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BEHIND CLOSED DOORS: THE USE OF 4(M) AGREEMENTS TO EFFECT FEDERAL RESERVE POLICY

In this article, the authors discuss the Federal Reserve's role in supervision and enforcement, give a brief history of financial holding company activities, and describe the post-crisis regulatory response. They then highlight the use by the Federal Reserve of confidential section 4(m) agreements as a "shadow" policy tool to reign in activities it deems to be risky. They close by noting a recent speech by Vice-Chair Quarles proposing specific reforms to increase transparency of the bank supervisory process.

By Douglas Landy and James Kong *

In the years following the 2008 financial crisis, U.S. bank holding companies ("BHCs") and financial holding companies ("FHCs") have adjusted to a new normal: a cornucopia of new regulations, a renewed emphasis on oversight and supervision by prudential regulators, and a string of headline-grabbing enforcement actions. However, the breadth of the prudential regulators' supervisory and enforcement powers, as well as the confidential nature of bank supervision, mean that public enforcement actions are often only the last, and most visible, measure in a regulator's toolbox. Much of a regulator's supervisory and enforcement activity occurs behind the scenes, whether in the form of orally communicated concerns, examination reports, confidential interpretive letters, or informal enforcement actions (such as "Matters Requiring Attention" or "MRA" letters), to name a few.

In this article, we highlight one of the most impactful supervisory tools that the Board of Governors of the Federal Reserve System has wielded in recent years – agreements made under section 4(m) of the Bank Holding Company Act of 1956, (the "BHC Act").[1] These agreements (commonly known as "4(m) agreements"), are considered "confidential supervisory information" ("CSI") and may not be publicly disclosed by the subject institution.[2] At the same time, however,

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[1] The BHC Act is found at 12 U.S.C. § 1841 *et seq*. Section 4(m) of the BHC Act is found at 12 U.S.C. § 1843(m).

[2] 12 C.F.R. § 261.22. In general, CSI is broadly defined and encompasses, with respect to a prudential regulator, information that is prepared by, on behalf of, or for the use of that regulator. CSI with respect to any regulator is the property of that regulator, and may only be disclosed in accordance with applicable laws and regulation. In July 2019, the Federal Reserve issued a proposed rule that would make a number of changes to the regulations governing CSI. Among the proposed changes include those that would allow financial institutions to more freely share CSI with its affiliates, other supervisory authorities, and auditors and outside legal counsel. *See* Board of Governors of the Federal Reserve System, *Rules Regarding Availability of Information*, 84 Fed. Reg. 27296 (June 17, 2019).

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4(m) agreements may place significant limitations on the ability of an FHC to conduct the very activities that are fundamental to FHC status – the ability to engage in activities that are "financial in nature," such as merchant banking and securities underwriting. The ability to impose such limitations – confidentially and for potentially indefinite durations – allows the Federal Reserve to wield 4(m) agreements as a "shadow" policy tool to reign in activities that it deems to be risky, often with little public awareness or accountability.

The longstanding culture of secrecy represented by these agreements may finally be changing: last year, the Federal Reserve issued a proposed rule that would allow financial institutions to more freely share CSI with affiliates and certain other parties,[3] and in a recent speech, Federal Reserve Vice Chair Randal K. Quarles indicated that improving the transparency of bank supervision would be significant focus of his going forward.[4] These indications, while promising, represent only the beginning of what will likely be an extensive and ongoing dialogue in which financial institutions will wish to participate.

Part I of this article discusses the Federal Reserve's supervisory and enforcement role generally. Part II of this article reviews the history of financial in nature activities, including merchant banking, while Part III reviews the post-crisis regulatory response in general and the Federal Reserve's attempt in recent years to curtail the practice of merchant banking in particular. Part IV discusses the use of 4(m) agreements, both as formal (but confidential) enforcement measures, but also as an ad hoc means to advance Federal Reserve policy. Part V concludes.

