STANFORD BUSINESS GRADUATE SCHOOL OF | Corporations and Society Initiative

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July 15, 2019

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket No. R–1662; RIN 7100–AF 49

Re: Control and Divestiture Proceedings

Dear Ms. Misback:

I write today to comment on the Board's proposal to revise its framework for determining ownership and control. To summarize my views, the proposal lacks a robust evidentiary justification, fails to address some of the critical issues in ownership and control facing an already concentrated financial sector, and has potential consequences that are not fully explained. For those reasons, I oppose the Board's proposal.

1. **The proposal lacks proper documentation of its evidentiary basis.**

While the proposal is accompanied by observations about the complex nature of bank ownership and control determinations, it lacks any demonstration of a detrimental impact caused by the current regime. [1]

Regulatory thresholds and triggers that contain bright lines are not necessarily a bad thing.[2] It is also true that some of the Board's ownership and control decisions appear to

[1] *See* Press Release, "Federal Reserve Board Invites Public Comment on Proposal to Simplify and Increase the Transparency of Rules for Determining Control of a Banking Organization," Board of Governors of the Federal Reserve System, Apr. 23, 2019 (statement by Vice Chair Randal Quarles that the "control framework has developed over time through a Delphic and hermetic process"). Other commentators have noted that the current regime is "challenging for corporate lawyers and clients alike—one may be greeted with 'That can't be right!' when explaining the likely Federal Reserve view of control." Arthur Long & James Springer, Potential Reform to the Federal Reserve Board's "Control Rules," Harvard Law School Forum on Corporate Governance and Financial Regulation, Sept. 7, 2018, available at: https://corpgov.law.harvard.edu/2018/09/07/potential-reform-to-the-federal-reserve-boards-control-rules/.

[2] In general, bright lines are good when they force action and bad when they prevent it, while discretion and flexibility are good when they permit regulators to act, bad when they can be exploited by passive and

raise important policy questions.[3] Nonetheless, the Board acknowledges that the thrust of its proposal would be to implement more permissive standards for ownership and control.[4] In the case of bank ownership and control, being more permissive is not the answer.

The banking industry is highly profitable and there are no indications that large banks are struggling to attract capital. Relaxing ownership rules in an already highly profitable industry will only make bank ownership even more attractive to, for example, private equity funds, potentially driving additional leveraging and consolidation.[5]

Research has shown that industry concentration implicates a variety of potential harms for customers, the financial system, and the economy more broadly.[6] Given the proposal's potential implications, the Board should identify an actual harm or market failure that it seeks to remedy, and an empirical basis for believing that its proposal will do so.

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complacent regulators. *See*, *e.g.*, Cheyenne Hopkins, *'New' Powers in Reg Reform Feel Familiar*, Am. Banker, Apr. 6, 2010 quoting Michael Barr, Treasury assistant secretary for financial institutions, saying that, "We learned painfully in the last crisis that authority, while necessary, is insufficient.").

[3] While some large investors have been granted leeway to increase their ownership stakes in certain banks, reports indicate that the limitations on banking relationships with portfolio banks have been a constraint for other investors. *See*, *e.g.*, Letter to Satish M. Kini, Apr. 11, 2013 (advising that The Vanguard Group, Inc. and affiliated entities collectively may acquire up to 15 percent of any class of voting securities of a bank holding company, bank, savings and loan holding company, or savings association without being deemed to have acquired control of that institution under the Bank Holding Company Act, the Home Owners' Loan Act, or the Change in Bank Control Act when the acquisition complies with certain conditions); *see also* Jonathan Stempel, *Berkshire Cuts Wells Fargo Stake, Pulls Fed Application*, Reuters, Apr. 12, 2017. Despite this disparate treatment, studies have concluded that "there is no difference between the anti-competitive threats from common ownership of index funds or from common ownership of Berkshire Hathaway[.]" Azar, Raina, & Schmalz, José Azar, Sahil Raina, & Martin C. Schmalz, Ultimate Ownership and Bank Competition 23, fn. 23 (May 4, 2019), available at SSRN: https://ssrn.com/abstract=2710252.

