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Financial Regulation and Supervision Across Business Lines in the United States

Financial Holding Companies post Gramm-Leach-Bliley Act

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CONTENTS

A. INTRODUCTION

The financial services industry worldwide has undergone major transformation since the late 1970s. Technological advancements in information processing and communication facilitated financial innovation and narrowed traditional distinctions in financial products and services, allowing them to become close substitutes for one another.[1] The deregulation process in many major economies prior to the recent financial crisis blurred the traditional lines of demarcation between the distinct types of financial institutions, exposing those firms to new competitors in their traditional business areas, while the increasing globalization of financial markets fostered the provision of financial services across national borders.[2]

Against this backdrop, a trend toward consolidation across financial sectors as well as across national borders increasingly manifested itself since the 1990s.[3] The developments in the financial markets ever more intensified competition in the financial services industry and induced financial institutions to redefine their business strategies in search of higher profitability and growth opportunities. Consolidation across distinct financial sectors, i.e. financial conglomeration, in particular became a popular business strategy in light of the potential operational synergies and diversification benefits it can offer.[4] This trend spurred the growth of diversified financial groups, the so-called financial conglomerates, which commingle banking, securities, and insurance activities under one corporate umbrella.[5] Still today, large, complex financial conglomerates are represented among major players in the financial markets worldwide, whose activities not only sway across traditional boundaries of banking, securities, and insurance sectors but also across national borders.

Notwithstanding the economic benefits that conglomeration may produce as a business strategy, the emergence of financial conglomerates also exacerbated existing and created new prudential risks in the financial system.[6] The mixing of a variety of financial products and services under one corporate roof and the generally large and complex group structure of financial conglomerates expose such organizations to specific group risks such as contagion and arbitrage risk as well as systemic risk.[7] When realized, these risks may not only cause the failure of an entire financial group but threaten the stability of the financial system as a whole, as evidenced by the events during recent financial crisis of 2007-2009.[8]

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1 Herring/Santomero (1990), p. 471; Koguchi (1993), p 7.

2 Herring/Santomero (1990), pp. 471-472; Koguchi (1993), pp. 13-14; Canals (1997), pp. 9, 13.

3 *See* Group of Ten (2001); Ruding (2002).

4 Tripartite Group (1995), paras. 26-27; Dierick (2004), pp. 6, 14.

5 Koguchi (1993), p. 7; Tripartite Group (1995), paras. 26-27; Bank of Japan (2005), p. 5.

6 In response to the rapid emergence of financial conglomerates, financial authorities have convened at the international level since the early 1990s to find ways for more effective supervision of financial conglomerates. Formed under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) in 1996, the Joint Forum composed of banking, securities, and insurance supervisors represents the main international body today that carries out work on supervisory issues relating to financial conglomerates and those that are of cross-sector relevance.

7 Koguchi (1993), p. 4; Walker (2001), pp. 176-177; NBB (2002), p. 74.

8 E.g. American International Group or Lehman Brothers in 2008.

In an effort to devise an effective regulatory framework with respect to financial conglomerates, the United States in particular represents an interesting case within the international community. While other countries have traditionally permitted financial institutions with diversified activities, such as the German archetype universal bank, or have gradually dismantled regulatory barriers on cross-sector activities, the U.S. financial system remained strictly segmented for the most part of the 20th century. The Glass-Steagall Act of 1933 [9] features most prominently in this context, which fundamentally separated the business of commercial banking and investment banking for nearly seven decades. The Bank Holding Company Act of 1956[10] ("BHC Act") reinforced the Glass-Steagall barriers while the Garn-St Germain Depository Institutions Act of 1982[11] restricted the insurance powers of banking organizations.[12]

Nonetheless, the U.S. financial services industry was no exception to the global trend of consolidation and conglomeration during the last quarter of the 20th century.[13] The walls between the distinct financial sectors were not always perfect. Regulatory loopholes and inconsistencies enabled financial institutions to gradually encroach into new business areas with the help of favorable administrative and judicial decisions. Still, the underpinning legal foundation remained untouched for many decades and hampered the development of full-fledged U.S. financial conglomerates until the late 1990s.

In 1999, the U.S. Congress passed the Gramm-Leach-Bliley Act[14] ("GLB Act") which brought the regulatory landscape more in line with the developments in the financial services industry and broke with the tradition of product separation. The GLB Act represents a landmark legislation, which has repealed long-standing restrictions on affiliations between banks and non-banking financial institutions.[15] It has in particular introduced a new corporate structure, the "financial holding company", which is permitted to engage in a broad range of activities, including banking, securities underwriting and dealing, and insurance underwriting activities as well as merchant banking activities. At the same time as the GLB Act greatly liberalized cross-sector financial integration, it also brought changes to the regulatory arrangement for the oversight of diversified financial groups in the United States.[16]

This paper aims at examining the current U.S. regulatory framework governing financial holding companies that are permitted to operate across financial sectors by combining diverse business lines under a single corporate umbrella. To this end, it first and foremost looks into the regulatory changes that the GLB Act has instituted. Further, it takes account of the impact of the Dodd-Frank Wall Street Reform and Consumer

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9 Banking Act of 1933, June 16, 1933, ch. 89, 48 Stat. 162.

10 Act of May 9, 1956, Pub. L. 84-511, 70 Stat. 133.

11 Act of Oct. 15, 1982, Pub. L. 97-320, 96 Stat. 1548.

12 *See infra* C for a more in-depth analysis of the regulatory developments as regards cross-sector activities and affiliations in the U.S. financial services industry over the last century.

13 GAO Report (2000), pp. 14-15. For a detailed analysis of the consolidation trend in the United States in particular, *see* e.g. Wilmarth (2002) who explains how U.S. financial industry leaders have pursued a twofold consolidation strategy since the mid 1970s to enhance their profitability and market powers by (i) acquiring their traditional competitors and (ii) by acquiring firms in other sectors to diversify their activities.

14 Act of Nov. 12, 1999, Pub. L. 106–102, 113 Stat. 1338.

15 McCoy (2012), § 5.01.

16 Herring/Carmassi (2008), p. 62.

Protection Act[17] ("Dodd-Frank Act"), which was enacted in July 2010 in the aftermath of the recent financial crisis.

The first part of the paper (B) offers a succinct overview of the current U.S. financial regulatory system (incl. banking, securities, and insurance sectors) with a view to facilitating a better understanding of the main topic. The second part (C) outlines the historical development of cross-sector financial activities and affiliations prior to the GLB Act, shedding light on the reasons behind the passage of the GLB Act. The third part (D) mainly discusses the impact of the GLB Act on cross-sector financial activities and affiliations permitted in the corporate structure of a financial holding company. It examines the key regulatory changes introduced by the GLB Act, complemented by an overview of the new changes introduced by the Dodd-Frank Act. The last part (E) concludes with a summary and an assessment of today's regulatory framework that governs cross-sector financial activities and affiliations in the United States.

B. OVERVIEW OF THE U.S. FINANCIAL REGULATORY SYSTEM

The U.S. regulatory system governing the financial services industry is well-known for its structural fragmentation and multiplicity, most saliently with respect to the banking sector. It is not only complex and intricate but also contains some "*oddities*", which have been put into place over the past 150 years and are only explicable on historical grounds.[18] Several references made by American regulators and scholars, including "*a jurisdictional tangle that boggles the mind*"[19], "*a hodgepodge of federal and state agencies with overlapping authority*"[20] and "*Rube Goldberg regulatory structure*"[21], are sufficiently indicative of the level of complexity.

In essence, the U.S. financial regulatory system oversees three sectors, i.e. the banking, the securities, and the insurance sectors, and comprises two levels of regulation, the federal and the state level. All in all, over 115 different federal and state agencies are involved in overseeing banks, securities firms, and insurance companies and their products and services.[22] The fragmentation and multitude in the system has largely been driven by two major forces in the past, namely the political tradition in favor of federalism and regulatory competition and the practice of resolving financial crises and market failures by creating new regulatory agencies in different segments rather than expanding the jurisdiction of existing regulators.[23]

17 Act of July 21, 2010, Pub. L. 111-203.

18 Carnell/Macey/Miller (2009), p. 2.

19 Referring to the banking regulatory structure, *Arthur F. Burns*, Chairman of the Federal Reserve Board, address before the American Bankers Association, October 21, 1974.

20 Brown (2005), p. 10.

21 Carnell/Macey/Miller (2009), p. 2.

22 Brown (2005), p. 5. Although the former regulatory structure has been substantially overhauled by the Dodd-Frank Act of 2010, the new law has not mitigated the complexity of the institutional set-up. While it has pooled the regulatory powers over thrifts and national banks into the Office of the Comptroller of the Currency (OCC) and abolished the Office of the Thrift Supervision (OTS), it has also created several new agencies, including the Consumer Financial Protection Bureau, the Federal Insurance Office and the Financial Stability Oversight Council.

23 Brown (2005), pp.10-11; Scott (2008), para. 3-007.

Designed to provide a succinct overview of the U.S. financial regulatory system, this part is structured into three sections discussing the regulatory framework of the banking (I), the securities (II), and the insurance industry (III).

I. BANKING INDUSTRY

From a regulatory perspective, the banking industry presents the most complex and fragmented system in the U.S. financial services industry. Based on the general definition of banks, i.e. institutions whose core business involves deposit-taking and lending, the U.S. banking industry can be divided into three segments comprising commercial banks, savings associations[24], and credit unions.[25] Commercial banks represent the most significant and largest group of depository institutions by asset size and also offer the broadest range of permissible activities.[26] Throughout this article, the term "bank(ing)" will generally mean to refer to commercial bank(ing).

The U.S. banking industry is based on a "dual banking system"[27], the hallmark of banking for nearly 200 years, and divides the regulation of banks between the federal government and the states.[28] The dual banking system allows banks to choose between a federal and a state charter. Any institution that wishes to collect deposits and operate as a bank needs to obtain a charter, which serves as entry controls into the banking industry.[29] The chosen charter then triggers the entire scheme of banking regulation, determining the relevant banking regulator and the governing laws and regulations.[30]

The ensuing part introduces four major types of banking organization, i.e. national banks (1), state banks (2), state (non-) member banks (3), and bank holding companies (4), and briefly discusses the pertinent regulators and governing laws.

1. NATIONAL BANKS

National banks are banks that choose to be chartered at the federal level and are regulated under the National Bank Act of 1864[31]. The chartering authority and primary regulatory agency is the Office of the Comptroller of the Currency (OCC).[32] The OCC is placed in the Treasury Department and headed by the Comptroller of the Currency who performs his duties under the general directions of the Secretary of the Treasury.[33] National banks are required to become a member of the Federal Reserve System, the nation's central bank consisting of a seven member Board of Governors and twelve

24 Also referred to as the thrift industry, which comprises two types of savings institutions, i.e. savings banks and savings associations.

25 This categorization reflects the different types of bank charters that are available.

26 In the United States, commercial banks hold about $ 12.1 trillion in total assets (as of September 2010) while savings institutions hold about $ 1.3 trillion (as of September 2010) and all federally insured credit unions hold about $ 885 billion in total assets (as of end 2009). *See* FDIC at www.fdic.gov/bank/statistical/stats/2010sep/industry.pdf; NCUA at www.ncua.gov/Resources/Reports/statistics/Yearend2009.pdf.

27 The dual banking system also applies to savings associations and credit unions.

28 OCC (2003), p. 1.

29 McCoy (2012), § 3.01.

30 McCoy (2012), § 3.01.

31 Chapter 106, 13 Stat. 99; codified at 12 U.S.C. §§ 1 et seq.

32 12 U.S.C. §§ 21 et seq., 93a.

33 12 U.S.C. § 1.

Reserve Banks, and are insured by the Federal Deposit Insurance Corporation (FDIC).[34]

The National Bank Act defines the powers of national banks as corporate entities and restricts national banks to the "*business of banking*" and "*all such incidental powers as shall be necessary to carry on the business of banking*" (12 U.S.C.[35] § 24 (seventh)). The following five traditional bank powers are expressly enumerated in the statute as "*business of banking*": (i) discounting and negotiating promissory notes; (ii) receiving deposits; (iii) trading currency; (iv) making loans on personal security; and (v) circulating notes. The scope of business of banking is not limited to these enumerated powers and may be expanded by the OCC.[36] In addition, national banks are authorized to exercise "*all such incidental powers*" to the business of banking, which have been construed broadly to authorize new financial activities over the years, including both traditional as well as nontraditional banking activities.[37] This "incidental powers"-test is a case-by-case inquiry and contributes to a fluid notion of banking, allowing banks to accommodate society's changing needs for financial services.[38]

The power of national banks to engage in securities activities are limited by special statutory restrictions under 12 U.S.C. § 24 (seventh). National banks may provide brokerage services only for the account of customers and are generally prohibited from underwriting and dealing in securities.[39] This general prohibition is, however, subject to certain exceptions. Most importantly, national banks may underwrite, deal in, and invest in U.S. government bonds and general obligations of state and local governments. Moreover, a bank may purchase for its own account investment securities, i.e. investment-grade corporate debt securities, as permitted by the OCC.[40] In the years leading up to the passage of the GLB Act, the OCC has substantially broadened the list of permissible activities and eligible securities for national banks.

National banks have limited powers to engage in insurance activities. They may sell general lines of insurance as agents to customers in other locations so long as their insurance offices are located in places with no more than 5000 inhabitants under Section 92 of the National Bank Act.[41] Moreover, national banks have obtained certain insurance powers under the "incidental powers"-test under 12 U.S.C. § 24 (seventh) in the past. For instance, although national banks may generally not perform insurance underwriting activities, they have been allowed to underwrite and sell credit-related insurance without geographic restrictions through their operating subsidiaries.[42]

The GLB Act has changed the laws to allow national banks to engage in a broader range of nonbanking financial activities through the establishment of a "financial

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34 12 U.S.C. § 222.

35 United States Code. As it is more common to refer to the section numbers of the legal acts rather than to the U.S.C., statutory references will be made to the sections of the pertinent acts, where appropriate, while the official citations of the U.S.C. will be provided additionally.

36 *See* McCoy (2012), § 5.02[2][b][i], esp. the analysis of the court case *Nationsbank of North Carolina, N.A. v. Variable Annuity Life Insurance Company* (*id.*, note 77).

37 McCoy (2012), § 5.02[2][b][i]; Malloy (2012), § 6.07.

38 Malloy (2012), § 6.07.

39 This general prohibition originates from Section 16 of the Glass-Steagall Act that fundamentally separated commercial banking from investment banking business in the United States. A more in-depth discussion on the history and content of the Glass-Steagall Act is to be found *infra* C.I.

