May 28, 2014

# Dodd-Frank Act: Additional Concentration Limits on Large Financial Companies

## Federal Reserve Proposes Rules Implementing Dodd-Frank Section 622's Prohibition on Business Combinations Where the Resulting Financial Company's Total Consolidated Liabilities Would Exceed 10 Percent of Aggregate U.S. Financial Sector Liabilities


### SUMMARY

On May 8, 2014, the Board of Governors of the Federal Reserve Board (the "*FRB*") issued a notice of proposed rulemaking (the "*Proposed Rule*")[1] implementing the financial institutions concentration limit provision in new Section 14 of the Bank Holding Company Act of 1956 (the "*BHCA*"), which was added to that statute by Section 622 of the Dodd-Frank Act.[2] Section 622 generally prohibits financial companies from consummating business combinations if, after giving effect to the consummation, the total consolidated liabilities of the resulting financial company would exceed 10 percent of the aggregate consolidated liabilities of all financial companies in the United States at the end of the calendar year preceding the transaction. The term "*financial company*" is defined to include: U.S. insured depository institutions; bank holding companies; savings and loan holding companies; other companies that control insured depository institutions; foreign financial companies that have a U.S. branch or agency or control an insured depository institution in the United States;[3] and non-bank companies designated by the Financial Stability Oversight Council (the "*FSOC*") under Section 113 of the Dodd-Frank Act to be regulated by the FRB because of their systemic importance.[4] Of note, this definiton means that most non-depository financial services companies are not included in the the aggregate consolidated liabilities of all financial companies in the United States and that, for example, some insurance companies are defined as financial services companies (and included in the the aggregate consolidated liabilities of all financial companies in the United States), although most are not.

The FRB estimates the aggregate consolidated liabilities of all financial companies in the United States for this purpose – defined in the Proposed Rule as "*financial sector liabilities*" – to be approximately $18 trillion as of year-end 2013 – with the consequence that total consolidated liabilities of a resulting financial company after consummation of an acquisition covered by the Proposed Rule could not exceed approximately $1.8 trillion. Consolidated liabilities for foreign financial companies are defined as the liabilities of their *combined U.S. operations*, not of their worldwide operations. Consolidated liabilities of U.S. financial companies are effectively defined as the consolidated liabilities of their *worldwide operations*.

Section 622's concentration limit, as it would be implemented by the Proposed Rule, would expand existing limitations on acquisitions by the largest U.S. bank holding companies. Because the consolidated liabilities of foreign financial companies are determined with reference only to the liabilities of their combined U.S. operations, Section 622 and the Proposed Rule are not likely to act as a constraint on their potential acquisitions in the United States, at least in the normal case where the resulting company is a foreign financial company.

Comments on the Proposed Rule must be submitted by July 8, 2014.

## BACKGROUND

Size-based limitations on acquisitions by U.S. banking organizations have existed since the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "*Riegle-Neal Act*"). That Act precluded regulatory approval of any acquisition that would result in the acquiror holding 10 percent or more of total U.S. deposits.[5] Although in 1994 no bank holding company approached that 10 percent level, subsequent consolidation, including "rescue" transactions, and organic growth have resulted in three U.S. bank holding companies exceeding the 10 percent deposit ceiling.

In addition, Section 604(d) of the Dodd-Frank Act amended Section 3(c) of the BHCA[6] to add the so-called "*financial stability factor*" to the relevant considerations for the FRB in approving bank acquisitions. The FRB has broadly interpreted that provision to prohibit all but very small acquisitions by the largest banking organizations. Importantly, unlike the deposit cap imposed by the Riegle-Neal Act and the financial stability factor analysis, Section 622's prohibition is absolute, and applies irrespective of whether a regulatory approval application is required with respect to the relevant acquisition.[7]

## DISCUSSION

The Proposed Rule would be added to the FRB's rules as Regulation XX, 12 C.F.R. Part 251.[8] The operative concentration limit, as set forth in Section 251.3(a)(1) of the Proposed Rule, states that "a financial company may not consummate a covered acquisition if the liabilities of the resulting financial company upon consummation of the transaction would exceed 10 percent of the financial sector liabilities."

