aspect of the Legislation—the creation of a class of Regulated NonBHCs—has attracted little attention for an unusual reason: **it is unclear which entities or what types of entities will be regulated** (other than that such firms are "financial firms"), or how many entities will be regulated. It is further unclear whether the determination of Regulated NonBHC status will be made in a mechanical manner (*e.g.*, all firms above a certain asset size), or in a subjective, ad-hoc manner.

An important issue is whether it is appropriate to impose (or authorize regulators to impose) **activity restrictions** and **capital requirements intended for banking organizations** on NonBHCs.[4] However, this issue may not receive the full and fair discussion it deserves inasmuch as the

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1 Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (as passed by House, Dec. 11, 2009).

2 Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (as passed by Senate, April 29, 2010).

3 A company that controls a bank is deemed to be a "BHC" under the Bank Holding Company Act ("**BHCA**") and Regulation Y of the Federal Reserve Board. 12 U.S.C. § 1841 *et seq.*; 12 C.F.R. Part 225.

4 *See House Regulatory Reform Bill May Impose Further Burdens on Large Funds* (Cadwalader Clients & Friends Memo, Feb. 4, 2010), *available at* http://www.cadwalader.com/assets/client_friend/020410HouseRegReformBill.pdf.

subjects of the law have no way to know that they will be subject to the proposed regulatory and capital regime until after the law is passed and implementing rules are adopted.

I. Why Banks and BHCs Are Regulated

A. Capital Regulation

Banks differ from nonbanks in that banks collect deposits from the general public and convert public savings into extensions of credit. Because this credit intermediation function is viewed as essential to the U.S. economy, banks are supported by a governmental "safety net," the most significant component of which is federal insurance for deposits. FDIC deposit insurance prevents depositor runs and liquidity crises at a bank by assuring depositors of repayment up to a certain insured amount. Because small depositors essentially make risk-free loans to FDIC-insured banks, banks do not have to compensate depositors for taking on credit risk and the bank can access unsecured funding at very low rates of interest, comparable to those available to the U.S. government.

The federal "safety net" also provides banks with access to the Federal Reserve discount window should a liquidity crisis arise. Access to the discount window allows a bank to obtain funding to meet its payment obligations as long as the bank has acceptable collateral to post to the Federal Reserve for emergency borrowing.

In return for these special privileges, banks are subject to safety and soundness regulation that includes governmentally-imposed limits on their activities and capital.[5]

B. Activity Restrictions

A BHC has indirect access to such low cost funding through its subsidiary bank, which carries FDIC-insured deposits and the other advantages of the federal safety net. If BHCs were permitted to exploit this funding advantage in competition with NonBHCs, the BHCs would have a significant competitive advantage.

Section 4 of the Bank Holding Company Act ("**BHCA**") addresses this competitive concern and limits affiliations between banks and nonbanking firms. In effect, Section 4 prevents BHCs from passing their funding advantages on to commercial affiliates. These restrictions on the affiliations,

[5] Banking law in general imposes on banks and BHCs numerous additional safety and soundness measures, including limitations on loans to insiders and affiliates, limits on lending concentration and inter-bank exposures, and special collateralization requirements for certain extensions of credit. Banking regulators examine banks regularly and may require asset write-downs and write-offs in the event the examiner disagrees with the bank's asset valuations.

and thus on the activities, of BHCs seek to prevent low-cost bank funding from concentrating economic power into the hands of a few large banking-industrial enterprises, such as the "Zaibatsu" system in Japan.

II. Some Distinctions between NonBHCs and BHCs

NonBHCs differ from BHCs in that NonBHCs do not own banks. As a corollary, NonBHCs do not have bank subsidiaries that benefit from federal deposit insurance, nor do they generally have access to the discount widow. In other words, the primary policy reasons for regulating BHCs (which are predicated on owning a bank, having low cost funding through deposits and access to the discount window) do not appear relevant to NonBHCs.

III. Which Companies Would be Regulated NonBHCs?

Under the House bill, a firm could be designated a Regulated NonBHC (the term the House bill uses is "financial holding company subject to stricter supervision" ("**FHCSSS**")) if the firm is deemed to be one that "presents a threat to financial stability or the economy" or if "the nature, scope, size, scale, concentration, and interconnectedness, or mix of the company's activities could pose a threat to financial stability or the economy."[6]

Under the Senate bill, a firm could be designated a Regulated NonBHC (the term in the Senate bill is "Nonbank financial company supervised by the Board of Governors") if "material financial distress at the nonbank financial company would pose a threat to the financial stability of the United States."[7]

The determination of "threat to financial stability" under both bills would be made by a newly created government entity, the Financial Services Oversight Council (the "**FSOC**").[8] Both the Senate and House bills would permit a NonBHC to contest these determinations in a hearing before the FSOC and appeal the FSOC's determination in federal court, but in light of the standard of review (a court may overturn the FSOC's determination if it was "arbitrary and capricious"), it

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6 House bill § 1103(a).