40 12 U.S.C. § 24 (seventh); 12 C.F.R. Part I; *also see* Carnell/Macey/Miller (2009), p. 133.

41 12 U.S.C. § 92.

42 McCoy (2012), § 5.02[5][b].

subsidiary"[43], which is permitted to carry out activities that are "*financial in nature*", including securities underwriting and dealing activities.

2. State banks

State banks are banks that are chartered at the state level. They are primarily regulated under the governing state law and supervised by the relevant state banking department. While federally chartered banks are governed by one set of laws (the National Bank Act and supporting regulations), state chartered banks are governed by 50 different sets of laws, not permitting a general statement about the powers of state banks.[44]

In 1991, the Federal Deposit Insurance Corporation Improvement Act[45] ("FDICIA") brought the principal activities of FDIC-insured state banks broadly in line with the list of activities permissible for national banks, rendering state and national banks more alike.[46] Although FDIC-deposit insurance is not compulsory for state banks, unless prescribed by the governing state law, it remains a necessity for state banks in reality.[47] Over 98% of state banks have FDIC-insurance.[48]

3. State (non) member banks

The term "member bank" designates any national or state bank that has become a member of the Federal Reserve System.[49] Member banks are subject to examination and regulation by the Board of Governors of the Federal Reserve System ("Federal Reserve Board" or "the Board") in addition to their primary banking regulator. All national banks are obliged to become a member of the Federal Reserve System whereas state banks can choose to obtain membership.[50] State banks that opt to become members of the Federal Reserve System are given the more specific term "state member banks".[51] Some states used to grant state banks broader banking powers than national banks in the past but the state banks lost this privilege once they became state member banks and thereby subject to stricter regulation by the Federal Reserve Board.[52]

"State nonmember banks" are state banks that are not members of the Federal Reserve System.[53] In addition to the primary state regulator, FDIC-insured state nonmember

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43 12 U.S.C. § 24a.

44 Felsenfeld/Glass (2011), p. 10. Generally, whether a bank charters at the federal or state level is considered more as a matter of taste than business necessity except where the nation-wide scope of business plays a strategic role, *see id*.

45 Pub. L. 102-242, 105 Stat. 2236.

46 12 U.S.C. § 1831a. However, the FDIC may authorize state nonmember banks to carry out impermissible activities if it deems the activity would not pose a significant risk to the deposit insurance fund*; see* Fein (2012), § 2.03[1][c], p. 2-10.

47 Malloy (2012), § 2.02[F].

48 Felsenfeld/Glass (2011), p. 13.

49 12 U.S.C. § 221.

50 12 U.S.C. § 222 and § 321.

51 12 U.S.C. §§ 321 et seq.

52 Fein (2012), § 2.03[1][b], p. 2-9.

53 12 U.S.C. § 1813(e)(2).

banks are regulated by the FDIC under the Federal Deposit Insurance Act of 1950[54] ("FDI Act") at the federal level.[55]

4. Bank holding companies (BHCs)

A bank holding company ("BHC") is any company that has control over any bank or any company that is a BHC (12 U.S.C. § 1841(a)(1)). The definition of "company" under the BHC Act is very broad and includes virtually all business entities while excluding individuals.[56] "Control" refers to having 25 % or more ownership votes in a bank, having control over the election of a majority of the bank's directors, or where the Federal Reserve Board determines that the company exercises a controlling influence over the management or policies of the bank.[57] "Bank" generally means any bank the deposit of which are insured under the FDI Act.[58]

A typical BHC consists of a parent holding company and one or more bank and non-bank subsidiaries and while a BHC itself may not take deposits, it can engage in almost every other activity of a bank such as making commercial and consumer loans.[59] Although BHCs are exclusively state-chartered corporations, they are primarily regulated by the Federal Reserve Board under the BHC Act.[60] The Board has adopted "Regulation Y" (codified at 12 C.F.R.[61] Part 225), which implements the BHC Act.

The primary goal of the BHC Act is to preserve competition in the banking industry by controlling the ownership of banks by holding company organizations and to separate banking and commerce by imposing limits on BHCs' nonbanking activities.[62] To this end, Section 4 of the BHC Act[63] generally prohibits a BHC from controlling any company which is not a bank or a BHC (ownership restrictions) and from engaging in any activities other than banking, managing or controlling banks and other subsidiaries, and furnishing services to its subsidiaries (activity restrictions).[64] Nonetheless, Section 4(c) BHC Act sets forth a number of important exemptions to the nonbanking prohibition of BHCs.[65] Most importantly, Section 4(c)(8) allows BHCs to own shares in any company the activities of which are "*so closely related to banking as to be a proper incident thereto*".[66] The Federal Reserve Board has construed this provision to permit BHCs to underwrite and deal in bank-ineligible securities through the establishment of subsidiaries (so-called "Section 20 subsidiary") since 1987, provided that the revenue from such securities activities did not exceed a fixed percentage of the total revenue of

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54 Pub. L. 81-797, 64 Stat. 873.

55 Fein (2012), § 2.03[1][c], p. 2-10.

56 12 U.S.C. § 1841(b); Carnell/Miller/Macey (2009), p. 437.

57 12 U.S.C. § 1841(a)(2).

58 12 U.S.C. § 1841(c)(1)(A).

59 Fein (2012), § 5.01[3], p. 5-4.

60 States only play a secondary role in BHC regulation; Fein (2012), § 5.01[1], p. 5-3.

61 Code of Federal Regulations.

62 Fein (2012), § 3.03[1], p. 3-18.

63 Codified at 12 U.S.C. § 1843.

64 Fein (2012), § 17.01[2], p. 17-6.

65 There are altogether 14 exemptions apart from some grandfathering and transitional exemptions, *see* 12 U.S.C. § 1843(c)(1) to (14).

66 12 U.S.C. § 1843(c)(8).

the subsidiary; the fixed percentage was initially set at 5 percent in 1987 but was raised to 10 percent in 1989 and to 25 percent in 1996.[67]

In 1999, the GLB Act substantially enlarged the scope of financial activities for holding companies by introducing a sub-category of BHCs, the "financial holding company" ("FHC") structure, which is permitted to combine banking, securities, insurance, and merchant banking activities.[68] BHCs, including FHCs, are a dominant feature in today's U.S. banking system. At year-end 2009, BHCs controlled nearly 85 percent of all FDIC-insured commercial banks and held approximately 99 percent of all insured commercial bank assets in the United States.[69]

II. SECURITIES INDUSTRY

The securities industry is characterized by great diversity where various kinds of institutions engage in a range of securities activities, including brokerage, market-making, underwriting, investment advice, and fund management, as well as commodities and real estate dealings.[70] Market players include securities brokers, dealers, investment banks, investment advisers, and investment companies. These entities contribute to an efficient capital allocation and enhance market liquidity by connecting investors to investment opportunities.

Although U.S. securities regulation originally began at the state level and is still influenced by individual states in selected areas, it has primarily become a matter of federal law since the enactment of the first federal regulation of securities, the Securities Act of 1933[71].[72] The Securities and Exchange Commission (SEC), created by the Securities Exchange Act of 1934[73], is the agency upon which the U.S. Congress has conferred the responsibility for the administration and enforcement of the federal securities laws.[74] Two types of organizations fall under the purview of the SEC, namely all corporations that sell securities to the public and securities markets and intermediaries.[75]

Any company that sells securities to the public is required to register with the SEC under the federal securities laws.[76] In contrast to banking regulation, which focuses on the risks of banks and seeks to ensure the safety and soundness of the institutions, securities regulation primarily aims at maintaining fair, orderly, and efficient markets.[77] The SEC seeks to protect investors from fraud and not risks and pursues this goal

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67 *See infra* C.I. for a more detailed discussion of this regulatory practice.

68 12 U.S.C. § 1843(k). Since its introduction, FHC has practically replaced BHC as the vehicle to engage in various financial activities across financial industry sectors.

69 *See* 96th Annual Report 2009 of the Federal Reserve Board, pp. 102-104; FDIC "Bank Statistics at a Glance" as of Dec. 31, 2009, available online at www.fdic.gov.

70 Hazen (2009), § 1.1[3].

71 Act of May 27, 1933, 48 Stat. 74, codified at 15 U.S.C. §§ 77a et seq.

72 Hazen (2009), §§ 1.0[2], 1.2[2] et 1.2[3].

73 Act of June 6, 1934, 48 Stat. 881, codified at 15 U.S.C. §§ 78a et seq.

74 Hazen (2009), § 1.2[3][B].

75 Jickling/Murphy (2010), p. 18.

76 Jickling/Murphy (2010), pp. 18-19. However, it does not follow from the act of registration that the registered securities are good or safe investments, *see id.*

77 The stated mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation, *see* http://www.sec.gov/about/whatwedo.shtml.

through financial disclosure by companies to the markets and the public.[78] Securities regulation includes registration and disclosure process for public offerings of securities, reporting and disclosure obligations of public companies, and antifraud and anti-manipulation regulation. Furthermore, the SEC also regulates and requires registration of securities markets and securities professionals, including stock exchanges, brokers, dealers, and investment advisers.[79]

The SEC regulation is supplemented by an elaborate system of self-regulation.[80] The SEC involves nongovernmental bodies in the exercise of its regulatory power by delegating a number of responsibilities to self-regulatory organizations ("SRO") in overseeing securities firms, most importantly the Financial Industry Regulatory Authority (FINRA).[81] The SEC oversees the SROs and may veto rulings of these nongovernmental bodies.[82] As in banking, there are securities supervisors at the state level that retain certain oversight power over securities business.[83]

In addition to the securities markets, investors can participate in the commodities futures markets, where commodities and commodity futures and options are traded. The commodities futures markets are regulated by the Commodity Futures Trading Commission (CFTC), which was created in 1974.[84] Similar to the SEC, the CFTC oversees industry SROs (the futures exchanges and the National Futures Association) and requires the registration of certain commodities markets participants such as futures commission merchants, floor traders, commodity pool operators, and commodity trading advisers.[85]

III. INSURANCE INDUSTRY

The insurance industry can broadly be divided into non-life insurance (property-casualty) and life insurance business and involves two main types of activities, namely "insurance selling" where the intermediary acts as an agent for a fee and "insurance underwriting" where the intermediary bears the direct risk of underwriting losses.[86]

Insurance companies require a license to carry out insurance activities which is solely obtainable from the state insurance regulators, i.e. insurance companies cannot resort to the federal level.[87] Insurance companies are subject to capital requirements to ensure their solvency, which are much more stringent than those applicable to general corporations.[88] Insurance regulation encompasses several other elements such as product regulation, market conduct, and financial regulation and consumer services.[89]

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78 Jackson et al. (2006), p. 4; McCoy (2012), § 12.02[1].
79 Jickling/Murphy (2010), p. 19.
80 Hazen (2009), § 14.1[3][C].
81 Stock exchanges are also self-regulatory organizations and as such exercise certain regulatory power over their members and the corporations whose shares they list, *see* Jackson et al. (2006), p. 4.
82 Jackson et al. (2006), p. 4.
83 Jackson et al. (2006), p. 4.
84 Hazen (2010), § 1.1[4].
85 Jickling/Murphy (2010), p. 21.
86 Saunders (2000), p. 487.
87 Carnell/Macey/Miller (2009), p. 544.
88 Carnell/Macey/Miller (2009), p. 544.
89 Boozell (2009), p. 3.

In contrast to banks and securities firms that are regulated both at the federal and the state level, insurance companies have historically been subject to regulation at the state level only.[90] Challenged since the Civil War, the states' authority over insurance regulation was at last endorsed by the U.S. legislator through the passage of the McCarran-Ferguson Act[91] in 1945.[92] Each state has an insurance department within the executive branch which typically has broad, legislatively delegated powers to enforce state insurance laws, to promulgate rules and regulations, and to enforce compliance by insurance companies.[93] Consequently, the U.S. insurance oversight framework involves more than 50 different standard-setters and is characterized by regulatory complexity and overlaps.[94] This condition has been largely mitigated through the regulatory harmonization efforts by the National Association of Insurance Commissioners (NAIC)[95] at the federal level, which functions *de facto* as a national insurance regulator by providing inputs on new legislative proposals and support services to insurance regulators across the county.[96]

While the Dodd-Frank Act has newly created a Federal Insurance Office within the Department of the Treasury, it has retained the current structure of state-based insurance regulation and does not provide for an optional federal charter for insurance companies.[97] The new law expressly denies general regulatory authority of the Federal Insurance Office or the Department of the Treasury over the business of insurance.[98] The Federal Insurance Office has limited powers and is mainly entrusted with monitoring all aspects of the insurance industry and with advisory functions in setting policy on international insurance issues.

C. CROSS-SECTOR FINANCIAL ACTIVITIES BEFORE GRAMM-LEACH-BLILEY ACT

U.S. financial institutions have developed on separatist and segmented product lines for the most part of the last century, largely dictated by legal barriers and strict regulation that inhibited the mixing of banking, securities, and insurance activities.[99] In particular, the Glass-Steagall Act of 1933 introduced a strict legal barrier between the business of banking and securities which was reinforced by other following legislations. The fundamental structure of the U.S. financial services industry remained highly fragmented for the most part of the 20th century.

This part aims at exploring the historical development of cross-sector financial integration in the United States, highlighting the emergence and growth of diversified financial groups over the last century prior to the GLB Act in 1999. It demonstrates that

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90 Carnell/Macey/Miller (2009), p. 539.
91 Act of March 9, 1945, ch. 20, 59 Stat. 33, codified as amended at 15 U.S.C. §§ 1011-1015.
92 Grace/Klein (2009), p. 1; *see* 15 U.S.C. § 1012.
93 Boozell (2009), Current Oversight Framework, p. 3.
94 Carnell/Macey/Miller (2009), p. 541.
95 Formed in 1871, the NAIC is a voluntary organization of the chief insurance regulatory officials of the 50 states whose mission is to assist state insurance regulators, individually and collectively, in serving the public interest. *See* NAIC at http://www.naic.org/index_about.htm.
96 Carnell/Macey/Miller (2009), p. 541.
97 Pub. L. 111-203, § 502.
98 Pub. L. 111-203, § 502, codified at 31 U.S.C. § 313(k).
99 Saunders (2000), p. 476; Saunders/Cornett (2009), p. 383.

despite the legal barriers between the distinct financial sectors, market forces have succeeded in pushing cross-sector integration with the aid of favorable judicial and administrative decisions. The focal point of discussion will center on banks and revolve around the development of affiliation between banking and non-banking financial activities, as mirrored by the regulatory and market practice. This part first delineates how the relationship between banking and securities businesses has evolved (1), followed by an illustration of the relationship between banking and insurance businesses (2).

