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MICHAEL GRUSON

CONSOLIDATED AND SUPPLEMENTARY SUPERVISION OF FINANCIAL GROUPS IN THE EUROPEAN UNION



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**Consolidated and Supplementary Supervision of Financial Groups
in the European Union**

Institute for Law and Finance

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Consolidated and Supplementary Supervision of Financial Groups in the European Union^{*}

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^{*} The full citation of the following frequently cited Directives can be found in the following notes: Annual Accounts Directive, note 88; Banking Directive, note 3; Capital Adequacy Directive, note 21; Consolidated Accounts Directive, note 10; First Life Insurance Directive, note 84; First Non-Life Insurance Directive, note 84; Insurance Group Directive, note 83; Investment Services Directive, note 22; Supplementary Supervision Directive, note 120; Proposed Supplementary Supervision Directive, note 120; UCITS Directive, note 135.

The following frequently used abbreviations can be found in note 9:

BHC – bank holding company under the BHCA

BHCA – Bank Holding Company Act of 1956

FHC – financial holding company under the Gramm-Leach-Bliley Act of 1999

GLBA – Gramm-Leach-Bliley Act of 1999.

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A. Consolidated Supervision of Banking Groups and Investment Firm Groups

I. The Concept of Consolidated Supervision

The basic concept of consolidated supervision is that a realistic assessment of a credit institution's or financial institution's¹ compliance with supervisory standards should take into consideration all credit and financial institutions in which the investor credit institution or financial institution holds a participation or that are its subsidiaries.² Like participations in the nonbanking sector,³ equity investments in credit institution or financial institutions require particular attention, because they may affect the financial stability and soundness of the investor credit institution if the subsidiary credit or financial institution runs into financial difficulties (contagion risk). Equity investments also constitute a long-term freezing of the assets of the investor credit institution.⁴ Only consolidated supervision prevents a credit institution from escaping compliance with supervisory standards by moving activities into subsidiaries or by double-leveraging its capital.⁵ A noncredit institution parent of one or more credit institutions

¹ For the definitions of *credit institution* and *financial institution*, see *infra* notes 7 & 8.

² For the definitions of *subsidiary* and *participation*, see *infra* notes 10 & 15 and accompanying text.

³ Art. 51, Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institution, O.J. Eur. Comm. No. L 126/1 (2000) [*herein* Banking Directive], as amended by Directive 2000/28/EC of the European Parliament and of the Council of 18 September 2000, O.J. Eur. Comm. No. L 275/37 (2000), and by the Supplementary Supervision Directive.

⁴ See Proposal for a Second Council Directive, COM(87)715 Final, O.J. Eur. Comm. No. C 84/1 (1988) (explanatory memorandum accompanying the proposal for the Second Banking Directive) [*herein* 1988 Explanatory Memorandum].

⁵ For a discussion of double or multiple gearing and excessive leveraging, see *infra* notes 247 & 248.

can equally use the group structure to evade compliance with supervisory standards applicable to the credit institutions.

Consolidated supervision principally relates to the following supervisory standards: capital adequacy, solvency ratio, lending limits, adequacy of funds to cover market risks, and restrictions on investments by credit institutions in the nonbank sector. Consolidated supervision also applies to groups that include investment firms.

II. Groups Subject to Consolidated Supervision

The Banking Directive⁶ requires consolidated supervision of (1) every credit institution⁷ that has another credit institution or a financial institution⁸ as a subsidiary or that

⁶ Arts. 52–56, Banking Directive. These Articles are based on the Council Directive of 6 April 1992 on the supervision of credit institutions on a consolidated basis, 92/30/EEC, O.J. Eur. Comm. No. L 110/52 (1992), as amended by the Capital Adequacy Directive. Directive 92/30/EEC replaced Council Directive of 13 June 1983 on the supervision of credit institutions on a consolidated basis, 83/350/EEC, O.J. Eur. Comm. No. L 193/18 (1983) (Directive 83/350/EEC only covered the consolidated supervision of credit institution groups the parent of which was a credit institution).

⁷ Art. 1(1), second subparagraph, Banking Directive defines *credit institution* for “the purposes of applying the supervision on a consolidated basis” as (1) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account and that has been authorized in a Member State, (2) an electronic money institution within the meaning of Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000, on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, O.J. Eur. Comm. No. L 275/39 (2000), that has been authorized in a Member State, and (3) any private or public undertaking that corresponds to the definition of (1) or (2) above and that has been authorized in a country other than a Member State. The entities named in (3) are *herein* referred to as non-EU credit institutions.

Member States are the member states of the European Union [*herein* EU], *i.e.*, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and United Kingdom.

⁸ Pursuant to Art. 1(5), Banking Directive, *financial institution* means an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in numbers 2–12 of Annex I to the Banking Directive. These activities are: (2) lending; (3) financial leasing; (4) money transmission services; (5) issuing and administering means of payment (*e.g.*, credit cards, travellers’ cheques and bankers’ drafts); (6) guarantees and commitments; (7) trading for own account or for account of customers in: (a) money market instruments (cheques, bills, certificates of deposit, etc.), (b) foreign exchange, (c) financial futures and options, (d) exchange and interest-rate instruments, (e) transferable securities; (8) participation in securities issues and the provision of services related to such issues; (9) advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings; (10) money broking; (11) portfolio management and advice; and (12) safekeeping and administration of securities.

Number 1 covers “acceptance of deposits and other repayable funds”. An institution that engages in that activity and also grants credits is a *credit institution*. Number 13 covers credit reference services and number 14 covers safe custody services.

It is curious that under the wording of Art. 1(5), Banking Directive (“the principal activity of which is to acquire holdings or ...”), an undertaking that holds only or principally participations in undertakings that are not engaged in financial activities (*i.e.*, an industrial holding company) qualifies as *financial institution*. See, *e.g.*, the German law transforming Art. 1(5), Banking Directive, § 1(3), *Gesetz über das Kreditwesen*

holds a participation in such institution, and (2) every credit institution whose parent is a financial holding company.⁹ *Subsidiary*¹⁰ is, in summary, an undertaking (1) in which a parent

of July 10, 1961, 1961 BGBl. I 881, in the version of Sept. 9, 1998, 1998 BGBl. I 2776, as amended [*herein* KWG], that defines financial undertaking (*Finanzunternehmen*) as including such industrial holding companies. *See* Karl-Heinz Boos, Reinfried Fischer & Hermann Schulte-Mattler, KREDITWESENGESETZ, at 171, § 1 margin note 160 (2000). The definition of an industrial holding company as financial institution remains without consequence for purposes of consolidated supervision except in the case in which a credit institution or an investment firm is part of the holding group.

⁹ Art. 52(1) & (2), Banking Directive.

Art. 1(21), Banking Directive, as amended by Art. 29(1)(b), Supplementary Supervision Directive, defines *financial holding company* as a “financial institution, the subsidiary undertakings of which are either exclusively or mainly credit institutions or financial institutions, at least one of such subsidiaries being a credit institution, and which is not a mixed financial holding company within the meaning of [the Supplementary Supervision Directive]”. *See infra* note 174 for the definition of *mixed financial holding company*. The inclusion of a financial holding company in the consolidated supervision does not imply that the competent authorities are required to play a supervisory role in relation to the financial holding company standing alone. Art. 52(2), Banking Directive. *See infra* note 26 and accompanying text. Since credit institutions that are subsidiaries of financial holding companies are subject to consolidated supervision, the term *credit institutions* in the definition of *financial holding company* must include non-EU-authorized credit institutions. *See supra* note 7 (*definition of credit institution* for purposes of consolidated supervision as including non-EU-authorized credit institutions). For the definition of *financial holding company* in the Capital Adequacy Directive, *see infra* note 23.

Compare the definition of a bank holding company in § 2(a)(1), Bank Holding Company Act of 1956, as amended [*herein* BHCA], 12 U.S.C. § 1841(a)(1) (2000). The typical bank holding company [*herein* “BHC”] under the BHCA would be a financial institution and a financial holding company under the Banking Directive and as such would be subject to consolidated supervision. If the BHC is a financial holding company [*herein* FHC] under the Gramm-Leach-Bliley Act of 1999 [*herein* GLBA], the subsidiaries of which exclusively or mainly are banks and broker-dealers, it would also be a financial holding company under the Banking Directive and as such would be subject to consolidated supervision. The same is true if the FHC itself is a broker-dealer with a bank subsidiary. *See infra* text accompanying notes 21–23. However, if an FHC is an insurance company or mainly has subsidiaries that are insurance companies, it would not be a financial holding company under the Banking Directive and would not be subject to consolidated supervision. It may be subject to supplementary supervision as a financial conglomerate, *see infra* C., and may be subject to supplementary supervision as an insurance group, *see infra* B. In the United States, control over one U.S. bank makes a company a bank holding company, § 2(a)(1), BHCA, 12 U.S.C. § 1841(a)(1) (2000). For a discussion of whether BHCs and FHCs are subject to supervision on a consolidated basis by virtue of the BHCA, *see infra* E. For a discussion of FHCs, *see* Michael Gruson, *Foreign Banks and the Financial Holding Company* [*herein* Gruson, *Financial Holding Company*], ch. 10 in Michael Gruson & Ralph Reisner (eds.), REGULATION OF FOREIGN BANKS, vol. 1 (4th ed., 2003) [*herein* Gruson & Reisner]. *See* GLBA, Pub. L. No. 106-102, 106th Cong., 1st Sess. (Nov. 12, 1999), 113 Stat. 1338 (1999).

¹⁰ *Subsidiary* is defined for purposes of consolidated supervision in Art. 1(13), second subparagraph, Banking Directive by reference to Art. 1(1), Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts, O.J. Eur. Comm. No. L 193/1 (1983) [*herein* Consolidated Accounts Directive], as amended by Eleventh Council Directive 89/666/EEC of 21 December 1989, O.J. Eur. Comm. No. L 395/36 (1989), by Council Directive 90/604/EEC of 8 November 1990, O.J. Eur. Comm. No. L 317/57 (1990), by Council Directive 90/605/EEC of 8 November 1990, O.J. Eur. Comm. No. L 317/60 (1990), by Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001, O.J. Eur. Comm. No. L 283/28 (2001), and by Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003, O.J. Eur. Comm. No. L 178/16 (2003).

(a) has, or controls alone, pursuant to a shareholder agreement, a majority of the shareholders' or members' voting rights, or (b) has the right to appoint or remove a majority of the members of the administrative, management or supervisory board and is at the same time a shareholder or a member, or (2) that can be controlled by the parent (the parent "has the right to exercise a dominant influence") pursuant to a contract between the parent and the subsidiary or a provision in the subsidiary's charter, the parent at the same time being a shareholder or a member.¹¹ In addition, a subsidiary is any undertaking over which, in the opinion of the competent authorities, a parent effectively exercises a dominant influence.¹² The term *subsidiary* includes direct and indirect subsidiaries.¹³ The definition of *parent undertaking* [*parent*] corresponds to the definition of *subsidiary*.¹⁴ *Participations* for the purpose of supervision on a consolidated basis are (1) rights in the capital of other undertakings which "by creating a durable link with those [other] undertakings, are intended to contribute to the company's [the holder of the participation] activities", or (2) the ownership, directly or indirectly, of 20 percent or more of the voting rights or capital of another undertaking.¹⁵ Thus, the Banking Directive applies consolidated supervision to (1) groups that are headed by credit institutions and include at least one credit institution or financial institution as a subsidiary or participation,¹⁶ and (2) groups that are headed by financial institutions whose subsidiaries are either exclusively or mainly credit institutions or financial

¹¹ See Art. 1(1)(a), (b), (c) & (d)(bb), Consolidated Accounts Directive referred to in Art. 1(13), second subparagraph, Banking Directive. The Member States have some discretion to modify the parent-subsidiary definition based on dominant influence, Art. 1(1)(c), Consolidated Accounts Directive. In particular, a Member State may define a parent-subsidiary relationship as a relationship based on dominant influence of the parent over another company even though the parent is not a shareholder in or a member of the other company. *Id.*

The definition of *subsidiary* for purposes of consolidated supervision does not include all entities that must be consolidated for accounting purposes, because Art. 1(13), second subparagraph, Banking Directive refers only to Art. 1(1) and not to Art. 1(2), Consolidated Accounts Directive. Note that the term *subsidiary* for purposes of supplementary supervision includes *subsidiaries* pursuant to Art. 1(2), Consolidated Accounts Directive. See *infra* notes 148 & 150 and accompanying text.

¹² Art. 1(13), second subparagraph, Banking Directive. In this case the dominant influence need not be exercised pursuant to a contract or charter provision. The same test applies to the determination of *subsidiary* for purposes of supplementary supervision, see *infra* note 152 and accompanying text.

¹³ Art. 1(13), third subparagraph, Banking Directive ("All subsidiaries of subsidiary undertakings shall also be considered subsidiaries of the undertaking that is their original parent.").

¹⁴ *Parent undertaking* is defined in Art. 1(12), second subparagraph, Banking Directive referring to Art. 1(1), Consolidated Accounts Directive and adding "any undertaking which, in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking".

¹⁵ Art. 1(9), Banking Directive, as amended by Art. 29(1)(a), Supplementary Supervision Directive, referring to Art. 17, first sentence, Annual Accounts Directive. Note that the term *participation* for purposes of consolidated supervision was defined differently by the Banking Directive prior to the amendment of Art. 1(9), Banking Directive by Art. 29(1)(a), Supplementary Supervision Directive. Although for purposes of easier presentation, a *participation* is frequently referred to herein as a 20 percent equity holding, a lower percentage of equity ownership could constitute a participation if the durable link and the requisite intention to contribute to the participation holder's activities exist. See *infra* notes 88, 150 & 156.

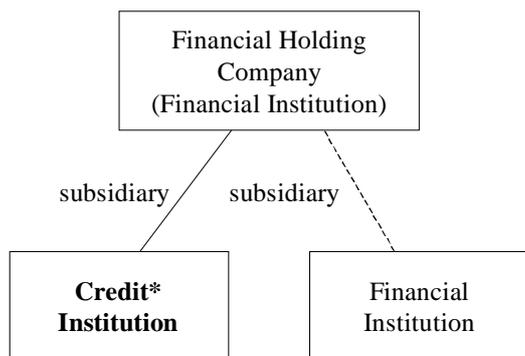
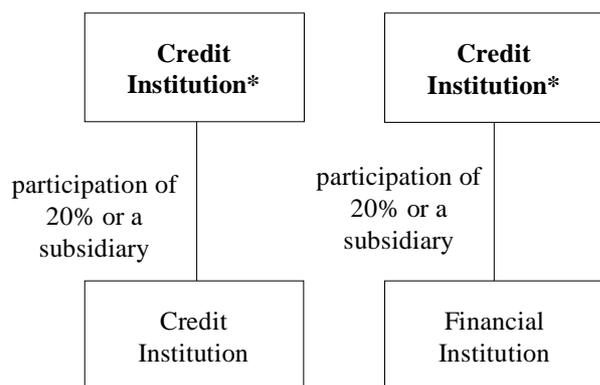
¹⁶ Art. 52(1), Banking Directive. The term *group* is not used in the Banking Directive.

institutions (at least one subsidiary must be a credit institution).¹⁷ Once consolidated supervision is required, ancillary banking services undertakings¹⁸ shall be included in the consolidation,¹⁹ although the existence of such undertaking does not trigger the need for consolidated supervision.

The Banking Directive requires consolidated supervision regardless of whether the members of the group are located in different Member States.

The following diagram shows the credit institutions that are subject to consolidated supervision under the Banking Directive:

Diagram 1: Credit Institutions Subject to Consolidated Supervision



Financial Holding Company:

- Principal activity is acquisition of holdings or being engaged in nos. 2–12 Annex I activities
- Subsidiaries are exclusively or mainly credit institutions or financial institutions
- One subsidiary is a credit institution

* Subject to consolidated supervision.

¹⁷ Art. 52(2), Banking Directive. These are the groups headed by a financial holding company.

¹⁸ *Ancillary banking services undertaking* is defined in Art. 1(23), Banking Directive as an undertaking “the principal activity of which consists in owning or managing property, managing data-processing services, or any other similar activity which is ancillary to the principal activity of one or more credit institutions”. Cf. the U.S. concept of operating subsidiaries, Gruson & Reisner, *supra* note 9, § 9.04 [8][a] & [b][vi].

¹⁹ Art. 54(5), Banking Directive. Ancillary banking service undertakings shall be included in the consolidation in the cases of, and in accordance with the methods set forth in, Art. 54(1)–(4), Banking Directive.

For an understanding of the application of consolidated supervision under EU law, it is important to remember that a *financial institution* is an institution that is not a depository institution but that is engaged in one or more of the activities listed in numbers 2–12 of Annex I to the Banking Directive.²⁰ The activities listed in numbers 2–12 of Annex I to the Banking Directive not only include lending and other more traditional banking activities, but also activities that in the United States would be considered as investment banking, such as underwriting, dealing and brokering.

The provisions of the Banking Directive on consolidated supervision apply,²¹ *mutatis mutandis*, to (1) every investment firm²² that has a credit institution, an investment firm

²⁰ See *supra* note 8.

²¹ Art. 7(2), Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, O.J. Eur. Comm. No. L 141/1 (1993) [*herein* Capital Adequacy Directive], as amended by Directive 98/31/EC of the European Parliament and of the Council of 22 June 1998, O.J. Eur. Comm. No. L 204/13 (1998), by Directive 98/33/EC of the European Parliament and of the Council of 22 June 1998, O.J. Eur. Comm. No. L 204/29 (1998), and by the Supplementary Supervision Directive (referring to the predecessor provisions of Arts. 52–56, Banking Directive). If the investment firm group does not include a credit institution, the provisions of the Banking Directive on consolidated supervision (Arts. 52–56) apply with certain modifications. Art. 7(3), Capital Adequacy Directive. Generally speaking, Arts. 52–56, Banking Directive are applied to investment firm groups that do not include a credit institution by replacing every reference to *credit institutions* by a reference to *investment firm*. Art. 7(3), Capital Adequacy Directive. See Art. 7(10)–(13), Capital Adequacy Directive for the calculation of the consolidation requirements (permitting the setoff of certain positions) and Art. 7(14) & (15), Capital Adequacy Directive for a definition of consolidated own funds.

²² *Investment firm* is defined in Art. 2(2), Capital Adequacy Directive by reference to Art. 1(2), Investment Services Directive, as any legal person the regular occupation or business of which is the provision of investment services listed in Section A of the Annex to the Investment Services Directive relating to any of the instruments listed in Section B of the Annex to the Investment Services Directive for third parties on a professional basis. Art. 1(1) & (2), Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field [*herein* Investment Services Directive], O.J. Eur. Comm. No. L 141/27 (1993), as amended by European Parliament and Council Directive 95/26/EC of 29 June 1995, O.J. Eur. Comm. No. L 168/7 (1995), by Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997, O.J. Eur. Comm. No. L 84/22 (1997), by Directive 2000/64/EC of the European Parliament and of the Council of 7 November 2000, O.J. Eur. Comm. No. L 290/27 (2000), and by the Supplementary Supervision Directive. Currently a new Proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, O.J. Eur. Comm. No. C 71/62 (2003), is under discussion. It is intended to replace the Investment Services Directive by the end of 2004.

Section A of the Annex to the Investment Services Directive lists the following services: (1) (a) reception and transmission, on behalf of investors, of orders in relation to one or more of the instruments listed in Section B and (b) execution of such orders other than for own account, (2) dealing in any of the instruments listed in Section B for own account, (3) managing portfolios of investments in accordance with mandates given by investors on discretionary, client-by-client basis where such portfolios include one or more of the instruments listed in Section B, and (4) underwriting in respect of issues of any of the instruments listed in Section B and/or the placing of such issues. Section B lists transferable securities, units in collective investment undertakings, money market instruments, financial futures contracts, forward interest rate agreements, interest rate, currency and equity swaps, and options to acquire or dispose of any instruments falling within Section B.

Investment firm does not include credit institutions and firms that receive and transmit customer orders without holding money or securities belonging to their customers. Art. 2(2), Capital Adequacy Directive.

or another financial institution as a subsidiary or that holds a participation in such entity and (2) every investment firm whose parent is a financial holding company.²³ Investment firms are in effect brokers, dealers, investment managers having discretion, and underwriters. All investment firms are financial institutions, but not all financial institutions are investment firms.

