June 4, 2013

MEMORANDUM TO: Board of Directors

FROM: Jim R. Wigand, Director
Director, Office of Complex Financial Institutions

Richard J. Osterman, Jr.
Acting General Counsel

SUBJECT: Final Rule Establishing Criteria for Determining if a Company is "Predominantly Engaged in Activities that are Financial in Nature or Incidental Thereto" for Purposes of Title II

Proposal: That the Board of Directors ("Board") of the Federal Deposit Insurance Corporation ("FDIC") adopt and issue the attached final rule titled *Definition of "Predominantly Engaged in Activities that are Financial in Nature or Incidental Thereto"* ("final rule") and authorize its publication in the Federal Register. The final rule adds section 380.8 to Part 380 of the FDIC's Rules and Regulations ("section 380.8"). Section 380.8 establishes criteria for determining if a company is predominantly engaged in "activities that are financial in nature or incidental thereto" for purposes of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or the "Act").[1] A company that is predominantly engaged in such activities is a "financial company" for purposes of Title II of the Act ("Title II") unless it is one of the few entities specifically excepted by the Act. A financial company, other than an insured depository institution, may be subject to Title II's orderly liquidation authority if, among other things, it is determined that the failure of the company and its resolution under otherwise applicable law would have serious adverse effects on financial stability in the United States.

Recommendation: Staff recommends that the Board approve the final rule and authorize its publication in the Federal Register.

Discussion

Background

Title II provides for the appointment of the FDIC as receiver of certain financial companies following the prescribed recommendation, determination, and, if applicable, judicial

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

review process set forth in the Act. Under this process, certain designated Federal regulatory authorities (herein referred to as the "recommending agencies") must recommend to the Secretary of the Treasury (the ''Secretary'') that the Secretary, after consultation with the President, appoint the FDIC as receiver of the company.[2] Title II requires that each recommendation to the Secretary include, among other things, an evaluation of whether the company is a "financial company."

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, other than a subsidiary that is an insured depository institution or insurance company.[5]

Section 201(b) of the Act states 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 FDIC, in consultation with the Secretary [of the Treasury], shall establish by regulation."[6]

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[2] The recommending agencies are the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission, in consultation with the FDIC, if the company or its largest subsidiary is a broker or a dealer; the Board of Governors of the Federal Reserve System and the Director of the Federal Insurance Office, in consultation with the FDIC, if the company is an insurance company; and the Board of Governors of the Federal Reserve System and the FDIC in all other cases.
[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] 12 U.S.C. § 5381(a)(11).

While section 201(b) of the Act requires the FDIC to issue a rule establishing the criteria for determining whether a company is predominantly engaged in activities that are financial-in-nature or incidental thereto for purposes of Title II, section 102(b) of the Act requires the Board of Governors to issue a regulation establishing criteria for determining whether a company is predominantly engaged in activities that are financial in nature for purposes of Title I. As indicated in the preceding sentence, section 102(b) of the Act is focused on activities that are financial in nature, while section 201(b) is focused on activities that are financial in nature or incidental to a financial activity. The only activity that has been identified as "incidental" is the finder activity. Section 102 of the Act also differs from section 201 of the Act in that section 102 of the Act includes an asset test as well as a revenue test for determining whether a company is predominantly engaged in financial activities. Specifically, under section 102 of the Act, a company could be predominantly engaged in financial activities if either 85 percent of its consolidated assets are related to financial activities or 85 percent of its consolidated revenues are derived from financial activities. By contrast, under section 201 of the Act a company would be predominantly engaged in financial activities only if 85 percent of its consolidated revenues are derived from financial activities.

In accordance with the authority granted by section 102(b), the Board of Governors published on February 11, 2011 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' first NPR"). The Board of Governors' first 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. The Board of Governors' first NPR generally defined the term "financial activity" by reference to 12 CFR 225.86 and section 4(k)(1)(A) of the BHC Act.

