CENTER FOR CAPITAL MARKETS COMPETITIVENESS
OF THE
UNITED STATES CHAMBER OF COMMERCE

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March 30, 2011

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Notice of Proposed Rulemaking Regarding Definitions of "Predominantly Engaged in Financial Activities" and "Significant Nonbank Financial Company and Bank Holding Company"; RIN 7100-AD64

Dear Ms. Johnson:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation, representing over three million companies of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in the 21st Century economy. The CMCC welcomes the opportunity to comment on the Notice of Proposed Rulemaking ("Proposal") regarding the definitions of "predominantly engaged in financial activities," "significant nonbank financial company," and "significant bank holding company" published by the Board of Governors of the Federal Reserve System ("Board") on February 11, 2011.

The CCMC believes that significant revisions should be made to the Proposal if it is adopted as a final regulation.

- As discussed in detail below, the proposed definition of the term "predominantly engaged in financial activities" should be revised in a number of important respects in order to ensure that the definition is consistent with the corresponding provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act"), is not overly inclusive, and provides clear guidance to potentially impacted companies in assessing whether they are considered to be predominantly engaged in financial activities.

- The proposed definition of the term "significant nonbank financial company" should be modified to eliminate the automatic designation of a nonbank financial company as a significant nonbank financial company based on a $50 billion asset threshold.

Definition of Predominantly Engaged in Financial Activities

The Board in accordance with Section 102(b) of the Act has proposed to establish the requirements for determining if a company is "predominantly engaged in financial activities." This phrase is defined in Section 102(a)(6) of the Act. The requirements to be adopted have great significance because a company that is determined to be predominantly engaged in financial activities is subject to being designated by the Financial Stability Oversight Council ("Council") under Section 113 of the Act as a company to be supervised by the Board (generally referred to as a systemically important financial institution or "SIFI"). As a SIFI, a company would be subject to registration requirements, examination, supervision, and enforcement action by the Board and to the application of enhanced prudential standards under Title I of the Act. Thus, there are a range of potentially significant consequences associated with a determination that a company is predominantly engaged in financial activities.

As a result, the CCMC believes it is of critical importance that the Board implement a number of revisions to the proposed definition that would avoid inappropriately determining that companies are predominantly engaged in financial activities and would provide essential clarification as to how the calculations required under the proposed definition are to be performed.

<u>The Proposed Rule Should Be Modified with Regard to the Identification of the Entities Included in the Calculation of Revenues and Assets to Conform to the Clear Directive Provided by the Act Regarding Consolidation and Subsidiary Status</u>

Section 102(a)(6) of the Act states that a company is "predominantly engaged in financial activities" if either a revenue test or an asset test is satisfied:

> (A) [T]he annual gross revenues derived by the company and all of its subsidiaries from activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, from the ownership or control of one or more insured depository institutions, represents 85 percent or more of the *consolidated annual gross revenues of the company*; or
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> (B) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, related to the ownership or control of one or more insured depository institutions, represents 85 percent or more of the *consolidated assets of the company*. (emphasis added)

The plain language of the Act mandates that the Board's definition of "predominantly engaged in financial activities" be based on a company's consolidated income statement (in the case of the revenue test) or a company's consolidated balance sheet (in the case of the asset test). By directing the use of consolidated financial statements, Congress incorporated the rules of consolidation under applicable accounting standards. As a general matter, under Generally Accepted Accounting Principles ("GAAP") the revenues and assets of an entity will be included in a company's consolidated financial statements when the parent company owns or controls, directly or indirectly, a majority interest in the entity.

The proper application of Section 102(a)(6) is quite clear. For example, if a company owned or controlled 35 percent of the voting stock of another entity – Entity A – and the GAAP-compliant consolidated financial statements of the company include the revenues and assets of Entity A, then those revenues and assets are relevant for purposes of calculating whether the company is predominantly engaged in financial activities. On the other hand, if the same company owned or controlled 35 percent of the voting stock of another entity – Entity B – but the GAAP-compliant consolidated financial statements of the company did not include the revenues and assets of Entity B, and instead included a stock or equity investment in Entity B in the company's consolidated balance sheet and the revenues derived from that stock or equity investment in the company's consolidated income statement, then the amount of assets or revenues related to Entity B reflected on the company's consolidated financial statements would be excluded for purposes of calculating whether the company was predominantly engaged in financial activities.

This treatment is consistent with the purpose of Section 102(a)(6) which is to evaluate the extent to which a company is engaged in financial activities. Where a company's control and management influence over an entity is sufficient to cause the entity's assets and revenues to be reported directly on the company's consolidated balance sheet and income statement, it is appropriate to consider those assets and revenues for purposes of Section 102(a)(b) because they represent the company's activities. Where such control and management are absent, as in the case of an unconsolidated entity, whose assets and revenues are not consolidated in the company's financial statements, those assets and revenues are not appropriately considered to be activities of the company, and the equity investment and revenues derived from that investment should be deducted from the company's consolidated balance sheet and consolidated income statement for purposes of the asset and revenue tests.

The plain language of Section 102(a)(6) places one limitation on the use of a company's consolidated financial statements. The consolidated revenues and consolidated assets are only to be derived from or relate to "a company and all of its subsidiaries." Section 2(18)(A) of the Act defines a "subsidiary" by reference to its definition in the Federal Deposit Insurance Act ("FDI Act").[1] Under the FDI Act, a subsidiary is any company that is owned or controlled directly or indirectly by another company. For purposes of this definition, the term "control" is defined in the Bank Holding Company Act ("BHC Act").[2] In the BHC Act, the definition of control, and thus the definition of "subsidiary" in the Act, rests upon a three-part test. A company has control over any other company, and the second company is considered to be a subsidiary of the first company, if (i) the first company directly or indirectly or acting through one or more persons has the power to vote 25 percent or more of any class of voting securities of the second company, (ii) the first company controls in any

1 12 U.S.C. § 1813(w)(4).