I. BANKING AND SECURITIES ACTIVITIES

After the end of the Civil War (1861-1865), the U.S. banking industry was influenced by the British standards of sound banking and believed in drawing a sharp distinction between the types of institutions performing traditional banking (commercial banking) and securities (investment banking) functions.[100] It was considered improper for commercial banks to engage in highly speculative securities underwriting and dealing activities with the savings they received from the general public.[101] Starting from the late 19th century, however, a shift from traditional banking activities occurred and commercial banks started to move into the securities fields either directly or, more commonly, by forming security affiliates.[102] This development was precipitated by the emergence of new competitors in the form of trust companies[103] offering "department store" style of banking.[104] In addition, the events during and after World War I increased the demand for investment banking services and spurred the growth of securities investments as the U.S. government attempted to finance the war through the issue of government bonds.[105] Wartime financing raised public awareness of securities issues and markets and provided corporations with new access to the supply of short-term capital, making them less reliant on bank loans.[106]

Against this backdrop, commercial banks increasingly ventured into the field of investment banking in the early decades of the 20th century, while private bankers, who had hitherto focused on securities activities, started to accept deposits.[107] No effective barriers in law or custom were in place by the beginning of World War I that precluded financial institutions from diversifying their palette of products and combining traditional banking services with other financial activities.[108] By the late 1920s, banks

100 Perkins (1971), pp. 485-486; Sametz (1981), p. 7. The term "investment banking" is employed to mean the business of securities underwriting, distributing and dealing. The term is used in juxtaposition with the term "commercial banking" so as to highlight the distinction between the traditional banking activities (deposit-taking and lending) and securities activities. Unless expressly defined otherwise, "investment banking (activities)" and "securities activities" are used interchangeably.

101 Perkins (1971), p. 485; Carnell/Macey/Miller (2009), p. 131.

102 Perkins (1971), p. 492; Sametz (1981), p. 8; Maycock (1986), p. 34.

103 Trust companies were state-chartered institutions permitted to engage in virtually any type of financial business. They started out as managers of estates and wills of wealthy individuals in the late 19th century, which naturally led to offering financial services to survivors, including solicitation of deposits in competition with commercial banks, investment advice to individuals, and financial counseling and assistance to business, *see* Sametz (1981), p. 8.

104 Perkins (1971), p. 487-489; Maycock (1986), p. 34.

105 Perkins (1971), p. 491; Nance/Singhof (2006), pp. 1315-1316.

106 Studenski/Krooss (1963), p. 336; Perkins (1971), pp. 487-489 et 493.

107 Perkins (1971), p. 490; Sametz (1981), p. 9.

108 Perkins (1971), p. 490; Sametz (1981), p. 9; Nance/Singhof (2000), p. 1316.

had widely become "financial department stores".[109] Until 1927, the market share of commercial banks in the securities field remained fairly low, but skyrocketed henceforth against the backdrop of the sharply rising stock market prices from 1927 to 1929 and the passage of the McFadden Act[110], which recognized the right of national banks to buy and sell marketable securities[111].[112]

Despite the general prosperity in the 1920s and the seemingly healthy appearance of the banking industry, the number of bank failures remained high[113] and started to spread rapidly and virally in the late 1920s.[114] Bank panics escalated all over the nation in the early 1930s, forcing the federal and state governments to declare bank holidays as a means to stop repayment and to relieve pressure on banks.[115] Between 1929 and 1933, more than 40 percent of all commercial banks failed in the United States.[116] Public confidence in the banking system was shattered and by 1933, the nation's economy had entirely collapsed. The stock market crash of October 1929 and the failure of the banking industry in the early 1930s incited public opinion against the interrelationship between commercial and investment banking. As the nation's economy was stricken with major calamities and fell into depression, a popular perception emerged that this state of affairs was instigated by the uncontrollable and abusive securities activities and affiliations of commercial banks.[117] The Pecora Commission, established in 1932 to investigate the causes of the stock market crash of 1929, revealed that banks and their affiliates had engaged themselves in serious conflict of interest abuses and identified the mixing of commercial and investment banking as a major cause of the stock market crash and the ensuing Great Depression.[118]

In response to the widely held opinion on banks' securities affiliation, Congress passed the Glass-Steagall Act[119] in June 1933. Although the Glass-Steagall Act did not entirely

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109 Klebaner (1990), p. 127.

110 Pub.L. 69-639, ch. 191, 44 stat. 1224 (Feb. 25, 1927). The main purpose of this act was to establish branch banking parity for national banks. Until then, national banks were prohibited from establishing any branch offices and were confined to a single office (unit banking) under the National Bank Act of 1864, while state banks were free to branch in accordance with their respective state law. The act represents a compromise between expanding the freedom of national banks to branch and subjecting state members to national bank regulations, *see* White (1983), p. 164.

111 Perkins (1971), p. 494; Sametz (1981), p. 10.

112 Perkins (1971), p. 495; *also see* Maycock (1986), p. 34. Commercial banks' aggressive encroachment into investment banking during this period is evidenced by the sharp increase of their market share in new securities issues which rose from approximately 37 percent in 1927 to 61 percent in 1930, *see* Perkins (1971), p. 495, Appendix I; Klebaner (1990), p. 126.

113 From 1921 to 1929, at least one bank closed every day of the year; in 1926, on average 2.7 banks closed on each day, *see* Klebaner (1990), p. 136. *See* Studenski/Krooss (1963), pp. 334-335 for detailed statistics on commercial bank suspensions from 1921 to 1929, broken down into national banks, state member banks, and non-member banks.

114 Carnell/Macey/Miller (2009), pp. 16-17.

115 Klebaner (1990), pp.140-141; Carnell/Macey/Miller (2009), pp. 16-17.

116 Benston/Kaufman (1986), p. 49. The number of commercial banks declined from about 25,000 to approximately 14,000 between 1929 and 1933, *id.*

117 Felsenfeld/Glass (2011), p. 304; Fein (2012a), §4.02.

118 *See* Saunders (2000), p. 480. The contemporary public view on banks' role in the Great Depression has been discredited over time.

119 The Glass-Steagall Act is the popular name used to refer to four sections (sections 16, 20, 21, and 32) of the Banking Act of 1933, June 16, 1933, ch. 89, 48 Stat. 162. Apart from the separation of commercial and investment banking, the Banking Act of 1933 introduced several innovations of particular historical significance, including the establishment of a federal deposit

prohibit commercial banks from engaging in securities activities, as is widely perceived, it fundamentally separated the business of commercial banking from that of investment banking for nearly seven decades. The main provisions that erected the firewall between commercial and investment banking were laid down in Sections 16, 20, 21, and 32 of the act.

Sections 16 and 21 of the Glass-Steagall Act[120], still in effect today, limit the ability of banks and securities firms to engage *directly* in each other's business. Section 16 generally bars national banks from securities underwriting and dealing, limiting banks' activities to buying and selling securities as agents. However, the provision exempts certain securities from the general prohibition, most notably U.S. government bonds, and has been amended repeatedly over the years to allow more exceptions.[121] Section 21 makes it legally impossible for one single institution to conduct the business of issuing, underwriting, selling, or distributing securities and to take deposits at the same time.

Sections 20 and 32 of the Glass-Steagall Act, repealed by the GLB Act in 1999, restricted the ability of banks and securities firms to *indirectly* engage in each other's business through affiliation and management interlocks. Section 20 used to prohibit banks from being affiliated with any organization "*engaged principally in"* issuing, underwriting, or distributing securities, while Section 32 prohibited banks from having management interlocks with firms "*engaged primarily in*" purchasing, selling, or negotiating securities.

At the same time that the Glass-Steagall Act divorced commercial banking and investment banking, the laws regulating the securities industry generally exempted banks from the purview of the securities regulatory framework and SEC's control.[122] Although banks were still required to comply with securities laws in certain cases, the regulatory responsibility for securities issued or dealt in by banks were not given to the SEC but instead to the banking regulators.[123]

Following the enactment of the Glass-Steagall Act in 1933, the banking industry generally seemed disposed to abide by the letter and spirit of the law for the following three decades until the 1960s.[124] This period was marked by steady economic growth, low inflation, and modest unemployment. And as a result of strict regulation that reduced competition among banks and financial intermediaries, commercial banks were able to prosper and grow by taking interest-free demand deposits and making commercial loans.[125]

In 1956, the U.S. Congress passed another important legislation pertaining to cross-sector financial regulation. The BHC Act was primarily introduced to contain the

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insurance, the prohibition of interest on demand deposits, and the expansion of national bank branching.

120 Codified at 12 U.S.C. § 24 (Seventh) and 12 U.S.C. §378(a)(1), respectively.

121 Other permitted securities include general obligation bonds of state and local governments and municipal revenue bonds, *see* 12 U.S.C. § 24 (Seventh).

122 The Securities Act of 1933 exempted securities issued by banks from all significant provisions from the act with the exception of antifraud provisions. The Securities Exchange Act of 1934 excluded banks from the definitions of brokers, dealers, investment advisers, and investment companies, *see* Sametz (1981), p. 13.

123 Sametz (1981), p. 13.

124 Saunders (2000), p. 482.

125 White (1992), pp. 1-3.

interstate geographic expansion of banks that used the holding company structure to circumvent geographic restrictions and to prevent the mixing of banking and nonbanking activities in one corporate group.[126] The act further reinforced the barriers between the distinct financial sectors. According to the U.S. Supreme Court, the BHC Act intended to "*maintain and even to strengthen*" the restrictions of the Glass-Steagall Act on the relationship between commercial and investment banking.[127] Embodying the BHC Act's purpose to separate banking and commerce and to prevent undue concentrations of economic power, Section 4[128] of the BHC Act generally prohibited the acquisition and ownership of nonbanking interests by BHCs.[129]

By the 1960s, the commercial banking industry started to face heightened competitive pressure. Their share of assets held by all financial institutions had declined from 52 percent in 1950 to 38 percent in 1960.[130] In particular, banks dealt with difficulties raising funds for their lending business during a period of rising inflation as they were constrained by the ceilings on deposit interest rates under "Regulation Q" of the Federal Reserve Board, a product of the Glass-Steagall Act that had initially been introduced to safeguard banks' competitiveness and encourage local lending.[131] Against the rising inflation and interest rates, however, these restrictions strongly hampered the competitiveness of banks as their customers reduced their non-interest bearing demand deposits in exchange for more lucrative alternatives such as federal securities.[132] The 1960s were also marked by the revival of the commercial paper market and the start of the growing competition for banks from nonbank and nonfinancial companies that were subject to less burdensome regulation and challenged banks' share in the lending business.[133]

Additional developments in the 1970s and 1980s significantly contributed to the erosion of product barriers between the banking and securities businesses.[134] The ever rising inflation and interest rates up to double digits in the mid 1970s and again in the early 1980s had turned the interest rate caps of "Regulation Q" into a straitjacket for banks while technology advancements and financial innovation facilitated the entry of nonbanking organizations into the traditional domain of banks.[135] Once considered special, banking products became fungible with products offered by the securities industry, and real market rates drove bank customers to place their savings in higher yielding instruments such as securities and money market mutual funds while blue-chip borrowers abandoned banks in exchange for lower-interest credit.[136]

Given these developments, commercial banks came under extreme pressure to look for growth opportunities. As changes in market structure and financial innovation produced gray areas, banks increasingly sought to expand their activities into those areas that

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126 Felsenfeld/Glass (2011), p. 189.
127 Board of Governors v. Investment Company Institute, 450 U.S. 46, 69 (1981).
128 Codified at 12 U.S.C. § 1843.
129 *See supra* B.I.4.
130 White (1992), p. 7.
131 White (1992), p. 8.
132 Litan (1987), p. 32. As a countermeasure, commercial banks introduced innovative products such as the "negotiable certificate of deposit" that allowed them to pay the market rate of interest, *see* White (1992), pp. 8-9.
133 White (1992), p. 10.
134 Litan (1987), p. 33.
135 Litan (1987), p. 33.
136 McCoy (2012), § 7.01.

were not specifically prohibited by law.[137] Between 1963 and 1987, banks challenged many regulatory restrictions with some success, in particular those on underwriting certain securities as well as advising and managing open-end and closed-end mutual funds.[138] These expansionary efforts of banks were especially facilitated by the dual chartering system and the multiple regulatory structures.[139]

In 1987, the Federal Reserve Board made a new ruling on Section 20 of the Glass-Steagall Act by authorizing securities subsidiaries of three BHCs to underwrite and deal in certain bank-ineligible securities (the so-called "Section 20" affiliates), namely in commercial paper, municipal revenue bonds[140], mortgage-backed securities, and consumer-receivable-related securities.[141] The Federal Reserve Board maintained that these underwriting and dealing activities of BHCs through nonbank subsidiaries were permissible under Section 4(c)(8) of the BHC Act because they were "*closely related to*" banking.[142] In order to comply with the affiliation restrictions in Section 20 of the Glass-Steagall Act, the Federal Reserve Board imposed a revenue limit on these activities and ordered that the revenue from such securities activities may not exceed 5 percent of the total gross revenues of the securities subsidiary.[143] Since then, the Federal Reserve Board continuously expanded the powers of Section 20 subsidiaries by enlarging their range of permissible activities, increasing the revenue limit on ineligible securities activities, and allowing a more favorable method to calculate ineligible revenues.[144] The initial 5 percent gross revenue limitation for ineligible underwriting activities was raised to 10 percent in 1989[145] and further increased to 25 percent in 1996[146].

