



## Supervised Securities Holding Companies: Federal Reserve Finalizes Regulation OO

Today, June 4, 2012, the Federal Reserve Board (the “Board”) published new Regulation OO for companies that control U.S. registered brokers or dealers to register with the Board as supervised securities holding companies (“SSHCs”).<sup>1</sup> Supervision by the Board will enable these companies to satisfy any requirements of foreign regulators that they be subject to comprehensive consolidated supervision (“CCS”). Registration with the Board is not required. Regulation OO itself is entirely procedural in nature, but supervision by the Board will have important consequences relating to the extent of Board supervision, capital requirements, and the possible application of the Volcker Rule.

### The SSHC Program

Section 618 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) establishes the new regime for the supervision by the Board of those broker-dealer holding companies that are subject to a CCS requirement from a foreign regulator.<sup>2</sup> The program seems likely to reach a small population of broker-dealer organizations. Many of the largest broker-dealers are subsidiaries of companies already regulated by the Board as bank holding companies. Other broker-dealers in the United States are owned by foreign banks and are ineligible for the program. Additionally, a large broker-dealer could in the future be designated as systemically important by the Financial Stability Oversight Council and therefore not be subject to this particular program.<sup>3</sup> The Board has identified five companies with a foreign presence that might trigger a CCS requirement, but also notes that only one such institution has expressed interest.

Section 618 and the Board’s SSHC regime follow the unsuccessful and now-discontinued Consolidated Supervised Entities program (the “CSE Program”) of the Securities and Exchange Commission (“SEC”).<sup>4</sup> In 1999, section 231 of the Gramm-Leach-Bliley Act authorized certain broker-dealer holding companies to register with the SEC as supervised investment bank holding companies (“SIBHCs”). SIBHCs were subject to limited examination and supervision by the SEC under the CSE Program. SIBHC status was voluntary and was designed for broker-dealer holding companies that needed to demonstrate the same kind of CCS that now triggers section 618. Over time, five firms participated in the program: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. Two of the firms disappeared in 2008, and the other three now are regulated by the Board through its supervision of bank holding companies.

<sup>1</sup> 77 Fed. Reg. 32881 (June 4, 2012). We discussed the earlier proposed rule in a client alert dated Sept. 6, 2011, available at <http://www.mofo.com/files/Uploads/Images/110906-Securities-Holding-Companies.pdf>.

<sup>2</sup> See 12 U.S.C. § 1850a.

<sup>3</sup> Also ineligible are insured banks or savings associations and any affiliates thereof, foreign banking organizations, foreign banks that control Edge Act corporations and companies subject to comprehensive consolidated regulation by a foreign supervisory agency.

<sup>4</sup> The SEC ended the CSE Program in September 2008. Section 617 of Dodd-Frank repealed the statutory basis for the program.

## Impact of the SSHC Program

Section 618 envisions wide-ranging examination and supervision. As a starting point, SSHCs will be subject to the same provisions of the Bank Holding Company Act (“BHCA”) as a bank holding company with one exception: the limitations on activities or investments not closely related to banking or otherwise not permitted under section 4(c) do not apply to SHCs. Section 618 imposes more specific requirements as well, which will entail various obligations, as follows:

### *Regulatory capital*

Section 618 requires the Board to prescribe “appropriate” capital standards tailored to the activities and risks of each SSHC. The standards will take into account several factors, including the nature, scope and mix of an SSHC’s activities, the differences among the types of business activities of the SSHC, the amount and nature of its financial assets, the amount and nature of its liabilities (including its reliance on short-term funding), the extent and nature of its off-balance sheet exposures, the extent and nature of the transactions and relationships with other financial companies, and its importance as a source of credit or liquidity.

The nature of the new capital standards is unforeseeable. The net capital rules of the SEC may play a part, but the Board is unlikely to defer to those rules. In the case of bank holding companies with broker-dealer subsidiaries, the Board requires these companies to calculate capital on the same consolidated basis as other bank holding companies. There are no special provisions for broker-dealer subsidiaries. Bank holding company capital historically has been designed to capture credit risk, a risk that is not a meaningful part of broker-dealer operations. The Board, together with foreign bank regulators, has, however, recognized the need to account for market risk, a risk inherent in broker-dealer operations. Potential SSHCs accordingly may wish to consult the Board’s recent proposal on market risk capital.

### *Risk management*

Section 618 also requires risk management standards, taking into account the same factors as for regulatory capital. Arguably, nearly all of the Board’s supervision and examination of an SSHC will involve an assessment of the SSHC’s ability to manage its risks. Broker-dealer supervision is not new to the Board and has been addressed to a degree in its supervision manuals,<sup>5</sup> but the SSHC program would likely drill much further down into the risks. In addition, as an analogy, the Board recently proposed enhanced prudential standards that included a risk committee requirement for bank holding companies with more than \$10 billion in consolidated assets, even though companies over the \$10 billion mark, but with less than \$50 billion, are not systemically important.

