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Memorandum

Financial Sector M&A Update: Federal Reserve Adopts Concentration Limit Rules for Financial Companies

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On November 5, 2014, the Federal Reserve approved final rules implementing the "concentration limit" under Section 622 of the Dodd-Frank Act. This statutory limit restricts financial companies from engaging in certain acquisitions if the total consolidated liabilities of the acquirer would, on a *pro forma* basis, exceed 10% of the aggregate consolidated financial sector liabilities (a figure that would be published by the Federal Reserve by July 1 of each year).[1] However, it does not restrict a financial company's ability to surpass this "10% of financial sector liabilities" threshold through organic growth, but a financial company whose liabilities exceeded this threshold would not be able to engage in a covered acquisition.

The final rules largely track Section 622, which adds a new Section 14 to the Bank Holding Company Act of 1956 (the "BHC Act"). Based on recommendations made by the Financial Stability Oversight Council (the "FSOC"), however, the final rules include certain modifications and clarifications to Section 622, which provides that the concentration limit is "subject to" recommendations made by the FSOC. Notably, despite industry concerns about unequal treatment of U.S. and foreign financial companies under the statute, the FSOC did not recommend, and the final rules do not include, modifications to the concentration limit that would treat U.S. and foreign financial companies equally.

Although the final rules, to be known as "Regulation XX," are largely similar to the concentration limit rules initially proposed in May 2014, they include a number of important changes in response to public comment. Notable changes from the proposed rules include:

- *Phase-In for Financial Sector Liabilities Calculation* — The final rules provide that financial sector liabilities will be calculated as of December 31, 2014, for purposes of the period beginning July 1, 2015 and ending June 30, 2016, and the two-year average methodology described below will be adopted for each

[1] 79 Fed. Reg. 68095 (Nov. 14, 2014).

year thereafter;

- *Elimination of Prior Notice Requirement* — The final rules removed the proposed rule's prior notice requirement for covered acquisitions by financial companies with total consolidated liabilities of at least 8% of aggregate financial sector liabilities;
- *Modified Carve-Outs from "Covered Acquisitions"* — The final rules removed the proposed rule's exception from the definition of "covered acquisition" for merchant banking investments and added an exception for securitization transactions.

A. The Concentration Limit

The final rules generally restrict a "financial company" from directly or indirectly merging or consolidating with, acquiring all or substantially all the assets of, or otherwise acquiring control of, another company (a "covered acquisition") if the total consolidated "liabilities" of the acquirer would, on a pro forma basis, exceed 10% of the "financial sector liabilities." The components of this concentration limit are described in further detail below.

1. Definition of "Financial Company"

Consistent with Section 622, "financial companies" subject to the restriction on covered acquisitions are defined as insured depository institutions, bank holding companies ("BHCs"), savings and loan holding companies, companies that control insured depository institutions, nonbank financial companies designated by the FSOC for Federal Reserve supervision ("nonbank SIFIs"), and foreign banks or companies that are treated as BHCs for purposes of the BHC Act. The final rules also apply to covered acquisitions between a financial company and a non-financial company, including those in which the non-financial company is the acquirer and becomes a financial company as a result of the transaction.

2. Definition of "Liabilities"

For U.S. financial companies that are not insurance companies or nonbank SIFIs, Section 622 measures "liabilities" as (i) the financial company's total risk-weighted assets, as determined under the risk-based capital rules applicable to BHCs, adjusted to reflect exposures that are deducted from regulatory capital, *minus* (ii) the financial company's total regulatory capital under the risk-based capital rules. Section 622 also directs the Federal Reserve to specify consistent and equitable standards for insurance companies and other nonbank SIFIs. Because some U.S. financial companies, including nonbank SIFIs, are not subject to capital rules applicable to BHCs, the final rules measure the liabilities of such companies using GAAP or other applicable accounting standards that the Federal Reserve determines are appropriate.

For foreign banking organizations ("FBOs"), Section 622 provides a similar measurement of liabilities, except that only the U.S. operations of the FBO are to be considered in the calculation of risk-weighted assets and total regulatory capital, and such calculations are to be made under "applicable risk-based capital rules."[2] The final rules measure the liabilities of a FBO as the sum of (i) the total consolidated assets of the FBO's U.S. branches and agencies; (ii) the total consolidated liabilities of each top-tier U.S. subsidiary subject to applicable risk-based capital rules (or that reports information regarding its capital to the Federal Reserve under risk-based capital rules applicable to BHCs);[3] and (iii) the total consolidated assets of each top-tier U.S. subsidiary that is not subject to applicable risk-based capital rules and does not report information regarding its capital under risk-based capital rules applicable to BHCs.

The U.S. assets of a foreign financial company that is not a foreign banking organization are calculated in a similar manner to the method described for FBOs, but the liabilities of each top-tier U.S. subsidiary not subject to risk-based capital rules are calculated based on the U.S. subsidiary's liabilities under applicable accounting standards, rather than its assets.