Given the Federal Reserve Board's liberal interpretation, the number and importance of holding companies grew rapidly and the use of holding company affiliates became the principal means for banks to expand their business into securities activities.[147] While in 1970 only 16 % of U.S. domestic bank deposits were held by BHCs, more than 90 % of bank deposits were held in holding company banks in the 1990s.[148] By the late 1990s, the classes of bank-ineligible securities that were permissible for Section 20 affiliates of BHCs included corporate debt and equity, commercial paper, municipal revenue bonds, mortgage-backed securities, and asset-backed securities.[149]

In light of the growing importance of BHCs and the power of the Federal Reserve Board, the OCC adopted the "Operating Subsidiary Rule" in 1996.[150] Under the new

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137 Sametz (1981), p. 12.
138 Saunders (2000), p. 482.
139 Sametz (1981), p. 12.
140 A type of municipal bonds the debt service of which is based on specific types of revenue and not on the general taxing power of states and municipalities.
141 In 1989, the Federal Reserve Board allowed five BHCs to underwrite and deal in all debt and equity securities, *see* Wagner (2000), pp. 356-357.
142 *See* Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp., 73 Fed. Res. Bull. 473 (1987).
143 73 Fed. Res. Bull. 473, 485 (1987).
144 Kwan (1997).
145 75 Fed. Res. Bull. 751 (1989).
146 61 Fed. Reg. 68750 (1996).
147 Wagner (2000), p. 351.
148 Jackson (1994), p. 509.
149 Kwan (1997).
150 61 Fed. Reg. 60342, 60352 (Nov. 27, 1996), codified in relevant part at former 12 C.F.R. § 5.34(f).

rule, the activity restrictions applicable to national banks were not to be applied to their operating subsidiaries anymore. The OCC declared that operating subsidiaries of banks would be granted, on a case-by-case basis, the power to engage in certain activities that were impermissible for banks but nonetheless part of or "*incidental to*" the business of banking. This step by the OCC was quite controversial from a legal and political view[151] and was seen as an attempt by the OCC to impede the expanding jurisdiction of the Federal Reserve Board in the ongoing turf war between the agencies.[152] Soon after the Operating Subsidiary Rules became effective, the OCC granted permission to operating subsidiaries of national banks to engage in bank-ineligible securities activities; the first application concerned revenue bonds underwriting, which was approved in 1997.[153]

Despite the seemingly rigid legal barriers of the National Bank Act, the Glass-Steagall Act, and the BHC Act, the changes in the financial services industry have led to the gradual erosion of the walls between the banking and securities sectors since the 1970s.[154] Market forces pushed U.S. banking organizations to expand their activities into the securities business through continued extension of national banks' powers and the use of holding companies during the decades leading up to the passage of the GLB Act.

II. BANKING AND INSURANCE ACTIVITIES

The barriers between the banking and the insurance industries have traditionally been very rigid. Although not entirely excluded from the insurance industry, U.S. banks have been subject to strict entry regulation into the field of insurance prior to the passage of the GLB Act. The first federal statutory reference to bank insurance agency powers was enacted in 1916 (codified at 12 U.S.C. § 92), which empowers national banks located and doing business in a town with a population of 5000 or less to act as insurance agents for certain insurance products.[155] This provision went unnoticed for the most part of the last century to the extent that the validity of the provision needed to be reaffirmed by the Supreme Court in 1993 after a series of court cases.[156] In general, commercial banks have been under very stringent restrictions with regard to insurance selling and underwriting activities. Banking regulators and courts have authorized banks to perform limited insurance activities over the years, mostly agency activities, as "incidental powers" of banks under the National Bank Act.[157]

As regards the powers of BHCs to engage in insurance activities, Section 4(c)(6) BHC Act initially authorized BHCs to engage in activities "*of a financial, fiduciary, or insurance nature*".[158] Based on this statutory wording, the Federal Reserve Board approved at least 25 applications of BHCs to engage in insurance agency activities

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151 *See* Wagner (2000), pp. 368 et seq. for a detailed discussion on the controversial aspects.

152 McCoy (2012), § 4.06[1][a][i].

153 The first application was submitted by Zions First National Bank of Salt Lake City, Utah. *See* Wagner (2000), pp. 375 et seq. for a discussion of the case.

154 Walker (2001), p. 170; Fein (2012a), § 1.02, speaks of "*Houdini-like methods of evading* [the Glass-Steagall Act's] *grasp*" by banking organizations prior to the passage of the GLB Act.

155 Lybecker (1998), p. 874.

156 Lybecker (1998), p. 875.

157 *See* Saunders (2000), p. 488 for a list of permissible insurance activities for national banks under the "incidental powers"-test of the National Bank Act.

158 12 U.S.C. § 1843(c)(6) (1956).

from 1956 to 1970 while it rejected at least two applications to engage in insurance underwriting activities at the same time.[159] Although the wording "*financial, fiduciary, or insurance*" was replaced by "*so closely related to banking*" in the 1970 amendments to the BHC Act, the Federal Reserve Board continued to regard certain insurance activities as permissible for BHCs, including the sale of credit life insurance, credit health and accident insurance, mortgage redemption insurance, liability insurance for bank borrowers, and any type of insurance sold in a town with a population of 5000 or less without adequate insurance agencies facilities.[160] In 1972, the Federal Reserve Board additionally authorized BHCs to engage in underwriting of credit life, accident and health insurance.[161]

Insurers, in an attempt to keep BHCs out of the insurance business, challenged the permissibility of BHCs' insurance activities before the courts on numerous occasions without any major success. Through intense lobbying, however, the insurance industry succeeded in pushing the legislator to enact the Garn-St. Germain Depository Institutions Act in 1982, which amended the BHC Act to expressly exclude insurance activities (with certain limited exceptions) from the "*so closely related to banking*" activities and consequently restricted the Federal Reserve Board's ability to expand BHC's powers into the insurance field.[162]

At the same time as banking organizations attempted to enter the insurance business, insurance companies also found ways to make inroads into the banking industry in the early 1980s by establishing "nonbank bank subsidiaries".[163] As the BHC Act required a bank to both take deposits and make commercial loans, insurance companies acquired full banks and divested one of the banking operations to escape banking regulation under the Federal Reserve Board.[164] This loophole was closed through the passage of the Competitive Equality Banking Act in 1987.[165]

The restriction of the BHC Act on the affiliation between banking and insurance business was greatly challenged in 1998, when Citicorp, engaged primarily in banking, and Travelers Group, a large insurance company, merged into Citicorp-Travelers Inc. The newly created Citigroup was the first U.S. financial group since 1933 that could fully engage in banking, securities, and insurance activities and was hailed as the first modern American "universal bank" (financial conglomerate).[166] The Federal Reserve Board approved the merger of these firms, which was seen as a bold action and possibly one that may have accelerated the financial services modernization through the passage of the GLB Act a year later in 1999.[167]

159 Fein (2012), § 20.02, p. 20-4.
160 Fein (2012), § 20.02, p. 20-4.
161 Fein (2012), § 20.02, p. 20-4.
162 Fein (2012), § 7.02[12], p. 7-28; § 20.03, p.20-5.
163 Saunders (2000), p. 489.
164 Saunders (2000), p. 489.
165 Saunders (2000), p. 489.
166 Wilmarth (2002), p. 220; *see id.* note 10 for further references on the merger.
167 Travelers Group, Inc./Citicorp, 84 Fed. Res. Bull. 985 (1998). There was a five-year grace period for the merged company to divest certain businesses in compliance with the standing laws. As the GLB Act was enacted about a year later, the divestiture requirement became obsolete. Nonetheless, Citicorp-Travelers Inc. broke apart only a few years after the merger.

D. CROSS-SECTOR FINANCIAL REGULATION AND SUPERVISION AFTER GRAMM-LEACH-BLILEY ACT

Until the late 1990s, business expansion across different financial sectors mostly occurred by exploiting regulatory loopholes and inconsistencies while seeking administrative and judicial approval. Although this practice *de facto* effectuated the gradual erosion of the regulatory barriers between the different financial sectors, the core legal framework governing cross-sector financial activities and affiliations remained essentially unchanged since the early 1930s and inhibited the development of full-fledged financial conglomerates in the United States.

On November 12, 1999, the GLB Act was finally signed into law following a period of over twenty years of effort to modernize the financial regulatory landscape.[168] The GLB Act represents a landmark legislation, which removed many of the legal barriers that inhibited financial institutions from expanding their business beyond their sectoral boundaries.[169] Most importantly, it repealed Sections 20 and 32 of the Glass-Steagall Act, which prohibited affiliations and management interlocks between banks and securities firms, and substantially modified Section 4 of the BHC Act to allow qualifying BHCs to operate as FHCs and to engage in any activity which is *"financial in nature"*.[170] Under the new law, it became possible to combine banking, securities underwriting and dealing, insurance selling and underwriting, and merchant banking activities under the same corporate umbrella.[171]

The GLB Act did not go as far as to allow financial institutions to *directly* carry out the full range of sectorally distinct financial activities.[172] Instead, it opted for an indirect route by choosing the holding company affiliate model as the main vehicle to channel through the full spectrum of financial activities, i.e. sectorally distinct businesses are only permitted in separate legal entities within a group structure.[173] At the same time, the GLB Act expanded the powers of banks to engage in securities underwriting and dealing activities through the establishment of "*financial subsidiaries*".[174] The legislator thereby reached a compromise solution to the long-standing debate on which corporate structure is most appropriate for expanded banking activities against the backdrop of the ongoing turf war between the OCC and the Federal Reserve Board.[175]

168 The U.S. Congress had been deluged with numerous bills proposing similar reforms prior to the GLB Act but failed to pass a reform for a number of reasons, including lobby pressures from the industry as well as disagreements among legislators and financial regulators on fundamental issues of banking regulation, *see* Wagner (2000), p. 333, note 16.

169 Fein (2012), § 7.02[18], p. 7-31.

170 Pub. L. 106-102, § 101 and § 103.

171 Pub. L. 106-102, § 103(a), codified at 12 U.S.C. § 1843(k).

172 The universal banking model prevalent in Europe, which allows one single legal entity to enter into banking and securities activities, was not considered a viable option in the United States with reference to the heighted risks for the safety of banks and their deposits, *see* Wagner (2000), p. 335, note 20.

173 Wagner (2000), p. 336.

174 Pub. L. 106-102, § 121, codified at 12 U.S.C. § 24a. However, the scope of permitted nonbanking financial activities for financial subsidiaries is not as broad as the scope of permitted activities for FHC subsidiaries and excludes insurance underwriting and merchant banking activities, *see* 12 U.S.C. § 24a(a)(2)(B).

175 Wagner (2000), pp. 336-337, 381. The main argument in support of the holding company affiliate model was that it provides higher protection to banking subsidiaries as financial

The liberalization of cross-sector businesses in the financial services industry naturally called for an adjustment of the regulatory regime. This section examines the regulatory framework applicable to FHCs as the representative structure of U.S. financial conglomerates. In particular, it highlights the changes that have been made to the regulatory regime by the GLB Act and the Dodd-Frank Act to accommodate the FHC structure and its special risk profile. To this end, the following part examines the relevant election criteria and the scope of permitted activities of FHCs (I). It then discusses the objectives and the principles of FHC regulation and supervision (II) and further looks into a selected number of supervisory issues that are of particular relevance for FHCs (III).

I. Financial holding company (FHC)

FHCs are important players in the U.S. financial markets today. As of June 30, 2012, out of the list of Top 50 holding companies (HCs) with total assets ranging between $ 2.3 trillion and $ 25 billion, 36 groups (including the first 14 largest groups) qualified as FHCs. [176] Financial activities across distinct business lines, especially the combination of banking and securities underwriting and dealing businesses, are predominantly carried out by FHC subsidiaries today and not through Section 20 subsidiaries of BHCs as in the past. As of March 31, 2011, only one Section 20 subsidiary of a BHC existed while 80 securities subsidiaries of FHCs were identified by the Federal Reserve Board.[177]

The FHC structure is viewed as a further evolution of the BHC structure, which allows for more flexibility in not only commingling distinct financial activities but also combining financial with non-financial activities under one corporate umbrella. The law permits FHCs to engage in activities that are "*financial in nature*", including securities underwriting and dealing, insurance underwriting and selling, financial and investment advisory services as well as merchant banking. [178] The GLB Act has consequently shifted the focus of the "*closely related to banking*" exemption of Section 4(c)(8) BHC Act to the "*financial in nature*" concept of the FHC authorization in Section 4(k) BHC Act.[179]

Any BHC that wishes to engage in the full range of financial activities can elect to become a FHC under certain conditions.[180] The following outlines the criteria that a

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difficulties of the holding company or a non-bank subsidiary would not directly impact bank capital.

176 National Information Center, List of the Top 50 holding companies (HCs), available at: http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx.

177 Federal Reserve Board, List of Securities Underwriting and Dealing Subsidiaries, available at: http://www.federalreserve.gov/bankinforeg/suds.htm.
Already by the end of 2003, 40 of the 45 BHCs that operated a Section 20 subsidiary had become FHCs and operated such subsidiary as a FHC subsidiary (*source:* "*Report to the Congress on Financial Holding Companies under the Gramm-Leach-Bliley Act*" of November 2003 at p. 8, submitted to the Congress by the Federal Reserve Board and the Secretary of the Treasury as required by §103(d) of the GLB Act).

178 *See* 12 U.S.C. § 1843(k)(4).

179 Malloy (2012), § 11.02.

180 BHCs that do not elect to become FHCs may continue to carry out nonbanking financial activities as permitted under Section 4(c)(8) BHC Act prior to the enactment of the GLB Act, *see* 12 U.S.C. § 1843(c)(8).

BHC needs to meet in order to become a FHC (1) and lists the main activities that a FHC may engage in (2).

1. Election to become FHC

In order to elect FHC status, an institution must first become a BHC. Any BHC may elect to become a FHC upon meeting the following requirements under 12 U.S.C. § 1843(l):

(i) all depository institution subsidiaries of the BHC are well capitalized;

(ii) all depository institution subsidiaries of the BHC are well managed;

(iii) the BHC is well capitalized and well managed[181];

(iv) the BHC must file with the Federal Reserve Board a declaration that it elects to be a FHC and a certification that the BHC and its depository institution subsidiaries meet the requirement of being well capitalized and well managed;

(v) all depository institution subsidiaries of the BHC must have a rating of at least "*satisfactory*" under the Community Reinvestment Act of 1977 in the most recent examination.