2 12 U.S.C. § 1813(w)(5).

manner the election of a majority of the directors or trustees of the second company, or (iii) the Board determines that the first company directly or indirectly exercises a controlling influence over the management or policies of the second company.[3]

The use of the term "subsidiary" in the revenue and asset tests indicates that if an entity is included in a company's consolidated financial statements, but the entity does not also meet the Act's definition of being a "subsidiary" of that company, then its revenues and assets must be excluded from the company's consolidated financial statements for purposes of determining whether the company is predominantly engaged in financial activities. Accordingly, if a company included the revenues and assets of another entity - Entity C - in its consolidated financial statements, but the company held only a 20 percent voting interest in Entity C, did not control the election of a majority of the board of directors of Entity C, and had not been determined by the Board to directly or indirectly exercise a controlling influence over Entity C, then Entity C would not qualify as a "subsidiary" of the company and its revenues and assets should be deducted from the company's consolidated financial statements for purposes of determining whether the company was predominantly engaged in financial activities.

Put simply, the revenue and asset tests of Section 102(a)(6) of the Act mandate that a company will include the revenues and assets of another company in the calculation of its financial activities only if:

- The revenues and assets of the second company are reported directly in the first company's consolidated financial statements;

  <u>and</u>

- The second company is a subsidiary of the first company under the provisions of the BHC Act.

The Proposal does not follow either part of the Act's clear mandate. Without any analysis of the legal authority or basis for its proposed approach, the Board has simply ignored these clear limitations and is proposing effectively to include revenues

3 12 U.S.C. § 1841(a)(2). *See also* the Board's Regulation Y at 12 C.F.R. § 225.2(e) and (o).

and assets from **unconsolidated** entities in its revenue and asset tests. The Board achieves this result by considering a company's equity investment in, and revenues derived from, an unconsolidated entity predominantly engaged in financial activities to be financial assets and revenues, even disregarding whether such an unconsolidated entity qualifies as a subsidiary. The Board does not have the authority to simply disregard the clearly expressed intention of Congress and to substitute its own plainly inconsistent test for measuring whether a company is predominantly engaged in financial activities.

Proposed Section 225.301(e)(1) provides as follows:

> (1) *Investments that are not consolidated.* Except as provided in paragraph (e)(2) of this section, revenues derived from, or assets related to, an equity investment by the company in another company **the financial statements of which are not consolidated** with those of the company under applicable accounting standards shall be treated as revenues derived from, and assets related to, activities that are financial in nature if the other company is predominantly engaged in financial activities . . . . (emphasis added)

This proposed rule on its face cannot be supported under the terms of Section 102(a)(6). Congress expressly determined that the revenue and asset tests are to be applied on the basis of a company's consolidated revenues and consolidated assets. Congress did not give the Board any authority to disregard this straightforward requirement or to adopt a regulation that seeks to transform balance sheet and income statement items that reflect an investment in an unconsolidated entity into "revenues and assets" attributable to the activities of a company.

The proposed regulation is even more striking by not requiring when a company's investment in, and revenues derived from an unconsolidated entity are to be treated as financial assets and financial revenues under the proposed rule, that the unconsolidated entity must at least be a "subsidiary." In fact, while the term "subsidiary" appears at several points in the proposed regulation, at no point in the preamble or the proposed regulation does the Board address the requirements for an entity to be a "subsidiary."

Proposed Section 225.301(e)(2) is defective for similar reasons. That section provides in part:

> (2) *Treatment of de minimis investments.* A company may treat revenues derived from, or assets related to, an equity investment by the company in another company as revenues or assets not derived from, or related to, activities that are financial in nature, regardless of the type of activities conducted by the company, if –
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> (i) The company's aggregate ownership interest in the other company constitutes less than five percent of any class of outstanding voting shares, and less than 25 percent of the other company . . . .

Under proposed Section 225.301(e)(2) the Board plainly contemplates that an investment in 5 percent or more of a class of voting stock would not be subject to the *de minimis* exclusion provided under that section but instead would be subject to the treatment set forth in proposed Section 225.301(e)(1). Under this approach, a 6 percent voting stock interest in an unconsolidated entity that is a not a subsidiary – Entity D – which is predominantly engaged in financial activities, would result in the amount of that investment being treated as a financial asset and the revenues derived from, or attributed to, that investment being treated as financial revenues. Such an approach is as clearly unsupportable under the plain language of Section 102(a)(6) of the Act as it is contrary to that provision to include investments in and revenues received derived from or attributed to, investments in unconsolidated entities. Moreover, even if the revenues and assets of Entity D were directly included in the consolidated financial statements of the company, they would be excluded under Section 102(a)(6) because they would not qualify as revenues or assets of a subsidiary.

For the reasons described above, we respectfully request that the Board delete proposed Sections 225.301(e)(1) and (2). We further request that Section 225.301(e) be revised to clarify the treatment of unconsolidated entities as set forth below:

> (e) *Rule of construction* For purposes of determining whether a company is predominantly engaged in financial activities

> under paragraph (a)(1) or (2) of this section, assets (including, but not limited to, stock ownership or other equity investments) related to and revenues (including, but not limited to, dividends, capital distributions or adjustments to equity investment) derived from an equity investment by the company in another company the financial statements of which are not consolidated with those of the company under applicable accounting standards, shall be disregarded regardless of the type of activities conducted by the other company.

<u>If the Proposed Rule Regarding Unconsolidated Entities Is Not Eliminated Entirely, It Should Be Modified to Eliminate the 100% Financial Attribution of Assets and Revenues When an Unconsolidated Entity Is Deemed to Be Predominantly Engaged in Financial Activities and to Address Other Disparities</u>

If, notwithstanding the foregoing points, the Board was to retain Section 225.301(e)(1) of its proposed rule, the substance of that subsection still must be modified in several respects.