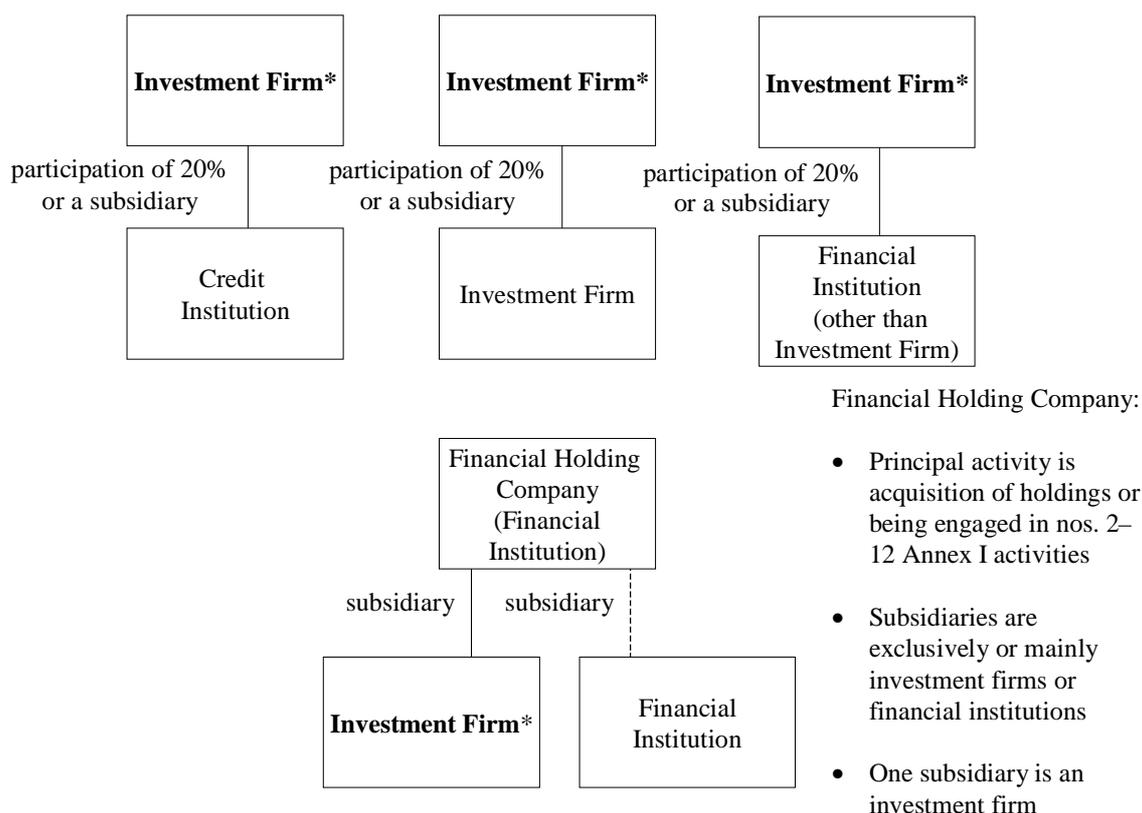
The following diagram shows the investment firms that are subject to consolidated supervision under the Capital Adequacy Directive and the Banking Directive:

It must be noted that the Capital Adequacy Directive also applies to credit institutions by setting up standards for market risks incurred by credit institutions and provides a framework for the supervision of credit institutions and investment firms with regard to the risks incurred by such institutions, in particular, market risks, *i.e.*, position risks, counterparty risks, settlement risks and foreign exchange risks. *See* 12th recital, Capital Adequacy Directive. Many provisions of the Capital Adequacy Directive apply to *institutions* which term includes credit institutions and investment firms. Art. 2(3), Capital Adequacy Directive. To the extent the Capital Adequacy Directive applies to credit institutions, it partly overlaps with the Banking Directive.

²³ *Financial holding company*, for purposes of the Capital Adequacy Directive, means any financial institution, the subsidiary undertakings of which are either exclusively or mainly credit institutions, investment firms or other financial institutions, at least one of which is a credit institution or an investment firm. Art. 2(8), Capital Adequacy Directive. This definition is substantively identical with the definition of *financial holding company* set forth in the Banking Directive prior to its amendment by the Supplementary Supervision Directive. *See supra* note 9. For investment firm groups that do not include a credit institution, *financial holding company* means a financial institution, the subsidiary undertakings of which are either exclusively or mainly investment firms or other financial institutions, at least one of which is an investment firm and which is not a mixed financial holding company within the meaning of the Supplementary Supervision Directive. Art. 7(3), first indent, Capital Adequacy Directive, as amended by Art. 26, Supplementary Supervision Directive. *See infra* note 174 for the definition of *mixed financial holding company*. The Supplementary Supervision Directive does not amend the definition of *financial holding company* in Art. 2(8), Capital Adequacy Directive, although it amends Art. 7(3), first indent, Capital Adequacy Directive by adding “and which is not a mixed financial holding company within the meaning of [the Supplementary Supervision Directive]”. Art. 7(3), first indent, Capital Adequacy Directive, as amended by Art. 26, Supplementary Supervision Directive. This failure to conform the definition of *financial holding company* in Art. 2(8), Capital Adequacy Directive to the definitions of that term in Art. 7(3), first indent, Capital Adequacy Directive and in Art. 1(21), Banking Directive may be an oversight.

Since credit institutions and investment firms that are subsidiaries of financial holding companies are subject to consolidated supervision, the term *credit institution* in the definition of *financial holding company* must include non-EU-authorized credit institutions. *See supra* notes 7 & 9 (definition of *credit institution* for purposes of consolidated supervision as including non-EU-authorized credit institutions). The same should be correct for investment firms, but the Investment Services Directive and the Capital Adequacy Directive do not provide, for purposes of consolidated supervision, that *investment firm* means the institutions defined in Art. 2(2), Capital Adequacy Directive and *recognized third country investment firms* referred to in Art. 2(4), Capital Adequacy Directive. *See infra* note 72 for the argument that non-EU financial institutions (including investment firms) are included in the consolidated supervision. For purposes of supplementary supervision, the definition of *investment firm* includes EU-authorized investment firms and non-EU investment firms. *See infra* note 135.

Diagram 2: Investment Firms Subject to Consolidated Supervision



* Subject to consolidated supervision.

Only credit institutions, investment firms and financial holding companies can head a group subject to consolidated supervision. A financial institution that is not an investment firm or a financial holding company does not create a group subject to consolidated supervision even if the financial institution is a parent of a credit institution, financial institution or investment firm. Consolidated supervision is not required for credit institutions or investment firms that are subsidiaries of companies that are neither credit institutions, investment firms or financial holding companies. Financial institutions (other than investment firms) are part of a group subject to consolidated supervision only if they are subsidiaries of credit institutions, investment firms or financial holding companies; they are not part of a group subject to consolidated supervision if they are subsidiaries of other financial institutions that are neither investment firms nor financial holding companies.

Only the credit institutions and investment firms that are part of a group described above are subject to supervision on a consolidated basis.²⁴ Other members included in the group may be required to supply information that is relevant for the consolidated supervision, and that information may be subject to verification;²⁵ but they are not subject to consolidated supervision, and their inclusion in the group does not subject them to supervision on a stand-alone basis.²⁶

The Member States have discretion to decide whether a credit institution, financial institution or ancillary banking services undertaking which is a subsidiary or in which a participation is held needs to be included in the consolidation in any of the following cases: (1) the undertaking is situated in a non-EU country in which there are legal impediments to the transfer of the necessary information, (2) in the opinion of the competent authorities, the undertaking is only of negligible interest with respect to the objectives of monitoring credit institutions, or the balance sheet total of the undertaking is less than a certain amount, or (3) in the opinion of the competent authorities, the consolidation of the financial situation of the undertaking would be inappropriate or misleading as far as the objectives of the supervision of credit institutions are concerned.²⁷

²⁴ See Art. 52(1) & (2), Banking Directive; Art. 7(2) & (3), Capital Adequacy Directive. Although it is frequently said that a group headed by a credit institution, investment firm or financial holding company is subject to consolidated supervision, only the credit institutions and investment firms in such groups are technically subject to consolidated supervision.

If the credit institution or investment firm heads the group, it is subject to consolidated supervision “on the basis of its consolidated financial situation” and if a financial holding company heads the group, the credit institution and investment firm subsidiaries in the group are subject to consolidated supervision “on the basis of the consolidated financial situation of that financial holding company”. Art. 52(1) & (2), Banking Directive, Art. 7(2) & (3), Capital Adequacy Directive. Note, however, that Art. 52(7), Banking Directive envisions that a Member State may subject financial holding companies to the same supervision as that exercised over credit institutions, particularly the requirements on consolidated supervision set forth in Art. 52(5), Banking Directive. See *infra* note 50.

²⁵ See Art. 52(10), Banking Directive (information from subsidiaries of a credit institution or a financial holding company that are not included within the scope of supervision on a consolidated basis); Art. 55, Banking Directive (information from and inspection of mixed-activity holding company and its subsidiaries); Art. 56(7) (verification of information concerning financial holding companies, financial institutions, ancillary banking services undertakings, mixed-activity holding companies, subsidiaries of the kind covered in Art. 55 or 52(10), Banking Directive, if such entities are situated in another Member State). See also Art. 52(2), Banking Directive (the consolidated financial statements of a financial holding company are the basis of consolidated supervision of the credit institutions in the group). These provisions also apply to investment firm groups. Art. 7(2) & (3), Capital Adequacy Directive.

²⁶ See Art. 52(2), Banking Directive (for financial holding companies); Art. 56(3), in connection with Arts. 55 & 52(10), Banking Directive (for financial holding companies, financial institutions, ancillary banking service undertakings and mixed-activity holding companies and its subsidiaries that are not credit institutions, subsidiaries of a credit institution or a financial holding company that are not included within the scope of supervision on a consolidated basis; the collection or possession by the competent authorities of information relating to these entities “shall not in any way imply that the competent authorities are required to play a supervisory role in relation to those institutions or undertakings standing alone”. *Id.*). These provisions also apply to investment firm groups. Art. 7(2) & (3), Capital Adequacy Directive.

²⁷ Art. 52(3), Banking Directive. Undertakings are not supervised on a consolidated basis as set forth in clause (2) if the balance sheet total of the undertaking is less than the smaller of €10 million or 1 percent of

As further discussed below, consolidated supervision is not limited to EU-authorized credit institutions and investment firms.²⁸

III. Scope of Consolidated Supervision

I. Areas of Consolidated Supervision

Supervision on a consolidated basis²⁹ of groups that include credit institutions³⁰ means supervision on the basis of the consolidated financial situation³¹ in the following areas:

- Consolidated calculation of own funds³²
- Consolidated computation of the solvency ratio³³

the balance sheet total of the parent or the undertaking that holds the participation. *Id.* When a credit institution subsidiary is not included in the consolidated supervision on the basis of clause (2) or (3), the competent authorities of a Member State in which that credit institution subsidiary is located may ask the parent for information that may facilitate their supervision of that credit institution subsidiary. Art. 52(4), Banking Directive. This provision also applies to investment firm groups. Art. 7(2) & (3), Capital Adequacy Directive.

²⁸ See *infra* A.V.

²⁹ Art. 52, Banking Directive.

³⁰ Art. 52(5), Banking Directive applies directly to groups that include credit institutions as defined in Art. 52(1) & (2), Banking Directive. See *supra* text accompanying notes 7–9. Art. 52(5), Banking Directive also applies, by virtue of Art. 7(2), Capital Adequacy Directive, to investment firm groups as defined in Art. 7(2), Capital Adequacy Directive (see *supra* text accompanying notes 21–23) that include a credit institution. The consolidation of investment firm groups relates to the requirements of Arts. 4 & 5, Capital Adequacy Directive and must be carried out not only in accordance with Arts. 52–56, Banking Directive, but also in accordance with Art. 7(7)–(14), Capital Adequacy Directive. Art. 7(2), Capital Adequacy Directive. For investment firm groups that do not include a credit institution, see *infra* note 38 and accompanying text.

³¹ The consolidated supervision takes place on the basis of the consolidated financial data of (1) the credit institution that has a credit institution or financial institution subsidiary or that holds a participation in such institution (see Art. 52(1), Banking Directive), or (2) the financial holding company that has a credit institution subsidiary (see Art. 52(2), Banking Directive). In the case of an investment firm group, the consolidated supervision takes place on the basis of the consolidated financial data of (1) the investment firm that has a credit institution, an investment firm or another financial institution as a subsidiary or that holds a participation in such institution (see Art. 7(2), first point, Capital Adequacy Directive in connection with Art. 52(1), Banking Directive), or (2) the financial holding company that has an investment firm subsidiary (see Art. 7(2), second point, Capital Adequacy Directive in connection with Art. 52(2), Banking Directive).

³² Art. 52(5), first subparagraph, in connection with Art. 37, Banking Directive. See 41st recital, Banking Directive. This also applies to investment firm groups that include a credit institution; see Art. 7(2) in connection with Art. 7(14) & (15), Capital Adequacy Directive which refer to the predecessor provisions of Arts. 34–39, Banking Directive. For investment firm groups that do not include a credit institution, see *infra* note 38 and accompanying text.

³³ Art. 52(5), first subparagraph, in connection with Art. 40(3), Banking Directive. This also applies to investment firm groups that include a credit institution, see Art. 7(2) in connection with Art. 4(1)(iii), Capital Adequacy Directive. For investment firm groups that do not include a credit institution, see *infra* note 38 and accompanying text.

- Consolidated control of adequacy of own funds to cover market risks³⁴
- Consolidated control of large exposures³⁵
- Consolidated restriction on investments in the nonbank sector³⁶

If (1) an investment firm has a financial institution (which may also be an investment firm) as a subsidiary or holds a participation in such an entity or (2) an investment firm is a subsidiary of a financial holding company, but the group referred to in (1) or (2) does not include a credit institution, the consolidation provisions of the Banking Directive apply *mutatis mutandis*.³⁷ Supervision on a consolidated basis of groups that include investment firms (but not credit institutions) means supervision on the basis of the consolidated financial situation in the areas mentioned above, except that it does not apply to the restriction on investments in the nonbank sector.³⁸

The competent authorities must ensure that all undertakings that are included in the scope of the supervision on a consolidated basis have adequate internal control mechanisms for the production of data and information that are relevant for the purposes of supervision on a consolidated basis.³⁹

³⁴ Art. 52(5), first subparagraph, in connection with Art. 4(1), Capital Adequacy Directive. *See* 12th and 22nd recital, Capital Adequacy Directive. This also applies to investment firm groups that include a credit institution; *see* Art. 7(2) in connection with Art. 4(1), Capital Adequacy Directive. For investment firm groups that do not include a credit institution, *see infra* note 38 and accompanying text.

³⁵ Art. 52(5), first subparagraph, in connection with Art. 50, Banking Directive. This also applies to investment firm groups that include a credit institution; *see* Art. 7(2) in connection with Art. 5, Capital Adequacy Directive, which refers to the predecessor provisions of Arts. 48–50, Banking Directive, as modified by Annex VI, Capital Adequacy Directive. For investment firm groups that do not include a credit institution, *see infra* note 38 and accompanying text.

³⁶ Art. 52(5), second subparagraph, in connection with Art. 51(1) & (2), Banking Directive. This also applies to investment firm groups that include a credit institution, *see* Art. 7(2), Capital Adequacy Directive. For investment firm groups that do not include a credit institution, *see infra* note 38 and accompanying text.

³⁷ Art. 7(3), Capital Adequacy Directive.

³⁸ Art. 7(3), 5th indent, Capital Adequacy Directive that excludes the application of Art. 52(5), second subparagraph, Banking Directive (formerly Art. 3(5), Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis). Investment firms are not restricted to their investments in the industrial or commercial sector. As to the meaning of *supervision on the basis of the consolidated financial situation*, *see supra* note 31.

³⁹ Art. 52(6), Banking Directive, Art. 7(2) & (3), Capital Adequacy Directive. It follows from the language of Art. 52(6), Banking Directive that the group of companies that must comply with the internal control mechanism requirement is broader than the group of credit institutions and investment firms subject to consolidated supervision (the internal control mechanism requirement must be met by “all the undertakings included in the scope of the supervision on a consolidated basis that is exercised over a credit institution in implementation of [Art. 52(1) & (2), Banking Directive]”).

The credit institutions and investment firms subject to consolidated supervision are responsible for computing the information required for consolidated supervision and are also responsible for compliance by the group of which they are a member with the consolidated supervision requirements.

Consolidation for the purposes of supervision on a consolidated basis may take different forms. In the case of credit institutions and financial institutions that are subsidiaries of a parent, the competent authorities must require full consolidation.⁴⁰ However, proportional consolidation of a credit institution or financial institution subsidiary may be prescribed if, in the opinion of the competent authorities, the liability of a parent holding a share of the capital is limited to that share of the capital because of the liability of the other shareholders or members whose solvency is satisfactory.⁴¹ If an undertaking included in the consolidated supervision holds participations in credit institutions or financial institutions and the undertaking's liability is limited to the share of the capital held, the participations must be consolidated on a proportional basis.⁴² For all other participations or capital ties, the competent authorities shall determine whether and how consolidation is to be carried out.⁴³ In particular, they may permit or require

⁴⁰ Art. 54(1), first subparagraph, Banking Directive. The discussion in the text accompanying notes 40–44 also applies to investment firm groups, subject to modifications set forth in the Capital Adequacy Directive. *See* Art. 7(2) & (3) and Art. 7(7)–(14), Capital Adequacy Directive.

⁴¹ Art. 54(1), second subparagraph, Banking Directive. The liability of the other shareholders and members must be clearly established – if necessary, by means of formal, signed commitments. *Id.* In the case in which undertakings are linked by a horizontal structure in the meaning of Art. 12(1), Consolidated Accounts Directive, the competent authorities shall determine how consolidation is to be carried out. Art. 54(1), Banking Directive, as amended by Art. 29(7), Supplementary Supervision Directive. For a discussion of horizontal structures, *see infra* notes 158 & 159. A horizontal structure essentially exists if there is control, in the absence of an equity investment, due to management on a unified basis or cross-membership of governing boards.

⁴² Art. 54(2), Banking Directive. That provision speaks about participations in credit institutions and financial institutions “managed by an undertaking included in the consolidation together with one or more undertakings not included in the consolidation”. The liability of all undertakings holding participations in the credit institution or financial institution must be limited to the share of the capital they hold. *Id.*

⁴³ Art. 54(3), Banking Directive.

The competent authorities may require consolidation even in cases in which they find that, in the absence of a participation or other capital ties, a credit institution exercises a significant influence over one or more other credit institutions or financial institutions; or in which two or more credit institutions or financial institutions are placed under single management other than pursuant to a contract or clauses in their charters. Art. 54(4), Banking Directive, as amended by Art. 29(7)(b), Supplementary Supervision Directive. In these cases, the competent authorities may permit or require the use of the consolidation method provided for in Art. 12, Consolidated Accounts Directive. *Id.* The cases described in Art. 54(4), Banking Directive are very similar, but not identical, to the horizontal structure referred to in Art. 2(12), Supplementary Supervision Directive, *see supra* note 41 & *infra* note 158 and accompanying text. Whereas Art. 2(12), Supplementary Supervision Directive refers to the Art. 12(1), Consolidated Accounts Directive for the description of horizontal structures, Art. 54(4), Banking Directive contains a separate description of horizontal structures and refers only to the consolidation methods of Art. 12(1), Consolidated Accounts Directive. Art. 54(4), Banking Directive addresses only the need for and method of accounting consolidation of certain entities for purposes of consolidated supervision, it does not expand Art. 52(1) & (2), Banking Directive, which specifies which credit institutions or investment firms are subject to consolidated supervision. Art. 54(4), last sentence, Banking Directive. In order to be subject to

use of the equity method.⁴⁴ When consolidated supervision is required, the consolidation includes ancillary banking services undertakings.⁴⁵

2. *Subconsolidation*

Consolidated supervision of credit institutions and investment firms is not limited to the top-tier credit institution and its subsidiaries. A credit institution subsidiary that is included in the consolidated supervision of its parent credit institution may in turn be the parent of other credit institution or financial institution subsidiaries and, in that capacity, would be subject, together with its subsidiaries, to supervision on a subconsolidated basis.⁴⁶ The same rule applies to investment firms.⁴⁷ In addition, the credit institution or investment firm is subject to supervision on an individual basis.

A credit institution is subject to subconsolidated and individual supervision by the competent authorities of the Member State that authorized it if the parent credit institution has been authorized and is situated in another Member State.⁴⁸ The same rule applies to investment firms.⁴⁹ The rule that consolidated and individual supervision is carried out by different Member States if a parent credit institution is authorized and situated in one Member State and owns a

consolidated supervision, a credit institution or investment firm must have a parent-subsidary or participation relationship with another credit institution, investment firm, financial institution or be a subsidiary of a financial holding company, *see* Art. 52(1) & (2), Banking Directive; a horizontal structure is not sufficient to make a credit institution or investment firm subject to consolidated supervision, except, of course, in cases in which a Member State has provided for a parent-subsidary relationship based on dominant influence in the case of a horizontal structure. *See supra* note 11.

⁴⁴ Art. 54(3), Banking Directive. Consolidation on an equity method shall not, however, constitute inclusion of the undertakings concerned in supervision on a consolidated basis. *Id.*

⁴⁵ Art. 54(5), Art. 1(23), Banking Directive. *See supra* notes 18 & 19 and accompanying text.