An insured depository institution is deemed to be "*well capitalized*" if the institution has and maintains at least the capital levels required to be well capitalized under the capital adequacy regulations or guidelines applicable to the institution that have been adopted by the appropriate Federal banking agency for the institution under Section 38 of the Federal Deposit Insurance Act (12 U.S.C. § 1831o).[182]

A BHC is deemed to be "*well capitalized*" if it maintains, on a consolidated basis, a total risk-based capital ratio of 10 percent or greater and a tier 1 risk-based capital ratio of 6 percent or greater, and is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by the Board to meet and maintain a specific capital level for any capital measure.[183]

A company or depository institution is deemed to be "*well managed*" if it has received from the applicable federal banking agency at least a satisfactory composite rating and at least a satisfactory rating for management.[184]

In general, no prior approval by the Federal Reserve Board is necessary to be elected a FHC; the FHC is required to notify the Fed within 30 days after the event.[185]

2. Permitted range of activities

The GLB Act introduced a new Section 4(k) to the BHC Act (codified at 12 U.S.C. § 1843(k)), which authorizes FHCs to engage directly or indirectly through subsidiaries

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181 This requirement is new and was introduced by the Dodd-Frank Act, *see* Pub. L. 111-203, § 606.
182 12 C.F.R. § 225.2(r)(2)(i).
183 12 C.F.R. § 225.2(r)(1).
184 12 C.F.R. § 225.2(s).
185 12 U.S.C. § 1843(k)(6).

in a broad range of financial activities.[186] FHCs may engage in, and may acquire the shares of any company engaged in, any activity that are determined to be "*financial in nature*" or "*incidental to such financial activity*".[187] In addition, FHCs may also engage in nonfinancial activities which are "*complementary to a financial activity*" and do not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.[188]

12 U.S.C. § 1843(k)(4) lists nine classes of activities as "*financial in nature*":

(i) lending, exchanging, transferring, investing for others, or safeguarding money or securities ("lending and transferring money");

(ii) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent or broker for purposes of the foregoing, in any State ("insurance activities");

(iii) providing financial, investment, or economic advisory services, including advising an investment company ("advisory services");

(iv) issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly ("securitization");

(v) underwriting, dealing in, or making a market in securities ("securities underwriting and dealing");

(vi) activities that were permissible for BHCs under Section 4(c)(8) BHC Act ("Section 4(c)(8) activities")[189];

(vii) activities that a BHC may engage in outside of the United States as determined by the Federal Reserve Board[190] ("permissible activities abroad");

(viii) acquiring any type of ownership interest in any type of nonfinancial entity ("merchant banking activities"); and

(ix) owning securities as part of insurance company portfolio investments ("insurance company investments").

In addition to these financial activities pre-determined in the BHC Act, there are additional activities determined to be financial in nature or incidental to financial activities by the Federal Reserve Board[191] as well as activities that have been pre-approved in the BHC Act but the extent to which needs to be determined by the Federal

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186 Pub. L. 106-102, § 103.

187 12 U.S.C. § 1843(k)(1)(A).

188 12 U.S.C. § 1843(k)(1)(B).

189 *See* list of permissible activities codified at 12 C.F.R. § 225.28. The list includes asset management, leasing personal or real property, financial and investment advisory activities, securities brokerage, riskless principal transactions, private placement services, futures commission merchant, underwriting and dealing in government obligations, investing and trading activities, management consulting, courier services, acting as principal, agent, or broker for credit insurance, and data processing.

190 These activities relate to management consulting services, travel agency, and mutual funds, 12 C.F.R. § 225.86(b).

191 *See* 12 C.F.R. § 225.86(d).

Reserve Board.[192] All permitted financial activities for FHCs are listed in Regulation Y of the Federal Reserve Board.[193]

II. FUNDAMENTALS OF FHC REGULATION AND SUPERVISION

Holding companies can commonly be found in regulated industries such as electric and gas utility, railroad, and financial services because the organizational form offers opportunities to avoid some of the regulatory constraints.[194] The holding company structure in the U.S. financial services industry has served as a popular organizational form to circumvent geographic and activities restrictions, to achieve tax benefits, and to increase financial flexibility by avoiding some of the financing constraints in respect of leverage or types of assets and liabilities.[195]

Cognizant of the risks emanating from the organizational form, the authorities overseeing holding companies particularly focus on the impact that such organizations can have on the financial condition of regulated subsidiaries. The following discusses the supervisory objectives and principles in respect of FHCs.

1. OBJECTIVES OF FHC SUPERVISION

Financial supervisors seek to ensure that financial institutions are operated in a safe and sound manner so as to protect customers and to safeguard the stability of the financial system. In the case of holding companies, supervisors are especially concerned with the adverse effects that the organizational structure can have on the financial condition of subsidiary banks.[196]

The primary federal regulator of FHCs[197] is the Federal Reserve Board which has supervisory oversight authority and responsibility over such organizations.[198] In this capacity, the Board aims at ensuring that FHCs, including their non-depository subsidiaries, are operated in a safe and sound manner so that they do not threaten the safety and soundness of affiliated depository institutions.[199] The purpose of FHC supervision is to identify and control the group-wide risks, especially those that may adversely affect the viability of subsidiary banks in the organization.[200]

Especially in a group structure where diversified activities and risks are commingled, financial troubles in one part can spread easily to the other part, endangering the health of the group as a whole. Given that large financial groups increasingly manage their

192 12 U.S.C. § 1843(k)(5).

193 *See* 12 C.F.R. § 225.86 for complete list. “Complementary” activities are not included in the list as they are not financial activities and therefore subject to different rules than financial activities, *see* Gruson (2002), p. 71.

194 Federal Reserve Board (2012), Section 1020.0, p. 1.

195 Federal Reserve Board (2012), Section 1020.0, p. 1.

196 Federal Reserve Board (2012), Section 1020.0, p. 2.

197 As the FHC structure is a sub-category of a BHC, i.e. it is a BHC that satisfies certain regulatory requirements (as laid out *supra* D.I.1.), FHCs are generally subject to the same regulation as BHCs imposed by the Federal Reserve Board.

198 12 U.S.C. § 1844; *also see* Federal Reserve Board, Supervision and Regulation (“SR”) Letter 00-13 (SUP), “Framework for Financial Holding Company Supervision”, Aug. 15, 2000.

199 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.

200 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.

activities in an integrated manner and risks cut across business lines and legal entities, the Board oversees FHCs on a consolidated basis and focuses in particular on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy.[201]

Effective FHC supervision seeks to balance the objective of protecting subsidiary banks in increasingly complex group structure with significant inter-related activities and risks against the objective of not imposing an unduly duplicative or onerous burden on the subsidiaries of the group.[202]

2. PRINCIPLES OF FHC SUPERVISION

The GLB Act combines two principles of supervision with regard to FHCs, i.e. functional regulation and umbrella supervision, to accommodate the mixing of diverse financial activities under one corporate umbrella and to address potential conflicts arising from overlapping jurisdictions among the distinct financial regulatory agencies.[203]

Functional regulation essentially means regulation based on the type of activity, contrary to regulation that narrowly focuses on industry lines.[204] Umbrella supervision denotes the supervision of a group at the enterprise-wide level.[205] This combination, as adopted by the GLB Act, allows regulators to maintain the strengths and expertise of the sectoral regulatory regimes and at the same time to capture the risks that may arise or aggravate at the group level.

A. FUNCTIONAL REGULATION

Historically, U.S. financial regulation focused on entities and each regulator was charged with overseeing a particular type of institution irrespective of the actual products and services provided (“entity regulation”).[206] This meant that banking regulators oversaw banks, insurance regulators were in charge of insurance companies while securities firms were subject to regulation by securities regulators, irrespective of the actual business activities undertaken by these types of institution. Securities activities of banks had for instance long been placed under the general responsibility of the relevant banking regulator and exempt from regulation by the SEC under securities laws.[207]

The GLB Act embraced the principle of functional regulation for FHCs.[208] Functional regulation is based on the notion that similar activities should be regulated alike by the same authority with the most expertise in that area.[209] This approach permits regulators

201 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.
202 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.
203 Gruson (2002), p. 154; Fein (2012), § 15.02[2], p. 15-8.
204 Gruson (2002), p. 154; McCoy (2012), § 12.02[2].
205 Fein (2012), § 15.02[3], p. 15-10.
206 Brown (2005), p. 11.
207 Brown (2005), p. 11.
208 Gruson (2002), p. 154; Fein (2012), § 15.02[2], p. 15-8. However, the GLB Act did not entirely abandon entity regulation but supplemented functional regulation with entity regulation, *see* Greenlee (2008), p. 432; Fein (2012), § 15.02[2], p. 15-9.
209 Fein (2012), § 15.02[2], p. 15-8.

to develop specialized expertise, allowing them to better understand the associated risks, and promotes greater regulatory consistency across financial sectors.[210] In practice, this means that a FHC's securities activities are regulated by the SEC, its futures commission merchant activities are regulated by the CFTC, and its insurance activities are regulated by the appropriate state insurance commissioner.[211] Bank subsidiaries of a FHC continue to be regulated by their primary banking regulator (e.g. OCC). In furtherance of functional regulation, the GLB Act repealed some of the bank exemptions with regard to securities activities and requires banks to conduct certain securities and insurance activities outside of the bank in "*functionally regulated subsidiaries*"[212].[213]

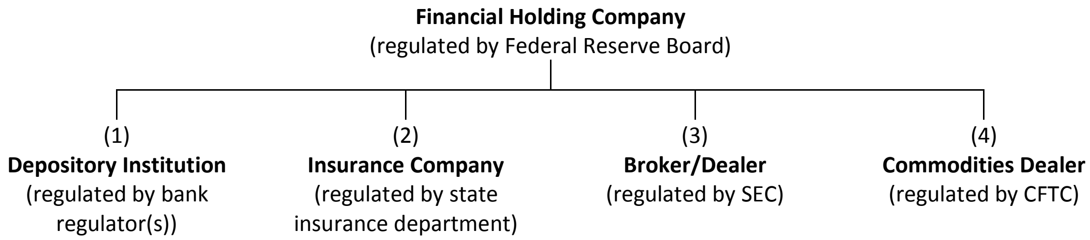

Figure 1[214]

A key element of functional regulation is the deference to the functional regulators by other regulators with overlapping jurisdiction.[215] The supervisory powers of the Federal Reserve Board over functionally regulated subsidiaries of FHCs have been rather restrictive under the GLB Act, which required the Board to give deference to examinations and reports by the functional regulator[216] and granted to the Board limited rulemaking and enforcement authority over functionally regulated subsidiaries of FHCs[217]. The Dodd-Frank Act eliminated many of these restrictions on the Board's supervisory authority, strengthening the Board's oversight of functionally regulated subsidiaries on a group-wide basis.[218]

B. UMBRELLA SUPERVISION

As a corollary to functional regulation, the GLB Act designated the Federal Reserve Board as the "umbrella supervisor" of FHCs and conferred prudential oversight

210 McCoy (2012), § 12.02[2].

211 Gruson (2002), p. 154. Oversight by the relevant functional regulator only relates to those activities of the entity that fall under the jurisdiction of the respective regulator, *see id*.

212 12 U.S.C. § 1844(c)(5) defines "*functionally regulated subsidiaries*" as any company that is not a BHC or a depository institution and is a registered broker or dealer, registered investment adviser, registered investment company, an insurance company, or an entity subject to regulation by the CFTC.

213 Fein (2012), § 15.02[2], p. 15-8; McCoy (2012), § 12.02 [2].

214 Garten (2001), p. 164, Illustration 1.

215 Fein (2012), § 15.02[2], p. 15-9.

216 Pub. L. 106-102, § 111.

217 Pub. L. 106-102, § 113.

218 *See infra* D.III.5.c. for a more detailed discussion.

authority and responsibility over FHCs to the Board.[219] The appointment of the Board in this capacity is not aimed at imposing a more bank-like supervision on FHCs or at replacing supervision of the primary bank or functional regulators but to ensure that the safety and soundness of bank subsidiaries are not threatened by the fact that they are embedded in a complex group structure with significant cross-sector activities and risks.[220] As risks in a FHC can cut as well as spread easily across business lines, the Board focuses on a consolidated or group-wide analysis of FHCs to identify any significant risks, in particular with a view to assessing their impact on subsidiary banks.[221]

Umbrella supervision (also referred to as "consolidated" or "group-wide" supervision) can be defined as "*[s]upervision of a BHC [or FHC] on a groupwide basis, including its nonbanking subsidiaries, providing important protection to its subsidiary banks and to the federal safety net beyond that afforded by supervision of a bank individually*".[222] It is designed to fill any gaps or undetected supervisory issues that may have been left by functional regulators and enables the Board to acquire a comprehensive view of group-wide risks and controls of a FHC.[223] This type of supervision allows the Board to understand the organization's structure, activities, resources, and risks as well as to address financial, managerial, operational, or other deficiencies within the overall organization before they can pose a threat to subsidiary banks.[224]

As the umbrella supervisor, the Board's task is to ensure that FHCs are operated in a safe and sound manner so that their financial health does not affect the viability of subsidiary banks.[225] Accordingly, the Board focuses on the financial strength and stability of the group, their consolidated risk-management processes, and overall capital adequacy. It reviews and assesses the internal policies, reports, and procedures and effectiveness of the FHC consolidated risk management process while the primary bank or functional regulators continue to have primary responsibility for evaluating risks, hedging, and risk management at the entity level.[226] The Board has set three main criteria for an effective group-wide oversight of FHCs: (i) strong, cooperative relationships between the Board and primary bank and functional regulators; (ii) substantial reliance by the Board on reports filed with or prepared by primary bank and functional regulators as well as publicly available information; and (iii) continued reliance on the risk-focused supervision and examination process and on market discipline.[227]

The Board's umbrella supervisory authority is broad and it can examine and require reports from the regulated holding company and its subsidiaries, impose consolidated capital requirements on the holding company, as well as take enforcement actions

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219 Fein (2012), § 15.02[3], p. 15-10; *see* Pub. L. 106-102, § 307(a), which reads "*[i]t is the intention of the Congress that the Board of Governors of the Federal Reserve System, as the umbrella supervisor for financial holding companies, […]*".

220 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.

221 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.

222 Federal Reserve Board, SR 08-9/CA 08-12, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations", Oct. 16, 2008, Attachment C - Definitions of Key Terms for Consolidated Supervision.

223 Fein (2012), § 15.02[3], p. 15-10.

224 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.

225 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.

226 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.

227 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.

against the holding company and its subsidiaries.[228] However, the GLB Act imposed certain limitations on the Board's supervisory powers vis-à-vis functionally regulated subsidiaries, requiring the Board to mainly rely on the functional regulators and to consult them prior to taking any actions.[229] During the recent financial crisis, these limitations on the Board's supervisory authority were proven to hamper the Board's ability to effectively supervise BHCs and FHCs in their entirety and as a consequence, the Dodd-Frank Act eliminated some of these limitations and broadened the Board's supervisory role over functionally regulated subsidiaries.[230]

III. SELECTED SUPERVISORY ISSUES

In view of the corporate structure and the diversified nature of FHC operations and risks, effective supervision over FHCs will most of all require supervisory assessment on a group-wide basis as well as strong and efficient interagency cooperation and collaboration.

The following examines a selection of supervisory issues, which contribute to an effective oversight of FHCs. It examines the Federal Reserve Board's practice of consolidated supervision over FHCs (1), the holding company rating system (2), the group capital regulation of FHCs (3), and supervisory measures as regards intra-group exposures and concentrations within FHCs (4). Finally, the main regulatory changes introduced by the Dodd-Frank Act in respect of FHCs are discussed (5).