The Proposed Rule includes three exceptions to the general prohibition: (i) an acquisition of an insured depository institution in default or in danger of default;[9] (ii) an acquisition with respect to which assistance is provided by the Federal Deposit Insurance Corporation (the "*FDIC*"); and (iii) *de minimis* acquisitions, defined as acquisitions which would result in an increase in the consolidated liabilities of the acquiring financial company that does not exceed $2 billion when aggregated with all other *de minimis* acquisitions by the financial company during the preceding 12 months. Notably, none of the exceptions cover acquisitions of failing or troubled non-depository institutions. The definition of "*covered acquisition*" effectively provides additional exemptions as described in further detail below.

The Proposed Rule's concentration limit is implemented primarily through its definitions of "*covered acquisition*" and "*financial company*" (and, in each case, related definitions) and the detailed provisions addressing the calculation of the total consolidated liabilities of a financial company that results from a covered acquisition (the "*numerator*" of the concentration limit) and of aggregate financial sector liabilities, which are used as the denominator of the concentration limit (the "*denominator*").

### Definition of Covered Acquisition

A "*covered acquisition*" is defined as "a transaction in which a company merges or consolidates with, acquires all or substantially all of the assets of, or otherwise acquires control[10] of another company, and the resulting company is a financial company." The term does not include purchase and assumption transactions (or asset acquisitions) that do not constitute "all or substantially all" of the target's assets.[11] In addition to the three exceptions to the concentration limit described above, a covered acquisition is defined not to include: (i) an acquisition of securities or other assets by a financial company in the ordinary course of collecting a debt previously contracted in good faith, so long as the acquired shares or assets are disposed of within specified time periods; (ii) an acquisition of securities or other assets in good faith in a fiduciary capacity; (iii) an acquisition of ownership or control of securities or other assets by a financial company in connection with a *bona fide* merchant or investment banking activity;[12] (iv) an acquisition of ownership or control of securities or assets in connection with *bona fide* underwriting or market-making activities; and (v) an acquisition of ownership or control of securities or assets in connection with an internal corporate reorganization.

### Definition of Financial Company

The term "*financial company*" includes: (i) an insured depository institution; (ii) a bank holding company; (iii) a savings and loan holding company; (iv) a company, whether U.S. or foreign, that otherwise controls an insured depository institution (for example, a company that controls an industrial loan company); (v) a non-bank financial company designated by the FSOC for supervision by the FRB; and (vi) a foreign bank or company that is treated as a bank holding company for purposes of the BHCA (an "*FBO*"). In order to facilitate calculating both a resulting financial company's total consolidated liabilities for the numerator of the concentration limit and financial sector liabilities for the denominator, the Proposed Rule divides financial companies between "*U.S. financial companies*," which are incorporated in or organized under the laws of the United States or any state thereof, and "*foreign financial companies*," which are incorporated or organized in a country other than the United States.

### Calculation of the Denominator

The concentration limit's denominator (that is, aggregate financial sector liabilities) is the average for the prior two years of the sum of the consolidated liabilities of all top-tier U.S. financial companies and the U.S. liabilities of all top-tier foreign financial companies, in each case, calculated in the manner described below. The FRB will calculate and publish by July 1 of each calendar year the total financial sector liabilities as at the end of each of the two preceding calendar years (for example, by July 1, 2015, financial sector liabilities as of December 31, 2014 and December 31, 2013). Financial companies and the FRB will use that denominator for purposes of calculating concentration limits during the period beginning on July 1 of the given year through June 30 of the following year.

### Calculation of the Numerator

The Proposed Rule's provisions addressing the calculation of the total consolidated liabilities of a financial company that results from a covered acquisition for purposes of the numerator in the concentration limit are relatively complex. Because the concentration limit takes into account only U.S. liabilities of a resulting company that is a foreign company, in cross-border transactions the calculation of the concentration limit will differ depending on whether the resulting financial company is a U.S. or a foreign company, as reflected in the following table:

| | | **Acquired Company** | |
|---|---|---|---|
| | | *U.S. Company* | *Foreign Company* |
| **Resulting Company** | *U.S. Company* | The total consolidated liabilities of the resulting company, calculated on a *pro forma* basis as described below. As a result, operations of the resulting company inside and outside of the United States would be included. | The total consolidated liabilities of the resulting company, calculated on a *pro forma* basis as described below with respect to a U.S. financial company. As a result, the operations of the resulting company (including those of the acquired company) both inside and outside of the United States would be included. |
| | *Foreign Company* | The sum of the U.S. liabilities of the acquiring foreign company immediately before the transaction calculated as described below and the consolidated liabilities of the acquired U.S. company immediately before the transaction calculated as described below. As a result, operations of the acquired U.S. company inside and outside of the United States would be included.[13] | The total U.S. liabilities of the resulting financial company, calculated on a *pro forma* basis as described below. |