⁴⁶ Art. 52(1), Banking Directive requires consolidated supervision of “every credit institution” that has a credit institution or financial institution as a subsidiary or that holds a participation in such institution. In the same way, Art. 52(2), Banking Directive does not require that the parent financial holding company is the ultimate holding company of the group, it can be an intermediary holding company. *See* Art. 52(5), second subparagraph, Banking Directive stating that compliance with the restrictions on investments in the nonbank sector shall be supervised and controlled on the basis of the consolidated and subconsolidated financial situation of the credit institution.

⁴⁷ Art. 7(2) & (3), Capital Adequacy Directive.

⁴⁸ Art. 52(8), Banking Directive. By virtue of agreements between the competent authorities of the Member State that authorized the subsidiary credit institution and the Member State that authorized the parent credit institution, the regular banking supervision of the subsidiary credit institution can be delegated to the authority supervising the parent credit institution. Art. 52(9), Banking Directive. Very similar rules apply to groups that include investment firms, Art. 7(8) & (9), Capital Adequacy Directive. Art. 52(8), Banking Directive and Art. 9(8), Capital Adequacy Directive on their face are very vague because it is not clear what “that authorization” and “that institution” refer to. The meaning of Art. 52(8), Banking Directive and Art. 7(8), Capital Adequacy Directive is clarified by Art. 52(9), Banking Directive and Art. 7(9), Capital Adequacy Directive, respectively.

⁴⁹ Art. 7(2) & (3), Capital Adequacy Directive.

subsidiary credit institution that is authorized and situated in another Member State differs from the rule applicable to a credit institution that is authorized in one Member State (the “Home Member State”) and establishes a branch in another Member State (the “Host Member State”): pursuant to Arts. 18 and 19, Banking Directive, the branch is only supervised by the Home Member State and not by the Host Member State. A Member State may waive the requirement for supervision of an entity on an individual or subconsolidated basis if the entity is a credit institution subject to consolidated supervision as a parent or if it is a subsidiary of such credit institution and is included in the consolidated supervision of the parent.⁵⁰ The same subconsolidation rules apply to groups that include investment firms.⁵¹

3. *Mixed-Activity Holding Companies*

The Banking Directive also introduces the concept of a *mixed-activity holding company*, which is defined for credit institution groups as a “parent undertaking, other than a financial holding company or a credit institution or a mixed financial holding company within the meaning of [the Supplementary Supervision Directive], the subsidiaries of which include at least one credit institution”,⁵² and for investment firm groups that do not include a credit institution, *mixed-activity holding company* is defined as a “parent undertaking, other than a financial holding company or an investment firm or a mixed financial holding company within the meaning of [the Supplementary Supervision Directive], the subsidiaries of which include at least one investment firm”.⁵³

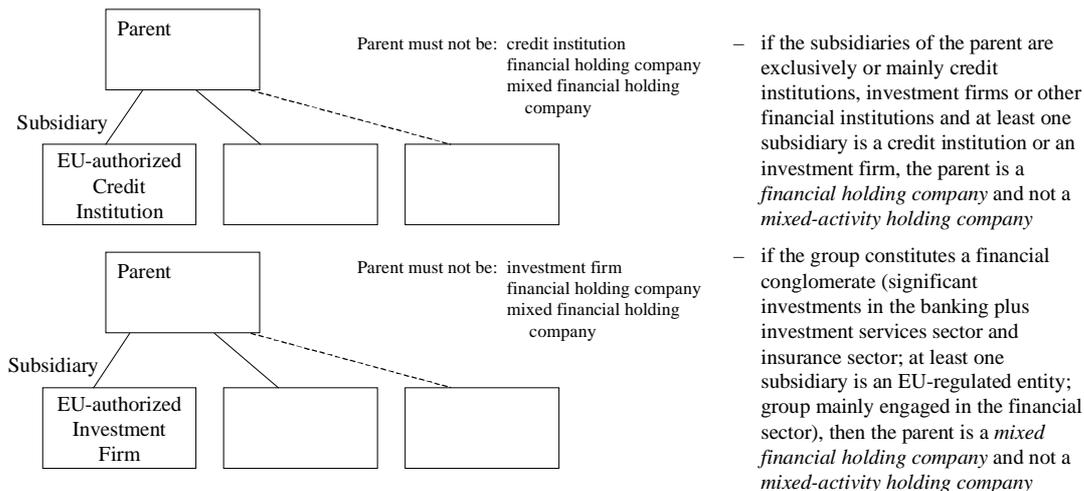
⁵⁰ Art. 52(7), Banking Directive. The same exemption option applies if the parent is a financial holding company that has its head office in the same Member State as the credit institution, provided that it is subject to the same supervision as that exercised over credit institutions. *Id.* See *supra* note 24.

⁵¹ Art. 7(7), Capital Adequacy Directive.

⁵² Art. 1(22), Banking Directive.

⁵³ Art. 7(3), second indent, Capital Adequacy Directive, as amended by Art. 26, Supplementary Supervision Directive. See *infra* note 174 for the definition of *mixed financial holding company* and *supra* notes 9 & 23 for the definition of *financial holding company*.

Diagram 3: Mixed-Activity Holding Company



Consolidated supervision does not extend to mixed-activity holding companies.⁵⁴ However, the competent authorities responsible for the supervision of a credit institution that is a subsidiary of a mixed-activity holding company shall exercise general supervision over transactions between the credit institution and the mixed-activity holding company and its subsidiaries.⁵⁵ Furthermore, the competent authorities of the Member States shall require mixed-activity holding companies and their subsidiaries to supply them (directly or via credit institution subsidiaries) with any information which would be relevant for the purpose of supervising their credit institution subsidiaries.⁵⁶ The competent authorities may also obtain such information from subsidiaries of a credit institution or a financial holding company that is not included within the scope of supervision on a consolidated basis.⁵⁷ The competent authorities shall require credit

⁵⁴ See Art. 52(1) & (2), Banking Directive. Because mixed-activity holding companies are not subject to consolidated supervision, the term *credit institution* for purposes of the definition of *mixed-activity holding company* does not include non-EU credit institutions. Art. 1(1), Banking Directive. See *supra* note 7. The term *investment firm* as defined in Art. 2(2), Capital Adequacy Directive does not include non-EU investment firms. See *supra* note 23

⁵⁵ Art. 55a, first subparagraph, Banking Directive, added by Art. 29(9), Supplementary Supervision Directive.

⁵⁶ Art. 55(1), Banking Directive. See 60th recital, Banking Directive. Member States shall provide that their competent authorities may carry out (or have carried out by external inspectors) on-the-spot inspections to verify information received from mixed-activity holding companies and their subsidiaries. Art. 55(2), Banking Directive. These rules also apply to mixed-activity holding companies of investment firms, Art. 7(2) & (3), Capital Adequacy Directive.

⁵⁷ Art. 52(10), Banking Directive. The procedures for transmitting and verifying the information set forth in Art. 55, Banking Directive apply to information from such subsidiaries. Art. 52(10), Banking Directive. See *supra* note 56. See also *supra* note 26.

institutions to have in place adequate risk management processes and internal control mechanisms, including reporting and accounting procedures, in order to identify, measure, monitor and control transactions with their parent mixed-activity holding company and its subsidiaries.⁵⁸ Credit institutions must report significant transactions with their parent mixed-activity holding company and its subsidiaries.⁵⁹ Where intra-group transactions are a threat to a credit institution's financial position, the competent authorities shall take appropriate measures.⁶⁰

4. *Management of Financial Holding Companies*

Persons who effectively direct the business of a financial holding company must be of sufficiently good repute and have sufficient experience to perform those duties.⁶¹

IV. Member States Responsible for Exercising Consolidated Supervision

If the parent of a credit institution or financial institution is another credit institution, supervision on a consolidated basis shall be exercised by the Member State which authorized such parent credit institution.⁶² If the parent undertaking of a credit institution is a financial holding company, consolidated supervision shall be exercised by the Member State that authorized the credit institution.⁶³ However, if a financial holding company has credit institution subsidiaries in more than one Member State, supervision on a consolidated basis shall be undertaken by the Member State in which the financial holding company and one credit institution have been set up.⁶⁴ The competent authorities concerned may by agreement waive these rules which determine the competent authorities in case the parent of a credit institution is a financial holding company.⁶⁵ If the financial holding company has been set up in a Member State in which no credit institution subsidiary is located, the Member States concerned (including the Member State in which the financial holding company was set up) will have to reach an agreement as to which Member State shall exercise consolidated supervision.⁶⁶ In the absence of

⁵⁸ Art. 55a, second subparagraph, Banking Directive, added by Art. 29(9), Supplementary Supervision Directive. *Cf. supra* note 39 and accompanying text discussing the requirement to establish internal control mechanism for the purpose of consolidated supervision.

⁵⁹ Art. 55a, second subparagraph, Banking Directive, added by Art. 29(9), Supplementary Supervision Directive.

⁶⁰ Art. 55a, third subparagraph, Banking Directive, added by Art. 29(9), Supplementary Supervision Directive.

⁶¹ Art. 54a, Banking Directive, added by Art. 29(8), Supplementary Supervision Directive.

⁶² Art. 53(1), Banking Directive.

⁶³ Art. 53(2), first subparagraph, Banking Directive.

⁶⁴ Art. 53(2), second subparagraph, Banking Directive.

⁶⁵ Art. 53(3) & (4), Banking Directive. The agreement shall contain procedures for cooperation and for the transmission of information. Art. 53(4), Banking Directive.

⁶⁶ Art. 53(2), third subparagraph, Banking Directive. The agreement shall contain procedures for cooperation and for the transmission of information. Art. 53(4), Banking Directive.

such agreement, the Member State to exercise consolidated supervision is selected on the basis of the largest credit institution balance sheet and, if that figure is the same in two or more Member States, on the basis of the first date of authorization of the credit institution subsidiaries.⁶⁷

The Banking Directive provides for certain measures to facilitate the supervision on a consolidated basis. Member States must take the necessary steps to ensure that there are no legal impediments preventing the undertakings included within the scope of supervision on a consolidated basis, mixed-activity holding companies and their subsidiaries or subsidiaries of credit institutions or of financial holding companies that are not included within the scope of supervision on a consolidated basis from exchanging among themselves information relevant for consolidated supervision.⁶⁸ If a parent and any of its subsidiaries that is a credit institution are situated in different Member States, the competent authorities of each Member State shall communicate to each other all relevant information which may allow or aid the exercise of supervision on a consolidated basis.⁶⁹ If, in applying the Banking Directive, the competent authorities of one Member State wish in specific cases to verify information concerning credit institutions or other entities in a consolidated group situated in another Member State, they must ask the competent authorities of that other Member State to have that verification carried out.⁷⁰ The requested authorities must carry out the verification themselves, by allowing the requesting authorities to carry it out, or by allowing an auditor or expert to carry it out.⁷¹

V. Consolidated Supervision of Non-EU Entities

Consolidated supervision is not limited to credit institutions and investment firms located in the EU.⁷² This does not mean, however, that the provisions of the Banking Directive

⁶⁷ Art. 53(2), third subparagraph, Banking Directive.

⁶⁸ Art. 56(1), Banking Directive.

⁶⁹ Art. 56(2), Banking Directive.

⁷⁰ Art. 56(7), Banking Directive. For an enumeration of the entities in a consolidated group other than credit institutions as to which verification may be requested, *see supra* note 25.

⁷¹ Art. 56(7), Banking Directive. The requesting authority may, if it so wishes, participate in the verification when it does not carry out the verification itself. Art. 56(7), Banking Directive, as amended by Art. 29(10), Supplementary Supervision Directive.

⁷² This follows from the definition of *credit institutions* that includes for purposes of consolidated supervision EU-authorized credit institutions as well as non-EU credit institutions. *See supra* notes 7 & 9. The definition of *financial institution* (which includes investment firms) in Art. 1(5), Banking Directive does not include undertakings authorized by a country other than a Member State. In other words, *financial institution* does not include recognized third-country investment firms referred to in Art. 2(4), Capital Adequacy Directive. *See supra* note 23. Furthermore, Art. 7, Capital Adequacy Directive, which makes the consolidation rules of the Banking Directive applicable to groups including investment firms (*see supra* A.II.) does not include recognized third-country investment firms. However, it might follow from Art. 52(3), Banking Directive that a financial institution (including investment firms) located in a non-EU country is included in consolidated supervision because otherwise the power given by Art. 52(3), Banking Directive to exclude such third-country entities from consolidated supervision would make little sense. Art. 56a, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive (which applies to investment firms, *see infra* note 77) is based on a recognition that non-EU investment firms are subject to

relating to consolidated supervision apply directly to (1) EU authorized credit institutions and investment firms whose parents have their head offices in non-EU countries or (2) credit institutions or investment firms situated in non-EU countries whose parents have their head offices in a Member State. Other than the BHCA, the Banking Directive hesitates to regulate directly non-EU entities.⁷³

Application of the principle of supervision on a consolidated basis to credit institutions whose parents have their head offices in non-EU countries and to credit institutions situated in non-EU countries whose parents (credit institutions or financial holding companies) have their head offices in a Member State shall be made possible by virtue of reciprocal bilateral agreements to be entered into between the competent authorities of the Member States and the non-EU countries concerned.⁷⁴ The Commission may submit proposals to the Council, either at the request of a Member State or on its own initiative, for the negotiation of such agreements.⁷⁵ The aim of the agreements is to ensure that the competent authorities of the Member States are able to obtain the information necessary for consolidated supervision of EU-authorized credit institutions and financial holding companies located in the EU which are the parents of non-EU credit institutions or financial institutions, or holding participations in such institutions.⁷⁶ The agreements also have the aim to provide the competent authorities in non-EU countries with information necessary for the supervision of parents with head offices in such countries and having subsidiary credit institutions or financial institutions in a Member State or holding participations in such institution.⁷⁷

The Supplementary Supervision Directive amended the Banking Directive to deal with the situation of an EU-authorized credit institution or investment firm that is a subsidiary of a non-EU credit institution or financial institution but is not subject to consolidated supervision – presumably because no agreement was entered into with the non-EU country of the parent. If an EU-authorized credit institution is a subsidiary of a non-EU credit institution or financial institution and is not subject to consolidated supervision under Art. 52, Banking Directive, the competent authority shall verify whether the EU-authorized credit institution is subject to consolidated supervision by the home country of the non-EU credit institution or financial

consolidated supervision, although such supervision cannot be exercised directly over the non-EU investment firms that are parents of EU-authorized credit institutions or investment firms.

For purposes of supplementary supervision, the definition of *investment firm* includes EU-authorized and non-EU investment firms. *See infra* note 135.

⁷³ For a discussion of a similar approach in connection with supplementary supervision, *see infra* C.IV. The BHCA applies not only to U.S. banks but also directly to foreign banks that control a U.S. bank subsidiary and to foreign banks that maintain a branch, agency or commercial lending company in the United States. Section 8(a), International Banking Act of 1978, 12 U.S.C. § 3106(a) (2000).

⁷⁴ Art. 25(1), Banking Directive.

⁷⁵ Art. 25(1), Banking Directive. *See* 21st recital, Banking Directive.

⁷⁶ Art. 25(2), first indent, Banking Directive.

⁷⁷ Art. 25(2), second indent, Banking Directive. Art. 25, Banking Directive is not applicable to investment firms, and the Capital Adequacy Directive does not contain similar provisions.

institution that is equivalent to that governed by the principles laid down in Art. 52, Banking Directive.⁷⁸ In the absence of such equivalent supervision, Member States shall apply the provisions of Art. 52, Banking Directive to the credit institution by analogy.⁷⁹ As an alternative, Member States shall allow their competent authorities to apply other appropriate supervisory techniques which achieve the objectives of the supervision on a consolidated basis.⁸⁰ The competent authorities which would be responsible for consolidated supervision, must agree on those methods; they may, in particular, require the establishment of a financial holding company which has its head office in the European Union, and apply the provision on consolidated supervision to the consolidated position of that financial holding company.⁸¹

The question of whether an EU-authorized credit institution that is a subsidiary of a U.S. holding company is subject to U.S. consolidated supervision that is equivalent to the consolidated supervision provided in Art. 52, Banking Directive will be discussed below.⁸²

B. Supplementary Supervision of Insurance Groups

I. Insurance Groups Subject to Supplementary Supervision

Insurance groups not are subject to consolidated supervision but to a more limited supplementary supervision under the Insurance Group Directive.⁸³ Supplementary supervision applies to any EU-authorized life or non-life insurance undertaking⁸⁴ that has at least one

⁷⁸ Art. 56a, first subparagraph, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive. The verification shall be carried out by the competent authority, which would be responsible for analogous consolidated supervision, *see infra* note 79, at the request of the parent undertaking or of any of the EU-authorized entities or on its own initiative. *Id.* Art. 56a, Banking Directive also applies to investment firm groups. Art. 7(2) & (3), Capital Adequacy Directive.

⁷⁹ Art. 56a, fourth subparagraph, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive.

⁸⁰ Art. 56a, fifth subparagraph, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive.

⁸¹ Art. 56a, fifth subparagraph, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive.

⁸² *See infra* E.

⁸³ Directive 98/78/EC of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of insurance undertakings in an insurance group, O.J. Eur. Comm. No. L 330/1 (1998) [*herein* Insurance Group Directive], as amended by the Supplementary Supervision Directive.

⁸⁴ *Insurance undertaking* is an undertaking that has received official authorization in accordance with (1) Art. 6, First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance, O.J. Eur. Comm. No. L 228/3 (1973) [*herein* First Non-Life Insurance Directive], as amended by Council Directive 76/580/EEC of 29 June 1976, O.J. Eur. Comm. No. L 189/13 (1976), by Council Directive 84/641/EEC of 10 December 1984, O.J. Eur. Comm. No. L 339/21 (1984), by Council Directive 87/343/EEC of 22 June 1987, O.J. Eur. Comm. No. L 185/72 (1987), by Council Directive 87/344/EEC of 22 June 1987, O.J. Eur. Comm. No. L 185/77 (1987), by Council Directive 88/357/EEC of 22 June 1988, O.J. Eur. Comm. No. L 172/1 (1988), by Council Directive 90/618/EEC of 8 November 1990, O.J. Eur. Comm. No. L 330/44 (1990), by Council Directive 92/49/EEC of 18 June 1992, O.J. Eur.

subsidiary,⁸⁵ that is an EU-authorized life or non-life insurance undertaking, reinsurance undertaking,⁸⁶ or non-EU insurance undertaking,⁸⁷ or holds a participation⁸⁸ in any such entity or

Comm. No. L 228/1 (1992), by European Parliament and Council Directive 95/26/EC of 29 June 1995, O.J. Eur. Comm. No. L 168/7 (1995), by Directive 2002/13/EC of the European Parliament and of the Council of 5 March 2002, O.J. Eur. Comm. No. L 77/17 (2002), and by the Supplementary Supervision Directive, or (2) Art. 6, First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance, O.J. Eur. Comm. No. L 63/1 (1979) [*herein* First Life Insurance Directive], as amended by Council Directive 90/619/EEC of 8 November 1990, O.J. Eur. Comm. L 330/50 (1990), by Council Directive 92/96/EEC of 10 November 1992, O.J. Eur. Comm. No. L 360/1 (1992), by European Parliament and Council Directive 95/26/EC of 29 June 1995, O.J. Eur. Comm. No. L 168/7 (1995), by the Banking Directive, by Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002, O.J. Eur. Comm. No. L 345/1 (2002), and by Supplementary Supervision Directive. In other words, an *insurance undertaking* is an EU-authorized life or non-life insurance company. Art. 1(a), Insurance Group Directive.

⁸⁵ *Subsidiary undertaking* [*subsidiary*] is (1) a subsidiary within the meaning of Art. 1(1) & (2), Consolidated Accounts Directive, *see supra* notes 10 & 11 and accompanying text for a discussion of Art. 1(1), Consolidated Accounts Directive and *infra* note 150 for a discussion of Art. 1(2), Consolidated Accounts Directive, and (2) any undertaking over which, in the opinion of the competent authorities, a parent effectively exercises a dominant influence. Art. 1(e), Insurance Group Directive. *Subsidiary* includes direct and indirect subsidiaries. *Id.*

The Insurance Group Directive introduces the term *participating undertaking* to include parents, undertakings that hold a participation and undertakings that are linked with another undertaking by a horizontal structure. The horizontal structure was added to the definition of *participating undertaking* by Art. 28(1), Supplementary Supervision Directive and refers to Art. 12(1), Consolidated Accounts Directive. A horizontal structure essentially exists if there is control, in the absence an equity investment, due to management on a unified basis or cross-membership of governing boards, *see infra* notes 158 & 159. Art. 1(g), Insurance Group Directive.