7 *See* Senate bill § 113. Note that the Senate bill provides more thoroughgoing distinctions between U.S. and non-U.S. financial companies receiving designation as a Regulated NonBHC. Non-U.S. firms must have "substantial assets or operations in the United States" to receive a NonBHC designation.

8 The FSOC must take into account differences between NonBHCs and BHCs in making recommendations regarding systemic significance, and the Board must consider such factors in prescribing prudential standards. *See* Senate bill §§ 115(b)(3)(A), 165(b)(3)(A); *see also U.S. Senate Bill Creates New Regime for Orderly Liquidation of Financial Companies That Present Systemic Risk* (June 1, 2010), *available at* http://www.cadwalader.com/assets/client_friend/060110FDIC_OrderlyLiquidationAuthority.pdf (discussing the legislation's orderly liquidation authority for systemically significant firms).

does not appear that a successful contest of a determination is likely.[9] Leaving aside the standard of review, it is difficult to understand how a NonBHC could articulate a legal challenge to designation as a Regulated NonBHC. For example, it is unclear how the operative standards (*i.e.*, "interconnectedness," "mix of activities," "threat to financial stability," "material financial distress") are measured.[10]

IV. Activity Burdens Imposed on Regulated NonBHCs

A. Under the House bill

A BHC is generally prohibited from engaging, directly, indirectly or through its subsidiaries, in nonfinancial activities.[11] Under the House bill, the same restrictions would apply, with some modifications, to a Regulated NonBHC.

A Regulated NonBHC that conducts activities impermissible under Section 4 of the BHCA (*i.e.,* nonfinancial activities) would be required to establish a "special purpose holding company" (a "**NonBHC Holding Company**") and move all activities that are "financial in nature" to the NonBHC Holding Company.[12] The NonBHC Holding Company may continue to affiliate with the original parent so long it operates independently.[13] The House bill thus appears to be a vehicle for separating a Regulated NonBHC so that the Federal Reserve Board can "ring-fence" the financial activities of the NonBHC Holding Company.[14]

By way of example, suppose a firm that was designated a Regulated NonBHC owns a registered investment adviser – an activity that is "financial in nature." Under the Legislation, the Regulated NonBHC would be required to form a NonBHC Holding Company and the Regulated NonBHC

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[9] *See* House bill § 1103(e); Senate bill 113(d), (g).

[10] The only apparent protection that a NonBHC has against designation as a Regulated NonBHC is § 170 of the Senate bill, which would provide a "Safe Harbor" that is to be implemented by Board regulation. The Safe Harbor would be available to "certain types or classes" of NonBHCs, but the Senate bill provides no detail as to which types or classes of NonBHCs the Board might exempt from designation.

[11] *See* 12 U.S.C. § 1843.

[12] *See* House bill § 1301(c) (new BHCA Section 6(a)(2)(B)).

[13] *See* House bill § 1103(f)(2). A limited amount of inter-affiliate "internal financial activities" permissible under Section 4(k) may continue to be conducted in the commercial parent under new Section 6(a)(2)(B) as long as at least 2/3 of the assets or revenues generated from such "internal financial activities" are "attributable" to the commercial parent or an affiliate thereof.

[14] NonBHC Holding Companies must also be established by certain other institutions that have not been designated a Regulated NonBHC. CEBA banks currently not registered as BHCs under BHCA §4(f)(1) and Unitary Savings and Loan Holding Companies under new BHCA §4(p)(1) must also form NonBHC Holding Companies through which they must conduct activities that are "financial in nature."

would not be able to operate its investment advisory business out of the parent as the House bill would prohibit the parent of a NonBHC Holding Company from engaging in financial activities.[15]

In addition, the NonBHC Holding Company would seemingly become a "Regulated NonBHC" and would be subject to heightened activity limitations and capital requirements.[16] (It is also unclear how or in what way the parent of a NonBHC Holding Company would be further regulated.)

The NonBHC Holding Company, which has now become a Regulated NonBHC, would also be subject to special corporate governance provisions intended to maintain its independence from the commercial parent.[17] These governance provisions include a requirement that 25% of the board of directors of the NonBHC Holding Company and each of its subsidiaries be "independent of the commercial parent" (even though the commercial parent may own 100% of the NonBHC Holding Company) and also a requirement that no management interlocks exist between the NonBHC Holding Company and its parent.

The Board is charged with issuing regulations that require effective legal and operational separation of the NonBHC Holding Company functions from its nonfinancial affiliates (except for human resources management, employee benefit plans, and information technology). In spite of this mandated separation, the parent of the NonBHC Holding Company would be required to serve as a source of financial strength to the NonBHC Holding Company, with an expectation that the parent would contribute capital to the NonBHC Holding Company if needed.

As described above, being deemed a Regulated NonBHC could have significant negative implications for a firm and its shareholders. For example, (i) the parent could lose substantial management control over the NonBHC Holding Company; (ii) the bar on shared functions could force the parent to expend additional employee resources; (iii) the source of strength requirement would constrain the parent's liquidity; and (iv) the parent would have "independent" board members whose fiduciary obligations are unclear as between the shareholders and the U.S. government.