On March 23, 2011, the FDIC published a notice of proposed rulemaking titled *Orderly Liquidation Authority* ("FDIC's first NPR").[7] The FDIC's first NPR was intended to provide clarity and certainty with respect to how key components of the orderly liquidation authority would be implemented and to ensure that the liquidation process under Title II reflects the Act's mandate of transparency with respect to the liquidation of covered financial companies. The FDIC's first NPR also included definitional criteria for determining if a company is

[7] 76 FR 16324 (March 23, 2011).

predominantly engaged in activities that are financial in nature or incidental thereto for purposes of Title II; those activities, together with the activity of owning or controlling an insured depository institution, are referred to as "financial activities."[8]

Section 380.8, as proposed in the FDIC's first NPR provided that a company is predominantly engaged in "financial activities" for purposes of Title II 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 ("two-year test"), 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 ("facts and circumstances analysis"). The two-year test and the facts and circumstances analysis are collectively referred to as the "revenue tests." The FDIC's first NPR defined the term "financial activity" by reference to the activities that the Board of Governors had determined were "financial in nature or incidental thereto" under 12 CFR 225.86 and section 4(k)(1)(A), and also included ownership or control of depository institutions.

On April 10, 2012, the Board of Governors published a supplemental notice of proposed rulemaking ("Board of Governors' second NPR") that proposed to amend the definition of financial activities set forth in the Board of Governors' first NPR.[9] In response to comments received, the Board of Governors' second NPR proposed to revise the definition of "financial activities" found in the Board of Governors' first NPR by describing in an appendix each activity that would be considered a "financial activity" for purposes of Title I. However, the descriptions of the activities in the appendix did not include the conditions and limitations that are imposed, either by section 4(k) or the Board of Governors' regulations, on the conduct of the activity by a bank holding company for reasons such as safety and soundness or compliance with other applicable law.

For example, the activity of providing securities brokerage services was determined by the Board of Governors to be permissible for bank holding companies as an activity that is closely related to banking.[10] Under the Board of Governors' regulation, bank holding companies conducting that activity are subject to certain conditions that were imposed to prevent

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[8]The FDIC adopted provisions other than section 380.8 of the FDIC's first NPR in a final rule published in the Federal Register on July 15, 2011. *See* 76 FR 41626 (July 15, 2011).
[9] 77 FR 21494 (April 10, 2012).
[10] 12 U.S.C. 1843(k)(4)(F); 12 C.F.R. 225.28(b)(7).

circumvention of the Glass-Steagall Act or for safety and soundness purposes. Specifically, bank holding companies providing securities brokerage services under this authority are limited to buying and selling securities solely as agent for the account of a customer and may not conduct securities underwriting or dealing activities. These conditions were intended to prevent a bank holding company from using the securities brokerage authority to engage in activities that were impermissible under the Glass-Steagall Act.[11] Because these conditions are not essential elements of providing securities brokerage services, they were not included in the Board of Governors' Second NPR.

Thereafter, on June 18, 2012, the FDIC published and requested comment on a supplemental notice of proposed rulemaking that revised the descriptions of the activities that would be considered "financial activities" for purposes of Title II ("FDIC's second NPR") in a manner that parallels the changes made by the Board of Governors to its descriptions of the activities that are financial in nature.[12] The FDIC's second NPR proposed to adopt the list of activities that the Board of Governors' second NPR determined are "financial in nature" for purposes of Title I along with the one activity that the Board of Governors has previously determined is 'incidental" to financial activities i.e., the finder activity. Staff coordinated closely with staff at the Board of Governors and consulted with the Secretary's staff during the development of both the FDIC's first NPR and the FDIC's second NPR. The FDIC received 8 comments in response to the FDIC's first NPR that addressed section 380.8 and 7 comments in response to the FDIC's second NPR.

