

June 12, 2012

MEMORANDUM TO: Board of Directors

FROM:

Jim R. Wigand, Director 
Office of Complex Financial Institutions

Richard J. Osterman, Jr.  Acting General Counsel

SUBJECT:

Notice of Proposed Rulemaking to Amend Proposed Section 380.8,
Definition of “Predominantly Engaged in Financial Activities” for
Purposes of Title II

Proposal: That the Board of Directors (“Board”) of the Federal Deposit Insurance Corporation (“FDIC”) approve publication of the attached notice of proposed rulemaking titled *Definition of “Predominantly Engaged in Activities That are Financial in Nature or Incidental Thereto”* (“NPR” or “proposed rule”), in the *Federal Register* for a 60-day comment period. The NPR would amend the definition of “financial activities” set forth in section 380.8 of the FDIC’s notice of proposed rulemaking published in the *Federal Register* on March 23, 2011 titled “Orderly Liquidation Authority” (“March 2011 NPR”).¹ The March 2011 NPR proposed criteria for determining if a company is predominantly engaged in financial activities for purposes of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “Act”).² The NPR would amend section 380.8 of the March 2011 NPR to clarify the scope of activities that would be considered to be “financial activities” for purposes of determining if a company is predominantly engaged in such activities under Title II of the Act.

Recommendation: Staff recommends that the Board approve publication of the NPR for a 60-day public comment period.

Discussion

¹ 76 FR 16324 (March 23, 2011).

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Background

Title II of the Act (“Title II”) provides for the appointment of the FDIC as receiver of a “covered financial company” following the prescribed recommendation, determination, and, if applicable, judicial review process set forth in the Act. Section 201(a)(11) of the Act defines “financial company,” for purposes of Title II, as any domestic company that is: (i) a bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (“BHC Act”)³; (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System (“Board of Governors”); (iii) any company that is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 4(k) of the BHC Act;⁴ or (iv) any subsidiary of any of the aforementioned companies that is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 4(k) of the BHC Act (“financial activities”), other than a subsidiary that is an insured depository institution or insurance company.⁵

Section 201(b) of the Act provides that, for the purposes of defining the term “financial company” under section 201(a)(11), “[n]o company shall be deemed to be predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 4(k) of the [BHC Act], if the consolidated revenues of such company from such activities constitute less than 85 percent of the total consolidated revenues of such company, as the Corporation, in consultation with the Secretary [of the Treasury], shall establish by regulation. In determining whether a company is a financial company under [Title II], the consolidated revenues derived from the ownership or control of a depository institution shall be included.”

Section 380.8 as proposed in the March 2011 NPR⁶ set forth proposed criteria for determining if a company is predominantly engaged in activities that are financial in nature or

³ 12 U.S.C. § 1841(a).

⁴ 12 U.S.C. § 1843(k).

⁵ Section 201(a)(11) also provides that “financial company” does not include Farm Credit System institutions chartered under and subject to the provisions of the Farm Credit Act of 1971, as amended (12 U.S.C. § 2001 *et seq.*), or governmental or regulated entities as defined under section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. § 4502(20)).

⁶ The provisions proposed in the March 2011 NPR were intended to provide notice on how the FDIC would implement a number of the key components of the orderly liquidation authority under Title II. Provisions of the March 2011 NPR, apart from section 380.8, were adopted in a final rule published in the Federal Register on July 15, 2011. 76 FR 41626 (July 15, 2011).

incidental thereto (“financial activities”) for the purposes of Title II. Specifically, proposed section 380.8 provided that a company would be predominantly engaged in financial activities if: (i) at least 85 percent of the total consolidated revenues of the company for *either* of its two most recent fiscal years were derived, directly or indirectly, from financial activities, or (ii) based upon all the relevant facts and circumstances, the FDIC determines that the consolidated revenues of the company from financial activities constitute 85 percent or more of the total consolidated revenues of the company. Proposed section 380.8 also included applicable definitions and a number of rules of construction that would be utilized in determining if a company is predominantly engaged in financial activities. The public comment period on the March 2011 NPR closed on May 23, 2011. The FDIC received six comments addressing proposed section 380.8 in the March 2011 NPR; one comment addressed the definition of “financial activities.” This commenter suggested that a firm that organizes, sponsors, and manages an open-end investment company (including a mutual fund or money market mutual fund) should not be considered to be engaged in a financial activity if the firm owns or controls more than a given percentage of the fund because a financial holding company may not own or control more than that amount of the fund.