Liabilities of an individual U.S. financial company:

- For a U.S. bank holding company, savings and loan holding company or insured depository institution subject to the risk-based capital rules of a U.S. banking agency (that is, the FRB, the FDIC or the Office of Comptroller of the Currency), the financial company's consolidated liabilities for concentration limit purposes are calculated as:
  - total risk-weighted assets as determined under those rules;[14] plus
  - amounts deducted from regulatory capital under those rules times a multiplier equal to the inverse of the financial company's total risk-based capital ratio minus one;[15] minus
  - the financial company's total regulatory capital.
- For a U.S. company not subject to the risk-based capital rules of a U.S. banking agency (for example, a designated company supervised by the FRB if the FRB determines not to apply risk-based capital rules to such company), the financial company's total liabilities for concentration limit purposes are calculated as such company's total liabilities determined under applicable accounting standards.
  - The Proposed Rule provides that "*applicable accounting standards*" would generally be defined as U.S. generally accepted accounting principles ("*U.S. GAAP*"). However, if a company does not calculate its total consolidated assets or liabilities for any regulatory purpose (including compliance with applicable securities laws) under U.S. GAAP, the company may request that the FRB permit it to use an accounting method other than U.S. GAAP. The FRB may permit the company to do so in its discretion.

The U.S. liabilities of a foreign financial company are equal to the sum of:

- the consolidated assets of each U.S. branch and U.S. agency of the foreign financial company, calculated in accordance with applicable accounting standards;
- the consolidated liabilities of each top-tier U.S. subsidiary that is subject to the risk-based capital rules of a U.S. banking agency (or reports information to the FRB regarding its capital under risk-based capital rules applicable to bank holding companies), calculated as if it were a U.S. financial company and as described above; and
- the consolidated assets (notably, not liabilities and without any offset for shareholders' equity) of each top-tier U.S. subsidiary that is not subject to the risk-based capital rules of a U.S. banking agency and does not report information regarding its capital under risk-based capital rules applicable to bank holding companies, calculated in accordance with applicable accounting standards.[16]

The Proposed Rule does not expressly address whether the relevant calculation date for the numerator is the consummation date of a proposed acquisition or, for example, the date an acquisition agreement is entered into or the date of application to the FRB.

### New Reporting Requirements

The FRB intends to use information already reported by financial companies to calculate consolidated assets and financial sector liabilities. Certain financial companies do not currently report consolidated financial information to any federal banking regulator. The FRB needs this information in order to calculate aggregate financial sector liabilities. Therefore, in connection with the Proposed Rule, the FRB is proposing a new reporting form (designated FR Y-17), titled Financial Company Report of Consolidated Liabilities, that would be required for such companies. A U.S. financial company would be required to report its consolidated liabilities under applicable accounting standards as of December 31. A foreign financial company would be required to report the consolidated liabilities of the combined U.S. operations of the financial company as of December 31. The FRB intends to collect the first report on FR Y-17 on March 31, 2015. That report would be required to cover both 2013 and 2014 so that the FRB is able to calculate a two-year average.

### Notice of Transactions not Otherwise Requiring Notice

The FRB proposes to enforce the concentration limits by reviewing the applications and prior notices submitted to it as required by statute and regulation. In order to be able to review transactions with respect to which no application or prior notice is otherwise required to be submitted to the FRB, the FRB proposes requiring a notice to be submitted with respect to any covered acquisition if: (i) the total consolidated liabilities of the resulting financial company would exceed 8 percent of financial sector liabilities; (ii) the acquisition would increase the liabilities of the financial company by more than $2 billion when aggregated with all other covered acquisitions by the financial company during the 12 months preceding the acquisition; and (iii) notice to the FRB is not otherwise required. Notice must be provided no later than the earlier of 60 days before consummating a covered acquisition and 10 days after execution of the agreement specifying the terms of the covered acquisition. The notification must include a description of the proposed covered acquisition, estimates of the *pro forma* assets and liabilities of the resulting company calculated as described above, and any other information that the FRB determines would be appropriate.