[4] *See* 93 Fed. Reg. 21,634, 21,635 (May 14, 2019) (noting that, "compared to past practice, the proposal would permit an investor to have a greater number of director representatives at the target company without triggering a presumption of control, and would allow investors seeking to terminate an existing control relationship to do *so* while retaining greater levels of ownership").

[5] *See* 93 Fed. Reg., at 21,655 (noting that the benefit of the rule "would be concentrated in companies engaged in the particular types of investments where controlling influence is a concern for the parties involved, rather a reduction in burden applicable to all transactions"). This is potentially true of small banks as well as large ones, given the increase in permissible leverage under the revised Small Bank Holding Company Policy Statement. *See* Board of Governors of the Federal Reserve System, Small Bank Holding Company and Savings and Loan Holding Company Policy Statement and Related Regulations; Changes to Reporting Requirements, 83 Fed. Reg. 44,195 (Aug. 30, 2018).

[6] *See* Azar, Raina, & Schmalz, *supra*, at 1. The potential implications are all the more troubling when one considers the sweeping nature of today's largest banking conglomerates, with their number of legal entities, geographic reach, and range of banking and nonbanking activities. See Dafna Avraham, Patricia Selvaggi & James Vickery, *A Structural View of U.S. Bank Holding Companies*, FRBNY Economic Policy Review, July 2012, at 65, available at: https://www.newyorkfed.org/medialibrary/media/research/epr/12v18n2/1207avra.pdf.

Failing that, the Board should conduct further analysis concerning the proposal's impact on industry consolidation before proceeding. Namely, the Board should analyze and seek comment on the degree to which the proposed changes to its ownership and control rules could drive consolidation in the banking industry, including through investments by private equity and hedge funds.

2. The proposal neglects important issues implicated by bank ownership and control.

This is a time in which "a vigorous and welcome debate is in full swing about the development and use of appropriate, theoretically motivated and empirically effective measures of common ownership."[7] In light of the absence of an adequate justification for the proposal, it is worth considering the proposal's failure to meaningfully address the pressing issues of concentration and competition, and therefore whether the proposal is worth the effort.

The ownership of large publicly traded companies is already heavily concentrated in the hands of a few large asset managers, and the same is true of the largest banks in particular.[8] The proposal has to potential to drive additional investment by these firms, further concentrating the ownership of the largest banks.[9]

The implications of this situation are still not fully understood. Researchers have examined the impacts of large ownership stakes in concentrated industries, including banking, and proposed common ownership limits well below those contained in the Board's proposal.[10] Others have suggested that large shareholders could actually provide some benefits from a financial stability perspective.[11]

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[7] Azar, Raina, & Schmalz, *supra*, at 34.

[8] *See* José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership* 3 (May 10, 2018), available at SSRN: https://ssrn.com/abstract=2427345; *see also* Azar, Raina, & Schmalz, *Ultimate Ownership and Bank Competition*, *supra*, at 2 ("The same four institutional investors are among the top 5 shareholders of the nation's five largest banks. The fifth important player is Berkshire Hathaway, which ranks among the top five shareholders of three of the top six banks.").

[9] In particular, analysts anticipate that the Board's proposal will cause Berkshire Hathaway to increase its investments in the largest banks, the implication being that the proposal removes some of its previous constraints. *See* Felice Maranz, *Buffett May Add to Bank Stakes After Fed Shift, Barclays Says*, Bloomberg, Apr. 25, 2019. Indeed, Berkshire's CEO, Warren Buffett, has stated that he would be interested in taking a larger ownership stake in some of its portfolio banks. *See* Brian Baker, *Berkshire Hathaway to Invest More in Banks if Fed Plan Adopted, Buffett Says*, MLex Market Insight, May 6, 2019 (quoting Mr. Buffett saying that the Board's existing rules "have been a deterrent," that they will be "be less of a deterrent in the future").