The final rules require FBOs to reduce the amount of consolidated liabilities of its U.S. by the amounts of intercompany account balances between U.S.-domiciled entities, and increase such liabilities by the amounts of intercompany account balances owed by U.S.-domiciled entities to non-U.S. domiciled entities, in each case to the extent not already reflected in consolidated calculations. A foreign financial companies that is not a FBO may, but is not required to, adjust its liabilities accordingly for such transactions with affiliates.

The final rules maintain the proposed rule's method of adjustment for exposures that are deducted from regulatory capital for U.S. and foreign financial companies, applying a risk-weight multiplier to deducted exposures equal to the inverse of a financial company's total capital ratio minus one.[4]

3. Measurement of "Financial Sector Liabilities"

The denominator of the 10% concentration limit, termed "financial sector liabilities" in the final rules, is comprised of the consolidated liabilities of all U.S. top-tier financial companies, plus the U.S. liabilities of all top-tier foreign financial companies, each as determined using the applicable methodology described above. This sum of all individual financial company liabilities is calculated as of the end of each calendar year to determine the annual "year-end financial sector liabilities" figure. Following the recommendation of the FSOC, the concentration limit's denominator for covered acquisitions occurring after July 1 of each year will be equal to the average of the "year-end financial sector liabilities" figures for the preceding two calendar years, which denominator will remain in effect for twelve months until June 30 of the following year.

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2 The term "applicable risk-based capital rules" refers to those rules established by a federal banking agency that are applicable to the financial company.

3 For purposes of calculating the liabilities of a FBO, total consolidated liabilities of such top-tier U.S. subsidiaries are calculated as (a) the total consolidated risk-weighted assets of the subsidiary, plus (b) the amount of assets that are deducted from the subsidiary's regulatory capital times a risk-weight multiplier, minus (c) the total consolidated regulatory capital of the subsidiary.

4 As an illustration, if a financial company's total capital ratio is equal to 8%, the risk-weight multiplier for deducted exposures would equal $\frac{1}{.08} - 1$, or 11.5.

Under the proposed rule, this two-year average calculation of the concentration limit's denominator would have required all financial companies to calculate their liabilities as of December 31, 2013 for purposes of the initial period between July 1, 2015, and June 30, 2016. In the final rules, however, the Federal Reserve recognized that certain companies (*e.g.*, FBOs) that are not currently subject to the reporting requirements of a federal banking agency may not have data available to report their U.S. liabilities as of December 2013. Accordingly, the final rules calculate the concentration limit's denominator for the initial period only (*i.e.*, from July 1, 2015 to June 30, 2016) using only the year-end financial sector liabilities as of December 31, 2014.

By July 1 of each year, the Federal Reserve will publish the year-end financial sector liabilities figure for the preceding year and the average financial sector liabilities figure covering the preceding two years.[5] The Federal Reserve has indicated that, to the maximum extent possible, it will calculate aggregate financial sector liabilities using information already reported by financial companies. Financial companies that do not otherwise report consolidated financial information to a federal banking agency will be required to report their total consolidated liabilities on a new report, the Financial Company Report of Consolidated Liabilities (FR XX-1), which generally will be made available to the public upon request. The Federal Reserve will begin collecting the FR XX-1 as of December 31, 2014, with a deadline for submission of 90 calendar days after the December 31 as-of-date.

In the preamble to the final rules, the Federal Reserve indicated that it will consider adjusting the calculation methodology if necessary in light of any potential destabilizing or distortive effects caused by future regulatory changes.

4. Elimination of the Prior Notice Requirement for Covered Acquisitions

The proposed rule would have required a financial company to provide written notice to the Federal Reserve at least 60 days before consummating a covered acquisition and within 10 days after execution of a definitive agreement if the consolidated liabilities of the resulting financial company would exceed 8% of financial sector liabilities and the acquisition would increase the liabilities of the financial company by more than $2 billion. The final rules eliminate this prior notice requirement, noting that companies are well-placed to monitor their own compliance with the concentration limit and will have incentives to consult with the Federal Reserve should a transaction put the company at risk of exceeding the limit. Furthermore, the Federal Reserve notes in the preamble to the final rules that it will consider compliance with the concentration limit in reviewing notices or applications for proposed acquisitions or mergers under other laws such as the BHC Act. If a company consummates a covered acquisition in violation of the limit, the company may be required to divest any company or assets acquired in violation of the limit.

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5 In the preamble to the final rules, the Federal Reserve estimates the financial sector liabilities as of December 31, 2013 to be approximately $18 trillion.

B. Exceptions To The Concentration Limit

Section 622 excludes three types of otherwise covered acquisitions from the concentration limit, provided that prior written consent of the Federal Reserve is obtained: (i) an acquisition of a bank in default or in danger of default, (ii) an acquisition with respect to which the FDIC provides assistance under Section 13(c) of the Federal Deposit Insurance Act, and (iii) an acquisition that would result only in a *de minimis* increase in the liabilities of the financial company. The final rules expand and define the scope of these exceptions, and carve out certain ordinary course business transactions from the definition of "covered acquisitions."