⁸⁶ *Reinsurance undertaking* is defined in Art. 1(c), Insurance Group Directive as an undertaking, other than an EU-authorized insurance undertaking or a non-EU insurance undertaking, “the main business of which consists in accepting risks ceded by an insurance undertaking, a non-member-country insurance undertaking or other reinsurance undertaking”.

⁸⁷ Art. 1(b), Insurance Group Directive defines *non-member-country insurance undertaking* as an undertaking that would require authorization in accordance with Art. 6, First Life Insurance Directive or Art. 6, First Non-Life Insurance Directive if it had its registered office in the EU. Non-member-country insurance undertakings are sometimes referred to *herein* as non-EU insurance undertakings.

⁸⁸ *Participation* is defined in Art. 1(f), Insurance Group Directive (1) by reference to Art. 17, first sentence, Fourth Council Directive 78/660/EEC of 25 July 1978 based on Art. 54(3)(g) of the Treaty on the annual accounts of certain types of companies, O.J. Eur. Comm. No. L 222/11 (1978) [*herein* Annual Accounts Directive], as amended by Council Directive 83/349/EEC of 13 June 1983, O.J. Eur. Comm. L 193/1 (1983), by Council Directive 84/569/EEC of 27 November 1984, O.J. Eur. Comm. L 314/28 (1984), by Council Directive 89/666/EEC of 21 December 1989, O.J. Eur. Comm. L 395/36 (1989), by Council Directive 90/604/EEC of 8 November 1990, O.J. Eur. Comm. L 317/57 (1990), by Council Directive 90/605/EEC of 8 November 1990, O.J. Eur. Comm. L 317/60 (1990), by Council Directive 94/8/EC of 21 March 1994, O.J. Eur. Comm. L 82/33 (1994), by Council Directive 1999/60/EC of 17 June 1999, O.J. Eur. Comm. L 162/15 (1999), by Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001, O.J. Eur. Comm. L 283/28 (2001), by Council Directive 2003/38/EC of 13 May 2003, O.J. Eur. Comm. L 120/22 (2003), and by Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003, O.J. Eur. Comm. L 178/16 (2003), as a right in the capital of other undertakings which “by creating a durable link with those [other] undertakings, are intended to contribute to the

is linked by a horizontal structure with any such entity.⁸⁹ Supplementary supervision also applies to every EU-authorized life or non-life insurance undertaking the parent⁹⁰ of which is an insurance holding company,⁹¹ a reinsurance undertaking or a non-EU insurance undertaking.⁹² Lastly, supplementary supervision applies to every EU-authorized life or non-life insurance undertaking the parent of which is a mixed-activity insurance holding company.⁹³

The following diagram shows the insurance undertakings that are subject to supplementary supervision under the Insurance Group Directive:

company's [the holder of the participation] activities" or (2) the holding, directly or indirectly, of 20 percent or more of the voting rights or capital of another undertaking. Note that in the case of (1), a *participation* would exist even though the equity ownership is below 20 percent. *See supra* note 15 and *infra* note 156.

⁸⁹ Art. 2(1), Insurance Group Directive.

For a discussion of horizontal structures, *see infra* notes 158 & 159. A horizontal structure essentially exists if there is control in the absence of an equity investment, due to management on a unified basis or cross-membership of governing boards.

⁹⁰ *Parent undertaking [parent]* is (1) a parent within the meaning of Art. 1(1) & (2), Consolidated Accounts Directive, *see supra* notes 10 & 11 and accompanying text for a discussion of Art. 1(1), Consolidated Accounts Directive and *infra* note 150 for a discussion of Art. 1(2), Consolidated Accounts Directive, and (2) any undertaking that, in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking. Art. 1(d), Insurance Group Directive.

⁹¹ *Insurance holding company* is a parent the main business of which is to acquire and hold participations in subsidiaries, where those subsidiaries are exclusively or mainly EU-authorized insurance undertakings, reinsurance undertakings or non-EU insurance undertakings, at least one of such subsidiaries being an EU-authorized life or non-life insurance undertaking, and which is not a mixed financial holding company within the meaning of the Supplementary Supervision Directive. Art. 1(i), Insurance Group Directive, as amended by Art. 28, Supplementary Supervision Directive. *See infra* note 174 for the definition of mixed financial holding company.

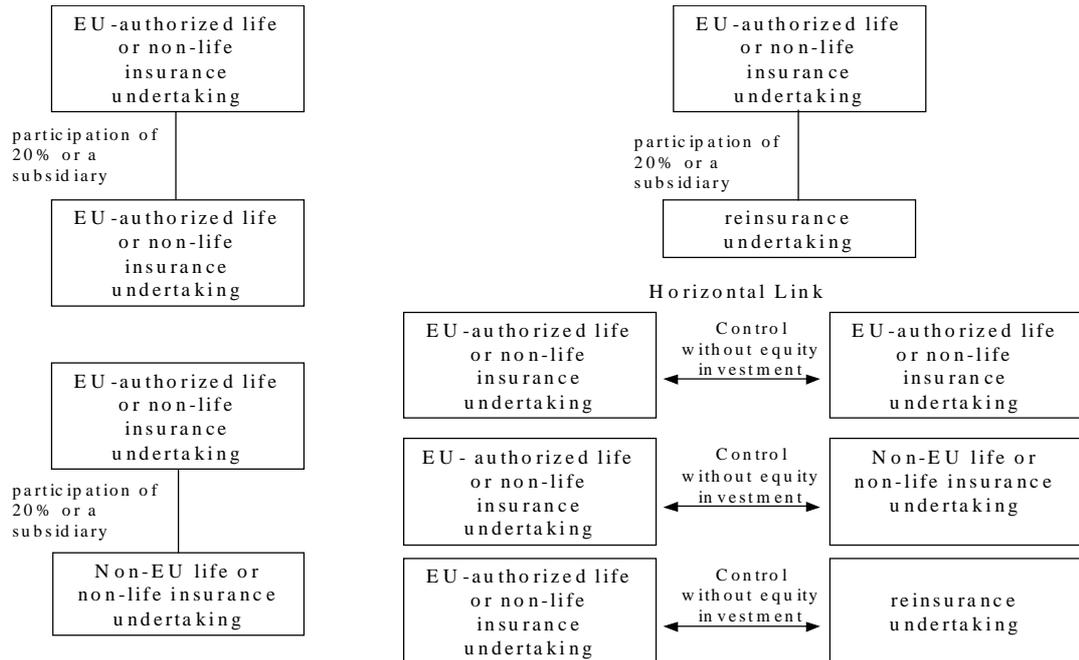
⁹² Art. 2(2), Insurance Group Directive.

⁹³ Art. 2(3), Insurance Group Directive. *Mixed-activity insurance holding company* is a parent, other than an EU-authorized insurance undertaking, a non-EU insurance undertaking, a reinsurance undertaking, an insurance holding company or a mixed financial holding company as defined in the Supplementary Supervision Directive, that includes at least one EU-authorized life or non-life insurance undertaking among its subsidiaries. Art. 1(j), Insurance Group Directive, as amended by Art. 28, Supplementary Supervision Directive. *See infra* note 174 for the definition of *mixed financial holding company*, and *supra* note 91 for the definition of *insurance holding company*. Note that mixed-activity insurance holding companies are subject to supplementary supervision, whereas mixed-activity holding companies in the banking and investment sector are not subject to consolidated supervision. *See supra* A.III.3.

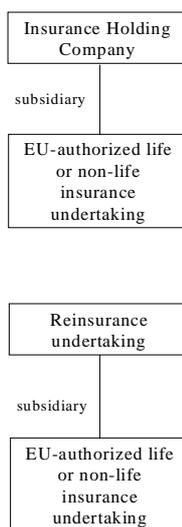
The dividing line between the definitions of *insurance holding company*, *supra* note 91, and *mixed-activity insurance holding company*, *supra*, is unclear: an *insurance holding company* is a company other than a *mixed-activity insurance holding company* and a *mixed-activity insurance holding company* is a company other than an *insurance holding company*. No definitional problem exists between the definitions *mixed-activity insurance holding company* and *mixed financial holding company*, *infra* note 174.

Diagram 4: Insurance Undertakings Subject to Supplementary Supervision

(a) Groups headed by an EU-authorized insurance undertaking



(b) Groups in which an EU-authorized insurance undertaking is a Subsidiary

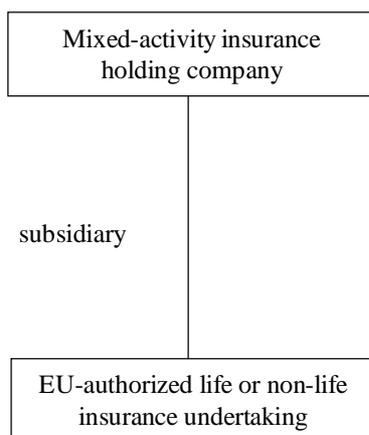


Insurance Holding Company:

- Main business is to acquire and hold subsidiaries
- Subsidiaries are exclusively or mainly EU-authorized insurance undertakings, reinsurance undertakings or non-EU insurance undertakings
- One subsidiary is an EU-authorized life or non-life insurance undertaking

- It is not a mixed financial holding company (if the group constitutes a financial conglomerate (significant investments in the banking plus investment services and insurance sector; at least one subsidiary is an EU-regulated entity; group mainly engaged in the financial sector), then the parent is a *mixed financial holding company* and not an *insurance holding company*)

(c) **Groups headed by a Mixed-Activity Insurance Holding Company**



Mixed-activity Insurance Holding Company:

- Parent undertaking *other than*
 - EU-authorized insurance undertaking
 - non-EU insurance undertaking
 - reinsurance undertaking
 - insurance holding company
 - mixed financial holding company
- One subsidiary is an EU-authorized life or non-life insurance undertaking
- - if the subsidiaries of the parent are exclusively or mainly EU-authorized insurance undertakings, reinsurance undertakings, or non-EU insurance undertakings, the parent is a *insurance holding company* and not a *mixed-activity insurance holding company*
 - if the group constitutes a financial conglomerate (significant investments in the banking plus investment services sector and insurance sector; at least one subsidiary is an EU-regulated entity; group mainly engaged in the financial sector), then the parent is a *mixed financial holding company* and not a *mixed-activity insurance holding company*

Member States may decide not to take into account in the supplementary supervision undertakings having their registered office in a non-Member State if there are legal impediments to the transfer of the necessary information, or if the undertaking that should be included is of negligible interest, or if the inclusion of the financial situation of the undertaking would be inappropriate or misleading.⁹⁴ The EU Council may upon request of the Commission negotiate agreements with the non-EU countries regarding supplementary supervision of (1) EU-authorized insurance undertakings that are subsidiaries of or 20 percent owned by non-EU insurance undertakings, by insurance holding companies, by reinsurance undertakings or by mixed-activity insurance holding companies that have their head office outside the EU or (2) non-EU insurance undertakings that are subsidiaries of or 20 percent owned by EU-authorized insurance undertakings, by insurance holding companies, by reinsurance undertakings or by mixed-activity insurance holding companies that have their head office in the EU.⁹⁵

Different from the Banking Directive and the Supplementary Supervision Directive,⁹⁶ the Insurance Group Directive does not require verification that an EU-authorized insurance undertaking that is a subsidiary of a non-EU insurance or other undertaking is subject to equivalent supplementary supervision by the home country of the parent and does not require analogous application of the Insurance Group Directive in case equivalence is not found.

The exercise of supplementary supervision over insurance groups does not imply that the competent authorities are required to play a supervisory role in relation to non-EU insurance undertakings, insurance holding companies or mixed-activity insurance holding companies or reinsurance undertakings taken individually.⁹⁷

II. Scope of Supplementary Supervision

1. Intra-group Transactions

The supplementary supervision of all insurance groups relates to intra-group transactions.⁹⁸ The competent authorities shall exercise general supervision over transactions of an EU-authorized life or non-life insurance undertaking and (1) subsidiaries of the insurance

⁹⁴ Art. 3(3), Insurance Group Directive.

⁹⁵ Art. 10a, Insurance Group Directive, added by Art. 28(4), Supplementary Supervision Directive. It is curious that an agreement under Art. 10a(1)(a), Insurance Group Directive, added by Art. 28(4), Supplementary Supervision Directive, may cover a non-EU insurance or other undertaking that is a 20 percent owner of an EU-authorized insurance undertaking, whereas Art 2(2), Insurance Group Directive applies supplementary supervision only to EU-authorized insurance undertakings that are *subsidiaries* of a non-EU insurance or other undertaking and does not apply supplementary supervision to EU-authorized insurance undertakings that are 20 percent owned by a non-EU insurance or other undertaking.

⁹⁶ *See supra* A.V. and *infra* C.IV.

⁹⁷ Art. 3(1), Insurance Group Directive.

⁹⁸ Art. 8(1), Insurance Group Directive. A non-exclusive list of intra-group transactions is set forth in Art. 8(1)(b), Insurance Group Directive, and includes loans, guarantees and off-balance-sheet transactions, elements eligible for the solvency margin, investments, reinsurance operations and agreements to share costs.

undertaking, undertakings in which the insurance undertaking holds a participation or undertakings that are linked to the insurance undertaking by a horizontal structure,⁹⁹ (2) the parent of the insurance undertaking, other undertakings holding a participation in the insurance undertaking or undertakings that are linked to the insurance undertaking by a horizontal structure,¹⁰⁰ and (3) undertakings of which an entity referred to in (2) is a parent, holds a participation or is linked by a horizontal structure (*i.e.*, essentially undertakings under common control with the insurance undertaking).¹⁰¹ See diagram 4 for the insurance groups subject to supervision of intra-group transactions. Member States shall require at least annual reporting by the insurance undertaking to the competent authorities of significant intra-group transactions.¹⁰² Member States shall require insurance undertakings to have in place adequate risk management processes and internal control mechanisms, including reporting and accounting procedures, in order to identify, measure, monitor and control intra-group transactions.¹⁰³ If, on the basis of this information, it appears that the solvency of the insurance undertaking is, or may be, jeopardized, the competent authority shall take appropriate measures at the level of the insurance undertaking.¹⁰⁴

2. *Adjusted or Analogous Solvency Ratio*

In cases in which an EU-authorized life or non-life insurance undertaking is the parent of, holds a participation in, or is linked by a horizontal structure with at least one EU-authorized life or non-life insurance undertaking, reinsurance undertaking or non-EU insurance undertaking,¹⁰⁵ Member States shall require the computation of an adjusted solvency

⁹⁹ Art. 8(1)(a)(i) in connection with Art. 1(h), Insurance Group Directive, as amended by Art. 28(1), Supplementary Supervision Directive (related undertaking of the insurance undertaking). The horizontal structure was added to the definition of *related undertaking* by Art. 28(1), Supplementary Supervision Directive and refers to Art. 12(1), Consolidated Accounts Directive. A horizontal structure essentially exists if there is control in the absence of an equity investment, due to management on a unified basis or cross-membership of governing boards. *See infra* notes 158 & 159.

¹⁰⁰ Art. 8(1)(a)(ii) in connection with Art. 1(g), Insurance Group Directive, as amended by Art. 28(1), Supplementary Supervision Directive (participating undertaking in the insurance undertaking). The horizontal structure was added to the definition of participating undertaking by Art. 28(1), Supplementary Supervision Directive and refers to Art. 12(1), Consolidated Accounts Directive. *See supra* note 99.

¹⁰¹ Art. 8(1)(a)(iii) in connection with Art. 1(h) & (g), Insurance Group Directive, as amended by Art. 28(1), Supplementary Supervision Directive (related undertaking of a participating undertaking in the insurance undertaking). *See* Art. 2(1), (2) & (3) Insurance Group Directive, referring to supplementary supervision in the manner provided in Art. 8, Insurance Group Directive.

The Insurance Group Directive extends consolidated supervision to transactions between insurance undertakings and certain natural persons. Art. 8(1)(b), Insurance Group Directive.

¹⁰² Art. 8(2), first subparagraph, Insurance Group Directive.

¹⁰³ Art. 8(2), Insurance Group Directive, as amended by Art. 28(3), Supplementary Supervision Directive.

¹⁰⁴ Art. 8(2), second subparagraph, Insurance Group Directive.

¹⁰⁵ Art. 1(b), Insurance Group Directive.

calculation.¹⁰⁶ See diagram 4(a) for the insurance company group subject to the computation of an adjusted solvency ratio. If the calculation results in a negative adjusted solvency, the competent authorities shall take appropriate measures at the level of the insurance undertaking.¹⁰⁷

In cases where an EU-authorized life or non-life insurance undertaking is a subsidiary of an insurance holding company, reinsurance undertaking or a non-EU insurance undertaking,¹⁰⁸ the competent authorities, shall ensure that at the level of the parent undertaking solvency computations are carried out that are analogous to those applicable to groups that are headed by an EU-authorized life or non-life insurance undertaking.¹⁰⁹ See diagram 4(b) for the insurance company group subject to analogous solvency computation. If, on the basis of this calculation, the competent authorities conclude that the solvency of the EU-authorized life or non-life subsidiary insurance undertaking subsidiary is, or may be, jeopardized, they shall take appropriate measures at the level of that insurance undertaking subsidiary.¹¹⁰

¹⁰⁶ Art. 9(1) referring to Art. 2(1), Insurance Group Directive. This calculation must be computed in accordance with Annex I to the Insurance Group Directive, as amended by Art. 28(5), Supplementary Supervision Directive. The calculation shall include (1) any subsidiary of the insurance undertaking, any undertaking in which the insurance undertaking holds a 20 percent interest, and any undertaking with which the insurance undertaking is linked by a horizontal structure, (2) the parent of the insurance undertaking and any holder of a 20 percent interest in the insurance undertaking, and (3) any undertaking for which such parent, such 20 percent holder or such horizontally linked undertaking is a parent, a 20 percent holder or a horizontally linked undertaking. Art. 9(2) in connection with Art. 1(g) & (h), Insurance Group Directive; Art. 1(g) & (h), Insurance Group Directive were amended by Art. 28(1), Supplementary Supervision Directive (adding horizontally linked undertakings by reference to Art. 12(1), Consolidated Accounts Directive). See *supra* notes 99 & 100 for a discussion of horizontal structures.

¹⁰⁷ Art. 9(3), Insurance Group Directive.

¹⁰⁸ Art. 10(1) referring to Art. 2(2), Insurance Group Directive. See *supra* text accompanying notes 90–93.

¹⁰⁹ Art. 10(2), Insurance Groups Directive; paragraph 3, Annex II to the Insurance Group Directive. The analogy shall consist in applying the general principles and methods described in Annex I to the Insurance Group Directive at the level of the insurance holding company, reinsurance undertaking or non-EU insurance undertaking. *Id.* The calculation shall include all subsidiaries of the insurance holding company, reinsurance company or non-EU insurance company, undertakings in which any of them holds a 20 percent participation and undertakings with which any of them is horizontally linked in the manner provided for in Annex II to the Insurance Group Directive. Art. 10(2) in connection with Art. 1(g) & (h), Insurance Group Directive; Art. 1(g) & (h), Insurance Group Directive were amended by Art. 28(1), Supplementary Supervision Directive (adding horizontally linked undertakings by reference to Art. 12(1), Consolidated Accounts Directive). See *supra* notes 99 & 100 for a discussion of horizontal structures.

¹¹⁰ Art. 10(3), Insurance Group Directive.

3. Information

The competent authorities shall prescribe that every insurance undertaking subject to supplementary supervision shall have adequate internal control mechanisms in place for the production of any data and information relevant for the purposes of such supplementary supervision.¹¹¹

If competent authorities need information which would be relevant for the purpose of supervision of an insurance undertaking subject to supplementary supervision, the competent authorities must address such request for information first to the insurance undertaking. Only if the insurance undertaking does not supply such information, the competent authority may address itself directly (1) to any subsidiary of the insurance undertaking or any undertaking in which the insurance undertaking holds a participation (20 percent interest), or any undertaking that is connected to the insurance undertaking by a horizontal structure, (2) to the parent of the insurance undertaking or any undertaking holding a participation in the insurance undertaking, or any undertaking that is connected with such parent or undertaking holding a participation by a horizontal structure, or (3) to any undertaking for which such parent or holder of a participation or such horizontally linked undertaking is a parent or a holder of a participation or is horizontally linked.¹¹² The competent authorities may carry on within their territory, either themselves or through intermediaries, on-the-spot verification of information referred to in the preceding sentence at the insurance undertaking subject to supplementary supervision, subsidiaries or parents of that insurance undertaking, or subsidiaries of the parent of the insurance undertaking.¹¹³ Where the competent authorities of one Member State wish to verify important information concerning an undertaking situated in another Member State which is a related insurance undertaking¹¹⁴ or a subsidiary, a parent or a subsidiary of a parent of the insurance undertaking subject to supplementary supervision, they must ask the competent authorities of that other Member State to have the verification carried out.¹¹⁵

¹¹¹ Art. 5(1), Insurance Group Directive.