Subsection 225.301(e)(1) provides that if an unconsolidated entity on a stand-alone basis satisfies either the revenue or the asset test proposed at Subsection 225.301(a), then 100 percent of the revenues derived from, or the assets related to, that entity shall be treated as being financial in nature. In the preamble, the Board has stated that this rule of construction is consistent with the definition of a nonbank financial company in the Act because all of a company is treated as being engaged in financial activities when 85 percent or more of its revenues or assets are attributable under Section 102(a)(6) of the Act to financial activities. This reasoning is not persuasive.

Under the Act, it is necessary to characterize a company as entirely financial or entirely non-financial because the Council is required under Section 113 of the Act to determine whether to designate a company that qualifies as a nonbank financial company for supervision by the Board. There is no comparable requirement to treat all the revenues or assets of a particular unconsolidated entity as either financial or non-financial. In the preamble, the Board also has stated that the proposed rule of construction would allow a company to avoid making a precise allocation of the revenues and assets of an unconsolidated entity when it may not have access to sufficient information to make such a determination. This reasoning also is not persuasive. A comparable amount of information is required to determine whether financial revenues or assets of an unconsolidated entity meet or exceed the 85 percent standard. Finally, there is no reason provided, and none is apparent, why the revenues or assets of an unconsolidated entity should be automatically treated as 100 percent financial in nature without regard to the actual facts, rather than automatically treating 85 percent of the revenues and assets as being financial in nature. The result of the Board's proposed rule would be to potentially (i) inflate the amount of a company's financial revenues and assets and (ii) cause companies to be erroneously characterized as being predominantly engaged in financial activities under the Act.

Proposed Section 225.301(e)(1) also is clearly incomplete. While it provides that 100 percent of the assets and revenues attributed to an unconsolidated entity should be treated as financial in nature if the entity is predominantly engaged in financial activities, there is no indication how the assets and revenues should be treated when the unconsolidated entity is not predominantly engaged in financial activities. Under the logic of the Board's proposed Section 225.301(e)(1), if such an entity had 84 percent of its revenues and assets attributed to financial activities, it would be deemed not to be predominantly engaged in financial activities and all of its revenues and assets would be treated as nonfinancial in nature. Any reasonable approach to this topic must also address the treatment of revenues and assets of a nonconsolidated entity that is not deemed to be predominantly engaged in financial activities.

The Proposed Rule Should be Modified to Make it Clear that Assets Related to or Revenues Derived from the Internal Financial Activities of a Company and Assets or Revenues Used for General Corporate Purposes Are Not Financial Assets or Revenues for Purposes of Section 102(a)(6) of the Act

The proposed rule focuses on revenues and assets that are financial in nature. The CCMC believes that it is critical that the rule be revised to expressly exclude revenues or assets that are derived from, or related to, internal financial activities from treatment as financial revenues or assets, regardless of whether they would otherwise qualify as being financial in nature.

We believe this treatment is strongly supported by a related provision of the Act and that it is consistent with the purpose of the statutory definition of "predominantly engaged in financial activities."

Section 167(b)(1) of the Act provides that the Board may require a SIFI that conducts activities in addition to those that are determined to be financial in nature under Section 4(k) of the BHC Act or incidental thereto to conduct some or all of its financial activities and activities incidental thereto in an intermediate financial company ("IHC"). Section 167(b)(2) of the Act states that, when such a SIFI establishes an IHC, the financial activities and activities incidental thereto that it is required to conduct in its IHC shall not include "internal financial activities," which include, but are not limited to, "internal treasury, investment, and employee benefit functions."

The permission granted to a SIFI to exclude its "internal financial activities" from its IHC is an acknowledgement by Congress that those activities do not possess the characteristics that are the basis for designating a nonbank financial company as a SIFI; that is, the internal financial activities of a nonbank financial company are no different from the general corporate financial operations of any other company and thus do not warrant Board supervision that is appropriately aimed at other financial activities of a nonbank company. Based on this supervisory treatment of internal financial activities, it would be inconsistent with the Act for the Board to include any of the revenues derived from, or assets related to, the internal financial activities of a company as part of the financial revenues or assets of the company for purposes of Section 102(a)(6) of the Act.

In the preamble to the proposed rule, the Board has noted that the reference in Section 102(a)(6) of the Act to activities that are financial in nature as defined in Section 4(k) of the BHC Act does not include activities that are incidental or complementary thereto. The restriction of Section 102(a)(6) only to what may be called "core" financial activities suggests that revenues or assets that have only a tangential relationship to a company's "core" function or functions as an institution focused on financial activities should also be disregarded under Section 102(a)(6) (even if those revenues or assets are attributable to activities that are "financial in nature" under Section 4(k) of the BHC Act). Such revenues or assets would include, in addition to revenues or assets related to a company's internal financial activities, those related to performing services or furnishing facilities to the company and its subsidiaries and to protecting or preserving their interests.

Congress Intended that Only Activities Determined to Be "Financial in Nature" as of the Date of Passage of the Act Should Be Treated as Financial Activities

Section 102(a)(6) of the Act states that activities that are financial in nature "as defined in section 4(k)" of the BHC Act are to be included as financial activities when determining whether a company is predominantly engaged in financial activities. By referring to financial activities "as defined" in Section 4(k), Congress intended that only those activities already defined as of the date that the Act became law are to be treated as financial activities. However, the Board in proposed Sections 225.301(d)(1)(ii) and (iii) takes the position that additional activities may be determined to be financial in nature under Section 4(k) for purposes of determining whether a company is predominantly engaged in financial activities. This is an overly broad reading of the Act.