1. CONSOLIDATED SUPERVISION FRAMEWORK OF THE FEDERAL RESERVE BOARD

The BHC Act provides for all BHCs, including FHCs formed under the GLB Act, to be supervised on a consolidated basis by the Federal Reserve Board.[231] Consolidated supervision introduces a holistic perspective to and is therefore crucial in overseeing financial groups that operate diverse business lines with risks that cut across distinct financial sectors. In fulfilling its responsibilities as consolidated supervisor, the Board aims at developing and maintaining an *understanding* and *assessment* of each organization and utilizes three main processes for these purposes, namely (i) continuous monitoring activities, (ii) discovery reviews, and (iii) testing.[232] As individual organizations may require different supervisory efforts and treatment, the Board's supervisory activities are tailored to each organization based on a number of factors, including the organization's legal entity and regulatory structure, the risks posed by the organization's specific activities and systems, and the potential effect of weaknesses in control functions on the organization, its subsidiary banks, or key financial markets.[233]

To develop an *understanding* of BHCs/FHCs on a consolidated basis, the Board mainly seeks to identify and understand an organization's (i) corporate strategy and significant activities, (ii) business line, legal entity, and regulatory structure, including

228 Greenlee (2008), p. 433.
229 Fein (2012), § 15.02[3], p. 15-12.
230 Fein (2012), § 15.02[3], pp. 15-11 et 15-12. *See infra* D.III.5.c. for a more detailed examination of the statutory changes by the Dodd-Frank Act.
231 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.
232 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.
233 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.

interrelationships and dependencies across multiple legal entities, (iii) corporate governance, risk management, and internal controls for managing risks, and for certain organizations, (iv) their presence in critical or key financial market activities.[234]

To develop an *assessment* of BHCs/FHCs on a consolidated basis, the Board uses a systematic approach and assigns ratings to BHCs/FHCs ("RFI rating") by evaluating and assessing (i) the key corporate governance, risk management, and control functions, (ii) the adequacy of the financial condition of the consolidated organization, and (iii) the potential negative impact of nonbank entities on subsidiary banks.[235]

The Board applies a "risk-focused approach" to consolidated supervision, an approach developed in the mid-1990s in recognition of the fact that new technologies and product innovation have changed the nature of financial markets and that supervision requires a new emphasis on risk management.[236] This approach is designed to place the greatest amount of supervisory attention on identifying the business areas with the greatest risks to a banking organization's overall condition and assessing whether the management of the organization is capable of identifying, measuring, monitoring, and controlling these risks.[237] The Board in particular seeks to reduce the adverse affects that large and complex BHCs/FHCs may have on the public (incl. consumers and tax payers) and the financial system by engaging more actively and comprehensively in the supervision of the largest and most complex organizations as well as those with the most dynamic risk profiles.[238]

Another important element to the Board's consolidated supervision program for BHCs/FHCs is the "portfolio approach" to supervision, i.e. evaluation of activities across groups of organizations with similar business lines, characteristics, and risk profiles.[239] The Board employs this approach to ensure consistency in supervisory treatment across comparable organizations and to detect "outliers" among peer groups with regard to risk profiles and risk management techniques.[240] It allows the Board to compare risk management practices within the industry and more broadly to detect industry trends that are of particular relevance for policymakers.[241] Until recently, the Board's BHC portfolios comprised three types of BHCs, i.e. (i) large complex banking organizations ("LCBO") BHCs, (ii) regional BHCs, and (iii) community BHCs.[242] The Board's supervision program for LCBOs[243] was formally established in 1999[244] and

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234 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.

235 For more detail on the RFI rating system, *see infra* D.III.2.

236 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008; Fein (2012), § 15.02[1], pp. 15-5 et 15-6.

237 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.

238 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.

239 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.

240 DeFerrari/Palmer (2001), p. 55.

241 DeFerrari/Palmer (2001), p. 56.

242 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008. For more detailed guidance on the first and second BHC portfolios, *see* Attachments A.1 and A.2 to the SR letter 08-9.

243 LCBOs are characterized by their operational scope and complexity and their complex regulatory structure, both domestically and internationally; their participation in large volume payment and settlement systems; and the extent of their custody operations and fiduciary activities. To be designated as an LCBO, a banking organization must meet certain criteria to be considered a significant participant in at least one key financial market, including the markets for federal funds, foreign exchanges, and commercial paper; *see* definition in Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008, Attachment C.

244 Federal Reserve Board, SR 99-15 (SUP), June 23, 1999. *Also see* DeFerrari/Palmer (2001) for an in-depth discussion on the Board's supervisory program for LCBOs.

used to be the most relevant program in respect of FHCs as many LCBOs have become FHCs after the GLB Act.[245]

Recently, the Board substituted its LCBO program for a new consolidated supervision framework for large financial institutions, as set forth in its Supervision and Regulation Letter (SR) of December 17, 2012.[246] The new framework has been devised in the aftermath of the crisis of 2007-09 to improve the existing supervisory program for large financial institutions. It strengthens the traditional microprudential supervision of individual firms to enhance safety and soundness but also incorporates macroprudential elements to reduce potential threats to the stability of the financial system and to provide insights into financial market trends.[247]

Subject to the new framework are (i) Large Institution Supervision Coordinating Committee (LISCC)[248] firms, i.e. the largest, most complex U.S. and foreign financial organizations that are subject to consolidated supervision by the Federal Reserve Board, including nonbank financial companies designated by the Financial Stability Oversight Council, and moreover, as far as they are not already included in the LISCC portfolio, (ii) domestic bank and savings and loan holding companies with consolidated assets of $ 50 billion or more (Large Banking Organizations) and (iii) foreign banking organizations with combined assets of U.S. operations of $ 50 billion or more (Large Foreign Banking Organizations).[249] The new framework for consolidated supervision focuses, on the one hand, on enhancing the resiliency of individual firms by requiring large financial firms to strengthen their capital and liquidity planning and positions, to provide effective corporate governance and recovery planning, and to effectively manage their core business lines.[250] On the other hand, the new framework seeks to reduce the impact of a firm's failure to financial stability and provides guidance as regards the management of critical operations, resolution planning, and a firm's ability to support its affiliated bank offices; it also introduces a number of additional macroprudential supervisory approaches.[251]

Finally, effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve Board and relevant primary bank and functional regulators.[252] Well-functioning interagency coordination and information sharing arrangements are vital for an effective FHC supervision and contributes to eliminating duplication or undue burden.[253] The Board generally relies to the fullest extent possible on the reports of examinations as well as on information and assessments provided by

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245 *See* DeFerrari/Palmer (2001), p. 54; Half (2002), p. 49. For more detailed guidance on the first and second portfolios by the Federal Reserve Board, *see* Attachments A.1 and A.2 of Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.

246 Federal Reserve Board, SR 12-17/CA 12-14, "Consolidated Supervision Framework for Large Financial Institutions", Dec. 17, 2012.

247 Federal Reserve Board, SR 12-17/CA 12-14, Dec. 17, 2012.

248 LISCC is a multidisciplinary body that oversees supervision and evaluates conditions of supervised firms. It also develops cross-firm perspectives and monitors interconnectedness and common practices that could lead to greater systemic risk, *see* Federal Reserve Board, SR 12-17/CA 12-14, Dec. 17, 2012.

249 Federal Reserve Board, SR 12-17/CA 12-14, Dec. 17, 2012.

250 Federal Reserve Board, SR 12-17/CA 12-14, Dec. 17, 2012.

251 Federal Reserve Board, SR 12-17/CA 12-14, Dec. 17, 2012.

252 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000 and SR 08-9/CA 08-12, Oct. 16, 2008.

253 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000 and SR 08-9/CA 08-12, Oct. 16, 2008.

the primary bank and functional regulators to support effective supervision.[254] At the same time, the Board provides assistance to the other regulators in performing their supervisory responsibilities with respect to regulated subsidiaries.[255]

2. Holding company rating system

The Federal Reserve Board applies a rating system for BHCs/FHCs, which serves as an important supervisory tool to oversee the risks of a holding company in a comprehensive and systematic way. The assessment of BHCs/FHCs on a consolidated basis is reflected in the RFI (risk management, financial condition, and impact) rating that the Board assigns to each BHC/FHC.[256]

The Board first introduced a BHC rating system in 1979 in an effort to intensify the supervision and monitoring of BHCs. The initial rating system, the BOPEC rating system, served to evaluate and rate the condition of the BHC's bank subsidiaries (B), other non-bank subsidiaries (O), parent holding company (P), earnings (E), and capital (C), all of which was to be weighted equally.[257] However, the shortcomings of the initial rating system became apparent with the increasing complexity in the financial landscape as it mainly focused on historical analyses of financial condition and failed to produce more forward looking assessments of risk management and financial factors.[258]

Effective 2005, the BOPEC rating system was replaced by the RFI rating system to bring the rating system for BHCs and FHCs more in line with the supervisory processes that had become more risk-focused over the years.[259] Under the RFI rating system, each BHC/FHC is assigned a composite rating (C) on the basis of an overall evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its depository subsidiaries.[260] The main ratings relate to risk management (R), financial condition (F), and potential impact (I) of the parent and the non-depository subsidiaries on the depository institution subsidiaries and is complemented by a fourth rating relating to depository institution (D), which reflects the assessment of the subsidiary depository institution(s) by the primary bank regulator; altogether, the ratings are displayed as "RFI/C(D)".[261]

The (R) component is supported by four subcomponents that reflect the effectiveness of the banking organization's risk management and controls, which are (i) board and senior management oversight, (ii) policies, procedures, and limits, (iii) risk monitoring and management information systems, and (iv) internal controls.[262] The (F) component is similarly supported by four subcomponents reflecting an assessment of the quality of the banking organization's (i) capital, (ii) asset quality, (iii) earnings, and (iv)

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254 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008 and SR 12-17/CA 12-14, Dec. 17, 2012.
255 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.
256 Federal Reserve Board, SR 08-9/CA 08-12, Oct. 16, 2008.
257 The rating system was modified in 1995 to incorporate a risk management rating, *see* Bleier (2007), pp. 286-288.
258 Fein (2012), § 15.05[2], p. 15-29.
259 Federal Reserve Board, SR 04-18, "Bank Holding Company Rating System", Dec. 6, 2004.
260 Federal Reserve Board, SR 04-18, Dec. 6, 2004.
261 Federal Reserve Board, SR 04-18, Dec. 6, 2004.
262 Federal Reserve Board, SR 04-18, Dec. 6, 2004.

liquidity.[263] Ratings are assigned based on a one to five numeric scale, a "one" indicating the highest rating, strongest performance and practices, and least degree of supervisory concern.[264]

3. CAPITAL ADEQUACY REGULATION

Capital adequacy regulation is a key instrument for financial supervisors to ensure the safety and soundness of financial institutions.[265] Given that regulatory capital requirements for banks, securities firms, and insurance companies vary significantly with different definitions of capital elements and approaches to asset and liability valuations, diversified financial groups in the form of FHCs may easily be incentivized to exploit regulatory inconsistencies and engage in capital arbitrage by means of double/multiple gearing or excessive leveraging, putting their financial health at risk.[266] Therefore, it is imperative to regulate the capital of such organizations on a group-wide basis.[267]

The Federal Reserve Board is responsible for regulating the capital adequacy of FHCs on a consolidated basis with the ultimate goal of protecting insured banking subsidiaries from any disruptions that may arise in the nonbanking part of the organization.[268] As BHCs, FHCs are subject to the Board's holding company capital requirements under Regulation Y, which largely correspond to the requirements imposed on FDIC-insured depository institutions.[269] The capital requirements are applied to the holding company in its entirety, i.e. the holding company and all of its subsidiaries are viewed as a single, consolidated entity, and assessed in relation to the risk profile of the consolidated organization.[270] The Board has the power to regulate the capital at the holding company level regardless of the type of the holding company, i.e. the holding company can be a broker-dealer, an insurance company, or an investment company.[271]

Under the Board's Regulation Y, capital regulation on a consolidated basis is generally applied to any BHC/FHC with consolidated assets of $ 500 million or more.[272] The

263 A simplified version of the rating system is applied to noncomplex BHCs with assets below $ 1 billion, which only requires the assignment of the risk management component rating and composite rating, *see* Federal Reserve Board, SR 04-18, Dec. 6, 2004.

264 Federal Reserve Board, SR 04-18, Dec. 6, 2004.

265 In fact, the recent financial crisis has highlighted the importance of high-quality capital that financial institutions need to hold in an amount commensurate to their own risks to ensure that losses are not transferred to customers or taxpayers, *see* e.g. Testimony by Governor *Daniel K. Tarullo* on "Dodd-Frank Act Implementation" before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington D.C. on June 6, 2012, available at: http://www.federalreserve.gov/newsevents/testimony/tarullo20120606a.htm.

266 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000; Joint Forum (2001), Capital Adequacy Principles, para. 6.

267 *See* Joint Forum (2001), Capital Adequacy Principles, para. 1; Jackson (2005), p. 124.

268 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.

269 The Board's capital guidelines are laid down in Appendices A, B, D, E, and G to 12 C.F.R. Part 225.

270 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000; Carnel/Macey/Miller (2009), p. 459.

271 Gruson (2002), p. 51.

272 *See* 12 C.F.R. Part 225, Appendix A (I) and Appendix D (I)(b): BHCs with consolidated assets of less than $ 500 million are exceptionally subject to consolidated capital regulation if the holding company (i) is engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) conducts significant off-balance sheet activities (including

Board's holding company capital guidelines contain two sets of minimum capital ratios: the *risk-based capital ratios* (12 C.F.R. 225, Appendix A) and the *leverage ratio* (12 C.F.R. 225, Appendix D).[273]

The risk-based capital ratios are mainly based on the internationally developed Basel Capital Accord of 1988, as revised[274]. The main objectives of the risk-based capital framework is to take better account of the differences in credit risk profiles among banking organizations, to include off-balance sheet exposures in the assessment of capital adequacy, to minimize disincentives to holding liquid, low-risk assets, and to achieve greater consistency in the evaluation of the capital adequacy of major banking organizations worldwide.[275] The calculation of the risk-based capital ratios requires the division of the capital into two categories, i.e. tier 1 capital and tier 2 capital. While tier 1 capital mainly comprises common equity, noncumulative perpetual preferred shares, and minority shareholdings in subsidiaries, tier 2 capital is comprised of lesser quality capital instruments such as hybrid capital instruments or subordinated debt.[276] BHCs/FHCs are required to hold a minimum ratio of total capital to risk-weighted assets of 8 percent and a minimum ratio of tier 1 capital to risk weighted assets of 4 percent.[277]

As a supplement to the risk-based capital ratios, BHCs/FHCs are subject to a tier 1 leverage ratio, which plays an important role in restricting a firm's ability to acquire assets as it limits the amount of total assets to the amount of capital available.[278] The leverage ratio of a banking organization is calculated by dividing the book value of the tier 1 capital[279] by the book value of the average total consolidated assets.[280] The Board has established a minimum leverage ratio of at least 3 % for "strong" BHCs and for BHCs that have implemented the Board's risk-based capital measure for market risk[281] and a ratio of 4 % for all other BHCs.[282]

In addition to the Board's assessment of the consolidated capital adequacy of FHCs, the primary bank and functional regulators continue to apply their respective capital requirements to the entities that fall under their jurisdictions. The Board's power to

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securitization and asset management or administration) either directly or through a nonbank subsidiary; or (iii) has a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the SEC. The Board may moreover determine at its discretion the application of capital adequacy to any bank holding company, regardless of asset size, if such action is warranted for supervisory purposes.