## OBSERVATIONS AND IMPLICATIONS

As noted above, Section 622's concentration limit, as implemented by the Proposed Rule, would expand already severe limitations on acquisitions by the largest U.S. holding companies. In addition to creating a new metric, the Proposed Rule would apply to acquisitions of non-depository companies and non-U.S. companies. Furthermore, the Proposed Rule would have the effect of favoring business combinations between U.S. financial companies and foreign companies that are structured, as a legal matter, such that the foreign financial entity is the technical survivor of the merger, for example even where the U.S. financial company is the larger counterparty or where the merger is a merger of equals. Likewise, the Proposed Rule would have a particularly negative impact on those FBOs that are able to obtain an exemption for their U.S. subsidiaries from the intermediate U.S. holding company requirement or that maintain an excess of assets over liabilities in their U.S. branches and agencies.

An additional issue that may invite comment is that the method for adjusting risk-weighted assets to reflect amounts deducted from regulatory capital will greatly affect institutions that deduct a large amount of assets from regulatory capital. It is not clear that such a strong effect for assets deducted from regulatory capital on risk-weighted assets and, therefore, on concentration limits, was intended by Section 622. The FRB did not provide a detailed analysis for its decision to use a high multiplier and has asked commenters for rationales regarding the use of a smaller multiplier for certain deducted assets.

Finally, to the extent that a financial company reaches the 10 percent limit in the future, the Proposed Rule may significantly inhibit internal growth in a manner that the FRB did not intend. Despite the fact that the release accompanying the Proposed Rule states that it is not the aim of the Proposed Rule to constrain internal growth, certain transactions that are generally not considered strategic acquisitions may trigger the Proposed Rule to the extent that a financial company has reached the 10 percent limit. For example, the acquisition of a portfolio of loans by a financial company that has reached the 10 percent limit may be prohibited if such loans constitute all or substantially all of the assets of a subsidiary of the company that is selling them. The same transaction would not be prohibited if the purchased assets constituted less than "all or substantially all" of the seller subsidiary's assets (which under normal corporate law principles would not be triggered if, for example, only half of the assets of the same seller subsidiary were the subject of the purchase). Other transactions that are generally deemed non-strategic may be also be caught up in this prohibition, especially because of the broadness of the definition of "control" in the BHCA and the FRB's Regulation Y and related interpretations and the broadness of the anti-evasion provision of the Proposed Rule. For example, taking control of a securitization vehicle may raise issues for a financial company that has reached the 10 percent limit, depending on the structure of the transaction.

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## ENDNOTES

[1] The Proposed Rule and the FRB's related release were published in the Federal Register on May 15, 2014 at 79 Fed. Reg. 27801.

[2] 12 U.S.C. § 1852.

[3] The FRB has recently issued final rules addressing certain aspects of the supervision and regulation of large U.S. bank holding companies and foreign banking organizations as required by Section 165 of the Dodd-Frank Act. (79 Fed. Reg. 17240). These final rules establish a number of enhanced prudential standards for large U.S. bank holding companies and foreign banking organizations to help increase the resiliency of their operations, as described in our memo to clients titled "*Enhanced Prudential Standards for Large U.S. Bank Holding Companies and Foreign Banking Organizations*" (February 24, 2014).

[4] To date, three non-bank financial companies have been designated by the FSOC for supervision by the FRB. These companies are American International Group, General Electric Capital Corporation and Prudential Financial, Inc.

[5] More specifically, the Riegle-Neal Act's nationwide deposit cap generally prohibits the appropriate federal banking agency from approving an application by a bank holding company, insured depository institution, or savings and loan holding company to acquire an insured depository institution located in a different home state than the acquiring company if the acquiring company controls, or following the acquisition would control, more than 10 percent of the total amount of deposits of insured depository institutions in the United States. *See* 12 U.S.C. §§ 1467a(e)(2)(E), 1828(c), 1842(d)(2) and 1843(i)(8).