Summary of the final rule

In developing the final rule, staff considered the comments responding to both the FDIC's first NPR and the FDIC's second NPR, consulted with the Secretary's staff as required by section 201(b) of the Act, and coordinated with the Board of Governors' staff. Staff also considered the Board of Governors' final rule defining the term "predominantly engaged in financial activities" for purposes of Title I that was published in the *Federal Register* on April 4, 2013 ("Board of Governors' final rule").[13] The final rule that is proposed for adoption by the Board contains several modifications to the FDIC's first NPR and the FDIC's second NPR, as discussed below, that are intended to address concerns raised by commenters.

[11] See 62 FR 9290, 9308 (February 28, 1997).
[12] 77 FR 36194 (June 18, 2012).
[13] See 78 FR 20756 (April 5, 2012).

1. The Revenue Tests

As discussed earlier, the proposed section 380.8 provided that a company is predominantly engaged in financial activities if it satisfies either of the two revenue tests (i.e., the two-year test or the facts and circumstances analysis). Commenters generally supported the revenue tests as proposed, but one commenter requested that the FDIC remove the facts and circumstances analysis which the commenter asserted would avoid unnecessary uncertainty with respect to how the test will be conducted.

Staff believes that the mix of a company's revenues may change significantly and quickly as a result of various types of transactions or actions that can occur at any time during the fiscal year. The facts and circumstances analysis will be necessary in order to promptly consider the effect of changes in the nature or mix of a company's revenues that may not be reflected in the company's financial statements for either of the two preceding years. For these reasons, the final rule retains the facts and circumstances analysis. Additionally, the final rule recognizes that the recommending agencies and the Secretary, not just the FDIC, may conduct a facts and circumstances analysis to determine if a company is, at the time that the recommendation or determination is made, predominantly engaged in financial activities for purposes of Title II.

2. Financial Activities

The FDIC's first NPR defined "financial activity" to include: (i) any activity, wherever conducted, described in section 225.86 of the Board of Governors' Regulation Y ("Regulation Y") or any successor regulation;[14] (ii) ownership or control of one or more depository institutions; and (iii) any other activity, wherever conducted, determined by the Board of Governors in consultation with the Secretary, under section 4(k)(1)(A) of the BHC Act,[15] to be financial in nature or incidental to a financial activity.

In response to the comments received and in an effort to provide greater clarity, the FDIC's second NPR proposed to amend the FDIC's first NPR with respect to the definition of financial activities for purposes of Title II. Accordingly, and as discussed earlier, the FDIC's second NPR proposed to clarify that, consistent with the Board of Governors' second NPR and the purposes of Title II, the term "financial activity" would include each activity referenced in section 4(k) of the BHC Act that the Board of Governors has determined is financial in nature or

[14] See 12 C.F.R. 225.86.
[15] See 12 U.S.C. 1843(k)(1)(A).

incidental thereto but without regard to the conditions or limitations that are imposed on bank holding companies engaged in such activities that do not define the essential nature of the activity itself.[16] As a result, the FDIC's second NPR proposed to exclude all of those conditions that the Board of Governors' second NPR identified as prudential and non-definitional. The FDIC received a number comments addressing whether the amendments contained in the FDIC's second NPR were appropriate. One commenter expressed concerns with the FDIC's interpretation of the Act and argued that the FDIC's second NPR exceeds the rulemaking authority granted to the FDIC under Title II because the definition of "financial activities" in the FDIC's second NPR was based upon the Board of Governors' second NPR, which the commenter argued was flawed. However, the definition of "financial company" in section 201(a)(11) of the Act includes firms that are not bank holding companies, and such firms may not be operating in compliance with the prudential limitations and other restrictions that apply to bank holding companies. Sections 201(a)(11) and 201(b) of the Act are silent with respect to whether the references to section 4(k) of the BHC Act are intended to limit the scope of companies that could be eligible for resolution under Title II to only those companies engaged in financial activities that comply with prudential and other non-definitional conditions imposed by section 4(k) of the BHC Act and the Regulation Y. Staff believes that a reading of Title II that limits the scope of companies considered to be "predominantly engaged in activities that are financial in nature or incidental thereto" to only those companies that conduct such activities in compliance with the conditions applicable to bank holding companies would allow some financial companies to avoid consideration for Title II's orderly liquidation process simply because such companies do not comply with one or more of the prudential or non-definitional conditions that apply to bank holding companies for safety and soundness reasons or to ensure compliance with other laws applicable to bank holding companies. Such a reading would undermine the purpose of the orderly liquidation authority established by Title II to extend eligibility for the orderly liquidation process beyond bank holding companies to other types of financial companies that pose systemic risk. For these reasons, the final rule generally adopts the