[10] *See*, *e.g.*, Eric A. Posner, Fiona Scott Morton, & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors* (Mar. 22, 2017) (recommending a 1 percent limit on ownership in "oligopolistic" industries), available at SSRN: https://ssrn.com/abstract=2872754.

[11] *See* Yesha Yadav, *Too-Big-to-Fail Shareholders*, Vanderbilt Law Research Paper No. 17-3 (February 23, 2017), available at SSRN: https://ssrn.com/abstract=2922681.

At the same time, the Board has not shown any meaningful evolution in its thinking regarding merger analysis. For example, it has not publicly denied a merger application in the last 13 years.[12] This is an opportunity for the Board to engage with scholars and proposals to update its analysis.[13]

Statements about the scarcity of regulatory resources are commonplace.[14] In that sense, the Board's decision to prioritize this proposal over updating its analysis of concentration and competition represents a missed opportunity. Rather than finalizing the proposed rule, I urge the Board to direct its finite resources toward engaging experts on the issues of competition, consolidation, and common ownership, and to seek solutions that address those issues in a comprehensive manner.

3. The proposal has other potential risks that are not outweighed by its purported benefits.

Finally, it is also important to note the potential for additional unintended, or unappreciated, consequences arising from the proposal. Such consequences include:

- The cumulative impact of these and other deregulatory changes resulting from the enactment of S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act, upon banks with less than $10 billion in total consolidated assets—particularly potential implications for those with riskier business models and/or those which are owned by private equity and hedge funds;

- The impact of these changes upon relevant provisions of the Volcker Rule's prohibition on the sponsorship of certain private funds;[15] and

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[12] *See* Jeremy Kress, *Fed is a Rubber Stamp for Bank mergers — It's a Problem*, Am. Banker, Apr. 10, 2019.
[13] *See* Azar, Raina, & Schmalz, *supra*, at 34 (proposing a revised merger analysis that takes into account issues like common ownership).
[14] *See*, *e.g.*, Remarks by Kevin J. Stiroh, Executive Vice President, Federal Reserve Bank of New York, "Policy Efficiency in Supervision," Mar. 01, 2019 (noting the importance of "allocative efficiency of scarce resources and the deadweight loss associated with the misallocation of those resources").
[15] *See* Long & Springer, Potential Reform to the Federal Reserve Board's "Control Rules," *supra* (noting that potential changes have "the potential to affect certain rules applicable to bank holding companies (BHCs) themselves, particularly in the area of so-called 4(c)(6) investments and the Volcker Rule"); *see also* Dechert LLP, Federal Reserve Proposes Revisions to its Control Framework: Implications for Asset Managers and Other Bank Investors, OnPoint, July 2019, available at https://info.dechert.com/10/12549/july-2019/frb-proposes-revisions-to-its-control-framework--implications-for-asset-managers-and-other-bank-investors(1).asp.

- The effects, if any, on the Board's authority to exercise oversight of investment companies and funds under the Bank Holding Company Act.[16]

In the interest of transparency, the Board should more comprehensively consider and explain the full range of implications of its proposal, and how those issues will be addressed, before moving forward. This proposal should not contribute to creating, or undermine any other regulations intended to address, additional risks in the financial system.

4. Conclusions

For the foregoing reasons, I urge the Board to reconsider this proposal, and instead to devote its efforts to the most pressing issues of consolidation in ownership and control in the banking industry.

Thank you for considering my views on this important matter.

Sincerely,

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[16] For example, while the asset manager BlackRock is among the five largest shareholders of the six largest U.S. banks, the large bank holding company PNC also owns a nearly 22 percent stake in Blackrock. This relationship has implications for its treatment as a nonbank subsidiary of a bank holding company and eligibility for regulation under the Bank Holding Company Act. *See* Federal Reserve Order Approving Acquisition of a State Member Bank, at fn. 11 (Dec. 23, 2011), available at https://www.federalreserve.gov/newsevents/pressreleases/files/order20111223.pdf.