I. THE FEDERAL RESERVE'S ROLE IN SUPERVISION AND ENFORCEMENT

The Federal Reserve is the primary federal regulator and supervisor of all U.S. BHCs and FHCs, including foreign banking organizations ("FBOs") that maintain a formal U.S. banking presence.[5] As a prudential regulator, the Federal Reserve is responsible for ensuring the safety and soundness of subject institutions. In addition to its supervisory and examination authority, the Federal Reserve has an arsenal of enforcement tools – some formal and some informal, some public and some confidential – that it may wield to penalize or force remediation of illegal, unpermitted, unsafe, or unsound conduct.

For example, MRAs are notices used by banking regulators to communicate deficiencies identified through the course of an examination, inspection, or other supervisory process. While MRAs are not defined under law or regulation and do not constitute a formal enforcement action, the Federal Reserve has described MRAs as constituting "matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period of time," and that "an MRA typically will remain an open issue until resolution and confirmation by examiners that the banking organization has taken corrective action."[6] The existence and content of an MRA constitutes CSI that may not be disclosed to third parties, except under certain prescribed circumstances. MRAs that are not remediated in a timely manner may be "elevated" and result in a formal or informal investigation or enforcement action (such as a civil money penalty or a cease-and-desist order).[7]

In this way, MRAs exemplify the nature of much of banking supervision and enforcement – confidential obligations, imposed for a potentially indefinite duration,

[3] *Id*.

[4] *Infra* note 24.

[5] BHCs are companies that, directly or indirectly, control a U.S. insured depository institution. 12 U.S.C. §1841(a)(1). Pursuant

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to Section 8(a) of the International Banking Act of 1978, FBOs that maintain a formal U.S. banking presence in the form of a licensed branch or agency are regulated as BHCs, and are subject to the provisions of the BHC Act in substantially the same manner as U.S. BHCs, even if such FBOs do not control a subsidiary U.S. insured depository institution. FHCs are BHCs (or FBOs that are regulated as BHCs) that meet certain requirements and that have elected FHC status, as discussed further herein. References to BHCs and FHCs in this article include FBOs that are regulated as BHCs and FHCs.

[6] Federal Reserve SR 13-13, *Supervisory Considerations for the Communication of Supervisory Findings* (June 17, 2013).

[7] *See, e.g.*, 12 U.S.C. § 1847 and 12 U.S.C. § 1818.

which an institution must take care to comply with lest it face even more dire consequences. As discussed below, 4(m) agreements (though statutorily defined, unlike MRAs) exhibit many of the same general characteristics in practice.

II. A BRIEF HISTORY OF FHCs AND "FINANCIAL IN NATURE" ACTIVITIES

To understand how the Federal Reserve has used 4(m) agreements to limit the financial activities of FHCs, we must first review the history of FHC status and financial in nature activities, beginning in 1999. Before the passage of the Gramm-Leach-Bliley Act (the "GLBA") that year, FHC status did not exist; rather, holding companies that directly or indirectly controlled a U.S. insured depository institution (as well as FBOs that maintained a U.S. banking presence) were regulated solely as BHCs. BHCs were, and continue to be, narrowly restricted in their ability to own or control shares of nonbanking companies (i.e., companies that are not banks). Specifically, section 4 of the BHC Act[8] prohibits BHCs from investing in or owning any shares of nonbanking companies, unless an exception from the general prohibition is available. These exceptions, generally referred to as "authorities," are available for a range of holdings, but those available to BHCs carry important limitations and are generally narrow in their scope: for example, section 4(c)(6) of the BHC Act is available for *de minimis* investments that represent no more than five percent of any class of the voting shares of a company, while section 4(c)(2) allows a BHC to hold shares in satisfaction of a debt previously contracted in good faith (but requires those shares to be disposed within a certain time period). Other authorities, such as those under 4(c)(9) of the BHC Act, are available for certain foreign investments and are meant to blunt the extraterritorial impact of the BHC Act. In general, however, BHCs are limited to engaging directly or indirectly through subsidiaries in only those nonbanking activities that are "closely related to banking," pursuant to the authority set forth in section 4(c)(8) of the BHC Act. The list of activities that are considered closely related to banking is circumscribed in the Federal Reserve's Regulation Y and has been frozen since the passage of the GLBA.[9] These strict limitations on the ability of a BHC to affiliate with nonbanks is best understood in the context of one of the BHC Act's original purposes, which was to enforce the separation of banking and commerce.[10]