¹¹² Art. 6(1) in connection with Art. 3(2), Insurance Group Directive. Art. 3(2), Insurance Group Directive uses the terms *related undertaking*, *participating undertaking* and *related undertaking of a participating undertaking*, defined in Art. 1(g) & (h), Insurance Group Directive, as amended by Art. 28(1), Supplementary Supervision Directive.

¹¹³ Art. 6(1) & (2), Insurance Group Directive. Note that on-the-spot verification does not extend to companies in which the insurance undertaking only holds a participation, companies that hold a participation in the insurance undertaking or horizontally linked undertakings. *See* Art. 6(2), Insurance Group Directive.

Thus, the group of entities from which information can be requested is larger than the group of entities with respect to which such information can be verified.

¹¹⁴ *See* Art. 1(h), Insurance Group Directive, as amended by Art. 28(1), Supplementary Supervision Directive (related undertaking means either a subsidiary, another undertaking in which a participation is held or an undertaking linked by a horizontal structure). *See supra* notes 99 & 100 for a discussion of horizontal structures.

¹¹⁵ Art. 6(3), Insurance Group Directive. The authorities receiving such request must act on it by carrying out the verification themselves, by allowing the requesting authorities to carry it out or by allowing an expert or

4. *Management of Insurance Holding Companies*

Persons who effectively direct the business of an insurance holding company must be of sufficiently good repute and have sufficient experience to perform their duties.¹¹⁶

III. Member States Responsible for Supplementary Supervision

Supplementary supervision shall be exercised by the competent authorities of the Member State in which the EU-authorized life or non-life insurance undertaking was authorized.¹¹⁷ Where an insurance holding company, reinsurance undertaking, non-EU insurance undertaking or mixed-activity insurance holding company has as subsidiaries EU-authorized life or non-life insurance undertakings in more than one Member State, the competent authorities of the Member States concerned may reach agreement as to which of them will be responsible for exercising supplementary supervision.¹¹⁸ If insurance undertakings established in different Member States are directly or indirectly related or are under common control, the competent authorities of each Member State shall communicate to one another all relevant or essential information that may allow or facilitate the exercise of supplementary supervision.¹¹⁹

C. Cross-Sectoral Supplementary Supervision of Financial Conglomerates

I. Purpose of Cross-Sectoral Supplementary Supervision

On November 20, 2002, the European Parliament adopted Directive 2002/87/EC¹²⁰ introducing supplementary supervision of financial conglomerates [*herein* the

auditor to carry it out. *Id.* The competent authority which made the request may, if it so wishes, participate in the verification when it does not carry out the verification itself. Art. 6(3), Insurance Group Directive, as amended by Art. 28(2), Supplementary Supervision Directive.

¹¹⁶ Art. 10b, Insurance Group Directive, added by Art. 28(4), Supplementary Supervision Directive.

¹¹⁷ Art. 4(1), Insurance Group Directive. The Insurance Group Directive does not address the case in which an EU-authorized insurance undertaking in one Member State is the parent of an EU-authorized insurance undertaking in another Member State.

¹¹⁸ Art. 4(2), Insurance Group Directive.

¹¹⁹ Art. 7, Insurance Group Directive. This Section refers (1) to insurance undertakings that are directly or indirectly related undertakings, *i.e.*, undertakings that are either a subsidiary or in which a participation is held or that are linked by a horizontal structure, Art. 1(h), Insurance Group Directive, as amended by Art. 28(1), Supplementary Supervision Directive, and (2) to insurance undertakings that have a common participating undertaking, *i.e.*, an undertaking that is a parent undertaking or holds a participation or that is linked by a horizontal structure, Art. 1(g), Insurance Group Directive, as amended by Art. 28(1), Supplementary Supervision Directive. Relevant information that may allow or facilitate the exercise of supervision pursuant to the Insurance Group Directive shall be communicated upon request, essential information shall be communicated on own initiative. Art. 7(1), Insurance Group Directive.

¹²⁰ Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the

Supplementary Supervision Directive]. The Supplementary Supervision Directive requires a closer coordination among supervisory authorities of different sectors of the financial industry and among the supervisory authorities of the different Member States.

The principal objective of the Supplementary Supervision Directive is to face the accelerating pace of consolidation in the financial industry and the intensification of links between financial markets. Over the past years, a number of cross-sector groups combining insurance companies, banks and investment firms have been created and have become of significant importance in the EU.¹²¹ Such groups straddle traditional sectoral boundaries.¹²² Combined financial operations may create new prudential risks or exacerbate existing ones.¹²³ Laws and regulations in the different financial sectors have traditionally adopted different approaches with different definitions of capital, different types of risks and different capital requirements.¹²⁴ For instance, insurance supervisors have historically been primarily concerned with the liability side of the balance sheet as the main source of risk, although assets are of course monitored too.¹²⁵ Regulations in the banking sector regard the asset side of the balance sheet as the principal source of risk, although an examination of the source of funding is an important aspect of the supervisory process.¹²⁶ Securities supervisors require securities firms to

Council, O.J. Eur. Comm. No. L 35/1 (2003) [*herein* the Supplementary Supervision Directive]. *See also* Commission of the European Communities, Proposal for a Directive of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, O.J. Eur. Comm. No. C 213/227 (2001) [*herein* the Proposed Supplementary Supervision Directive]. For a discussion of the Proposed Supplementary Supervision Directive, *see* Michael Gruson, *Supervision of Financial Holding Companies in Europe: The EU Directive on Supplementary Supervision of Financial Conglomerates*, 36 INT'L L. 1229 (2002) [*herein* Gruson, *Supplementary Supervision*].

A number of interested parties had commented on the Proposed Supplementary Supervision Directive. *See* Gruson, *Supplementary Supervision, supra*, at 1231 n.13 for a list of such comments.

¹²¹ Recitals (2) & (3), Supplementary Supervision Directive.

¹²² Commission of the European Community, Explanatory Memorandum to the Proposed Supplementary Supervision Directive (Apr. 24, 2001), O.J. Eur. Comm. No. C 213/227 (2001) [*herein* 2001 Explanatory Memorandum], at 2, *sub* 1.

¹²³ 2001 Explanatory Memorandum, *supra* note 122, at 2 *sub* 1.

¹²⁴ Tripartite Group of Bank, Securities and Insurance Regulators, *The Supervision of Financial Conglomerates* (Bank for International Settlements, July 1995) [*herein* Tripartite Report], at 39, *sub* no. 104; The Joint Forum, *The Joint Forum Compendium of Documents* (July 2001) [*herein* Joint Forum Report], *Capital Adequacy Principles Paper*, at 12, *sub* no. 6. The Tripartite Group was formed at the initiative of the Basle Committee on Banking Supervision (Basle Committee) in early 1993 to address a range of issues relating to the supervision of financial conglomerates. The Joint Forum was established in early 1996 under the aegis of the Basle Committee, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to take forward the work of the Tripartite Group. The Joint Forum Report is a compilation of papers that have been prepared by the Joint Forum since its inception in January 1996.

¹²⁵ Tripartite Report, *supra* note 124, at 16, *sub* no. 41.

¹²⁶ Tripartite Report, *supra* note 124, at 16, *sub* no. 41.

have sufficient liquid assets to repay promptly all liabilities at any time.¹²⁷ The scope for potential supervisory problems increases if a financial conglomerate spans a number of financial markets due to the web of financial interrelationships characteristic for financial conglomerates. On the other hand, such conglomerates may gain financial solidity by diversifying that risk.¹²⁸ The Supplementary Supervision Directive intends to ensure the stability of the European financial market, establish common prudential standards for the supervision of such financial groups throughout Europe, and introduce level playing fields and legal certainty between financial institutions.¹²⁹

The basic philosophy of the Supplementary Supervision Directive is that the solo supervisions of individually regulated entities should continue to be the foundation for effective supervision, but that the various supervisors need to establish a coordinated approach in order that prudential assessment can be made from a group-wide perspective.¹³⁰

II. Determination of Financial Conglomerates and the Addressees of Supplementary Supervision

1. Sectoral and Cross-Sectoral Supervision

The EU legal framework for the supervision of financial institutions before the adoption of the Supplementary Supervision Directive was incomplete because it only covered the so-called sectoral supervision; that is, supervision over institutions within a particular sector of the financial industry.¹³¹ Except in the case of credit institutions and investment firms,¹³² cross-sectoral supervision of financial groups (combining institutions from different financial sectors) existed only to a very limited extent.¹³³ The Supplementary Supervision Directive changes this

¹²⁷ Tripartite Report, *supra* note 124, at 16, *sub* no. 41.

¹²⁸ Tripartite Report, *supra* note 124, at 16, *sub* no. 41.

¹²⁹ 2001 Explanatory Memorandum, *supra* note 122, at 2, *sub* 1.

¹³⁰ Tripartite Report, *supra* note 124, at 16, *sub* no. 42.

¹³¹ Arts. 52–56, Banking Directive provide for prudential regulation of banking groups; Art. 7, Capital Adequacy Directive provides for prudential regulation of investment firm groups; and the Insurance Group Directive provides for additional supervision of insurance groups.

¹³² See Art. 7, Capital Adequacy Directive; Art. 52, Banking Directive (the term financial institution includes investment firms). See *supra* A.II.

¹³³ *E.g.*, Art. 56(4), Banking Directive requires cooperation and exchange of information between the different supervisory authorities if a credit institution, financial holding company of a credit institution or mixed-activity holding company of a credit institution has as a subsidiary an insurance company or an undertaking providing investment services. The same rule applies where a mixed-activity holding company of a credit institution itself is an insurance undertaking. Art. 55(2), Banking Directive. Art. 7(3), 8th indent, Capital Adequacy Directive extends this rule to situations where an investment firm, a financial holding company of an investment firm or a mixed-activity holding company of an investment firm has as a subsidiary an insurance company. Note that *financial holding company* and *mixed-activity holding company* have different meanings depending on whether they relate to credit institutions or investment firms. See *supra* notes 9, 23 & 72 (financial holding company) and notes 52 & 53 (mixed-activity holding company). Similarly, Art. 7(2), Insurance Group Directive requires close cooperation and information-

situation by, generally speaking, introducing supplementary supervision of regulated entities in financial conglomerates that straddle several financial sectors.

The Supplementary Supervision Directive uses the term *financial sector* to refer to the banking, insurance or investment services sector.¹³⁴ A *regulated entity* is defined as a credit institution, an insurance undertaking or an investment firm.¹³⁵

sharing among competent authorities where EU-authorized life or non-life insurance undertakings and either a credit institution or an investment firm, or both, are directly or indirectly related (*i.e.*, one being a subsidiary of the other or holding a participation (20 percent or more of the voting rights or capital) in the other, Art. 1(h) & (f), Insurance Group Directive) or have a common participating undertaking (*i.e.*, an undertaking that is a parent undertaking or holds a participation, Art. 1(g), Insurance Group Directive). Art. 1(g) & (h), Insurance Group Directive was amended by Art. 28(1), Supplementary Supervision Directive by adding horizontally linked undertakings by reference to Art. 12(1), Consolidated Accounts Directive. *See supra* notes 99 & 100 for a discussion of horizontal structures.

¹³⁴ Art. 2(8), Supplementary Supervision Directive. Art. 2(8), Supplementary Supervision Directive defines *financial sector* as a sector composed of one or more entities of the banking sector, of the insurance sector or of the investment services sector or of a mixed financial holding company, as defined in Art. 2(15), Supplementary Supervision Directive.

The banking sector consists of (i) credit institutions (see supra note 7), (ii) financial institutions (i.e., undertakings, other than credit institutions, the principal activity of which is to acquire holdings or to carry on one or more of the activities referred to in numbers 2–12 of the list appearing in the Annex to the Banking Directive, see supra note 8), and (iii) ancillary banking services undertakings (i.e., undertakings the principal activity of which consists in owning or managing property, managing data-processing services, or any other similar activity which is ancillary to the principal activity of one or more credit institutions, see supra note 18), as defined in Art. 1(1), second subparagraph, 1(5) & 1(23), respectively, Banking Directive. Art. 2(8)(a) & (1), Supplementary Supervision Directive.

The insurance sector consists of (i) insurance undertakings within the meaning of Art. 6, First Non-Life Insurance Directive, Art. 6, First Life Insurance Directive (i.e., EU-authorized life or non-life insurance undertakings), and Art. 1(b), Insurance Group Directive (i.e., non-EU insurance undertakings, see supra note 87), (ii) reinsurance undertakings, as defined in Art. 1(c), Insurance Group Directive (i.e., undertakings, other than insurance undertakings or non-EU insurance undertakings (see supra note 87), the main business of which consists in accepting risks ceded by an insurance undertaking, a non-EU insurance undertaking or other reinsurance undertakings), and (iii) insurance holding companies, as defined in Art. 1(i), Insurance Group Directive (i.e., parents, the main business of which is to acquire and hold participations in subsidiaries, where those subsidiaries are exclusively or mainly insurance undertakings, reinsurance undertakings or non-EU insurance undertakings, one at least of such subsidiaries being an insurance undertaking). Art. 2(8)(b), (2) & (6), Supplementary Supervision Directive.

The investment services sector consists of (i) investment firms, as defined in Art. 1(2), Investment Services Directive (i.e., any legal person the regular occupation or business of which is the provision of investment services for third parties on a professional basis), and in Art. 2(4), Capital Adequacy Directive (i.e., recognized third-country investment firms), and (ii) financial institutions, as defined in Art. 2(7), Capital Adequacy Directive by reference to (the predecessor provision of) Art. 1(5), Banking Directive (i.e., undertakings, other than credit institutions, the principal activity of which is to acquire holdings or to carry on one or more of the activities referred to in numbers 2–12 of the list appearing in the Annex to the Banking Directive). Art. 2(8)(c) & (3), Supplementary Supervision Directive.

Asset management companies within the meaning of Art. 2(5), Supplementary Supervision Directive are also part of the financial sector, either the banking sector, the investment services sector or the insurance sector. Art. 30, first subparagraph, Supplementary Supervision Directive.

The *financial sector* is not limited to the EU, because the *banking sector* includes non-EU credit institutions, the *insurance sector* includes non-EU insurance undertakings, and the *investment services sector* includes non-EU investment firms and asset management companies include non-EU asset management companies, *see infra* note 135.

Sectoral rules means the EU legislation relating to the prudential supervision, in particular laid down in (1) the First Non-Life Insurance Directive, (2) the First Life Insurance Directive, (3) the Insurance Group Directive, (4) the Capital Adequacy Directive, (5) the Investment Services Directive, and (6) the Banking Directive. Art. 2(7), Supplementary Supervision Directive.

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Art. 2(4), Supplementary Supervision Directive. For the purpose of the Supplementary Supervision Directive, the following definitions apply:

Credit institution means a credit institution within the meaning of Art. 1(1), second subparagraph, Banking Directive. *Credit institution* means:

- (i) an institution that takes deposits from the public and extends credit for its own account that is authorized by a Member State,
- (ii) an electronic money institution within the meaning of Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, O.J. Eur. Comm. No. L 275/39 (2000), that is authorized by a Member State, and
- (iii) any private or public undertaking that corresponds to the definition of (i) or (ii) above and that has been authorized by a country other than a Member State [*herein* a non-EU credit institution].

Art. 2(1), Supplementary Supervision Directive.

Insurance undertaking means:

- (i) an undertaking within the meaning of Art. 6, First Non-Life Insurance Directive or Art. 6, First Life Insurance Directive, that is, a life insurance company or a non-life insurance company authorized by a Member State, and
- (ii) an undertaking within the meaning of Art. 1(b), Insurance Group Directive; that is, a non-member-country insurance undertaking, *i.e.*, an undertaking that would require authorization under the First Life Insurance Directive or the First Non-Life Insurance Directive if it had its registered office in the EU [*herein* a non-EU insurance undertaking].

Art. 2(2), Supplementary Supervision Directive.

Investment firm means:

- (i) an investment firm within the meaning of Art. 1(2), Investment Services Directive, *i.e.*, any legal person whose regular occupation or business it is to provide any investment service for third parties on a professional basis (investment services are any of the services listed in the Annex A to the Investment Services Directive (brokerage, dealing, portfolio management and underwriting)), and
- (ii) a recognized third-country investment firm referred to in Art. 2(4), Capital Adequacy Directive, *i.e.*, a firm that (x) would be covered by the definition of investment firm in Art. 2(2), Capital Adequacy Directive (this Article refers to Art. 1(2), Investment Services Directive) if it were established within the EU, (y) is authorized in a third

The following table sets forth the entities that are part of the financials sectors:

Diagram 5: Financial Sector Entities

	Banking Sector	Investment Sector	Insurance Sector	Mixed financial holding company
Regulated Entities	credit institution asset management company	investment firm asset management company	life insurance undertaking non-life insurance undertaking asset management company	
Non-Regulated Entities	financial institution (other than an investment firm) ancillary banking service undertaking	financial institution (other than an investment firm)	reinsurance undertaking insurance holding company	mixed financial holding company

country, and (z) is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down in the Capital Adequacy Directive [*herein* non-EU investment firms].

Art. 2(3), Supplementary Supervision Directive.

Asset management companies that are part of a financial conglomerate are also regulated entities. Art. 30, third subparagraph, Supplementary Supervision Directive. *Asset management company* means:

- (i) a management company within the meaning of Art. 1a(2), Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investments in transferable securities (UCITS), O.J. Eur. Comm. No. L 375/3 (1985) [*herein* UCITS Directive], as amended by Council Directive 88/220/EEC of 22 March 1988, O.J. Eur. Comm. No. L 100/31 (1988), by European Parliament and Council Directive 95/26/EC of 29 June 1995, O.J. Eur. Comm. No. L 168/7 (1995), by Directive 2000/64/EC of the European Parliament and of the Council of 7 November 2000, O.J. Eur. Comm. No. L 290/27 (2000), by Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002, O.J. Eur. Comm. No. L 41/20 (2002), and by Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002, O.J. Eur. Comm. No. L 41/35 (2002), and
- (ii) an undertaking the registered office of which is outside the EU and which would require authorization in accordance with Art. 5(1), UCITS Directive if it had its registered office within the EU.

Art. 2(5), Supplementary Supervision Directive.

It is curious that a non-EU investment firm that is subject to less supervision than an EU investment firm is not a *regulated entity* and is disregarded in the determination whether a financial conglomerate exists. See *infra* note 167 for a discussion of such determination.

The definition of *regulated entity* itself does not require that the regulated entity be located in the EU and therefore also includes non-EU entities that would have to be authorized under one of the sectoral Directives if they were located in the EU. However, only regulated entities that have obtained an authorization pursuant to one of the sectoral Directives¹³⁶ are subject to supplementary supervision within the meaning of the Supplementary Supervision Directive.¹³⁷ Such an authorization is only required for undertakings that are located in the EU.¹³⁸ Thus, supplementary supervision only applies to regulated entities that are established and authorized in the EU, except that EU-regulated entities with a parent outside the EU are not subject to supplementary supervision. As further discussed below, if the parent of an EU-regulated entity has its head office in a country outside the EU, the Supplementary Supervision Directive yields in favor of the supervision by the home country of the parent if that supervision is equivalent to the supervision under the Supplementary Supervision Directive. Only if the parent's home country does not have an equivalent supervision, are the EU-regulated entities subject to analogous or appropriate supplementary supervision under the Supplementary Supervision Directive.¹³⁹

It is important to note that the Supplementary Supervision Directive does not replace the existing sole, consolidated or supplementary supervision of the different sectoral groups but introduces a *supplementary* supervision of the regulated entities in a group that straddles more than one financial sector. This supplementary supervision deals with the

¹³⁶ Art. 6, First Non-Life Insurance Directive; Art. 6, First Life Insurance Directive; Art. 3(1), Investment Services Directive; Art. 4, Banking Directive.

¹³⁷ See Arts. 1 & 5(1), Supplementary Supervision Directive. The Supplementary Supervision Directive uses the term *regulated entity* with two meanings: As defined in Art. 2(4), Supplementary Supervision Directive, the term also includes non-EU-authorized entities. See *supra* notes 134 & 135. As used in Art. 1, Supplementary Supervision Directive, the term *regulated entities* only refers to entities which have obtained an authorization under a sectoral Directive. The Supplementary Supervision Directive calls EU-authorized regulated entities *regulated entities referred to in Article 1*. See, e.g., Art. 5(1), Supplementary Supervision Directive. Regulated entities referred to in Article 1 are *herein* sometimes called *EU-regulated entities* and regulated entities that are not EU-regulated entities are *herein* sometimes called *non-EU-regulated entities*.

¹³⁸ Art. 6, First Non-Life Insurance Directive and Art. 6, First Life Insurance Directive require an authorization of insurance undertakings having established their head office within the territory of a Member State. Art. 3(1) in connection with Art. 1(6), Investment Services Directive states that only investment firms having their registered office or head office in a Member State are subject to authorization. Although Art. 4, Banking Directive provides for the authorization of credit institutions prior to commencement of activities in a Member State without expressly referring to the head office or registered office of that credit institution, it is clear from the context of the Banking Directive and Arts. 23-25, Banking Directive (governing relations with third countries) that only credit institutions established under the laws of a Member State are subject to authorization pursuant to Art. 4, Banking Directive.