[16] As noted in the Board of Governors' second NPR, conditions that do not define the activity itself include those conditions that were imposed to ensure that a bank holding company that conducts the activity does so 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).

definition of "financial activities" proposed in the FDIC's second NPR, with certain modifications that are described below.

In response to issues raised by commenters regarding the Board of Governors' second NPR, the Board of Governors' final rule modified several of the descriptions of "financial activities" by restoring certain conditions. These include conditions relating to the activities of providing agency transactional services, engaging as principal in derivative transactions, data processing, management consulting, and investing as part of a bona fide underwriting, or merchant or investment banking activity. As discussed in the Board of Governors' final rule, the Board of Governors found that the restored conditions are essential parts of the definitions of the authorized activities.

For example, the activity of management consulting services, which includes providing management consulting services on any matter to unaffiliated depository institutions and on any financial, economic, accounting, or audit matter to any other company was determined to be closely related to banking by the Board of Governors.[17] Under the Board of Governors' regulations, bank holding companies engaged in management consulting activities are prohibited from owning more than 5 percent of the client institution or having a management interlock with the client institution. The Board of Governors proposed removing this prohibition from the description of "financial activities" for purposes of Title I in the Board of Governors' second NPR because the prohibition was intended to ensure that bank holding companies do not effectively exercise control over a client company, thereby circumventing the prohibitions and notice requirements applicable to bank holding companies seeking to acquire a controlling interest in a company engaged in nonbanking activities. In the Board of Governors' final rule, the Board of Governors determined that the prohibition also serves a definitional role by distinguishing management consulting from the actual conduct of the commercial activity in which the client firm is engaged. For this reason, the condition that a company may not own more than 5 percent of the client institution or have a management interlock was restored in the description of this financial activity in the Board of Governors' final rule.

Staff believes that adopting the definitions utilized in the Board of Governors' final rule for activities that are financial in nature is also appropriate for purposes of Title II. As noted in both the FDIC's first NPR and the FDIC's second NPR, staff believes that it is important that the

[17] 12 U.S.C. 1843(k)(4)(F); 12 C.F.R. 225.86(b)(9)(i).

definitions of the activities that are "financial in nature" for purposes of Title II remain substantively identical to the definitions of the activities that are "financial in nature" under Title I. First, any interpretation of "financial in nature" under section 4(k) that is inconsistent with the Board of Governors' interpretation could frustrate Congressional intent regarding Title II. Section 204 of the 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. Among other things, Title I is designed to provide enhanced supervisory tools for regulating and supervising financial companies that could pose a risk to the financial stability of the United States with the goal of minimizing those risks. Staff believes that it is important that Title I and Title II work together in a manner that provides a coherent framework for monitoring and supervising such companies , as they operate, and for liquidating them with the least disruption to the financial stability of the United States, if any should fail. Moreover, 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 Title I and Title II.

Furthermore, staff believes that the conditions that were restored in the Board of Governors' final rule are also definitional for purposes of determining whether the respective activities are financial for purposes of Title II. Like the Board of Governors' final rule, this final rule retains all of the conditions set forth in the descriptions of the financial activities listed in section 4(k) of the BHC Act, other than those conditions that do not define the activity itself. Consequently, the definition of activities that are financial in nature in this final rule includes those activities listed in the appendix to the Board of Governors' final rule as "financial activities." In addition, since Title II, unlike Title I, also requires consideration of activities that are incidental to a financial activity, this final rule includes finder activities that the Board of Governors has determined are incidental to financial activities for purposes of section 4(k) of the BHC Act.