The GLBA allowed the possibility of eroding the barrier between banking and commerce, at least for certain BHCs: in particular, the GLBA amended the BHC Act to allow BHCs that meet certain criteria – for example, if all of the depository institutions controlled by the BHC are well-capitalized and well-managed – to elect treatment as an FHC and engage in a wide range of permissible activities that are "financial in nature," or incidental or complementary to a financial activity.[11] In addition to enjoying all of the authorities available to traditional BHCs, an FHC may engage in activities, such as securities underwriting and dealing, certain insurance activities, and merchant banking activities, among others. The merchant banking authority, set forth in section 4(k)(4)(H) of the BHC Act, allows an FHC to acquire or control, directly or indirectly through a private equity fund, any amount of shares, assets, or ownership interests in any company engaged in nonfinancial activities, including an investment of up to 100 percent ownership. Merchant banking authority is available regardless of a portfolio company's location, type of nonfinancial activity, or the geographical scope of its activities. The GLBA, therefore, allowed FHCs to enjoy nearly unfettered latitude to invest in nonfinancial companies.

In 2001, the Federal Reserve issued final rules implementing the merchant banking authority.[12] The final rules impose risk management and recordkeeping requirements on FHCs engaged in merchant banking

[8] The BHC Act (originally passed in 1956, and as amended) and the regulations issued thereunder are the primary laws and regulations governing the establishment, activities, and oversight of BHCs and FHCs in the United States. Section 4 of the BHC Act is found at 12 U.S.C. §1843.

[9] 12 C.F.R. § 225.28.

[10] *See, e.g.*, *Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act*, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (September 2016). This report may also be viewed as a more accurate indication of the Federal Reserve's belief of the riskiness of nonfinancial investments in general. *See, e.g.*, a prior article by the authors, "*All that glitters is not gold": The Federal Reserve's unsupported recommendation to eliminate merchant banking investments*, *available at* https://www.milbank.com/images/content/2/5/25004/9-12-16-Financial-Institutions-Regulation-Group-Client-Alert.pdf.

[11] The authority for FHCs to engage in these new activities is in section 4(k) of the BHC Act, 12 USC 1843(k).

[12] https://www.federalreserve.gov/boarddocs/press/boardacts/2001/20010110/.

activity, and subject merchant banking investments to a number of requirements and restrictions, including:

- a 10-year holding period for investments held directly by the FHC or its subsidiary (or a 15-year holding period for investments held through a qualifying private equity fund);
- that the investment may not be held by a depository institution (including a U.S. branch or agency of a foreign bank), or a subsidiary of a depository institution; and
- that the FHC may not "routinely manage or operate" the portfolio company, except in certain limited circumstances.[13]

In addition to regulatory restrictions, the Federal Reserve has issued additional guidance regarding how FHCs should mitigate the risk of merchant banking activities, including through establishing appropriate policies, procedures, and systems, and maintaining appropriate records.[14]