¹³⁹ See *infra* C.IV. If a financial conglomerate is headed by a non-EU entity (a regulated entity or a mixed financial holding company), the EU-regulated entities are subject to analogous or appropriate supplementary supervision according to Arts. 5(3) & 18(2) & (3), Supplementary Supervision Directive if the parent is not subject to supervision that is equivalent to that provided by the Supplementary Supervision Directive. When Arts. 5(3) & 18(1), Supplementary Supervision Directive speak about "a regulated entity ... having its head office outside the Community", they refer to credit institutions, investment firms and insurance companies authorized by a state that is not a Member State.

relationship among the EU-regulated entities within the group and of EU-regulated entities with other entities in the group. Furthermore, supplemental supervision does not lead to supervision of unregulated entities within a group *on a stand-alone basis*.¹⁴⁰ However, certain entities in a financial conglomerate that are not EU-regulated entities are subject to supervision in their relations with the EU-regulated entities, for instance, in the computation of capital adequacy at the level of the financial conglomerate¹⁴¹ or in the evaluation of intra-group transactions.¹⁴²

2. *Financial Conglomerates*

The Supplementary Supervision Directive applies to certain EU-regulated entities (credit institutions, insurance undertakings and investment firms) that have obtained an authorization pursuant to one of the sectoral Directives.¹⁴³ If such entities are part of a *financial conglomerate*, they may be subject to *supplementary* prudential supervision.¹⁴⁴ In order to determine whether a regulated entity is subject to supplementary supervision, three inquiries must be made: first, whether the regulated entity is part of a *group*; second, whether the group meets the requirements of a *financial conglomerate*; and third, whether the regulated entity is one that is the addressee of supplementary supervision.¹⁴⁵

a) *Definition of Group*

The Supplementary Supervision Directive defines a *financial conglomerate* as a *group* of undertakings meeting certain conditions.¹⁴⁶ A *group* is determined (a) by a parent-subsidiary relationship, (b) by a relationship based on a participation, or (c) by a horizontal structure.¹⁴⁷

A *subsidiary* or *subsidiary undertaking*¹⁴⁸ is, in summary, an undertaking (1) in which a parent (a) has, or controls alone, pursuant to a shareholder agreement, a majority of the shareholders' or members' voting rights, or (b) has the right to appoint or remove a majority of

¹⁴⁰ Art. 5(5), Supplementary Supervision Directive. Art. 5(5), Supplementary Supervision Directive states that the exercise of supplementary supervision at the level of the financial conglomerate shall in no way imply that the competent authorities are required to play a supervisory role in relation to mixed financial holding companies, non-EU-regulated entities or unregulated entities in a financial conglomerate, on a standalone basis.

¹⁴¹ See *infra* C.III.1.

¹⁴² See *infra* C.III.2.

¹⁴³ Art. 5(1), Supplementary Supervision Directive. For the relevant sectoral Directives, see *supra* note 134.

¹⁴⁴ Art. 1, Supplementary Supervision Directive.

¹⁴⁵ See *infra* C.II.3. for a discussion of the third point.

¹⁴⁶ Art. 2(14), Supplementary Supervision Directive.

¹⁴⁷ Art. 2(12), Supplementary Supervision Directive.

¹⁴⁸ *Subsidiary undertaking* and *parent undertaking* are defined in Art. 2(9) & (10), Supplementary Supervision Directive by reference to Art. 1, Consolidated Accounts Directive.

the administrative, management or supervisory board and is at the same time a shareholder or a member, or (2) that can be controlled by the parent (the parent “has the right to exercise a dominant influence”) pursuant to a contract between the parent and the subsidiary or a provision in the subsidiary’s charter, the parent at the same time being a shareholder or a member.¹⁴⁹ Furthermore, a Member State may consider an undertaking as a *parent undertaking* if it has the power to exercise, or actually exercises, a dominant influence or control over another undertaking (a subsidiary) or manages another undertaking (a subsidiary) and the parent on a unified basis.¹⁵⁰ The definition of *parent undertaking* and *subsidiary undertaking* is based on the requirement to prepare consolidated accounts.¹⁵¹ However, the definitions go beyond the group of companies required to prepare consolidated accounts, because a parent-subsidiary relationship also exists if, in the opinion of the competent authorities, the parent undertaking effectively exercises a dominant influence over another undertaking.¹⁵² The group includes direct and indirect subsidiaries of a parent.¹⁵³

A group also includes all entities in which the parent or a subsidiary thereof holds a *participation*.¹⁵⁴ A *participation* is (1) a right in the capital of other undertakings which “by creating a durable link with those [other] undertakings, are intended to contribute to the

¹⁴⁹ See Art. 1(1), Consolidated Accounts Directive referred to in Art. 2(9) & (10), Supplementary Supervision Directive. The Member States have some discretion to modify the parent-subsidiary definition based on dominant influence, Art. 1(1)(c), Consolidated Accounts Directive. See *supra* note 11.

¹⁵⁰ Art. 1(2), Consolidated Accounts Directive referred to in Art. 2(9) & (10), Supplementary Supervision Directive. Note that the term *subsidiary* for purposes of consolidated supervision does not include *subsidiaries* pursuant to Art. 1(2), Consolidated Accounts Directive. See *supra* note 11.

Art. 1(2), Consolidated Accounts Directive was amended in 2003 by Art. 2(1), Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003, OJ. Eur. Comm. L 178/16 (2003). Before that amendment, Art. 1(2), Consolidated Accounts Directive referred to Art. 17, Annual Accounts Directive, which defines *participating interest*. Pursuant to Art. 17, second sentence, Annual Accounts Directive, a lower percentage than 20 percent of equity ownership could constitute a participation if the Member State requires consolidation under certain conditions in the case of a participating interest of less than 20 percent. Art. 17, second sentence, Annual Accounts Directive is excluded from the definition of *participation* in the Banking Directive and in the Supplementary Supervision Directive, see *supra* note 15 and *infra* notes 155 & 156, but prior to the above amendment of Art. 1(2), Consolidated Accounts Directive was not excluded from Art. 2(9) & (10), Supplementary Supervision Directive (definition of *parent undertaking* and *subsidiary undertaking*) in connection with Art 1(2), Consolidated Accounts Directive referring to Art. 17, Annual Accounts Directive.

¹⁵¹ See *supra* note 148.

¹⁵² Art. 2(9) (an undertaking is a *parent undertaking* if it “in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking”) & (10) (corresponding language for *subsidiary undertaking*), Supplementary Supervision Directive. See *supra* note 12 for the same test for the determination of *subsidiary* for consolidated supervision.

¹⁵³ Art. 2(10), Supplementary Supervision Directive (“all subsidiary undertakings of subsidiary undertakings shall also be considered as subsidiary undertakings of the parent undertaking”).

¹⁵⁴ Art. 2(12), Supplementary Supervision Directive.

company's [the holder of the participation] activities",¹⁵⁵ or (2) the ownership, directly or indirectly, of 20 percent or more of the voting rights or capital of another undertaking.¹⁵⁶ The Supplementary Supervision Directive abolishes the presumption of the Annual Accounts Directive that the holding of 20 percent of the capital of another undertaking constituted a participation; the direct or indirect ownership of 20 percent or more of the voting rights or capital of an undertaking constitutes a participation in any case.¹⁵⁷

Lastly, a *group* exists if undertakings are linked to each other in a *horizontal* structure. Such horizontal group exists if undertakings that have no equity relationship are (1) managed on a unified basis pursuant to a contract between those undertakings or provisions in the charters of those undertakings or (2) if the administrative, management or supervisory bodies of those undertakings consist for the major part of the same persons in office during the financial year.¹⁵⁸ The U.S. bank regulatory practice would describe the horizontal group as a case of control without equity investment.¹⁵⁹

A U.S. observer would say that a *group* in the meaning of the Supplementary Supervision Directive is determined by concepts very similar to the U.S. Bank Holding

¹⁵⁵ Art. 2(11), Supplementary Supervision Directive referring to Art. 17, first sentence, Annual Accounts Directive.

¹⁵⁶ Art. 2(11), Supplementary Supervision Directive. *Participation* for purposes of consolidated supervision was defined differently in the Banking Directive but the Supplementary Supervision Directive amended the Banking Directive in order to conform the definitions of *participation*. See *supra* notes 15 & 88. Although for purposes of easier presentation, a *participation* is frequently referred to herein as 20 percent equity holding, a lower percentage of equity ownership could constitute a participation if a durable link and the requisite intention to contribute to the participation holder's activities exist.

¹⁵⁷ The presumption is contained in Art. 17, second sentence, Annual Accounts Directive. The Member States can reduce the 20 percent threshold. *Id.* Art. 2(11), Supplementary Supervision Directive does not refer to Art. 17, second sentence, Annual Accounts Directive, but defines *participation* as ownership of at least 20 percent of the voting rights or capital of an undertaking. Thus, a Member State cannot reduce the 20 percent threshold of a participation. However, a lesser percentage can still result in a participation as set forth *supra* note 156.

¹⁵⁸ Art. 2(12), Supplementary Supervision Directive referring to Art. 12(1), Consolidated Accounts Directive. Art. 12(1), Consolidated Accounts Directive gives Member States discretion whether or not to require horizontal groups to prepare consolidated financials statements. Art. 2(12), Supplementary Supervision Directive refers only to the description of horizontal groups in Art. 12(1), Consolidated Accounts Directive, not to the discretion of the Member States. Thus, Member States do not have discretion whether or not to have horizontal groups as financial conglomerates.

The Proposed Supplementary Supervision Directive defined a *group* as two or more natural or legal persons between whom there are *close links*. See Art. 2(11), Proposed Supplementary Supervision Directive. By eliminating the *close link* requirement from the definition of *group*, the Directive responds to a major criticism of the Proposed Supplementary Supervision Directive. See Gruson, *Supplementary Supervision*, *supra* note 120, at 1237–38, 1255. The concept of *close link* is still used to define *intra-group transactions*, Art. 2(18), Supplementary Supervision Directive. See *infra* 292.

¹⁵⁹ See Gruson & Reisner, *supra* note 9, § 9.03[2][a] & note 153 and accompanying text.

Company Act's concept of *control* which determines whether a parent-subsidary relationship exists.¹⁶⁰

b) Definition of Financial Conglomerate

A *group* constitutes a *financial conglomerate* if it meets certain conditions.¹⁶¹ For purposes of determining a *financial conglomerate* the Supplementary Supervision Directive distinguishes between groups that are headed by an EU- regulated entity and groups that are not.¹⁶²

If the *group* is headed by an EU- regulated entity,¹⁶³ the *group* qualifies as a *financial conglomerate* if it meets the following requirements:¹⁶⁴

(a) such EU-regulated entity is either a parent of an entity in a financial sector, an entity that holds a participation in an entity in a financial sector, or an entity that is linked with another entity in a financial sector by way of a horizontal group,¹⁶⁵

(b) the group must straddle financial sectors: at least one of the entities (parent or subsidiary) in the *group* is within the insurance sector and at least one is within

¹⁶⁰ Section 2, BHCA, 12 U.S.C § 1841 (2000). See Gruson & Reisner, *supra* note 9, § 9.03.

¹⁶¹ Art. 2(14), Supplementary Supervision Directive.

¹⁶² Art. 2(14), Supplementary Supervision Directive. For a discussion of *regulated entities*, see *supra* notes 135–139 and accompanying text.

¹⁶³ Art. 2(14)(a), Supplementary Supervision Directive refers to a *regulated entity within the meaning of Article 1*. This means that the head of the group must be an insurance undertaking, a credit institution or an investment firm, each of which has obtained an authorization pursuant to the relevant sectoral Directive, *i.e.*, it must be an EU-regulated entity. See *supra* notes 135–139 and accompanying text.

¹⁶⁴ Art. 2(14)(a), (b), (d) & (e), Supplementary Supervision Directive.

¹⁶⁵ Art. 2(14)(b), Supplementary Supervision Directive. As to the definition of *horizontal group*, see *supra* note 158 and accompanying text.

The entity in the insurance sector need not be a regulated insurance undertaking, it could also be a reinsurance undertaking as defined in Art. 2(6), Supplementary Supervision Directive by reference to Art. 1(c), Insurance Group Directive, or an insurance holding company as defined in Art. 1(i), Insurance Group Directive. Art. 2(8)(b), Supplementary Supervision Directive. The entity in the banking sector may be a credit institution as defined in Art. 2(1), Supplementary Supervision Directive by reference to Art. 1(1), second subparagraph, Banking Directive, a financial institution as defined in Art. 1(5), Banking Directive or an ancillary banking services undertaking as defined in Art. 1(23), Banking Directive. Art. 2(8)(a), Supplementary Supervision Directive. The entity in the investment services sector may be an investment firm as defined in Art. 2(3), Supplementary Supervision Directive by reference to Art. 1(2), Investment Services Directive and Art. 2(4) Capital Adequacy Directive, or a financial institution as defined in Art. 2(7), Capital Adequacy Directive by reference to Art. 1(5), Banking Directive. Art. 2(8)(c), Supplementary Supervision Directive.

The terms insurance undertaking, credit institution and investment firm include such institutions authorized in or outside the EU. See *supra* note 135.

the banking or investment services sector, whereby the entity that is a subsidiary may be in or outside the EU,¹⁶⁶ and

(c) the consolidated and/or aggregated activities of the entities within the insurance sector and the consolidated and/or aggregated activities of the entities in the banking and investment services sector are both *significant*.¹⁶⁷

If the *group* is not headed by an EU-regulated entity, it could be headed by a mixed financial holding company or by a non-EU-regulated entity or it could not be headed by anyone (horizontal group). Such *group* not headed by an EU-regulated entity qualifies as a *financial conglomerate* if it meets the following requirements:¹⁶⁸

¹⁶⁶ Art. 2(14)(d), Supplementary Supervision Directive. The terms insurance undertaking, credit institution and investment firm include such institutions authorized in or outside the EU. *See supra* note 135.

¹⁶⁷ Art. 2(14)(e), Supplementary Supervision Directive. The significance of the activities of those entities may either be measured by looking at the financial sector entities in the financial sector in question as compared to all financial sector entities in the group, Art. 3(2), Supplementary Supervision Directive, or by looking at the balance sheet total of the smallest financial sector in the group, Art. 3(3), Supplementary Supervision Directive.

For the purpose of determining whether the activities in a financial sector are *significant*, the average of (i) the ratio of the balance sheet total of that financial sector to the balance sheet total of the financial sector entities in the group and (ii) the ratio of the solvency requirements of the same financial sector to the total solvency requirements of the financial sector entities in the group, must exceed 10 percent. Art. 3(2) first subparagraph, Supplementary Supervision Directive. For the purposes of calculating the average, the banking sector and the investment services sector shall be considered together. *Id.*, second subparagraph.

Activities are also presumed to be *significant* if the balance sheet total of the smallest financial sector in the group exceeds €6 billion. Art. 3(3), Supplementary Supervision Directive. The smallest financial sector in a financial conglomerate is the sector with the smallest average of the two ratios set forth in Art. 3(2), first subparagraph, Supplementary Supervision Directive. For the measurement of the smallest financial sector, the banking sector and the investment services sector shall be considered together. *Id.* However, if the *group* that reaches the €6 billion threshold does not reach the 10 percent threshold referred to in Art. 3(2), Supplementary Supervision Directive, the relevant competent authorities may agree not to regard the *group* as a *financial conglomerate* or not to apply Art. 7, 8 or 9, Supplementary Supervision Directive if the competent authorities are of the opinion that the inclusion of the groups in the scope of the Supplementary Supervision Directive or the application of such provisions is not necessary or would be inappropriate or misleading. Art. 3(3), Supplementary Supervision Directive. Art. 3(3), Supplementary Supervision Directive does not clearly state that the possible exclusion for groups that do not reach the 10 percent threshold applies only to those groups that met the €6 billion threshold, but any other reading would make no sense.

The significance test intends to distinguish between homogenous groups and financial conglomerates. The Supplementary Supervision Directive intends only to cover the latter groups. The former are covered by the existing sectoral Directives on a group-wide basis. *See* 2001 Explanatory Memorandum, *supra* note 122, at 5, *sub* 2, arts. 2, 3.

¹⁶⁸ Art. 2(14)(a), (c), (d) & (e), Supplementary Supervision Directive.

- (a) at least one of the subsidiaries in the *group* is an EU-regulated entity,¹⁶⁹
- (b) the *group* must straddle financial sectors: at least one of the entities (subsidiaries) in the *group* is within the insurance sector and at least one is within the banking or investment services sector whereby such entities may be in or outside the EU (except that, as stated under (a) above, one entity in the group must be an EU-regulated entity),¹⁷⁰
- (c) the *group's* activities *mainly* occur in the financial sector¹⁷¹ (*i.e.*, the financial sector entities represent at least 40 percent of the group),¹⁷² and
- (d) the consolidated and/or aggregated activities of the entities within the insurance sector and the consolidated and/or aggregated activities of the entities in the banking and investment services sector are both *significant*.¹⁷³

The Supplementary Supervision Directive introduces and defines the term *mixed financial holding company*¹⁷⁴ to cover financial conglomerates headed by a non-regulated entity

¹⁶⁹ Art. 2(14)(a), Supplementary Supervision Directive refers to a subsidiary that is a *regulated entity within the meaning of Art. 1*, Supplementary Supervision Directive. This means that at least one member of the group must be a credit institution, insurance undertaking or investment firm that has obtained its authorization pursuant to one of the sectoral Directives, *i.e.*, it must be an EU-regulated entity. *See supra* notes 135–139 and accompanying text. The requirement that an EU-regulated entity be a subsidiary does not fit the definition of horizontal group. Presumably one of the members of the horizontal group must be an EU-regulated entity.

¹⁷⁰ Art. 2(14)(d), Supplementary Supervision Directive. *See supra* note 166 and accompanying text.

¹⁷¹ Art. 2(14)(c), Supplementary Supervision Directive.

¹⁷² For the purpose of determining whether the activities of a group *mainly* occur in the financial sector, the ratio of the balance sheet total of the regulated and nonregulated financial sector entities in the group to the balance sheet total of the group as a whole must exceed 40 percent. Art. 2(14)(c) in connection with Art. 3(1), Supplementary Supervision Directive. This test intends to distinguish between financial and non-financial groups. *See* 2001 Explanatory Memorandum, *supra* note 122, at 5, *sub* 2, Arts. 2, 3. *Financial sector entities* is not defined. It must mean the entities of which a financial sector is composed of, *see* Art. 2(8), Supplementary Supervision Directive, *i.e.*, credit institutions, financial institutions, ancillary banking service undertakings, investment firms, insurance undertakings, reinsurance undertakings, insurance holding companies, mixed financial holding companies, and asset management companies. *See supra* notes 134 & 135 and *infra* note 174 and accompanying text. *See supra* diagram 5 setting forth the financial sector entities. Asset management companies that are part of a financial conglomerate are also financial sector entities. Art. 30, third subparagraph, Supplementary Supervision Directive. Art. 3(1), Supplementary Supervision Directive does not require that the regulated entities be EU-regulated entities. Nonregulated financial sector entities that are included in the 40 percent computation are financial institutions other than investment firms, ancillary banking service undertakings, reinsurance undertakings, insurance holding companies and mixed financial holding companies. *See supra* note 134. These entities are the entities that are part of the *financial sector*, Art. 2(8), Supplementary Supervision Directive, but not *regulated entities*, Art. 2(4), Supplementary Supervision Directive.

¹⁷³ Art. 2(14)(d), Supplementary Supervision Directive. For a discussion of the significance test, *see supra* note 167.

¹⁷⁴ *Mixed financial holding company* is a parent undertaking, other than a regulated entity (EU-regulated or non-EU-regulated), which, together with its subsidiaries, of which at least one is an EU-regulated entity,

holding company. In fact, every non-regulated entity head of a financial conglomerate by definition is a mixed financial holding company.¹⁷⁵ The Supplementary Supervision Directive could have called such entities “non-regulated entity holding companies”. The mixed financial holding company could be a non-regulated financial sector entity,¹⁷⁶ such as a financial institution¹⁷⁷ (a mere holding company without its own activities would likely be a financial institution)¹⁷⁸ or a reinsurance undertaking,¹⁷⁹ or it could be a commercial or industrial company. The definitions of *financial conglomerate* and *mixed financial holding company* do not require that the head of the financial conglomerate or the mixed financial holding company must be established or have its head office in the EU. However, if the financial conglomerate is headed by a regulated entity, it is subject to supplementary supervision only if the regulated entity is an EU-regulated entity.¹⁸⁰ If a financial conglomerate headed by a mixed financial holding company is to be covered by supplementary supervision, the mixed financial holding company

and other entities, constitutes a financial conglomerate. Art. 2(15), Supplementary Supervision Directive. Art. 2(15), Supplementary Supervision Directive does not refer to a *regulated entity referred to in Article 1*, but to a *regulated entity which has its head office in the Community*, which presumably means the same.