- *Acquisitions of Failing Depository Institutions* — By its terms, Section 622 only exempts acquisitions of "banks" in default or in danger of default. Following the recommendation of the FSOC, the final rules expand the failing bank exception to cover all types of insured depository institutions, including savings associations, industrial loan companies and limited-purpose credit card banks. A determination that an insured depository institution is in danger of default would be made by the appropriate federal banking agency of the insured depository institution, in consultation with the Federal Reserve.
- *FDIC-Assisted Transactions* —Under the final rules, the concentration limit does not apply to a covered acquisition with respect to which assistance is provided by the FDIC under section 13(c) of the Federal Deposit Insurance Act.
- *De Minimis Transaction* — The final rules define a de minimis increase in a financial company's liabilities as an increase of $2 billion or less, when aggregated with all other acquisitions by the company under the de minimis authority during the previous 12 months.
- *Ordinary Business Transactions* — The final rules identifies certain ordinary course transactions that are not treated as "covered acquisitions," such that the concentration limit will not apply to a financial company acquiring securities or other assets:
  - in the ordinary course of collecting a debt previously contracted, so long as the securities or other assets are acquired in good faith and divested within certain time periods;
  - in a bona fide fiduciary capacity so long as the securities or other assets are acquired in good faith under applicable fiduciary law and not for the benefit of the company or its shareholders, employees, or subsidiaries;
  - in connection with bona fide underwriting or market making activities;
  - solely in connection with an internal corporate reorganization, provided that the companies involved are lawfully controlled and operated by the financial company both before and following the reorganization; and
  - of a company that is or will be an issuer of asset-backed securities, so long as the financial company that retains an ownership interest in the company complies with the credit risk retention requirements

issued pursuant to Section 15G of the Securities and Exchange Act of 1934.6

While the proposed rule would have exempted acquisitions occurring as part of a financial company's *bona fide* merchant banking or investment banking activity from the concentration limit, the final rules eliminate this exemption. Therefore, to the extent that a merchant banking investment gives rise to "control" under the BHC Act, it will be treated as a covered acquisition subject to the concentration limit under the final rules.

Financial companies seeking to use the "acquisition of a failing depository institution" exemption, the "FDIC-assisted transaction" exemption or the "*de minimis* transaction" exemption from the concentration limit must request from the Federal Reserve prior written consent before consummating the transaction. The request to the Federal Reserve must contain a description of the covered acquisition, the projected increase in the company's liabilities resulting from the acquisition, the projected aggregate increase in the company's liabilities from acquisitions during the twelve months preceding the projected date of the acquisition (if the request is made pursuant to the "*de minimis* transaction" exemption); and any additional information requested by the Federal Reserve. However, a financial company may provide only after-the-fact notice to the Federal Reserve of a covered acquisition if the acquisition would not increase the liabilities of the financial company by more than $100 million, when aggregated with all other acquisitions by the company under the after-the-fact notice authority during the previous 12 months.

C. Unaddressed Concerns

In the near term, the concentration limit is not expected to have a significant adverse impact on financial institutions M&A. Since the recent financial crisis, large financial firms and their regulators have shown little appetite for transformative acquisitions. However, concerns about the long-term effects of the concentration limit on the U.S. financial sector remain unaddressed by the final rules.

Because U.S. acquirers would measure their global consolidated liabilities for purposes of the concentration limit, but foreign acquirers would only measure their U.S. liabilities, the concentration limit treats U.S. and foreign financial companies unequally. As noted by commenters to the FSOC's study, this disparate treatment gives foreign financial companies a competitive advantage in the market for acquisitions. Foreign financial companies might be able to make acquisitions of U.S. financial companies that other U.S. financial companies would not be able to make. Moreover, if a U.S. financial company would not be able to acquire a small foreign financial company because its global pro forma liabilities would exceed the concentration limit, the small foreign financial company might still be allowed to acquire the U.S. financial company as foreign liabilities would be excluded from the calculation. The FSOC study acknowledged that, over time, these disparities could increase the degree to which the largest financial firms operating in the U.S. are foreign-

[6] For more information regarding the recently adopted credit risk retention requirements for securitization transactions, please see our memorandum "Securitization After Dodd-Frank: A Summary of the Final Credit Risk Retention Rules," dated November 18, 2014, *available at* http://www.stblaw.com/about-us/publications/details?id=eeb6d80e-743d-6a02-aaf8-ff0000765f2c.

based. However, the FSOC concluded that, on balance, the concentration limit can be expected to enhance the competitiveness of U.S. financial markets by preventing the increased dominance of those markets by a small number of firms. The FSOC directed the Federal Reserve to continue to monitor and report on these competitive dynamics, and if the FSOC finds significant negative effects, it will issue a recommendation to Congress to address the problem.

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