The Board's attempt to incorporate its authority under Section 4(k) of the BHC Act to adopt rules and issue orders into the proposed definition of activities that are financial in nature is in conflict with the Act. Section 102(a)(6) refers only to activities "as defined" under Section 4(k), not to activities *to be defined* under Section 4(k) or that *may be determined pursuant to* Section 4(k). This limited reading of Section 102(a)(6) also is consistent with the very different purposes of the Act and Section 4(k). Section 4(k) is a permissive authority, which in Subsections (k)(1) and (2) permits the Board, in consultation with the Secretary of the Treasury ("Secretary"), to expand the authority of financial holding companies from time to time to engage in additional business activities, and in Subsection 4(k)(5) permits the Board, in consultation with the Secretary, to determine that particular activities related to a specified list of activities are financial in nature or incidental to financial activities pursuant to Section 225.86(e) of the Board's Regulation Y.

The Act serves a different purpose: to establish a regulatory regime for SIFIs, which will be certain nonbank financial companies, a category which is identified by applying the provisions of Section 102(a)(6). The Act, therefore, quite intentionally, identifies only a limited set of activities to be considered for the purpose of determining whether the revenues or assets of a company are derived from or related to financial activities. The Board has recognized this principle in footnote 25 of the preamble of the Proposal, where it observed that "section 102(a)(6) of the Dodd-Frank Act refers only to activities that have been determined to be financial in nature under section 4(k)" and not to "activities that have been (or are) determined to be 'incidental' to financial activities . . . or to be 'complementary' to financial activities under section 4(k)."[4]

Congress' decision to exclude activities that are incidental or complementary to financial activities is also a signal that Congress intended that only the *current* list of financial activities as defined in Section 4(k) should be used as the benchmark for determining whether a company is predominantly engaged in financial activities. It is illogical to think that Congress excluded activities deemed to be incidental to financial activities, but intended to include activities determined by the Board in the future to be financial in nature, when the statutory factors to be considered by the Board when evaluating the permissibility of either type of activity are identical.[5] Thus, any future expansion of activities that are financial in nature for FHCs under Section 4(k) should be excluded.

Accordingly, Section 225.301(d)(1) should be revised to delete Sections 225.301(d)(1)(ii) and 225.301(d)(1)(iii) in their entirety.

<u>The Final Rule Should Be Tailored to Incorporate Statutory Exclusions</u>

The Act clearly provides that "financial activities" are those that are financial in nature under section 4(k) of the BHC and related to the ownership or control of an insured depository institution. It is equally clear in the Act that this definition excludes not only "nonfinancial" activities, but also certain other nonbanking activities and services that are referenced in section 4 of the BHC Act, but not encompassed within the terms of section 4(k) (as discussed below). Indeed, any final rule should expressly provide that no revenues "derived from" nonfinancial activities and no assets "related to" nonfinancial activities can be counted when determining

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4 76 Fed. Reg. at 7735.

5 12 U.S.C. § 1843(k)(3); 12 C.F.R. § 225.86(e)((3).

whether a company is "predominantly engaged in financial activities" and thus meets the threshold criterion to be a significant nonbank financial company under the Act.

Even though the Act's language is clear that "financial activities" include only those that are financial in nature under section 4(k) and related to the ownership or control of an insured depository institution, the definition in proposed Section 225.301(d)(2) potentially expands its scope, as follows:

> (2) *Effect of other authority.* Any activity described in paragraph (d)(1) of this section is considered financial in nature for purposes of this section regardless of whether—
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> (i) A bank holding company (including a financial holding company or a foreign bank) may be authorized to engage in the activity, or own or control shares of a company engaged in such activity, under any other provisions of the BHC Act or other Federal law including, but not limited to, section 4(a)(2), section 4(c)(5), section 4(c)(6), section 4(c)(7), section 4(c)(9), or section 4(c)(13) of the BHC Act . . . and the Board's implementing regulations . . . .[6]

In order to ensure that only Section 4(k) activities are encompassed by the definition of activities that are financial in nature, we suggest that it should expressly provide that activities permissible under Sections 4(c)(1)-(4) of the BHC Act are excluded. These services – liquidation, DPC workout, and fiduciary activities – have been long treated as distinct from activities permissible under Section 4(c)(8) of the BHC Act. Section 4(k) incorporates Section 4(c)(8) and Section 4(c)(13) activities by reference, but not other activities permissible under Section 4(c). In both the Gramm-Leach-Bliley Act, which added section 4(k), and in the Act, Congress could have incorporated all of section 4(c) into section 4(k) or into the Act's "predominantly engaged in financial activities" provision in Section 102(a)(6), but chose not to do so.

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6 76 Fed. Reg. at 7739 (to be codified at 12 C.F.R. § 225.301(d)(2)).

We further question the inclusion of Section 4(c)(6) and (7) investments under proposed Section 225.301(d)(2). These provisions are a longstanding statutory carve-out for equity investments in nonbanking and nonfinancial companies. The ability to invest in any type of company within the limits permitted in these provisions antedates Section 4(k) and any investment that meets the terms of Sections 4(c)(6) and (7) should be excluded, even if it also might be encompassed by Section 4(k) financial activities specified under 12 C.F.R. § 225.86(a)-(c) or (e). Equity investments under Sections 4(c)(6) and (7) are not a distinct activity and it would not be consistent with the terms of Act to include any such investment in the calculation of "predominantly engaged in financial activities."

<u>Assets and Revenues Can Be Counted Toward the 85 Percent Financial Asset and Revenue Tests Only if They Are Related to or Derived from Section 4(k) Financial Activities</u>

Section 102(a)(6) of the Act and Sections 225.301(b) and (c) of the Proposal expressly provide that, for purposes of the 85% test, revenues must be "derived from" Section 4(k) financial activities and assets must be "related to" Section 4(k) financial activities. We request that the final rule confirm that the following types of revenues or assets are neither derived from nor related to a section 4(k) financial activity and thus are not included when determining whether a company is "predominantly engaged in financial activities."

- *Cash, liquidity instruments, corporate treasury assets, and similar holdings.* Cash, liquidity, hedging, or treasury investments and other similar assets held in connection with general corporate operations represent no distinct "activity" of the company, nor are derived from or related to a financial activity. These types of assets are held by companies in the normal course of their corporate functioning and are not part of a "financial activity."