Finally, the provision incorporating section 4(k)(1) of the BHC Act in the proposed definition of "financial activities" has been removed from the final rule. Like the Board of Governors' final rule, this final rule acknowledges that the list of the activities identified as financial in nature or incidental thereto under section 4(k) is not static. However, the final rule would not automatically include as "financial activities" any additional activities that the Board of Governors may later determine to be financial in nature or incidental thereto. If the Board of Governors determines in the future that other activities are financial in nature or incidental thereto for purposes of section 4(k), the FDIC can amend the definition of "financial activities" at that time.

3. *Equity Investments in Unconsolidated Entities*

The FDIC's first NPR proposed two rules of construction governing the application of the revenue tests to revenues derived from a company's equity investments in unconsolidated entities. The first rule of construction proposed to treat all revenues derived from the company's equity investment in any unconsolidated company as derived from a financial activity if that unconsolidated company is itself predominantly engaged in financial activities.[18] The second rule of construction permitted (but did not require) a company to treat as nonfinancial the revenues attributable to a *de minimis* equity investment in an unconsolidated company without having to separately determine whether the investee company is itself predominantly engaged in financial activities.[19] Both the first and second rule of construction were included in the Board of Governors' first NPR.

The FDIC received comments on the FDIC's first NPR arguing that the first rule of construction would be unduly burdensome. Several of these commenters suggested alternative approaches to the first rule of construction. Similarly, the Board of Governors received a number of comments addressing the two rules of construction proposed in the Board of Governors' first NPR. In response, the Board of Governors final rule revised the first rule of construction such that an investment in an unconsolidated company is now presumed to be made in the course of conducting a financial activity. However, the Board of Governors' final rule permits a company to rebut the presumption by providing evidence that the investment in an unconsolidated entity is not made in the course of conducting a financial activity. Given the changes to the first rule of construction, the Board of Governors' final rule eliminated the second rule of construction.

In response to commenters and in consideration of the Board of Governors' final rule, the FDIC's final rule revises the first rule of construction so that a company's revenues derived from an investment in an unconsolidated entity will be treated as revenues derived from a financial

[18] See § 308.8(d)(1) of the FDIC's first NPR.

[19] See § 308.8(d)(2) of the FDIC's first NPR.

activity unless the recommending agencies or the Secretary, as applicable, have information to the contrary at the time that the recommendation or determination is made under section 203 of the Act. While this approach differs from the rebuttable presumption contained in the Board of Governor's final rule, staff believes that it is necessary given the need for expeditious action under Title II. Title II is intended to resolve in an orderly, yet expeditious, manner financial companies that are in default or in danger of default and whose failure could have serious adverse effects on the U.S. financial system. The recommendations and determinations made by the appropriate recommending agencies and the Secretary necessarily must be made quickly if those serious adverse effects are to be avoided. Adding a new procedure for the rebuttal of presumptions could significantly slowdown that process.[20] In light of the modifications to the first rule of construction, the final rule does not contain a second rule of construction.

Conclusion

The final rule establishes criteria for determining if a company is predominantly engaged in financial activities for purposes of Title II. The final rule provides that a company is predominantly engaged in financial activities if at least 85 percent of a company's revenues are derived from financial activities under either of two revenue tests (i.e., the two-year test or the facts and circumstances analysis). Lastly, the final rule adopts for Title II the same definitions of activities that are financial in nature that the Board of Governors adopted for purposes of Title I, except that the final rule also includes finder activities that the Board of Governors' has determined are incidental to financial activities. Staff recommends that the Board approve the final rule and authorize its publication in the Federal Register.

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[20] In this regard, that Title II provides for expedited judicial review of any determination that a company is a "financial company." This review could include examination of whether the revenues derived from investments in unconsolidated companies are appropriately considered financial.