273 Hirtle (1998), pp. 1-2.

274 The Basel Capital Accord has been developed by the BCBS which comprises central bankers and banking supervisors from many countries. The standards have been developed primarily for internationally active banks to create a level playing field. The first Basel standards were issued in 1988 (Basel I). The second overhaul produced Basel II in 2004, which has introduced a new three pillar supervisory structure. Basel III was adopted in 2010 to address the regulatory shortcomings in the Basel capital framework, as evidenced during the financial crisis of 2007-09.

275 Federal Reserve Board (2012), Section 4060.3.2., pp. 1-2.

276 12 C.F.R. Part 225, Appendix A (II)(A)(1) and (2).

277 12 C.F.R. Part 225, Appendix A (IV)(A).

278 Eubanks (2006), p. 4. For the first time at the international level, the Basel III framework recommends a leverage ratio to serve as a backstop to the risk-based capital measures of the Basel II framework, *see* BCBS (2011), pp. 61 et seq.

279 Same definition of tier 1 capital as in the risk-based capital guidelines in 12 C.F.R. Part 225, Appendix A.

280 12 C.F.R. Part 225, Appendix D (II)(b).

281 Appendices A and E to 12 C.F.R. Part 225.

282 12 C.F.R. Part 225, Appendix D (II)(a).

directly regulate the capital of FHC subsidiaries is limited. The Board is barred from imposing separate capital requirements on any functionally regulated subsidiary that is in compliance with the capital requirements of its own regulator.[283] Consistent with the general practice, the Board relies significantly on the primary bank and functional regulator's analysis of the capital adequacy of FHC subsidiaries and uses it in assessing the consolidated capital adequacy.[284]

The Dodd-Frank Act amended the BHC Act to give explicit authority to the Federal Reserve Board to issue regulations and orders relating to the capital requirements for BHCs.[285] Under the Dodd-Frank Act, the Board needs to amend the current capital rules so as to make them "countercyclical", i.e. the amount of regulatory capital should increase in times of economic expansion and decrease in times of economic contraction.[286] Further, the new law requires the Federal Reserve Board to impose a minimum amount of contingent capital on large BHCs that is convertible to equity in times of financial stress.[287]

4. Intra-group transactions and exposures

FHCs are often exposed to a substantial amount of intra-group relations and engage in servicing arrangements across affiliates, which can increase the likelihood for aggregate risk concentrations across the group's legal entities.[288] The affiliation between banking and nonbanking entities under one corporate umbrella presents a source of heightened risk for the safety and soundness of banking organizations as their affiliated businesses take on new risk qualities.[289] For instance, the presence of an FDIC-insured bank affiliate may be used to take advantage of the public safety net. A bank may, against safe and sound banking practices, engage in preferential transactions with its nonbanking affiliates and thereby endanger its financial health and cause damages to the public safety net.

The main concern of the Federal Reserve Board is the potential adverse impact that intercompany relationships within a FHC may have on insured banking subsidiaries of a FHC.[290] The federal banking law therefore imposes strict restrictions on transactions between banks and its nonbanking affiliates. The primary statutory provisions governing such transactions are laid down in Sections 23A[291] and 23B[292] of the Federal Reserve Act[293].[294] Given the broadened possibility of affiliation under the FHC structure, the GLB Act particularly stresses the importance of these provisions.[295]

283 12 U.S.C. § 1844(c)(3)(A). This limitation on the Board's authority to impose capital requirements on functionally regulated subsidiaries remained unchanged under the Dodd-Frank Act.
284 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.
285 Pub. L. 111-203, § 616, codified at 12 U.S.C. § 1844(b).
286 Pub. L. 111-203, § 616, codified at 12 U.S.C. § 1844(b).
287 Pub. L. 111-203, § 165, codified at 12 U.S.C. § 5365. The requirement of contingent capital applies to Board-supervised nonbank financial companies and large BHCs with total consolidated assets equal to or greater than $ 50 billion.
288 Federal Reserve Board (2012), Section 1050.1.3.3., p. 12.
289 Felsenfeld/Glass (2011), p. 244.
290 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.
291 12 U.S.C. § 371c.
292 12 U.S.C. § 371c-1.
293 Pub. L. 63-43, 38 stat. 251.

Section 23A imposes four basic restrictions on certain types of transactions ("*covered transactions*") between a bank and its "*affiliates*". Employing the broadest definition of affiliate in federal banking law[296], Section 23A identifies an "*affiliate*" with respect to a bank as (i) any company that controls the bank or is controlled by a company that controls the bank; (ii) a bank subsidiary of the bank; (iii) any company controlled by, or for the benefit of, persons who control either the bank or a company that controls the bank; (iv) any company a majority of whose board of directors constitutes a majority of the bank's board of directors; (v) any investment fund for which the bank acts as investment adviser; or (vi) any company that the Federal Reserve Board determines to have a relationship with the bank or its subsidiary or affiliate that may, to the detriment of the bank, affect covered transactions between the company and the bank.[297] The last criterion presents a catch-all provision for the Board to determine potentially problematic relationships as affiliations.[298]

"*Covered transactions*" are defined to include (i) a loan or extension of credit to an affiliate; (ii) a purchase of or an investment in securities issued by an affiliate; (iii) a purchase of assets, including assets subject to a repurchase agreement, from an affiliate; (iv) the acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to anyone; or (v) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.[299]

The four restrictions of Section 23A on covered transactions contain both quantitative and qualitative limits. First, covered transactions with individual affiliates and affiliate transactions in aggregate may not exceed 10 percent and 20 percent respectively, of the bank's capital and surplus.[300] Second, each loan or extension of credit to an affiliate must be collateralized.[301] Third, low quality assets may not be purchased from an affiliate, and finally, all transactions must be on terms that comply with safe and sound banking practice.[302]

The GLB Act amended Section 23A to grant special treatment to "*financial subsidiaries*"[303] of banks, which are permitted to engage in a range of nonbanking financial activities such as securities underwriting, by exempting such subsidiaries from the limitation on covered transactions with an individual affiliate and by not including retained earnings of the financial subsidiary in a bank's investment in the financial subsidiary.[304] These exceptions were removed by the Dodd-Frank Act.[305]

294 The Federal Reserve Board has issued "Regulation W" to implement these provisions, codified at 12 C.F.R. Part 223. In addition, there are other policies that govern intra-group transactions such as the Federal Reserve Board's "source of strength" policy, codified by the Dodd-Frank Act at 12 U.S.C. § 1831o-1, or "firewalls" that the Federal Reserve Board has designed to insulate risks.

295 Heller/Fein (2010), § 16.03[2][b], 16-33.

296 Carnell/Macey/Miller (2009), p. 428.

297 12 U.S.C. § 371c(b)(1).

298 Carnell/Macey/Miller (2009), p. 428.

299 *See* 12 U.S.C. § 371c(b)(7).

300 12 U.S.C. § 371c(a)(1).

301 12 U.S.C. § 371c(c).

302 12 U.S.C. § 371c(a)(3) and (4).

303 12 U.S.C. § 24a.

304 Formerly 12 U.S.C. § 371c(e)(3)(A)

305 Pub. L. 111-203, § 609.

Section 23B was adopted to protect banks from abuses in connection with affiliated securities activities and applies to all transactions covered by Section 23A and beyond in certain cases.[306] In simplified terms, one can view Section 23A as applying to a bank's purchase of assets from an affiliate while Section 23B concerns a bank's sale of assets to an affiliate.[307] Section 23B generally requires that all affiliate transactions be conducted on an arms' length basis.[308]

At the entity level, the appropriate primary supervisors and functional regulators continue to monitor and enforce Sections 23A and 23B restrictions and other intra-group exposure restrictions applicable in their jurisdictions.

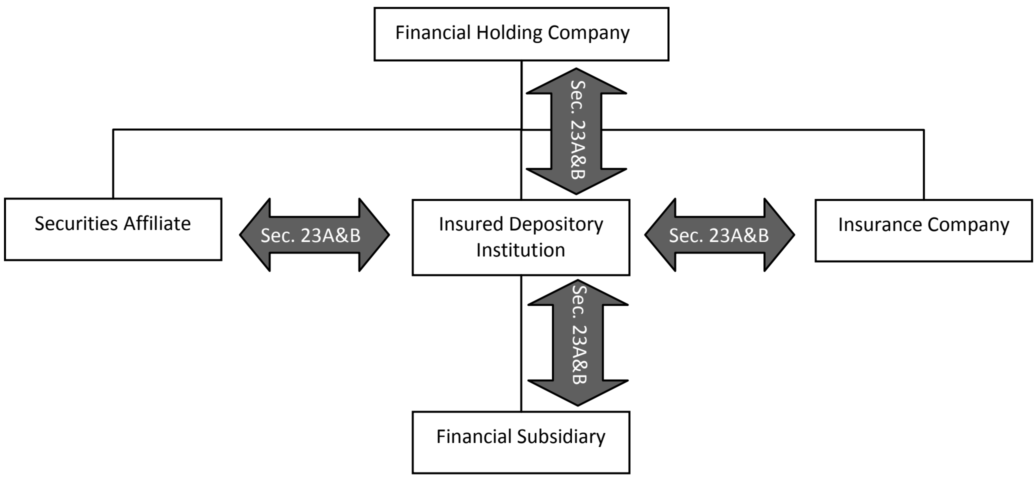

Figure 2[309]

In addition to the supervision at the entity level, overseeing such risks at the group level of a FHC is of paramount importance as seemingly prudent risks at the entity level may aggregate to prudentially substantial risk at the group level. The Federal Reserve Board as the umbrella supervisor therefore takes upon the task to understand and monitor intra-group exposures and risk concentrations of FHCs.[310] The Board focuses on understanding and monitoring exposures and concentrations at the holding company level (e.g. servicing agreements, derivatives exposures, and payment system exposures), particularly with regard to the risks that affect the safety and soundness of banks within the group, and looks into management's effectiveness in monitoring and controlling intra-group exposures and concentrations.[311]

5. Impact of the Dodd-Frank Act on FHC supervision

Signed into law on July 21, 2010, the Dodd-Frank Act has introduced important changes with a view to strengthening the overall financial system and protecting consumers from abusive market practices. It has significantly reshaped the U.S.

306 Fein (2012), § 14.03[1], p. 14-31.
307 Fein (2012), § 14.03[1], p. 14-31.
308 12 U.S.C. § 371c-1(a)(1).
309 Based on ABA (1999), p. 5, Chart 2.
310 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.
311 Federal Reserve Board, SR 00-13 (SUP), Aug. 15, 2000.

regulatory framework in response to the identified shortcomings during the financial crisis of 2007-09 by creating new regulators, conferring new rulemaking and enforcement powers to regulators, and subjecting new markets and firms to regulation.[312]

One of the major aspects that the Dodd-Frank Act deals with is systemic risk, i.e. risks that can cause the instability of the financial system as a whole, often through "contagion" or "spillover" effects.[313] The crisis has revealed that both banks and highly leveraged nonbank firms that are large and interconnected are potential sources for systemic risk. The Dodd-Frank Act has introduced new rules and amended existing laws to deal with large, interconnected financial institutions with a focus on systemic risk and changes the way how such firms will be supervised. In corporate terms, such firms are often structured as BHCs/FHCs.[314] Large BHCs/FHCs and their affiliates regulated by the Federal Reserve Board under the BHC Act will therefore be affected by the Dodd-Frank Act.[315]

The Dodd-Frank Act has introduced the following changes that can be viewed as important in the context of FHC supervision. It has created a new agency to oversee systemic risk and to designate certain financial firms as "systemically significant" (a) and subjects systemically important firms to more stringent prudential regulation by the Federal Reserve Board (b). It further enhances the general supervisory powers of the Federal Reserve Board (c) and imposes restrictions on certain forms of risky operations (d).

A. OVERSIGHT OF SYSTEMIC RISK

Perhaps the most important contribution of the Dodd-Frank Act has been the introduction of a new structure overseeing systemic risk, which is headed by the Financial Stability Oversight Council (FSOC). The FSOC consists of ten voting members, including the Treasury Secretary (who acts as the chair), eight heads of federal regulatory agencies, and a presidential appointee with insurance experience.[316]

FSOC has been established to oversee large, interconnected BHCs and nonbank financial companies for risks to the financial stability of the United States. The main purposes of the FSOC are:

> "*to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or*

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312 The full impact of the Dodd-Frank Act will only be felt in several years as the act requires numerous studies and reports on regulatory matters and many of the provisions are still being implemented through regulations by regulatory agencies. For instance, the Congressional Research Service has identified 330 provisions in the Dodd-Frank Act that requires or permits rulemaking, *see* Copeland (2010), p. 4.

313 Webel (2010), p. 3.

314 In 2008, two traditional investment banking organizations, Goldman Sachs and Morgan Stanley, first converted into BHCs and elected to be FHCs, subjecting the nation's largest bank-securities firms to the regulation of the Federal Reserve Board.

315 In addition, the act subjects new types of financial organizations to Board regulation and gives it new jurisdiction over every systemically important financial institution.