III. THE POST-CRISIS REGULATORY RESPONSE

The 2008 financial crisis – for good and obvious reason – spurred a reckoning among regulators and financial institutions alike. One initial realization by the Federal Reserve was that financial institutions – and especially, FBOs operating in the United States – had become so large, and their structures so labyrinthine, that it was impossible to take a full accounting of their activities and the risks they posed to the financial system. A key section of the Dodd-Frank Act,[15] passed in 2010, mandated that the Federal Reserve impose "enhanced prudential standards" on U.S. financial institutions and FBOs that exceeded certain asset thresholds, and in 2012, the Federal Reserve proposed to implement this mandate by requiring that FBOs with a certain amount of U.S. non-branch assets establish an intermediate holding company ("IHC") to hold all of their U.S. nonbank subsidiaries.[16] In this way, the IHC would serve as the single, top-tier U.S. holding company that could be supervised (and be subjected to enhanced prudential standards) on a consolidated basis by the Federal Reserve.

In proposing this rule, the Federal Reserve wrote the following:

> The recent financial crisis demonstrated that certain U.S. financial companies had grown so large, leveraged, and interconnected that their failure could pose a threat to overall financial stability in the United States and globally. The financial crisis also demonstrated that large foreign banking organizations operating in the United States could pose similar financial stability risks. Further, the crisis revealed weaknesses in the existing framework for supervising, regulating, and resolving significant U.S. financial companies, including the U.S. operations of large foreign banking organizations.

Similar to the largest, most complex U.S. banking organizations, some of the largest foreign banking organizations with operations in the United States maintain dozens of separate U.S. legal entities, many of which are engaged in nonbank activities. The structural diversity and consolidated management of capital and liquidity permitted under the current approach has facilitated cross-border banking and increased global flows of capital and liquidity. However, the increase in concentration, complexity, and interconnectedness of the U.S. operations of foreign banking organizations and the financial stability lessons learned during the crisis have raised questions about the continued suitability of this approach.[17]

The Federal Reserve eventually implemented the IHC requirement in a final rule issued in 2014.[18] Elsewhere in the rash of reforms enacted in response to the financial crisis, the merchant banking authority fell in the crosshairs of an important provision of the Dodd-Frank

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[13] 12 C.F.R. Part 225, subpart J.

[14] Federal Reserve SR 00-09, *Supervisory Guidance on Equity Investment and Merchant Banking Activities* (June 22, 2000).

[15] Public Law 111–203, 124 Stat. 1 (2010).

[16] Board of Governors of the Federal Reserve System, *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies*, 77 Fed. Reg. 76628 (Dec. 28, 2012),

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available at https://www.govinfo.gov/content/pkg/FR-2012-12-28/pdf/2012-30734.pdf.

[17] *Id.*

[18] Board of Governors of the Federal Reserve System, *Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations; Final Rule*, 79 Fed. Reg. 17240 (Mar. 24, 2014), *available at* https://www.govinfo.gov/content/pkg/FR-2012-12-28/pdf/2012-30734.pdf.

Act: Section 619 of the Act (commonly known as the "Volcker Rule")[19] and the regulations subsequently issued thereunder generally prohibited banking entities from engaging in proprietary trading or making proprietary investments in so-called "covered funds."[20] The latter restriction, also implemented after a public notice and comment period, significantly limited one of the primary powers available to FHCs – the ability to make merchant banking investments through private equity funds.[21]

IV. 4(M) AGREEMENTS AND THEIR USE BY THE FEDERAL RESERVE

In parallel with its public rulemaking efforts, however, the Federal Reserve undertook significant measures behind closed doors to reign in the activities of financial institutions. As noted above, BHCs must meet certain capitalization and management criteria in order to apply for, and maintain, FHC status. FHCs that fail to meet these criteria are subject to consequences under section 4(m) of the BHC Act, and in the years following the financial crisis, the Federal Reserve began making extensive use of its enforcement authority under this provision.