B. Under the Senate bill

The provisions of the Senate bill regarding Regulated NonBHCs that conduct activities impermissible under BHCA Section 4(k) are less detailed that those of the House bill. The Senate bill would authorize the Board to require, **on a case-by-case basis**, a company designated as a Regulated NonBHC to establish an intermediate holding company through which it must engage in

[15] *See* House bill § 1301(c) (new BHCA Section 6(a)(2)(B)).

[16] House bill § 1103(f)(2)(A)(ii).

[17] *See* House bill § 1301 (adding a new Section 6(e) to the BHCA (12 U.S.C. §1845(e))).

"financial activities."[18] What flows from this is largely unstated and is to be determined through regulation.

V. Capital Requirements Imposed on Regulated NonBHCs

The House and Senate bills would also require the Board to impose on Regulated NonBHCs bank-like "prudential standards" that are **stricter than** those required of banks and BHCs, including: risk-based capital requirements; leverage limits; liquidity requirements; concentration requirements; credit exposure reporting requirements; prompt corrective action requirements; resolution plan requirements; short-term debt limits; debt-to-equity ratios; "contingent" capital requirements; and risk management requirements.[19]

However, the uncertain utility of applying bank regulatory concepts to nonbank firms, such as insurance companies or operating companies, can be illustrated by comparing the asset and liability make-up of a bank's balance sheet with the balance sheet of a non-bank firm.

The **asset side** of a bank's balance sheet generally consists of loans and is supplemented by a securities portfolio for liquidity purposes. The asset make-up of a NonBHC, in contrast, is impossible to generalize—it depends entirely on what businesses the NonBHC is engaged in. Risk-based capital requirements serve to protect the bank against the credit risk present in a bank's balance sheet (*i.e.*, risk of borrower default; calculating loss given such default based on collateral, guarantees, letters of credit and other forms of credit support).[20] However, there is no *a priori* basis for assuming a NonBHC will be subject to similar credit risks on the asset side of its balance sheet.

On the **liability side** of a bank's balance sheet, there are FDIC-insured deposits; while a NonBHC, by definition, has no such deposit liabilities.

The Senate bill directs the Board to consider "nonfinancial activities and affiliations" when subjecting Regulated NonBHCs to heightened capital requirements,[21] while the House bill requires (i) "flexible application" of prudential standards in light of the "usual and customary practices in the business sector" of the Regulated NonBHC, and (ii) prudential standards that are appropriate "in

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[18] *See* Senate bill § 167(b)(1). The Senate bill does not impose the blanket activity limitations contained in House bill, but § 121(a)(1) of the Senate bill authorizes the Board to require a Regulated NonBHC to terminate an activity if the Board finds that the company "poses a grave threat to the financial stability of the United States."

[19] *See* House bill § 1104(a)(2); Senate bill § 165(b)(1)(A). The set of "stricter" prudential standards required under each bill are generally the same.

[20] *See generally* 12 C.F.R. Part 325, Appendix A.

[21] Senate bill § 165(b)(3)(A)(iii).

light of the predominant line of business" of the Regulated NonBHC.[22] These "standards" are extremely vague. Further, it is unclear how the Board could acquire or maintain a reliable understanding of customary practices in each of the business sectors relevant to Regulated NonBHCs in light of the fact that the Board does not regulate commerce generally, but merely the business of banking.

VI. Summary of Questions

The House and Senate bill provisions discussed above raise numerous questions. At a minimum, the Conference Committee should address the following:

- What is the policy rationale for regulating the capital and activities of Regulated NonBHCs as if they owned bank? What is the rationale for regulating the capital of NonBHCs more strictly than the capital of BHCs? How is the Board to determine capital standards for the assets and liabilities associated with the non-banking business lines of a Regulated NonBHC?
- How do the intended benefits of the Legislation compare to the costs to Regulated NonBHCs? Will the costs be substantial enough to cause firms to move activities outside of the United States (so as not to become a Regulated NonBHC) or to exit lines of business? Will subjecting Regulated NonBHCs to stricter capital regulation than BHCs significantly disadvantage Regulated NonBHCs?
- How many entities will be Regulated NonBHCs? Is the Legislation intended to affect a few companies or thousands?
- How will the FSOC ensure a consistent standard for its decisions to designate a firm a Regulated NonBHC? Should there be more specific considerations than a "threat to the stability" of the U.S. financial system? How will factors such as "interconnectedness" be measured?
- If a company would otherwise be deemed to be a Regulated NonBHC, should it have the opportunity to reduce its business or to spin off businesses to avoid Regulated NonBHC status?
- What is the role of an "independent director" of a Regulated NonBHC? Does an "independent director" represent the interests of both the Regulated NonBHC and the interests of the U.S. government or U.S. regulatory agencies?

[22] House bill §§ 1103(f)(2)(D) and 1104(a)(3).

If you have any questions about the foregoing, please contact:

Steven D. Lofchie	+1 212 504 6700	steve.lofchie@cwt.com
Richard M. Schetman	+1 212 504 6906	richard.schetman@cwt.com
Maurine R. Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
Bryan T. Shipp	+1 212 504 5615	bryan.shipp@cwt.com