- *Receivables derived from nonfinancial activities.* Sales of nonfinancial products often result in receivables on the books of the company. Even though these receivables would be a financial asset, such assets derive from a nonfinancial activity, *e.g.*, the sale of a manufactured product.

- *Goodwill and similar intangible assets.* Corporate transactions may result in the inclusion of goodwill or other similar intangible assets on the books of a company. When these assets derive from a nonfinancial transaction, such as the purchase or sale of a nonfinancial company, they are correspondingly nonfinancial for purposes of the 85% test.

- *Assets or revenues incidental to nonfinancial activities.* The Board has long recognized in the context of the BHC Act that a bank holding company may provide a service or function that may itself not be closely related to banking under Section 4(c)(8) if necessary for the permissible activity and thus "incidental" to it. Similarly, under this rule financial assets that are integral to a nonfinancial line of business or activity or generated as an element or a feature of a nonfinancial transaction and necessary for the completion of that transaction are related to a nonfinancial activity and revenues from holding that asset likewise are derived from a nonfinancial activity. Such revenues or assets are "incidental" to the nonfinancial activity, and thus not "financial" for purposes of Section 102(a)(6) or calculations under it.[7]

- *Proceeds from the sale of a nonfinancial subsidiary.* Any cash or other financial assets resulting from the sale of a nonfinancial company also are not assets "related to" financial activities, and revenues from that asset are not "derived from" financial activities. When those proceeds have been deployed the revenues and assets related to such a deployment may be subject to inclusion in the 85 percent financial assets or financial revenues calculation as appropriate based on the nature of activity.

7 For example, in the context of a particular sales transaction involving a nonfinancial (*e.g.*, manufactured) product, the seller finds it necessary or useful to provide certain seller financing that is transaction-specific and not effected through its captive finance subsidiary (if any). Such "one-off" seller financing would result in a loan or financing asset on the seller's books, but it is not related to a financial activity.

Definition of Significant Nonbank Financial Company

The Board's Proposed Definition of Significant Nonbank Financial Company and the Term's Use in Title I of the Act

Section 102(a)(7) of the Act requires the Board to define the terms "significant nonbank financial company" and "significant bank holding company."[8] These terms are used in the Act only in two provisions in Title I.

Section 113(a)(2) and (b)(2) sets forth criteria that the Council is required to consider when determining whether to designate a U.S. nonbank financial company or foreign nonbank financial company as a SIFI. Among these criteria are the extent and nature of the transactions and relationships that a company being considered by the Council for designation as a SIFI has with "other significant nonbank financial companies and significant bank holding companies."[9]

In addition, in Section 165 the Board is directed to require that each SIFI and bank holding company with total consolidated assets equal to or greater than $50 billion ("Large BHC") report periodically to the Council, the Board and the Federal Deposit Insurance Corporation ("FDIC") on the nature and extent of (i) its credit exposure to "other significant nonbank financial companies and significant bank holding companies" and (ii) the credit exposure of "other significant nonbank financial companies and significant bank holding companies" to the reporting company.[10]

For these purposes, the Board has proposed in the Proposal to define a "significant nonbank financial company" to mean:

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8 12 U.S.C. § 5311(a)(7).

9 12 U.S.C. § 5323(a)(2)(C) and (b)(2)(C).

10 12 U.S.C. § 5365(d)(2). Section 115(d)(2) of the Act provides that the Council may make recommendations to the Board regarding the reporting requirements in Section 165(d)(2) The Proposal states that the Board and the FDIC are jointly responsible for developing rules to implement these reporting requirements. 76 Fed. Reg. at 7737.

> (1) Any nonbank financial company supervised by the Board [*i.e.*, a SIFI]; and
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> (2) Any other nonbank financial company that had $50 billion or more in total consolidated assets . . . as of the end of its most recently completed fiscal year."[11]

The Board also has proposed to define a "significant bank holding company" as a bank holding company or foreign bank treated as a bank holding company under Section 8(a) of the International Banking Act of 1978 that had $50 billion or more in total consolidated assets as of the end of the most recently completed calendar year as reported to the Board.[12]

The Proposal Does Not Provide Any Basis for Treating All Nonbank Financial Companies With $50 Billion or More of Assets as Significant Nonbank Financial Companies

In the preamble of the Proposal, the Board provides the following explanation for its proposed definitions of "significant nonbank financial company" and "significant bank holding company:"

> In establishing *these definitions*, the Board considered its supervisory experience with **bank holding companies** as well as the fact that Congress established $50 billion in total consolidated assets as the threshold at which the **bank holding companies** should be subject to enhanced prudential supervision without any special determination by the Council that the **bank holding company's** failure would pose a threat to financial stability.[13]

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11 76 Fed. Reg. at 7740 (to be codified at 12 C.F.R. § 225.302(b)).

12 76 Fed. Reg. at 7740 (to be codified at 12 C.F.R. § 225.302(c)).

13 76 Fed. Reg.at 7736-37 (internal citation omitted) (emphasis added).

While the preamble may provide support for the Board's proposed definition of "significant bank holding company," it does not explain how this criterion might be applied to a nonbank financial company or address or support the Board's proposed definition of "significant nonbank financial company."

The preamble appears to point to the Board's experience with supervising bank holding companies solely as support for its definition of a "significant bank holding company." The Board has made no attempt to provide commenter's with an understanding of how its supervisory experience with bank holding companies is in any way relevant to the Board's proposed definition of "significant nonbank financial companies," or how this experience supports the proposed definition. Indeed, the Board has not previously regulated these types of companies precisely because they are not bank holding companies. Their balance sheets and activities can be very different from those of a bank holding company, but the Board has not explained how its "supervisory experience" with bank holding companies is relevant to its identification of significant nonbank financial companies.