Prior to the FDIC’s publication of the March 2011 NPR, the Board of Governors published a notice of proposed rulemaking titled “Definitions of ‘Predominantly Engaged in Financial Activities’ and ‘Significant’ Nonbank Financial Company and Bank Holding Company” (“Board of Governors’ NPR”).⁷ The Board of Governors’ NPR proposed criteria for determining whether a company is “predominantly engaged in financial activities” for purposes of determining if the company is a nonbank financial company under Title I of the Act.⁸ The Title I definition of “predominantly engaged in financial activities” is based upon activities that are “financial in nature” as defined in section 4(k) of the BHC Act. Similarly, the criteria for determining under Title II whether a company (other than a bank holding company or a nonbank financial company supervised by the Board of Governors) is predominantly engaged in financial activities is primarily based upon activities that the Board of Governors has determined are “financial in nature” under section 4(k) of the BHC Act. As a result of the commonalities

⁷ 76 FR 7731 (February 11, 2011).

⁸ Under section 113 of the Act, the Financial Stability Oversight Council (“FSOC”) may designate a nonbank financial company for supervision by the Board of Governors if the FSOC determines that the nonbank financial company could pose a threat to the financial stability of the United States.

between the definitions in Titles I and II, staff coordinated closely with the Board of Governors on the proposed criteria set forth in section 380.8 in the March 2011 NPR.

In April of 2012, the Board of Governors published a supplemental notice of proposed rulemaking that would amend the definition of financial activities set forth in the Board of Governors' NPR ("Board of Governors' Amended NPR").⁹ The Board of Governors' Amended NPR was published in response to comments that raised questions as to whether the conduct of certain financial activities in a manner that did not comply with applicable to bank holding companies under section 4(k) of the BHC Act and Regulation Y should be considered financial activities for purposes of Title I.

Section 4(k) of the BHC Act ("section 4(k)") and the Board of Governors' Regulation Y ("Regulation Y")¹⁰ contain a list of financial activities and impose conditions on bank holding companies and financial holding companies conducting those activities. Many of the conditions contained within section 4(k) and Regulation Y are intended to permit bank holding companies to engage in certain financial activities without threatening the safety and soundness of subsidiary depository institutions. Similarly, other conditions are intended to prevent financial holding companies from controlling commercial firms or are related to compliance with other provisions of law. Such conditions regulate the conduct of bank holding companies or financial holding companies engaged in such activities, but do not define the essential nature of the activity itself. As a result, the Board of Governors' Amended NPR proposes to clarify that any activity described as financial in nature in section 4(k) would be considered to be a financial activity for purposes of Title I of the Act without regard to the conditions and limitations imposed by section 4(k) and Regulation Y on bank holding companies and financial holding companies that do not define the activity itself. The Board of Governors' Amended NPR includes as an appendix a list of activities that are financial in nature identical to those in section 4(k), without the conditions and limitations imposed on the conduct of the activity by a bank holding company or a financial holding company that do not describe the financial activity.

⁹ 77 FR 21494 (April 10, 2012).

¹⁰ 12 CFR Part 225.