316 Pub. L. 111-203, § 111(b)(1), codified at 12 U.S.C. § 5321(b)(1).

that could arise outside the financial services marketplace; […] and to respond to emerging threats to the stability of the United States financial system."[317]

However, in lieu of creating an agency with regulatory powers, the law confers no rulemaking, examination, or enforcement powers to the FSOC.[318] Its duties are non regulatory and includes identifying and advising regulators on sources of systemic risk and "regulatory gap" problems as well as the identification of systemically important financial firms.[319] As the regulator of BHCs/FHCs, the Federal Reserve Board has the broadest systemic risk oversight authority among primary regulators, and the Dodd-Frank Act has expanded the Board's authority by making it the primary federal regulator of systemically important nonbank financial companies designated by the FSOC.[320] The Dodd-Frank Act prevents a firm from changing its charter in order to escape Board regulation, as the Board will subject all systemically important firms to stricter prudential oversight and regulation under the Dodd-Frank Act, including short-term debt limits, a 10% liability concentration limit, counterparty exposure set at 25% of total capital, risk-based capital requirements (that account for off-balance sheet activities), annual stress tests, and a 15-to-1 leverage limit.[321]

B. MORE STRINGENT PRUDENTIAL STANDARDS FOR SYSTEMICALLY IMPORTANT FIRMS

The Dodd-Frank Act requires the Federal Reserve Board to establish "more stringent" prudential standards for BHCs/FHCs with total consolidated assets of $50 billion or more and nonbank financial companies that have been designated by the FSOC as systematically important.[322] The purpose of these new rules is "*to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions*".[323]

The prudential standards, not fully adopted by the Board yet, must be "more stringent" than normally applicable standards, increasing in stringency with elevated risk levels, and concern a number of areas, including capital, leverage, liquidity, risk-management, exposures and transactions with affiliates, and public disclosures.[324] The FSOC may make recommendations for such prudential standards to the Board.[325] The Federal Reserve Board issued a proposed rule in 2012 that would create a new Regulation YY, "Enhanced Prudential Standards", to implement the requirement for enhanced prudential standards of the Dodd-Frank Act.[326]

C. ENHANCED SUPERVISORY POWER OF THE FEDERAL RESERVE BOARD

317 *See* Pub. L. 111-203, § 112(a)(1)(A), codified at 12 U.S.C. § 5322(a)(1)(A).
318 Webel (2010), p. 4.
319 *See* Pub. L. 111-203, § 112(a)(2).
320 Fein (2012), § 15.02[4], p. 15-14.
321 Webel (2010), p. 4.
322 Pub. L. 111-203, § 165, codified at 12 U.S.C. § 5365.
323 Pub. L. 111-203, § 165(a)(1).
324 Pub. L. 111-203, § 165; *see* Fein (2010), pp. 9-15.
325 Pub. L. 111-203, § 115.
326 77 Fed. Reg. 594 (Jan. 5, 2012).

The recent financial crisis has revealed various shortcomings in the regulatory system, including the weakness in functional regulation as demonstrated by the example of SEC's supervision of investment bank holding companies.[327] In response thereto, the Dodd-Frank Act has strengthened and expanded the Federal Reserve Board's umbrella oversight over FHCs, *inter alia*, by reducing limitations on its authority over functionally regulated subsidiaries as prescribed by the GLB Act.[328]

Prior to the Dodd-Frank Act, the Board was required to direct any unusual information requests vis-à-vis functionally regulated subsidiaries first to the pertinent functional regulator and could only require direct information if it was not made available but it was necessary to assess a material risk to the BHC/FHC or any depository institution subsidiaries or compliance with laws under the Board's jurisdiction to enforce.[329] As amended by the Dodd-Frank Act, the Board may now address information requests directly to functionally regulated subsidiaries.[330]

The Dodd-Frank Act also repealed certain limitations on the Board's authority to examine functionally regulated subsidiaries.[331] Prior to the act, the Board could only examine a functionally regulated subsidiary under strict conditions, including where the Board had "*reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution*"[332]. The Board may now examine any BHC/FHC and any of its subsidiaries in order to obtain information on (i) the nature of the operations and financial condition of the company and subsidiaries; (ii) the financial, operational, and other risks within the BHC system that may pose a threat to the safety and soundness of the company or of any depository institution subsidiary thereof or the stability of the financial system; and (iii) the BHC's internal systems for monitoring and controlling such risks.[333]

The Board may use the examination process to monitor the compliance of a BHC/FHC and its subsidiaries with the BHC Act and other federal laws and is required to rely to the fullest extent possible on examination reports made by other federal or state regulators.[334] The Board is also required to provide reasonable notice to and consult with the primary regulator of the subsidiary before examining a functionally regulated subsidiary and avoid to the fullest extent possible any duplication of examinations, reporting requirements, and requests for information.[335]

Moreover, the Dodd-Frank Act broadened the Board's rulemaking authority with respect to functionally regulated subsidiaries by repealing Section 10A of the BHC Act, introduced by the GLB Act[336], which imposed restrictions on the Board's authority to prescribe regulations, issue or seek entry of orders, impose restraints, restrictions, guidelines, requirements, safeguards, or standards, or otherwise take any actions with respect to functionally regulated subsidiaries of BHCs.[337]

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327 Fein (2012), § 15.02 [6], p. 15-17.
328 Fein (2012), § 15.02 [6], p. 15-17; *see* Pub. L. 111-203, § 604.
329 Fein (2012), § 15.03, p. 15-19; formerly 12 U.S.C. § 1844(c)(1)(B)(iii).
330 12 U.S.C. § 1844(c)(1)(C).
331 *Also see* Fein (2012), § 15.04 [3], p. 15-25 and 15-26.
332 Formerly 12 U.S.C. § 1844(c)(2)(B)(i).
333 12 U.S.C. § 1844(c)(2)(A).
334 12 U.S.C. § 1844(c)(2)(A)(ii) and § 1844(c)(2)(B).
335 12 U.S.C. § 1844(c)(2)(C).
336 Pub. L. 106-102, § 113 (formally 12 U.S.C. § 1848(a)).
337 Pub. L. 111-203, § 604(c)(2).

D. Limits on proprietary trading and relationships with covered funds

The Dodd-Frank Act added a new section to the BHC Act which imposes limitations on proprietary trading activities as well as on relationships with hedge fund or private equity funds by certain banking organizations, the so-called "Volcker Rule".[338]

The Volcker Rule generally contains two prohibitions. First, it prohibits proprietary trading activities for BHCs/FHCs, insured banks, and their subsidiaries and affiliates (banking entities).[339] "Proprietary trading" is defined to mean "*engaging as a principal for the trading account*" of the banking entity or financial company "*in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument*" that the regulators may by rule determine.[340] Exemptions from this prohibition exist, including the sale and purchase of government obligations, certain securities in connection with underwriting or market-making related activities, risk-mitigating hedging activities, certain customer-driven transactions, investments in small business investment companies, and certain investment activities of insurance companies.[341] Second, the Volcker Rule prohibits owning, sponsoring, or having certain relationships with a hedge fund or private equity fund, also subject to certain exemptions.[342]

Under the new rule, the Federal Reserve Board and other federal regulators, including the SEC and the CFTC, are required to adopt regulations to implement the above prohibitions, taking into consideration a study and recommendations for implementation issued by the FSOC.[343]

E. Conclusion

In the wake of the financial crisis that spread across the globe in 2007-2009, the importance of an effective system overseeing financial institutions and markets has become ever more evident. The events during the recent crisis has shed light on severe shortcomings in the existing financial supervisory system, including those that relate to the risks stemming from too-big-to-fail and too-interconnected-to-fail institutions, which were highly leveraged and held substantial contagion risks.

Financial activities and affiliations across financial sectors aggravated the crisis that led to the Great Depression in the 1930s. And again, activities across financial sectors, in particular the securities activities of banks and their affiliates, were highly implicated during the recent financial crisis.[344] The trends toward deregulation and consolidation over the past three decades increasingly led to the dominance of multiproduct financial conglomerates in the financial markets, many of which became problematic cases

338 Pub. L. 111-203, § 619, codified at 12 U.S.C. § 1851 (Section 13 of the BHC Act).
339 12 U.S.C. § 1851(a)(1)(A).
340 12 U.S.C. § 1851(h)(4).
341 12 U.S.C. § 1851(d).
342 12 U.S.C. § 1851(a)(1)(B).
343 The Federal Reserve Board, jointly with the FDIC, OCC, SEC and CFTC, issued a proposed rule to implement the requirements of the Volcker Rule, *see* 76 Fed. Reg. 68846 (Nov. 7, 2011).
344 *Cf.* Fein (2010a), p. 1.

during the recent crisis.[345] Against this backdrop, an effective prudential oversight of financial conglomerates remains one of the central concerns for financial authorities with a view to safeguarding the stability of the financial system and deterring financial crises.

Prior to the enactment of the GLB Act, activities and affiliations across business lines in the U.S. financial services industry were greatly impeded by fundamental legal barriers. Product expansion across business lines was therefore sought through administrative and judicial approval by exploiting regulatory loopholes and inconsistencies. While this approach in effect enabled financial institutions to broaden their palette of products to some extent, the prevailing entity approach to financial regulation created regulatory inconsistencies in the way new ventures were permitted and treated. The permissibility of cross-sector activities depended not on risks but rather on the organizational form of the institution, which determined the relevant regulator and the governing laws. This structural set-up heightened competition among regulators and resulted in a deregulatory trend on unequal conditions that partly led to different interpretation of identical provisions and different regulatory treatment of similar activities and risks.

The GLB Act alleviated the inequities among U.S. financial institutions to engage in cross-sector expansions and amended the regulatory framework to better deal with the risks that arise from cross-sector activities. The GLB Act liberalized cross-sector affiliations and activities by breaking down long standing legal barriers and paving the way for full-fledged financial conglomerates. At the same time, it provided two main mechanisms to oversee the relevant risks.

First, the formation of financial conglomerates under U.S. law has been channeled into a specific corporate structure, notably the FHC structure. Not allowing, for instance, a single legal entity to carry out a broad range of cross-sector activities (e.g. the typical "universal bank"), may reduce the efficiency gains and diversity benefits from an economic point of view. At the same time, placing sectorally distinct activities in separate legal entities, as it is the case within a holding company structure, can be a more prudent choice from a supervisory perspective as the structural and legal separation allows for better risk insulation. Limiting the choice of possible corporate structures may also contribute to more clarity and transparency for the supervisors in overseeing mixed financial activities while limiting opportunities for regulatory arbitrage.

Second, the GLB Act has introduced a silo-plus structure with regard to FHC supervision, where umbrella supervision is carried out on the basis of functional regulation. On the one hand, functional regulation at the entity level promotes regulatory consistency because same activities and risks are treated the same. Moreover, as financial products and operations become increasingly sophisticated and complex, it seems important that supervisors with the relevant expertise and experiences are charged with overseeing financial institutions and risks that fall within their specialties. Given the sectoral differences in the traditional business operations and risk profiles as well as in regulatory frameworks, a supervisor from one financial sector cannot be a substitute for a supervisor from a different financial sector. On the other hand, umbrella supervision at the holding company level ensures a group-wide assessment of FHCs. This is important in light of the risks that may arise or aggravate

345 E.g. Fortis, Citigroup, AIG, and ING Group.

at the group level. FHCs are in particular susceptible to the risk of capital arbitrage and risks arising from intra-group transactions and risk concentrations, which can only adequately be addressed at the holding company level. The risk-focused approach of the Federal Reserve Board's consolidated supervision seems apt to respond to the fast growing and changing financial industry. The Federal Reserve Board as the umbrella supervisor has received significant supervisory responsibilities and powers to oversee FHCs in a comprehensive manner.

While the GLB Act has introduced regulatory changes that serve as an important foundation for an effective regulation and supervision of FHCs, there are shortcomings in the regulatory framework that have surged to the surface in the past. Most importantly, the lack of an appropriate prudential system to oversee systemic risk and to capture risks arising from interconnectedness of financial institutions, which can threaten the financial system in its entirety, became evident during the financial crisis of 2007-09.[346] To address the shortcomings in the existing system, the Dodd-Frank Act has introduced substantial changes to the regulatory scenery, also affection the supervision of large BHCs and FHCs. An important macroprudential measure of the Dodd-Frank Act is the creation of FSOC as the authority over systemic risk, aided by the Federal Reserve Board. Moreover, while the Board has primarily focused on and received supervisory powers to ensure the protection of depository subsidiary institutions within BHCs/FHCs, the Dodd-Frank Act has also expanded the Board's purview to monitor and control risks to the holding company itself.[347] At the microprudential level, one of the weaknesses relating to an effective FHC supervision has been identified as the restrictions on the Board's powers in overseeing functionally regulated subsidiaries. These restrictions therefore have been partly lifted. The more stringent prudential standards for systemically important firms, still to be adopted, will also affect the way FHCs are regulated in the future. Also, new provisions that restrict the range of activities and affiliations, e.g. limits on proprietary trading activities and restrictions on relationships with hedge funds, will most likely have an impact on how large BHCs and FHCs will structure their operations in the future.[348] As they require the separation of such activities from banking, this may lead to a better protection of banks, strengthening the stability of the financial system.

The GLB Act has significantly liberated cross-sector financial activities in the United States and brought the U.S. financial regulatory scenery into greater parity with its European counterparts.[349] The GLB Act has eliminated competitive disadvantages and distortions in respect of cross-sector financial activities that had been created due to the legal barriers of major federal legislations and the fragmented regulatory structure. While the act did not change the core regulatory structure, it has introduced

346 *Cf.* Fein (2012), § 15.02[6], p. 15-17.

347 Statutory amendments have been made by the Dodd-Frank Act to expand the Board's examination authority to consider risks not only to depository institution subsidiary but also to the BHC itself as well as the U.S. financial system (*see* 12 U.S.C. § 1844(c)(2)(A)(i)(II)). Moreover, the Dodd-Frank Act expanded the "well-capitalized" and "well-maintained" criteria to apply to the BHC itself as a requirement to qualify as a FHC (*see supra* D.I.1.).

348 *Cf.* Fein (2012), § 5.01[3], p. 5-6.

349 Nonetheless, the U.S. regulatory framework still remains more restrictive given that operations across financial sectors may only be conducted in the organizational form of FHCs, while many European countries allow banks to choose the form of their preferred organization. *Also see* Barth/Brumbaugh/Wilcox (2000), pp. 200-201 for a comparison on the regulatory treatment of the mixing of banking, securities, and insurance activities in the EU and G-10 countries prior to the GLB Act (1997).

mechanisms that are more apt to provide for an effective cross-sector financial supervision and regulation. The U.S. legislator, drawing lessons from the recent crisis, has introduced numerous changes through the passage of the Dodd-Frank Act, including those that are intended to enhance cross-sector supervision and regulation and strengthen financial stability. The impact of the new laws in practice will have to be awaited.

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