The Board's reference to Congress' decision to establish a $50 billion total asset threshold for the application of enhanced prudential standards to Large BHCs under Section 165(a)(1) of the Act is plainly directed at supporting the Board's proposed definition for a "significant bank holding company" but provides no support for its proposed definition of "significant nonbank financial companies." As the Board is well aware, Congress did not establish a specific asset threshold for a nonbank financial company to be designated as a SIFI, although at the same time it did so specifically for a bank holding company to be treated as a Large BHC, which is subject to enhanced prudential standards under Section 165.

Congress clearly distinguished between bank holding companies and nonbank financial companies for purposes of the application of enhanced prudential standards under Section 165. For bank holding companies, Congress found that an automatic across-the-board standard of $50 billion of consolidated assets was appropriate. In contrast, for significant nonbank financial companies, Congress clearly chose not to adopt such a criterion for designating a company as a SIFI. Instead, Congress directed the Council to undertake a detailed multi-factor analysis of whether a particular nonbank financial company should be designated a SIFI,[14] and to provide a potential designee with an opportunity for a hearing before the Council.[15] Moreover, Congress provided for a right to judicial review for a nonbank financial company that is designated as a SIFI.[16]

The limited relevance of size alone for identifying a SIFI was emphasized in a colloquy between Senator John Kerry and Senator Christopher Dodd, the chairman of the Senate Committee on Banking, Housing and Urban Affairs, regarding the risk factors to be considered by the Council when designating a SIFI:

> **Mr. KERRY:** . . . The fact that a company is large or is significantly involved in financial services does not mean that it poses significant risks to the financial stability of the United States. There are large companies providing financial services that are in fact traditionally low-risk businesses, such as mutual funds and mutual fund advisers. We do not envision nonbank financial companies that pose little risk to the stability of the financial system to be supervised by the Federal Reserve. Does the chairman of the Banking Committee share my understanding of this provision?
>
> **Mr. DODD:** The Senator from Massachusetts is correct. Size and involvement in providing credit or liquidity alone should not be determining factors. . .[17]

Put simply, the preamble to the Proposal does not provide any rationale or support for the use of an automatic $50 billion asset threshold in the definition of a "significant nonbank financial company."

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14 12 U.S.C. § 5323(a)(2) and (b)(2).

15 12 U.S.C. § 5323(e).

16 12 U.S.C. § 5323(h).

17 156 Cong. Rec. S5903 (2010).

The Proposal's Approach to the Definition of Significant Nonbank Financial Company Does Not Satisfy the Requirements of the Administrative Procedure Act

An agency that proposes to issue a regulation "must disclose in detail the thinking that has animated the form of [the] proposed rule."[18] Where an agency fails to do so, as the Board has failed to do in this case, the agency violates the Administrative Procedure Act ("APA") by depriving the public of the required opportunity to comment meaningfully on the reasoning and rationale underlying the proposed rule.[19] Moreover, any final rule that is issued without an explanation of why the agency reached the conclusions embodied in the rule would be arbitrary and capricious and, therefore, void under the APA.[20]

In this case, the Board's statements in the preamble to the Proposal regarding the proposed definition of "significant nonbank financial company" do not satisfy the relevant standards under the APA. The Board's reference to its bank holding company supervisory experience and to a standard that was established by Congress for bank holding companies rather that nonbank financial companies (i) fails to provide a relevant or accurate picture of the reasoning that led it to set forth the proposed definition of "significant nonbank financial companies," (ii) deprives interested parties of the opportunity to respond meaningfully regarding the Board's rationale for the proposed definition, and (iii) if the Board continues on its current course in a final rule, would cause this definition to be subject to be set aside as arbitrary and capricious. For these reasons, the Board should modify the definition of significant nonbank financial company as discussed below.

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18 *Home Box Office, Inc. v. F.C.C.*, 567 F.2d 9, 35 (D.C. Cir. 1977). *See also United States Lines, Inc. v Federal Maritime Commission*, 584 F.2d 519, 534 (D.C. Cir. 1978) ("[W]e have insisted that agencies set forth their thinking and disclose their expert knowledge, in notices of proposed rulemaking.")

19 *See* 5 U.S.C. § 553(c); *Connecticut Power & Light Co. v. Nuclear Regulatory Comm'n*, 673 F.2d 525, 530 (D.C. Cir. 1982) ("If the notice of proposed rulemaking fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule, interested parties will not be able to comment meaningfully upon the agency's proposals.").

20 *See* 5 U.S.C. § 706(2)(A); *Owner-Operator Independent Drivers Ass'n, Inc. v. Fed. Motor Carrier Safety Admin.*, 494 F.3d 188, 204 (D.C. Cir. 2007) (holding that the "complete lack of explanation for an important step in the agency's analysis was arbitrary and capricious").

The Definition of Significant Nonbank Financial Company Should Be Modified to Delete Automatic Designation Based on $50 Billion Asset Size

In any rulemaking undertaken by the Board under Section 102(a)(7) of the Act, the CCMC believes that it is essential that a $50 billion asset automatic threshold be deleted from any final rule regarding the definition of a significant nonbank financial company. Just as the Board appears to believe that it is appropriate for the definition of "significant bank holding company" to mirror the $50 billion asset threshold used to make a bank holding company subject to enhanced prudential standards under Section 165, it is possible that the Council in designating a SIFI might look to mirror an automatic $50 billion asset threshold in a Board regulation defining a "significant nonbank financial company." As discussed above, such a result would clearly be inappropriate under Congress' requirements for the SIFI designation process and the Board should take appropriate action in any final rule to prevent such an event from occurring.

For the reasons discussed above, we respectfully request that the Board modify proposed Section 225.302(b) to delete the prong of the proposed definition regarding the automatic $50 billion asset trigger for designation. The revised regulation would read as follows:

> (b) *Significant nonbank financial company.* A "significant nonbank financial company means any nonbank financial company supervised by the Board.