Summary of the NPR

The NPR proposes to adopt the approach proposed in the Board of Governors' Amended NPR for determining which activities are financial activities for purposes of Title II. Staff believes that it is important for several reasons that "financial in nature" for purposes of Title II means the same as it does for purposes of Title I. First, section 4(k) is in the BHC Act, and the Board of Governors is the Federal agency charged with interpreting and implementing the BHC Act. Any interpretation of "financial in nature" under section 4(k) inconsistent with the Board of Governors' interpretation could frustrate Congressional intent regarding Title II. Section 204 of the Dodd Frank Act generally states that the intent of Title II is to provide for the liquidation of failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard. Based upon this expression of Congressional intent regarding Title II, and given that one of the goals of Title I is to provide the authority to require the supervision of certain nonbank financial companies that could pose a threat to the financial stability of the United States, staff believes that both of these goals can be achieved in a manner consistent with Congressional goals if such a key term as "financial in nature" is given the same meaning in both Titles I and II. Second, utilizing in Title II an interpretation of "financial in nature" that is inconsistent with the Title I interpretation could result in confusion on the part of companies that may be subject to either or both of Titles I and II. Third, staff believes that it is important that Titles I and II work together in a manner that provides a coherent framework for monitoring and controlling financial companies that could have a serious adverse effect on the financial stability of the United States, as they operate, and for liquidating those institutions, should it be necessary, with the least disruption to U.S. financial stability, if any should fail.

While both Title I and Title II rely on section 4(k) to determine whether a company is predominantly engaged in financial activities, there are two important differences between the two titles in how section 4(k) is utilized. One of those differences¹¹ is that, for purposes of Title

¹¹ Under section 102(a)(6) of the Act, a company is predominantly engaged in financial activities for purposes of Title I if (i) the company's annual gross revenues derived from such activities constitute 85 percent or more of the company's annual gross consolidated revenues, or (ii) the company's consolidated assets related to such activities represent 85 percent or more of the consolidated assets of the company. Conversely, under Title II, a company is predominantly engaged in financial activities only if the company's consolidated revenues derived from financial activities constitute 85 percent or more of the company's total consolidated revenues.

I, only those activities that are “financial in nature” as defined in section 4(k) are included in determining whether a company is predominantly engaged in financial activities.¹² In contrast, Title II includes activities that the Board of Governors has determined are either “financial in nature” or “incidental thereto” under section 4(k). Consequently, the NPR would amend the March 2011 NPR to clarify that, consistent with the Board of Governors’ Amended NPR and the purposes of Title II, the term “financial activity” includes each activity referenced in section 4(k) that the Board of Governors has determined are either financial in nature or incidental thereto without regard to conditions or limitations that are imposed on bank holding companies or financial holding companies engaged in such activities that do not define the essential nature of the activity itself.¹³

Section 380.8 of the March 2011 NPR proposed a definition of “financial activity” that includes: (i) any activity, wherever conducted, described in section 225.86 of the Board of Governors’ Regulation Y¹⁴ or any successor regulation; (ii) ownership or control of one or more depository institution(s); and (iii) any other activity, wherever conducted, determined by the Board of Governors in consultation with the Secretary of the Treasury, under section 4(k)(1)(A) of the BHC Act¹⁵ to be financial in nature or incidental to a financial activity.¹⁶ As amended by the NPR, the definition of “financial activities” under section 380.8 would include, in place of the reference to section 225.86 of Regulation Y in (i) above, a list of the activities described in section 4(k) and Regulation Y, but without the conditions and limitations imposed on bank holding companies and financial holding companies for safety and soundness reasons or that are related to compliance with other applicable law.

Similar to the conclusion cited in the Board of Governors’ Amended NPR, staff believes that defining financial activities for purpose of Title II to include all of those conditions likely would enable some companies to be predominantly engaged in financial activities and yet avoid the orderly liquidation process simply by choosing not to abide by such conditions. Staff believes that excluding such conditions is consistent with the purposes of Title II. Staff at the

¹² Section 102(a)(6) of the Dodd Frank Act.

¹³ As noted in the Board of Governors’ Amended NPR, conditions that do not define the activity itself include those conditions 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. *See* 77 FR 21494 (April 10, 2012).

¹⁴ 12 CFR Part 225.

¹⁵ *See*, 12 U.S.C. § 1843(k)(1)(A).

¹⁶ *See*, 76 FR 16324 (March 23, 2011).

Board of Governors was consulted during the development of this NPR. Staff at the U.S. Treasury also was consulted, as required by section 201(b) of the Act.

Recommendation:

Staff recommends that the Board approve for publication in the *Federal Register* the attached NPR, which seeks comment on a proposed amendment to the definition of “financial activities” set forth in section 380.8 of the March 2011 NPR.

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