[6] 12 U.S.C. 1842(c).

[7] As discussed in more detail below, the Proposed Rule also includes a proposed requirement to notify the FRB of proposed business combinations where the resulting company's consolidated liabilities, calculated as described in the Proposed Rule on a *pro forma* basis, reach a specified threshold and where an application or notice to the FRB is not otherwise required.

[8] Section references herein refer to sections of the Proposed Rule.

[9] The terms "*default*" and "*in danger of default*" are defined in Section 3 of the Federal Deposit Insurance Act, 12 U.S.C. 1813(x). The term "*default*" generally means any appointment of a conservator, receiver, or other legal custodian. The term "*in danger of default*" generally means the appropriate federal banking agency or state chartering authority has advised the FDIC that (i) (w) an institution or branch is not likely to be able to meet the demands of the institution's or branch's depositors or pay the institution or branch's obligations in the normal course of business, and (x) therefore the institution or branch requires federal assistance; or (ii) (y) the depository institution or insured branch has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and (z) therefore the institution or branch requires federal assistance.

[10] As Section 622 is codified in the BHCA, "*control*" has the meaning given it in Section 2 of the BHCA. The Proposed Rule further clarifies that "*control*" has the same meaning as in the Federal Reserve's Regulation Y (12 C.F.R. Part 225.2(e)).

[11] The FRB does not address, either in the text of the Proposed Rule or in the release accompanying the Proposed Rule, whether the phrase "all or substantially all" will be construed in a manner consistent with the construction of corporate statutes requiring shareholder approval of dispositions of all or substantially all of a company's assets (for example, Delaware General Corporation Law § 271(a)) or case law construing similar phrases in indenture covenants. If the FRB intends that the phrase be construed in accordance with such case law, the "all or substantially all" standard would generally only prohibit a transaction involving meaningfully more than 50 percent of the assets of the seller (if the asset percentage of the seller is used as the primary or only factor – the case law generally requires a number of qualitative and quantitative

factors to be analyzed). As a result, the definition in the Proposed Rule may permit several types of major acquisitions. For example, it would not prohibit a purchase of branches or another substantial part of a financial company that nevertheless does not amount to an acquisition of "all or substantially all" of a company's assets.

12 The wording of this exemption leaves ambiguity regarding its scope and extent. While it is clear that the FRB intends to exempt merchant banking activities as permitted by Sections 4(k)(4)(H) and (I) of the BHCA, it is not clear what the FRB intends by its reference to "investment banking" activity. The release accompanying the Proposed Rule appears to only discuss merchant banking activity, and underwriting and market-making are subject to a separate exemption. Further, it should be noted that although covered acquisitions in reliance upon the merchant banking authority are excluded from the concentration limit's prohibition, they do add to the acquiring financial company's total liabilities and, accordingly, impact the application of the concentration limit to non-excluded covered acquisitions.

13 Consequently, the foreign liabilities of the acquired U.S. company would not be included in calculations of the total consolidated liabilities of the resulting foreign company in any subsequent acquisitions by the resulting foreign company if the resulting foreign company reorganizes internally such that the acquired foreign liabilities no longer have a U.S. holding company.

14 Advanced approaches institutions would use the higher of the two risk-weighted assets values – that is, under the so-called "standardized approach" versus the models-based "advanced approach" – that they calculate for the purposes of their regulatory capital ratios to calculate their consolidated liabilities.

15 To illustrate, if an institution's total capital ratio is equal to 8 percent (the regulatory minimum), the institution-specific multiplier would equal 12.5 – 1, or 11.5. If an institution's total capital ratio is equal to 16 percent (twice the regulatory minimum), the institution-specific multiplier would equal 6.25 – 1, or 5.25. Thus, the more total regulatory capital an institution has, the lower its applicable multiplier.

16 A foreign financial company that is an FBO must reduce the amount of its U.S. liabilities by amounts corresponding to intercompany balances and intercompany transactions between the FBO's U.S.-domiciled affiliates, branches or agencies to the extent such items are not already eliminated in consolidation, and increase its U.S. liabilities by net intercompany balances and intercompany transactions between a non-U.S. domiciled affiliate and a U.S. domiciled affiliate, branch, or agency of the foreign banking organization, to the extent such items are not already reflected.

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