Under this approach, nonbank financial companies would not be swept up and labeled as significant nonbank financial companies without any analysis of whether a particular company, in fact, had the appropriate attributes for such a designation. With this modification, the Council when considering the interconnectedness criteria set forth in Sections 113(a)(2)(C) and 113(b)(2)(C) of the Act would look to the relationship between a nonbank financial company and (i) the numerous companies that would be treated as significant bank holding companies (under the Board's proposed definition) and (ii) any nonbank financial companies that the Council had designated as SIFIs. Avoiding arbitrary over inclusion of nonbank financial companies in the transactions and relationships to be examined under Sections 113(a)(2)(C) and

113(b)(2)(C) would prevent the introduction of a bias for unwarranted designations of SIFIs.

The Proposal Does Not Require A Company to Take Any Action that Would Result in Its Designation As a Significant Nonbank Financial Company

The Proposal contains proposed regulatory language that defines, among other things, a nonbank financial company, and what constitutes a company "predominantly engaged in financial activities." These definitions could be used by a nonbank financial company or the Board in determining whether a particular nonbank financial company qualifies as a significant nonbank financial company because it has $50 billion or more in assets under proposed Section 225.302(b)(2).

In a critical omission from the proposed regulation, the Board does not provide any procedure by which such a determination would be made. The regulation does not direct any company to perform any calculation of whether it meets the asset test or the revenue test that would cause it be deemed to be predominantly engaged in financial activities. Nor does the regulation require any company to submit any type of report to the Board regarding whether or not the company qualifies as a significant nonbank financial company. Furthermore, the proposed regulation does not require a company to make a filing with, or disclosure to, any other governmental or private party, including the Council, regarding whether or not it qualifies as a significant nonbank financial company. Nor does the proposed regulation provide any timeframe in which any company is required to make such an evaluation.

In addition, the proposed regulation does not require, or even suggest, that any company provide information to the Board that would potentially allow the Board to determine whether a particular company qualified as a significant nonbank financial company. If the Board intended to take this approach it would, of course, have to explain what information would have to be provided, when it must be submitted and to whom it must be submitted.

In fact, the Board has simply not established any obligation in the proposed regulation for a company to take any action whatsoever, in regard to a process that would result in a determination that a company is or is not a significant nonbank financial company. As a result, no company is subject to being deemed to be a significant nonbank financial company under proposed Section 225.302(b)(2).

The absence of any process for a significant nonbank financial company designation is amplified by the fact that the Board expressly addressed this process in connection with a "significant bank holding company." In that context, the Board explains precisely how it will determine which bank holding companies will be deemed to be a significant bank holding company.

> (c) *Significant bank holding company.* A "significant bank holding company" means any bank holding company or foreign bank treated as a bank holding company . . . that had $50 billion or more in total consolidated assets as of the end of the most recently completed calendar year, as reported -
>
> (1) In the case of a bank holding company (other than a foreign banking organization), on the Federal Reserve's FR Y-9C . . .; and
>
> (2) In the case of a foreign banking organization that is or is treated as a bank holding company, on the Federal Reserve's Form FR Y-7C . . . .[21]

Even if the Proposal Were Deemed to Require a Company to Determine and Report or Disclose Whether It Is a Significant Nonbank Financial Company or to Provide Information to the Board to Allow the Board to Determine Whether the Company Is a Significant Nonbank Financial Company, Such a Requirement Would be Void Under the Paperwork Reduction Act

As discussed above, the proposed regulation does not impose any requirement on any company to take any action in regard to a potential designation as a significant nonbank financial company. To the extent that the Board believes that it has in the proposed regulation required a company to analyze financial information and provide

21 76 Fed. Reg. at 7740 (to be codified at 12 C.F.R. § 225.302(c)).

a report to the Board or make a disclosure to any party or to submit financial data to the Board for its analysis, any such requirement is void under the Paperwork Reduction Act ("PRA"). Under the PRA, an agency cannot "conduct or sponsor the collection of information"[22] or impose any penalty for failing to comply with a demand for information[23] unless, among other things (i) the agency provides notice and opportunity for public comment on the proposed "collection of information," including information sufficient for the public to evaluate the accuracy of the agency's estimate of the burden of the proposed information collection obligation[24] and (ii) the OMB approves the proposed "collection of information."

Although the Proposal includes a PRA notice and request for comment regarding requests for determination as to whether a particular activity is financial in nature,[25] the Proposal contains no notice whatsoever about any "collection of information" with respect to determining whether a company should be designated a "significant nonbank financial company." Accordingly, any attempt to use the

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22 44 U.S.C. § 3507(a). *See, e.g., MacKenzie Medical Supply, Inc. v. Leavitt*, 506 F.3d 341, 350 (4th Cir. 2007) ("Under the PRA, the government is prohibited from sponsoring a collection of information unless certain procedures are followed, including an opportunity for public comment [and] approval from the Office of Management and Budget . . . ."); *Ctr. for Auto Safety v. Nat'l Highway Traffic Safety Admin.*, 244 F.3d 144, 146 (D.C. Cir. 2001) ("[B]ecause the [agency] violated the [PRA], the agency's [collection of information request] was not enforceable."). The PRA defines "collection of information" broadly in 44 U.S.C. § 3502(3) to include:

> [T]he obtaining, causing to be obtained, soliciting, or requiring the disclosure to third parties or the public, of facts or opinions by or for an agency, regardless of form or format, calling for . . . answers to identical questions posed to, or identical reporting or recordkeeping requirements imposed on, ten or more persons, other than agencies, instrumentalities, or employees of the United States.

23 *See* 44 U.S.C. § 3512(a); *see also Saco River Cellular, Inc. v. F.C.C.*, 133 F.3d 25, 31 (D.C. Cir. 1998) (holding that if a collection of information does not display a valid Office of Management and Budget ("OMB") control number, which is provided when the collection is approved by the OMB, an agency cannot penalize a person for failing to comply with a request); *United States v. Smith*, 866 F.2d 1092, 1099 (9th Cir. 1989) (reversing a criminal conviction because it was based on the failure to fulfill an obligation that violated the PRA).