The process by which the Federal Reserve initiates and enters into a 4(m) agreement with a subject FHC is prescribed by statute. Under section 4(m), if the Federal Reserve finds that an FHC is engaged in impermissible activities or is not in compliance with the requirements of FHC status, it will provide a notice to the FHC. Within 45 days of the receipt of such notice, the FHC is required to enter into an agreement (i.e., the 4(m) agreement) with the Federal Reserve pledging to correct its deficiencies. As part of a 4(m) agreement, the Federal Reserve may impose limitations on the FHC's conduct and activities "as the [Federal Reserve] determines to be appropriate." These limitations generally include a prohibition on engaging in any additional financial in nature activities under section 4(k) of the BHC Act, or acquiring or controlling shares of any company engaged in financial in nature activities under section 4(k) of the BHC Act, though such prohibitions may be lifted on a case-by-case basis with the Federal Reserve's approval, and the agreement itself may also be subject to individually negotiated carve-outs. Section 4(m)(4) of the BHC Act provides that if an FHC fails to correct the conditions described in its 4(m) notice within 180 days of receiving such notice (subject to any extensions granted in the Federal Reserve's discretion), the FHC may either be required to divest control of any subsidiary depository institution or lose its status as an FHC.

In reviewing the statutory language, one might be forgiven for thinking that 4(m) agreements are meant to be temporary measures: that FHCs would, in the ordinary course, correct any deficiencies and promptly regain their full range of investment authorities, and that FHCs that fail to do so within the statutorily prescribed timeframes would face the consequences of divestment or cessation of their financial activities. In practice, however, it appears that 4(m) agreements play a much different role. While it is impossible to cite any empirical data on this point, as 4(m) agreements are confidential and their existence – or absence thereof – may not be publicly disclosed by subject institutions, in our experience, we believe that generally speaking, (i) a wide range of institutions have had 4(m) agreements imposed upon them in recent years, and (ii) in many such cases, the agreement functions not as a temporary measure but remains outstanding for an extended period, often spanning several years or longer. A closer look at the statutory language reveals how, statutory timeframes notwithstanding, this can become the case: the statute allows the Federal Reserve the discretion to extend the duration of an agreement indefinitely, so long as the FHC has not remedied the conditions described in the 4(m) notice. The question of whether an institution has remedied such conditions may in many cases be determined in the discretion of the Federal Reserve with reference to sometimes vague and opaque standards. For example, the definition of a "well-managed" company means, in the case of a company that has not received an examination rating, "the existence and use of managerial resources which the [Federal Reserve] determines are satisfactory."[22]

The clearest public indication of the Federal Reserve's disfavor of merchant banking activities came in 2016, when the Federal Reserve, along with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, issued a joint study on activities and investments by banking entities

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[19] Section 619 of the Dodd-Frank Act added a new Section 13 to the BHC Act. 12 U.S.C. § 1851.

[20] 12 C.F.R. § 248.

[21] However, it did not impact the ability of FHCs to make direct merchant banking investments in portfolio companies, and FBOs continue to be able make certain investments in private equity funds pursuant to the Volcker Rule's exception for covered fund activities conducted solely outside of the United States.

[22] 12 U.S.C. § 1841(o)(9).

under state and federal law (the "Interagency Report").[23] In the Interagency Report, the Federal Reserve reviewed the history of FHCs, financial in nature activities, and the merchant banking authority, before concluding that "merchant banking investment activities pose a number of financial risks to FHCs" (without, however, citing empirical evidence) and recommending that Congress repeal the ability of FHCs to engage in merchant banking activities entirely. Congress did not take up the Federal Reserve on its recommendation, and the Federal Reserve has not reiterated its call for a repeal in the years since. However, through its ability to impose 4(m) agreements on FHCs, the Federal Reserve has effectively been able to curtail the practice in the absence of any congressional action.