### *Examination and Supervision*

The Board is granted broad authority in section 618 to examine and supervise SSHCs. This oversight may differ substantially from what a broker-dealer and its parent have been accustomed to under the SEC and the Financial Industry Regulatory Authority (“FINRA”). The Board is a prudential regulator and in this capacity will review all potential risks of the business, as well as most business decisions and the process for arriving at them.

Section 618 does not displace SEC and FINRA regulation at the broker-dealer level, but the Board is not required to defer to these regulators. Before the enactment of Dodd-Frank, the Board was required to give such deference (where a broker-dealer organization was also a bank holding company), but Dodd-Frank repealed that duty. The Board is expected to rely on the reports of these regulators “to the fullest extent possible.”

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<sup>5</sup> See, e.g., Trading and Capital Markets Activities Manual § 2140.1.

### *Recordkeeping and reporting*

Section 618 authorizes the Board to require an SSHC to maintain records and make reports. The nature of the reports is broadly within the Board's discretion, but section 618 calls for the reports to include a balance sheet or income statement, an assessment of capital and liquidity, a report by an independent auditor, and a report on the SSHC's compliance with section 618 and the Board's requirements.

### *Volcker Rule*

The application of the BHCA to an SSHC, with the exception solely of section 4(c), could mean that, as a matter of statutory construction, the Volcker Rule, which is memorialized in section 13 of the BHCA, may apply to the SSHC. This result would have a dramatic effect on an SSHC. Any trading by a broker-dealer is deemed proprietary trading by Volcker. An SSHC accordingly would be required to demonstrate, through detailed records and otherwise, that it is engaged in permissible underwriting and market making or in trading on behalf of customers. Under the proposed Volcker regulations, these requirements are onerous. Even when trading is permissible, vague "prudential backstops" apply, which deal with high-risk strategies and assets, conflicts of interest, and risks to the soundness of both the institution and the U.S. financial system.

The policy basis for this result is obscure at best, since an SSHC does not by definition control a bank or engage in commercial banking. We believe that the Board has authority to avoid this result. At a minimum, the Board should clarify this issue.

## **Registration Process**

The Board will develop a new form, modeled on the current form for acquisitions of U.S. banks or bank holding companies by foreign organizations. A securities holding company will file the form with the appropriate Federal Reserve Bank. On the 45th calendar day after the submission of the form, the registration will become effective. Several pieces of information will be required for registration, notably including evidence of a foreign regulator's requirement of CCS. Other data includes:

- An organization chart showing all subsidiaries.
- The name, asset size, general activities, place of incorporation, and ownership share held by the securities holding company for each of the securities holding company's direct and indirect subsidiaries that comprise 1% or more of the company's worldwide consolidated assets.
- A list of all persons in the upstream chain of ownership of the securities holding company, who, directly or indirectly, own 5% or more of the voting shares of the company. The form also would call for information on voting agreements or other mechanisms that exist among shareholders for the exercise of control over the company.
- For senior officers and directors with decision-making authority for the securities holding company, the biographical portion of the Interagency Biographical and Financial Report. The preamble is explicit that the financial portion would not be required.
- Copies of the most recent quarterly and annual reports prepared for shareholders, if any, for the securities holding company and certain subsidiaries.

- Income statement, balance sheets, and audited GAAP statements and any other financial statements submitted to the securities holding company's current consolidated supervisor, if any. The statements would be on both a consolidated and a parent-only basis, showing separately each principal source of revenue and expense, through the end of the most recent fiscal quarter and the past two fiscal years.
- A description of the methods used by the securities holding company to monitor and control its operations, including those of its domestic and foreign subsidiaries and offices (e.g., through internal reports and internal audits).
- A description of the bank regulatory system that exists in the home country of any of the securities holding company's foreign bank subsidiaries. This description would be detailed, including information on (i) the scope and frequency of on-site examinations, (ii) off-site monitoring, (iii) the role of external auditors, (iv) rules on transactions with affiliates, (v) other applicable prudential requirements, (vi) the remedial authority of the home-country supervisor, (vii) any prior approval requirements, and (viii) the regulatory capital framework.
- A description of any other regulatory capital framework to which the securities holding company is subject.

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### Financial Services

Dwight Smith  
(202) 887-1562  
[dsmith@mofocom](mailto:dsmith@mofocom)

Oliver Ireland  
(202) 778-1614  
[oireland@mofocom](mailto:oireland@mofocom)

Henry Fields  
(213) 892-5275  
[hfields@mofocom](mailto:hfields@mofocom)

Barbara Mendelson  
(212) 468-8118  
[bmendelson@mofocom](mailto:bmendelson@mofocom)

Charles Horn  
(202) 887-1555  
[charleshorn@mofocom](mailto:charleshorn@mofocom)

### Capital Markets

Anna T. Pinedo  
(212) 468-8179  
[apinedo@mofocom](mailto:apinedo@mofocom)

James Tanenbaum  
(212) 468-8163  
[jtannenbaum@mofocom](mailto:jtannenbaum@mofocom)

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