24 *See* 44 U.S.C. § 3506(c)(2)(A)(i)-(iv).

25 The Proposal estimates that the burden would be four hours per response and that there would be three respondents per year. 76 Fed. Reg. at 7737.

proposed rule as the basis for a "collection of information" regarding the designation of a "significant nonbank financial company" either by requiring a company to collect, analyze and report to the Board or to disclose to any other governmental or private party, including the Council, regarding whether or not it qualifies as a significant nonbank financial company, or to provide information to the Board in order to allow the Board to determine whether or not the company qualifies as a significant nonbank financial company would be void under the PRA.

<u>If the Automatic $50 Billion Designation Is Retained, It Should Be Modified to Exclude Assets Under Management that Are Attributed Under GAAP to Certain Investment Firms</u>

If the Board were to retain an automatic $50 billion asset threshold as an element of the definition of a significant nonbank financial company, CMCC believes that it would be important to exclude assets that might be attributable to certain investment funds in making this calculation with respect to such funds. This treatment would recognize the important distinction between proprietary at-risk assets, on the one hand, and assets under management and other similar assets, on the other, even in circumstances when both may be consolidated for accounting purposes. Under GAAP, as currently in effect, certain investment firms are required to consolidate their affiliated funds if the limited partners of those funds do not have the right to remove the funds' general partner(s) without cause by a vote of a majority in interest (or less). This accounting treatment, which is currently under review and may be changed in the near future, may result in firms reporting significant "total consolidated assets" under GAAP, although the vast majority of such consolidated assets are, in actuality, managed fund assets.

Using an investment firm's total consolidated assets without an exclusion for assets that are managed rather than owned would provide a misleading view of the size and inter-connectedness of investment firms that consolidate managed fund assets with proprietary assets under GAAP. A firm's managed assets stand in stark contrast to typical consolidated, on-balance-sheet assets, which are owned by a company and can be acquired, sold, otherwise financed, or disposed of in any manner the management of the company sees fit. Conflating on-balance-sheet, at-risk assets with assets under management in defining "significant nonbank financial company" would obfuscate these real differences, result in credit exposure reports and other reports that may be misleading to regulators, and further result in varying treatment for otherwise similarly situated asset managers. The CCMC believes that the proper metric for measuring the size of an investment firm is its risk assets.

If the Automatic $50 Billion Designation Is Retained, It Should Be Modified to Adjust the Amount to Reflect the Growth of the Economy

If the Board were to retain an automatic $50 billion asset threshold as an element of the definition of a significant nonbank financial company, CMCC believes that it would be important to provide for this threshold amount to be adjusted annually to reflect the growth of the U.S. economy. For example, under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended in 2000, the reporting thresholds for the federal pre-merger notification program are indexed to changes in the U.S. gross national product and are adjusted annually.[26] Since 2000, the reporting thresholds have increased approximately 32 percent.[27] In view of the purpose of Title I of the Act, including, in particular, the identification of systemic risks to the U.S. financial system, a comparable system to periodically adjust the $50 billion asset threshold would be appropriate to avoid the definition of significant nonbank financial companies becoming overly inclusive.[28]

Any Final Rule Should Address the Confidential Treatment of a Determination that a Company Is a Significant Nonbank Financial Company

To the extent that the Board were to validly provide for the designation of a company as a significant nonbank financial company under proposed Section 225.301(b)(2), in light of the lack of a process to do so in the regulatory language in the Proposal, and the lack of compliance with the PRA, and assuming that the Board does not delete that section as requested above, the fact that a company has been

26 *See* 15 U.S.C. § 18a.

27 *See* Revision of Jurisdictional Thresholds for Section 7a of the Clayton Act, 76 Fed. Reg. 4349 (Jan. 25, 2011).

28 Alternatively, the Board could provide for annual adjustment based on changes in the consumer price index for all urban consumers published by the Department of Labor similar to the manner provided in the Federal Civil Penalties Inflation Act. Pub. L. No. 104-410, 104 Stat. 890 (1990) (as amended).

determined to be a significant nonbank financial company will presumably be known by more than the company and the participants in the Council. The information presumably will be shared with other financial companies in connection with the Council's consideration whether to designate a company as a SIFI. Under Sections 113(a)(2)(C) and (b)(2)(C) of the Act, the Council will consider a potential SIFI's transactions and relationships with "other significant nonbank financial companies and significant bank holding companies." In addition, after designation, each SIFI and Large BHC is required under Section 165(d)(2) to report periodically to the Council, the Board, and the FDIC on the nature and extent of its credit exposure to such significant nonbank financial companies and significant bank holding companies and those entities credit exposure to the reporting company. Neither the Act nor the Proposal addresses who may or must make the determination that a company is a significant nonbank financial company or how the information generated will be handled. This omission raises issues regarding the confidential treatment of the information.

The fact that a company has been determined to be a significant nonbank financial company (depending on how this determination was arrived at) could qualify for an exemption from disclosure as a matter contained in or related to examination, operating, or condition reports, or as a matter prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.[29] Accordingly, the CCMC requests that the Board expressly address the circumstances under which a determination that a company is a significant nonbank financial company will be treated by the Board as being subject to confidential treatment under the Freedom of Information Act ("FOIA") and any other applicable law and to address how the confidentiality of the determination and the preservation of all applicable exemptions from the disclosure thereof under FOIA and other applicable law will be maintained in connection with the distribution of the information to public and private parties.

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[29] *See* 12 C.F.R. § 261.14(a)(8).

For the reasons described above, we respectfully request that the Board modify the definitions of predominantly engaged in financial activities and significant nonbank financial company as set forth in the Proposal. We appreciate the opportunity to submit these comments.

Sincerely,

David T. Hirschmann
President and Chief Executive Office
Center for Capital Markets Competiveness