¹⁷⁵ Compare Art. 2(15) with Art. 5(2)(b), Supplementary Supervision Directive. If the head of a financial conglomerate is a non-EU-regulated entity, it is not a mixed financial holding company. See Art. 5(3), Supplementary Supervision Directive.

Note that the Tripartite Report, *supra* note 124, at 36, *sub* no. 97, defines *mixed conglomerates* quite differently as those groups which are predominantly commercially or industrially oriented, but contain at least one regulated financial entity (which is more than merely a “captive” entity doing business only on behalf of the group) in some part of their corporate structure. Typically, mixed conglomerates would be headed by a commercial or industrial company (or by an unregulated non-financial holding company) with the regulated entities embedded downstream in the group structure. The Supplementary Supervision Directive covers such mixed conglomerates only if the conglomerate’s activities in the financial sector represent at least 40 percent of the conglomerate’s balance sheet, *see supra* note 172. See Tripartite Report at 36–38, *sub* nos. 97–103.

¹⁷⁶ See *supra* note 172.

¹⁷⁷ See *supra* notes 8, 134 & 172. The term *financial holding company* refers only to the banking sector and the investment services sector. See *supra* note 9. A financial institution that is an investment firm could not be a mixed financial holding company because it is a regulated entity.

¹⁷⁸ See *supra* note 8 (a financial institution is an undertaking, the principal activity of which is to acquire holdings). The typical bank holding company under the BHCA would be a financial institution, *see supra* note 9.

¹⁷⁹ See *supra* notes 134 & 172.

¹⁸⁰ See Art. 2(14) in connection with Art. 5(2), Supplementary Supervision Directive. Art. 5(2)(a), Supplementary Supervision Directive refers to regulated entities in Art. 5(1), Supplementary Supervision Directive which covers only EU-authorized regulated entities (regulated entities referred to in Art. 1, Supplementary Supervision Directive). Thus, Art. 5(2)(a), Supplementary Supervision Directive does not refer to non-EU-regulated entities. The term *regulated entity* as defined in Art. 2(4) by reference to Art. 2(1), (2) & (3), Supplementary Supervision Directive covers EU-regulated and non-EU-regulated entities. See *supra* note 135.

must be located in the EU.¹⁸¹ A financial conglomerate headed by a non-EU-regulated entity and a financial conglomerate headed by a mixed financial holding company having its head office outside the EU are still financial conglomerates but the regulated entities in those financial conglomerates are not subject to supplementary supervision; they may, however, be subject to equivalent supplementary supervision by the home country of the non-EU-regulated entity or the mixed financial holding company or to analogous or appropriate supplementary supervision by a Member State under the Supplementary Supervision Directive.¹⁸²

A group that is not headed by an EU-regulated entity only qualifies as a *financial conglomerate* if the group's activities *mainly* occur in the financial sector (*i.e.*, based on the balance sheets, the financial sector entities must represent at least 40 percent of the group).¹⁸³ On the other hand, a group that is headed by an EU-regulated entity qualifies as a *financial conglomerate* even though its activities do not mainly occur in the financial sector. In both cases (financial conglomerate headed by an EU-regulated entity and financial conglomerate not so headed), the activities of the entities in the insurance sector and the activities of the entities in the banking and investment services sector must be *significant* (*i.e.*, based on balance sheets and solvency ratio requirements, each financial sector must represent at least 10 percent of the group or the balance sheets of the smallest sector in the group must exceed €6 billion).¹⁸⁴ Once a financial conglomerate is subject to supplementary supervision, this supervision extends to entities outside the EU.¹⁸⁵

The competent authorities of the EU Member States¹⁸⁶ may by agreement exclude an entity when determining whether the activities of a group *mainly* occur in the financial sector or when determining the *significance* of the insurance sector and of the banking/investment services sector. An entity may be excluded from the calculation of ratios (1) if the entity is situated in a third country where there are legal impediments to the transfer of the necessary information or (2) if – with respect to the objectives of the supplementary supervision – the entity is of negligible interest or its inclusion would be inappropriate or misleading.¹⁸⁷ The competent authorities also may by agreement in exceptional cases, replace the criterion based on

¹⁸¹ See Art. 5(2)(b), Supplementary Supervision Directive. Art. 2(15) (definition of mixed financial holding company) requires that a mixed financial holding company must have at least one regulated entity subsidiary which has its head office in the EU. See *supra* notes 174–180 and accompanying text.

¹⁸² See Arts. 5(3) & 18, Supplementary Supervision Directive. See *infra* C.IV. The Supplementary Supervision Directive does not address the case of a horizontal group of which one member has its head office outside the EU.

¹⁸³ See *supra* note 171 & 172.

¹⁸⁴ See *supra* note 167 & 173.

¹⁸⁵ See text accompanying *infra* notes 220–227.

¹⁸⁶ Art. 2(16), Supplementary Supervision Directive defines *competent authorities* as the national authorities of the Member States which are empowered by law or regulation to supervise credit institutions, and/or insurance undertakings and/or investment firms. Thus, the Supplementary Supervision Directive does not introduce a new authority but provides cooperation between the existing national supervisory authorities.

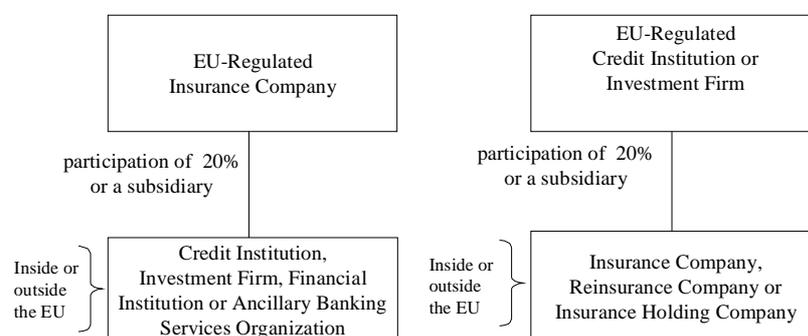
¹⁸⁷ Art. 3(4)(a) in connection with Art. 6(5), Supplementary Supervision Directive.

balance sheet total¹⁸⁸ with the criterion of income structure or off-balance sheet activities or both or add the criterion of income structure or off-balance sheet activities or both to the criterion based on balance sheet total, if the competent authorities are of the opinion that these parameters are of particular relevance.¹⁸⁹ Other provisions of the Supplementary Supervision Directive give the competent authorities discretion to lower certain thresholds for identifying a financial conglomerate or to disregard compliance with thresholds in order to avoid sudden regime shifts, *i.e.*, sudden inclusion under or exclusion from supplementary supervision.¹⁹⁰

Diagram 6. Financial Conglomerates

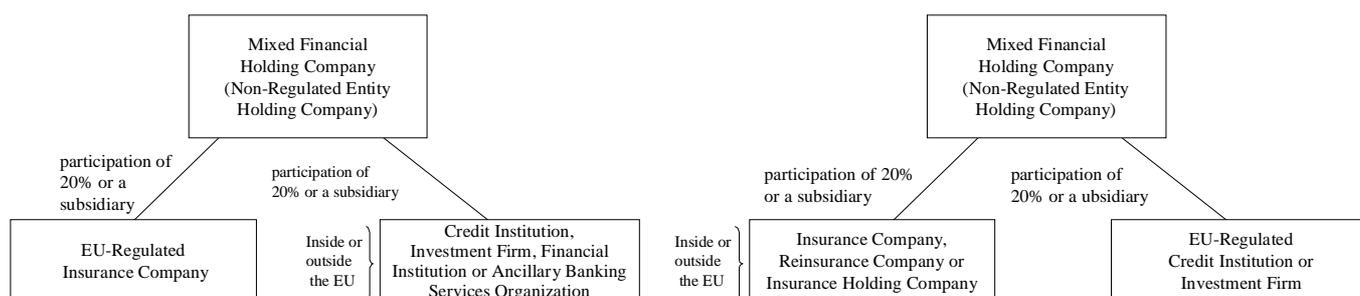
Financial Conglomerates Subject to Supplementary Supervision

(a) Group headed by an EU-Regulated Entity



- *Banking plus investment services sector and insurance sector must each be significant.*

(b) Group headed by a Mixed Financial Holding Company with EU Head Office



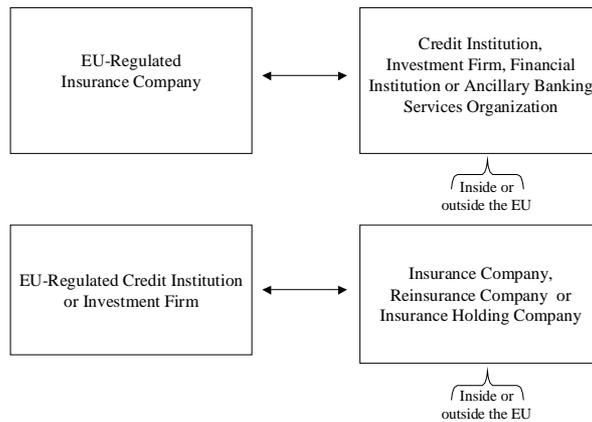
¹⁸⁸ See Art. 3(1) (determination whether activities of a group mainly occur in the financial sector) & 3(2) (determination whether activities in different financial sectors are significant), Supplementary Supervision Directive.

¹⁸⁹ Art. 3(5), Supplementary Supervision Directive.

¹⁹⁰ See Art. 3(4)(b) & (6), Supplementary Supervision Directive.

- *Banking plus investment services sector and insurance sector must each be significant.*
- *Group must be mainly engaged in the financial sector.*

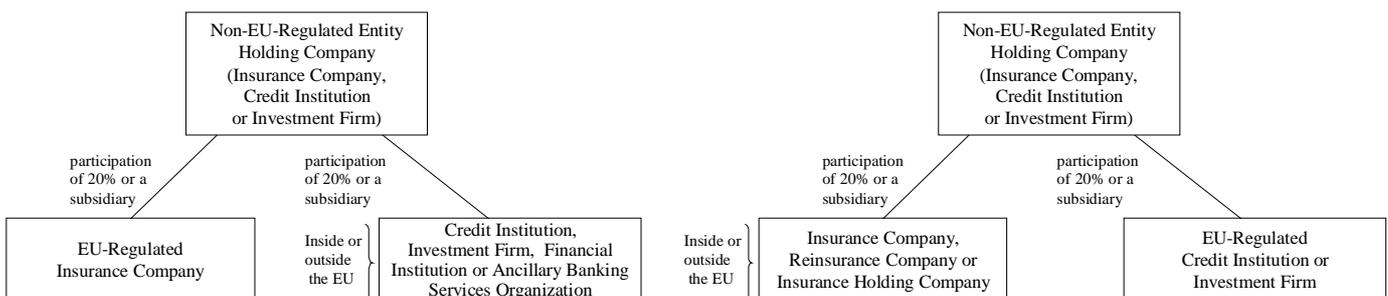
(c) Horizontal Financial Conglomerate



- *Banking plus investment services sector and insurance sector must each be significant.*
- *Group must be mainly engaged in the financial sector.*

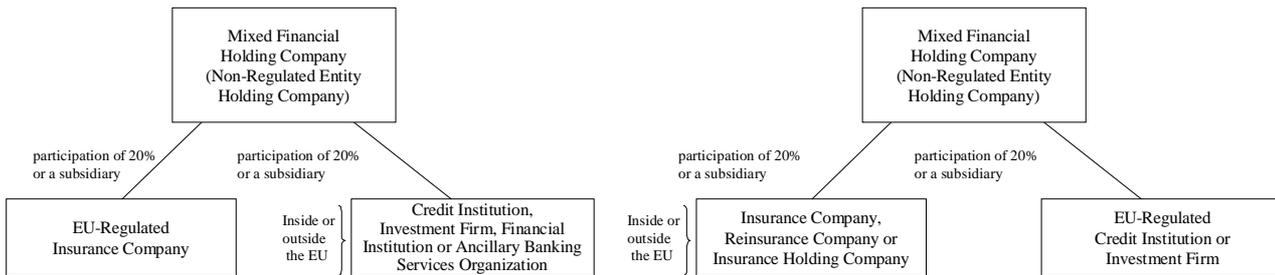
Financial Conglomerates Subject to Equivalent, Analogous or Appropriate Supplementary Supervision

(d) Group headed by a Non-EU-Regulated Entity



- *Banking plus investment services sector and insurance sector must each be significant.*
- *Group must be mainly engaged in the financial sector.*

(e) **Group headed by Mixed Financial Holding Company with Non-EU Head Office**



- *Banking plus investment services sector and insurance sector must each be significant.*
- *Group must be mainly engaged in the financial sector.*

From the U.S. perspective, it is surprising that conglomerates that are headed by a mixed financial holding company are subject to supplementary supervision only if the group is *mainly* engaged in the financial sector, *i.e.*, banking, insurance or investment services, and that in all financial conglomerates the banking sector and the insurance sector must be *significant*. If it is the purpose of the Supplementary Supervision Directive to protect regulated entities, the relative size of such regulated entities should not be a relevant factor. However, the Supplementary Supervision Directive goes further than the rules on consolidated supervision. The rules on consolidated supervision require consolidated supervision for credit institutions in which another credit institution holds a participation or that are subsidiaries of another credit institution or of a financial holding company, *i.e.*, a company the subsidiaries of which are exclusively or mainly credit institutions or financial institutions and that has at least one credit institution subsidiary.¹⁹¹ Consolidated supervision does not extend to a group headed by a *mixed-activity holding company*, which is defined as a parent other than a financial holding company, a credit institution or a mixed financial holding company, whose subsidiaries include at least one credit institution.¹⁹² Thus, neither the proverbial steel company that acquires a bank nor the acquired bank is subject to consolidated supervision under EU law because the steel company is not a financial holding company.¹⁹³

However, if the steel company is located in the EU and acquires a bank and an insurance company, and their combined balance sheet total of both amounts to 40 percent of the balance sheet total of the group, the steel company would be a *mixed financial holding company*¹⁹⁴ heading a financial conglomerate and the financial conglomerate would be subject to supplementary supervision under the Supplementary Supervision Directive. A holding company

¹⁹¹ Art. 52(1) & (2), Banking Directive. *See supra* A.II.

¹⁹² Art. 1(22), Banking Directive. *See supra* A.III.3.

¹⁹³ *See supra* note 9.

¹⁹⁴ *See supra* note 174.

without its *own* business activities whose principal activity consists of acquiring holdings in industrial and financial companies is a financial institution¹⁹⁵ and if the subsidiaries of such financial institution *mainly* consist of credit institutions or financial institutions,¹⁹⁶ it is a financial holding company and the group headed by it is subject to consolidated supervision.¹⁹⁷ If the subsidiaries do not *mainly* consist of credit or financial institutions, it is not a financial holding company subject to consolidated supervision. If the above holding company holds a credit institution and an insurance company, one of which is a subsidiary, and both of which are significant *and* if the group's activities *mainly* (based on the 40 percent test) consist of financial sector activities, it is a mixed financial holding company that heads a financial conglomerate subject to supplementary supervision. If its activities do not consist mainly of financial sector activities, it is neither subject to consolidated nor to supplementary supervision.¹⁹⁸

c) *Discretionary Expansion of Financial Conglomerate*

The Supplementary Supervision Directive gives the competent authorities discretion to apply supplementary supervision to groups that do not meet the definition of *financial conglomerate* or even the definition of *group*. The Supplementary Supervision Directive provides:¹⁹⁹

Where persons hold participations or capital ties in one or more regulated entities or exercise significant influence over such entities without holding a participation or capital ties, [although the conditions of Art. 5(2) or (3), Supplementary Supervision Directive are not met,] the relevant competent authorities shall, by common agreement and in conformity with national law, determine whether and to what extent supplementary supervision of the regulated entities is to be carried out, as if they constitute a financial conglomerate.²⁰⁰

¹⁹⁵ Art. 1(5), Banking Directive. *See supra* note 8. The holding company is not a regulated entity, *see* Art. 2(4), Supplementary Supervision Directive.

¹⁹⁶ *See supra* A.II.

¹⁹⁷ *See supra* A.II.

¹⁹⁸ It must be noted, however, that the “mainly” test for purposes of the definition of a financial holding company, differs from the “mainly” test for purposes of the definition of a mixed financial holding company: a financial holding company must exclusively or mainly hold credit institution or financial institution subsidiaries, *see supra* note 9, whereas a group headed by a mixed financial holding company must mainly be engaged in the financial sector based on the 40 percent test, *see supra* note 172.

¹⁹⁹ Art. 5(4), Supplementary Supervision Directive.

²⁰⁰ The 2001 Explanatory Memorandum, *supra* note 122, at 6, *sub* 2, Art. 4, states:

As some groups are not covered by the definitions under Art. 2, but do have financial entities with substantial activities in the financial markets the supervision of which would respond to the objectives of the Directive, the Directive introduces a basis for competent authorities to submit also these special group structures to supplementary supervision, on the condition that well defined conditions are met.

In other words, the competent authorities may exercise supplementary supervision over regulated entities that are controlled by another entity or in which another entity has a capital investment, even though the relationship does not qualify as a group or as a financial conglomerate. Regulated entities in such quasi financial conglomerates (“as if they constituted a financial conglomerate”) are, in the discretion of the relevant competent authorities, subject to supplementary supervision if (1) at least one of the regulated entities is an EU-regulated entity,²⁰¹ (2) at least one of the entities in the quasi financial conglomerate is within the insurance sector and at least one is within the banking or investment services sector,²⁰² and (3) the consolidated and/or aggregated activities of the entities in the quasi financial conglomerate within the insurance sector and the consolidated and/or aggregated activities of the entities within the banking and investment services sector are each significant.²⁰³

d) *Determination of Financial Conglomerate*

The Supplementary Supervision Directive does not impose on financial conglomerates a duty to report to or file with any supervisory authority the fact that they are financial conglomerates. The competent authorities themselves must make that determination. Competent authorities that have authorized regulated entities must identify any group that is a

The scope of Art. 5(4), Supplementary Supervision Directive is not clear:

(a) It seems that *person* in Art. 5(4), Supplementary Supervision Directive refers to legal entities as well as to natural persons.

(b) The relationship between the person and the regulated entity may be based solely on influence over such entities. Whereas a parent-subsidiary relationship requires a *dominant* influence, *see supra* notes 11 & 149 and accompanying text, Art. 5(4), Supplementary Supervision Directive permits a *significant* influence without defining that term. (Art. 3(2) & (3), Supplementary Supervision Directive refers to significant activities, not to significant influence.) Pursuant to Art. 5(4), Supplementary Supervision Directive, a significant influence without capital ties is sufficient, whereas a parent-subsidiary relationship based on equity requires at least a participation. *See supra* notes 154–157. However, Member States are permitted to define the parent-subsidiary relationship as a relationship based on dominant influence even in the absence of an equity relationship, *see supra* note 11.

(c) The relationship between the person and the regulated entity may be based on participations or capital ties in the regulated entity. Whereas, presumably, under Art. 5(4), Supplementary Supervision Directive any capital ties below the level of a participation are sufficient, a parent-subsidiary relationship based on equity requires at least a participation.

(d) The conditions for the existence of a financial conglomerate set forth in Art. 2(14)(c), Supplementary Supervision Directive (the group activities must mainly occur in the financial sector), *see supra* notes 171 & 172, are not requirements under Art. 5(4), Supplementary Supervision Directive.

²⁰¹ Art. 5(4), second paragraph, Supplementary Supervision Directive. *See* the identical requirement in Art. 2(14)(a), Supplementary Supervision Directive.

²⁰² Art. 5(4), second subparagraph, referring to Art. 2(14)(d), Supplementary Supervision Directive.

²⁰³ Art. 5(4), second subparagraph, referring to Art. 2(14)(e), Supplementary Supervision Directive. *See also* Art. 5(3), Supplementary Supervision Directive which provides for analogous or appropriate application of the Supplementary Supervision Directive headed by a non-EU parent. *See infra* C.IV. for a discussion of Art. 5(3), Supplementary Supervision Directive.

financial conglomerate.²⁰⁴ If a competent authority is of the opinion that a regulated entity authorized by it is a member of a group that may be a financial conglomerate, which has not already been identified according to the Supplementary Supervision Directive, the competent authority shall communicate its view to the other competent authorities concerned.²⁰⁵ The coordinator²⁰⁶ shall inform the parent of the group (or in the absence of a parent, the regulated entity with the largest balance sheet total in the most important financial sector in a group) that the group has been identified as a financial conglomerate and of the appointment of the coordinator.²⁰⁷ The coordinator shall also inform the competent authorities that have authorized regulated entities in the group and the competent authorities of the Member State in which the mixed financial holding company has its head office, as well as the Commission.²⁰⁸

The high degree of discretion given to the Member States and their supervisory authorities in determining whether a group or a financial conglomerate exists could lead to substantial differences among the Member States in the determination of whether supplementary supervision applies. This would not only create legal uncertainties but could also cause competitive distortions.²⁰⁹ It is noteworthy that a financial conglomerate does not exist if a group is composed only of credit institutions and investment firms. In most – if not all – cases, an investment firm owning 20 percent or more of a credit institution or a credit institution owning more than 20 percent of an investment firm is covered by the rules on consolidated supervision of credit institutions and financial institutions.²¹⁰ Consolidated supervision, on the other hand, always requires the existence of a deposit-taking institution or investment firm in the group.