The discretion granted by the statutory language allows the Federal Reserve to essentially wield 4(m) agreements as an ad hoc means of effecting policy, tempering the ability of FHCs to engage in activities, such as merchant banking, deemed by the Federal Reserve to be risky without requiring congressional action or the issuance of any new agency rulemakings. The burden of this uncertainty is borne by the subject institutions, who must contend with an indefinite restriction on their activities and an unclear path back to the good graces of the Federal Reserve. The confidential nature of 4(m) agreements also means that their existence and prevalence often go unnoticed, allowing them to function as a type of "shadow" policy tool that the Federal Reserve may wield without public accountability. Compounding the opacity of this form of regulation is the potential for civil and even criminal penalties if CSI, such as a 4(m) agreement, should ever be improperly disclosed. As a result, the existence of a 4(m) agreement is often kept tightly under wraps, even within the subject institution itself, potentially leading to confusion in cases where bank personnel may unknowingly pursue activities or investments that would otherwise be permissible but for the restrictions imposed upon the institution by a 4(m) agreement. 4(m) agreements (and restrictions regarding the disclosure of CSI more generally) are also in often in tension or conflict with the securities laws: one can easily see how a regulatory prohibition on the ability of an institution to expand its investment portfolio or engage in important business activities would be considered material information that should be disclosed to investors under the securities laws, but such disclosure is prohibited by Federal Reserve rules.

[23] *Supra* note 10.

The question of how to balance transparency and accountability with sensitivity and confidentiality is, to be sure, a long-standing and delicate question, and there is some indication that answers may be forthcoming – at least somewhat – in this area. In a recent speech given by Federal Reserve Vice Chair for Supervision, Randal K. Quarles,[24] Vice Chair Quarles acknowledged that "[s]upervision . . .is currently not subject to any specific process constraint promoting publicity or universality," leaving it "open to the charge, and sometimes to the fact, of capriciousness, unaccountability, unequal application, and excessive burden." He added that while "[w]e have a public interest in a confidential, tailored, rapid-acting and closely informed system of banking supervision," we also "have a public interest in all governmental processes being fair, predictable, efficient, and accountable," likening the tension between the two competing interests to "[squaring] a circle." Vice Chair Quarles went on to note that "[e]valuating this question will be a significant focus of [his] going forward." He proposed several specific reforms, including increasing the ability of supervised firms to share CSI with "employees, affiliates, service providers, and other government agencies" (while recognizing that, currently, Federal Reserve "rules can prevent banks from sharing CSI with a wide variety of relevant parties who need to know this information in order to help the bank remediate identified supervisory issues"). He also proposed subjecting supervisory guidance to a public comment process and limiting the use of MRAs to violations of law or regulation, and material safety and soundness issues.[25] While implementing such reforms may not completely resolve the tensions identified above, they (and the overarching regulatory stance endorsed by Vice Chair Quarles) would likely go a long way toward promoting a more fair and transparent system of banking supervision, and to ensuring that tools like 4(m) agreements are employed, not as informal means of advancing policy, but rather a measured response intended to ensure that penalized institutions resolve identified issues in a prompt and orderly manner.

V. CONCLUSION

The prudential banking regulators, including the Federal Reserve, wield great power over the institutions

[24] *See Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision*, Vice Chair for Supervision Randal K. Quarles, at the American Bar Association Banking Law Committee 2020 (Jan. 17, 2020), *available at* https://www.federalreserve.gov/newsevents/speech/quarles20200117a.htm.

[25] *Id.*

within their regulatory jurisdiction: although they are governmental agencies that must function within the statutory constraints prescribed by Congress, they have a wide array of tools to penalize or force remediation of identified issues. A number of these tools fall within the umbrella of CSI, meaning that their use is confidential and subject to uneven, or potentially capricious, application. In recent years, the Federal Reserve has appeared to use 4(m) agreements – widely and for indefinite periods – to limit the ability of many FHCs to engage in activities that the Federal Reserve had previously identified as risky, raising the question of whether such agreements are being used for their intended purpose or rather as a means of advancing Federal Reserve policy. There is some indication that the Federal Reserve has begun to reevaluate such practices, however, and the bank supervision process may yet evolve in the years to come. ■