3. *Undertakings in a Financial Conglomerate that Are the Addressees of Supplementary Supervision*

The Supplementary Supervision Directive does not envision that all companies in a financial conglomerate be subject to supplementary supervision and the scope of supplementary supervision differs between certain categories of companies in a financial conglomerate. The Supplementary Supervision Directive distinguishes between entities that are the addressees of supplementary supervision, entities that are subject to certain obligations under the Supplementary Supervision Directive and entities that are only indirectly affected by the Supplementary Supervision Directive.

²⁰⁴ Art. 4(1), Supplementary Supervision Directive.

²⁰⁵ Art. 4(1), Supplementary Supervision Directive.

²⁰⁶ *See infra* C.III.4. for a discussion of the coordinator.

²⁰⁷ Art. 4(2), Supplementary Supervision Directive.

²⁰⁸ Art. 4(2), Supplementary Supervision Directive.

²⁰⁹ Opinion of the Economic and Social Committee on the Proposal for a Directive of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (Oct. 17, 2001), O.J. Eur. Comm. No. C36/1 (2002), at 4, *sub* 3.7.

²¹⁰ *See supra* A.II.

The Supplementary Supervision Directive refers to entities that are the addressees of the supplementary supervision as entities that are “subject to supplementary supervision at the level of the financial conglomerate”.²¹¹ For instance, own funds for purposes of capital adequacy must be available at the level of the financial conglomerate,²¹² significant risk concentrations are measured at the level of the financial conglomerate,²¹³ and risk management processes and internal control mechanisms must be in place at the level of the financial conglomerate.²¹⁴ Only certain EU-regulated entities [*herein* the Responsible Entities] are “subject to supplementary supervision at the level of the financial conglomerate”.²¹⁵

1. every EU-regulated entity that is at the head of a financial conglomerate,
2. every EU-regulated entity, whose parent undertaking is a mixed financial holding company having its head office in the EU, and
3. every EU-regulated entity linked with another financial sector entity by a relationship of a horizontal group,²¹⁶ that is, every EU-regulated entity in a horizontal financial conglomerate.

These Responsible Entities must verify compliance with the requirements of supplementary supervision and are responsible for compliance by the financial conglomerate. In particular, the Responsible Entities must submit reports to the coordinator.²¹⁷ If a financial

²¹¹ Art. 5(2), Supplementary Supervision Directive.

²¹² Art. 6(2), Supplementary Supervision Directive.

²¹³ Art. 7(2), Supplementary Supervision Directive.

²¹⁴ Art. 9(1), Supplementary Supervision Directive.

²¹⁵ Art. 5(2), Supplementary Supervision Directive. Art. 5(2), Supplementary Supervision Directive refers generally to *regulated entities*, but Art. 5(2) must be read in conjunction with Art. 5(1), Supplementary Supervision Directive which only refers to EU-regulated entities. It follows from Art. 5(1), Supplementary Supervision Directive (“regulated entities referred to in Article 1”) in connection with Art. 1, Supplementary Supervision Directive (“regulated entities which have obtained an authorization pursuant to ...”) that the regulated entities referred to in Art. 5(1), Supplementary Supervision Directive are regulated entities that have obtained an authorization pursuant to one of the sectoral directives, *i.e.*, EU-regulated entities, and that only such EU-regulated entities are subject to supplementary supervisions. *See supra* notes 134 & 135. *See also* the caption of Art 5, Supplementary Supervision Directive that refers to EU-regulated entities. EU-regulated entities that are subject to supplementary supervision are subject to such supervision in addition to supervision pursuant to the applicable sectoral rules. Art. 5(1), Supplementary Supervision Directive.

²¹⁶ *Supra* note 158 and accompanying text.

²¹⁷ Such reports are the results of calculations regarding sufficient own funds at the level of the financial conglomerate, Art. 6(2), Supplementary Supervision Directive; information about significant risk concentrations at the level of the financial conglomerate, Art. 7(2), Supplementary Supervision Directive; and information about significant intra-group transactions, Art. 8(2), Supplementary Supervision Directive. The information shall be submitted to the coordinator by the EU-regulated entity at the head of the financial conglomerate (*see* Art. 5(2)(a), Supplementary Supervision Directive), or, if the financial conglomerate is not headed by an EU-regulated entity, *see* Art. 5(2)(b) & (c), Supplementary Supervision Directive, by the regulated entity in the financial conglomerate identified by the coordinator after consultation with the other

conglomerate is headed by an EU-regulated entity, only that entity (and not the other regulated entities in the financial conglomerate) must meet the requirements that must be met “at the level of the financial conglomerate”.²¹⁸ In this case supervision “on the level of the financial conglomerate” means supervision on the holding company level. On the other hand, if a financial conglomerate is headed by a mixed financial holding company having its head office in the EU, each EU-regulated entity in the financial conglomerate must meet the requirements that must be met “at the level of the financial conglomerate”.²¹⁹

The Supplementary Supervision Directive imposes certain obligations on all regulated entities in a financial conglomerate in order to make supplementary supervision at the level of the financial conglomerate possible.²²⁰ However, to the extent the regulated entities are non-EU-regulated entities, the supplementary supervision at the level of the financial conglomerate does not imply that the competent authorities play a supervisory role with respect to such non-EU-regulated entities.²²¹ Furthermore, the Supplementary Supervision Directive assigns duties and obligations in connection with supplementary supervision at the level of the financial conglomerate to mixed financial holding companies.²²² Again, this does not imply that the competent authorities play a supervisory role with respect to mixed financial holding companies.²²³

Finally, supplementary supervision of a financial conglomerate will indirectly affect all entities in a financial conglomerate, including non-EU-regulated entities, non-regulated entities and the mixed financial holding company in the financial conglomerate. For instance, *intra-group transactions*²²⁴ and *risk concentrations*²²⁵ are defined to include relations between

relevant competent authorities and with the financial conglomerate or by the mixed financial holding company. Arts. 6(2), 7(2) & 8(2), Supplementary Supervision Directive.

²¹⁸ Art. 5(2)(a), Supplementary Supervision Directive.

²¹⁹ Art. 5(2)(b), Supplementary Supervision Directive.

²²⁰ All regulated entities in a financial conglomerate must ensure that sufficient own funds are available on the level of the financial conglomerate, *see* Art. 6(2), Supplementary Supervision Directive; all regulated entities and mixed financial holding companies must report on (1) significant risk concentrations at the level of the financial conglomerate, *see* Art. 7(2), Supplementary Supervision Directive, and (2) significant intra-group transactions, *see* Art. 8(2), Supplementary Supervision Directive; and must have in place, at the level of the financial conglomerate, adequate risk management processes and internal control mechanisms, *see* Art. 9(1), Supplementary Supervision Directive. In the above-cited Articles, the Supplementary Supervision Directive speaks generally of *regulated entities*, and not of *regulated entities referred to in Article 1*. Thus, the Articles include EU-regulated entities as well as non-EU-regulated entities.

²²¹ Art. 5(5), Supplementary Supervision Directive.

²²² *See* the calculation duty and the requirement to submit reports to the coordinator, Art. 6(2), fourth and fifth subparagraphs, Arts. 7(2) & 8(2), second subparagraph, Supplementary Supervision Directive. Member states must ensure that penalties and measures may be imposed on mixed financial holding companies that infringe laws, regulations or administrative provisions enacted to implement the Supplementary Supervision Directive. Art. 17(2), Supplementary Supervision Directive.

²²³ Art. 5(5), Supplementary Supervision Directive.

²²⁴ Art. 2(18), Supplementary Supervision Directive.

regulated entities (EU-regulated or non-EU-regulated) in a financial conglomerate and other entities or undertakings in the financial conglomerate. For purposes of calculating the capital adequacy requirements of a financial conglomerate, mixed financial holding companies, non-EU-regulated entities and even non-regulated financial sector entities are included.²²⁶ This does not imply that the competent authorities play a supervisory role with respect to these unregulated entities.²²⁷

Not all EU-regulated entities in a financial conglomerate are subject to supplementary supervision. EU-regulated entities that are members of a financial conglomerate headed by an EU-regulated entity²²⁸ are not addressees of supplementary supervision, although they are included in the supplementary supervision of the EU-regulated entity head of the financial conglomerate. EU-regulated entities that are members of a financial conglomerate headed by a mixed financial holding company are subject to supplemental supervision only if the mixed financial holding company has its head office in the EU.²²⁹

EU-regulated entities in a financial conglomerate headed by a non-EU-regulated entity or by a mixed financial holding company, that has its head office outside the EU, are not at all subject to supplementary supervision.²³⁰ If the parent undertaking of an EU-regulated entity is a regulated entity having its head office outside the EU or is a mixed financial holding company having its head office outside the EU, the EU-regulated entity is either subject to equivalent supervision by the home country of the parent or subject to analogous or appropriate supplementary supervision by a Member State pursuant to Art. 18, Supplementary Supervision Directive.²³¹

Where a financial conglomerate is a subgroup of another financial conglomerate (the main financial conglomerate), Member States may apply the provisions of Arts. 6 to 17 of the Supplementary Supervision Directive (supplementary supervision) only to regulated entities within the main financial conglomerate and not to the subgroup.²³² The nonfinancial activities of a nonregulated entity heading a group could have the effect that the group does not meet the

²²⁵ Art. 2(19), Supplementary Supervision Directive.

²²⁶ Art. 6(3), Supplementary Supervision Directive.

²²⁷ Art. 5(5), Supplementary Supervision Directive.

²²⁸ Art. 5(2)(a), Supplementary Supervision Directive.

²²⁹ See Art. 5(2), Supplementary Supervision Directive.

²³⁰ Art. 2(15), Supplementary Supervision Directive.

²³¹ Art. 5(3) Supplementary Supervision Directive. See Art. 18, Supplementary Supervision Directive discussed *infra* C.IV.

²³² Art. 5(2), second subparagraph, Supplementary Supervision Directive.

financial conglomerate tests.²³³ In that case, one has to determine whether the non-qualifying group comprises subgroups that qualify as financial conglomerates.²³⁴

In order to avoid possible moral hazards,²³⁵ the Supplementary Supervision Directive emphasizes that the exercise of supplementary supervision at the level of the financial conglomerate shall not imply that the competent authorities are required to play a supervisory role in relation to mixed financial holding companies, unregulated entities or non-EU-regulated entities in a financial conglomerate, on a stand-alone basis, even though such entities are affected by the supplementary supervision.²³⁶

With regard to asset management companies, the Supplementary Supervision Directive requires the inclusion of asset management companies in the sectoral and supplementary supervision. Art. 30, Supplementary Supervision Directive provides that Member States shall include asset management companies in the scope of consolidated supervision of credit institutions and investment firms, and/or in the scope of supplementary supervision of insurance undertakings in an insurance group, and – where the group is a financial conglomerate – in the scope of supplementary supervision within the meaning of the Supplementary Supervision Directive.²³⁷ Asset management companies that are part of a financial conglomerate must be regarded as regulated entities.²³⁸

III. Supplementary Supervision

The Supplementary Supervision Directive introduces a series of rules with regard to the supplementary supervision of regulated entities in a financial conglomerate. They relate in

²³³ See Art. 2(14)(c), Supplementary Supervision Directive. The entity heading the group is not a *mixed financial holding company* if the group does not constitute a financial conglomerate. See Art. 2(15), Supplementary Supervision Directive.

²³⁴ The prohibition of separate regulation of subgroups set forth in Art. 5(2), second subparagraph, Supplementary Supervision Directive does not apply in that case because the subgroup is not a subgroup of another financial conglomerate.

²³⁵ See 2001 Explanatory Memorandum, *supra* note 122, at 6, *sub* 2, Art. 4, and Tripartite Report, *supra* note 124, at 36, *sub* no. 96 (the impression that the activities of unregulated entities in the financial conglomerate are in some way being monitored or supervised, even if only informally, creates a moral hazard).

²³⁶ Art. 5(5) & Art. 12(4), Supplementary Supervision Directive.

²³⁷ For the purposes of inclusion of asset management companies in the consolidated and/or supplementary supervision, (1) the relevant sectoral rules regarding the form and extent of the inclusion of financial institutions shall apply *mutatis mutandis* where asset management companies are included in the scope of consolidated supervision of credit institutions and investment firms and (2) the relevant sectoral rules regarding the form and extent of the inclusion of reinsurance undertakings shall apply *mutatis mutandis* where asset management companies are included in the scope of supplementary supervision of insurance undertakings. Art. 30, second subparagraph, Supplementary Supervision Directive. See *supra* notes 134 & 135.

²³⁸ Art. 30, third subparagraph, Supplementary Supervision Directive.

particular to capital adequacy,²³⁹ intra-group transactions and risk concentration,²⁴⁰ and to the management.²⁴¹ The Supplementary Supervision Directive also requires that for each financial conglomerate a single coordinator be appointed from among the competent authorities of the Member States concerned who shall be responsible for coordination and exercise of supplementary supervision.²⁴² The competent authorities are also required to cooperate and exchange information.²⁴³

It must be emphasized that supplementary supervision does not mean supervision on a consolidated basis like the supervision provided by some of the sectoral rules. The Supplementary Supervision Directive follows a so-called “solo-plus” approach to supervision. The basis of supervision is the supervision of individual group entities on a solo basis by their respective sectoral regulators. The solo supervision of individual entities is complemented by a general quantitative assessment of the group as a whole and by a quantitative group-wide assessment of the adequacy of capital.²⁴⁴ The Supplementary Supervision Directive does not require any additional consolidation of the accounts of the financial conglomerate as a whole if existing Directives do not impose such consolidation.

1. *Capital Adequacy*

One of the most important issues regarding the supervision of financial conglomerates is the supervision of the group’s financial condition. Therefore, Art. 6 and Annex I of the Supplementary Supervision Directive require the competent authorities to exercise supplementary supervision of the capital adequacy of the regulated entities in a financial conglomerate.²⁴⁵ Eliminating any inappropriate intra-group creation of own funds,²⁴⁶ such as double or multiple gearing,²⁴⁷ or excessive leveraging is the major goal of such supplementary

²³⁹ Art. 6, Supplementary Supervision Directive.

²⁴⁰ Arts. 7, 8 & 9, Supplementary Supervision Directive.

²⁴¹ Art. 13, Supplementary Supervision Directive.

²⁴² Arts. 10 & 11, Supplementary Supervision Directive.

²⁴³ Art. 12, Supplementary Supervision Directive.

²⁴⁴ Tripartite Report, *supra* note 124, at 17, *sub* no. 43.

²⁴⁵ Art. 6(1), Supplementary Supervision Directive.

²⁴⁶ Annex I, *sub* I, 2(i), Supplementary Supervision Directive.

²⁴⁷ According to the Joint Forum Report, *Capital Adequacy Principles Paper*, *supra* note 124, at 13, *sub* no. 18, *double gearing* occurs whenever one entity holds regulatory capital issued by another entity within the same group and the issuer is allowed to count the capital in its own balance sheet; *multiple gearing* occurs when the dependant in the previous instance itself downstreams regulatory capital to a third-tier entity, and the parent’s externally *generated* capital is geared up a third time. Annex I, *sub* I, 2(i), Supplementary Supervision Directive, refers to multiple gearing as the multiple use of elements eligible for the calculation of own funds at the level of the financial conglomerate.

group-wide capital adequacy requirements.²⁴⁸ In such situations, the same own funds are used simultaneously as a buffer more than once – to cover the capital requirements of the parent company, as well as those of a subsidiary (and possibly also those of a subsidiary of a subsidiary).²⁴⁹ Thus, the Member States must require regulated entities in a financial conglomerate to ensure that there are own funds at the level of the financial conglomerate that are always at least equal to the capital adequacy requirements as calculated in accordance with Annex I.²⁵⁰ That means that all Responsible Entities²⁵¹ in a financial conglomerate must see to it that *at the level of the financial conglomerate*,²⁵² the capital adequacy requirements calculated in accordance with Annex I are met. In addition to the regulated entities in a financial conglomerate, certain specifically mentioned nonregulated financial sector entities²⁵³ in the financial conglomerate that may not be subject to capital adequacy requirements on a stand-alone basis must nonetheless be included for the purpose of calculating capital adequacy at the level of the financial conglomerate.²⁵⁴ The solvency requirements for nonregulated financial sector

²⁴⁸ See 2001 Explanatory Memorandum, *supra* note 122, at 4, *sub* 1(b). The Joint Forum Report, *Capital Adequacy Principles Paper*, *supra* note 124, at 14, *sub* no. 23, defines *excessive leverage* as situations where a parent issues debt (or other instruments not acceptable as regulatory capital in the downstream entity) and downstreams the proceeds as equity or other forms of regulatory capital to its regular subsidiaries.

²⁴⁹ Tripartite Report, *supra* note 124, at 17, *sub* no. 44.

²⁵⁰ Art. 6(2), first subparagraph, in connection with Art. 5(2), Supplementary Supervision Directive.

²⁵¹ See *supra* text accompanying note 215 and Art. 5(2), Supplementary Supervision Directive.

²⁵² See *supra* note 211 and accompanying text.

²⁵³ See *supra* note 172.

²⁵⁴ Art. 6(3), Supplementary Supervision Directive states that “[f]or the purpose of calculating the capital adequacy requirements..., the following entities shall be included in the scope of supplementary supervision”: (1) *credit institutions* within the meaning of Art. 1(1), second subparagraph, Banking Directive, including non-EU credit institutions, see *supra* notes 7, 134 & 135; (2) *financial institutions* within the meaning of Art. 1(5), Banking Directive, see *supra* note 8; (3) *ancillary banking services undertakings* within the meaning of Art. 1(23), Banking Directive, see *supra* note 18; (4) *investment firms* within the meaning of Art. 1(2), Investment Services Directive, including the non-EU investment firms referred to in Art. 2(4), Capital Adequacy Directive, see *supra* notes 134 & 135; (5) *insurance undertakings* within the meaning of Art. 6, First Non-Life Insurance Directive and Art. 6 First Life Insurance Directive, including non-EU insurance undertakings, Art. 1(b), Insurance Group Directive, see *supra* notes 84, 134 & 135; (6) *reinsurance undertakings* within the meaning of Art. 1(c), Insurance Group Directive, see *supra* notes 86 & 134; (7) *insurance holding companies* within the meaning of Art. 1(i), Insurance Group Directive, see *supra* note 134; (8) *financial institutions* within the meaning of Art. 2(7), Capital Adequacy Directive referring to (the predecessor provision of) Art. 1(5), Banking Directive, see *supra* note 8; (9) *mixed financial holding companies* within the meaning of Art. 2(15), Supplementary Supervision Directive, *supra* note 174; and (10) *asset management companies*, see Art. 2(5), Supplementary Supervision Directive, *supra* notes 134 & 135 and notes 237 & 238 and accompanying text. See *supra* diagram 5 setting forth the financial sector entities.

The following entities of the entities listed above as being included in the scope of supplementary supervision for the purpose of calculating the capital adequacy requirement are not subject to capital adequacy requirements on a stand-alone basis: financial institutions (other than investment firms), ancillary banking services undertakings, reinsurance undertakings, insurance holding companies, mixed

entities that are not included in the sectoral solvency requirement computation are computed on a notional basis.²⁵⁵

The solvency requirements for each separate financial sector represented in a financial conglomerate continue to be covered by own funds elements in accordance with the corresponding sectoral rules.²⁵⁶ In case of a deficit of own funds at the financial conglomerate level, only own funds elements that are eligible according to each of the sectoral rules (*cross-sector capital*) shall qualify for the verification of the compliance with the solvency requirements at the financial conglomerate level.²⁵⁷

Annex I sets forth three different methods for calculating the solvency position on the level of a financial conglomerate. The competent authorities or the coordinator have the authority to choose which method shall be applied to a financial conglomerate²⁵⁸ and they may

financial holding companies and asset management companies. These companies are the nonregulated financial sector companies mentioned in *supra* note 172 (except for asset management companies which Art. 30, third subparagraph, Supplementary Supervision Directive treats as regulated entities, *see supra* notes 237 & 238 and accompanying text).

Non-EU credit institutions, non-EU insurance undertakings and non-EU investment firms may be subject to capital adequacy requirements of their home country on a stand-alone basis. If one of such non-EU-regulated entities is part of a financial conglomerate headed by an EU-regulated entity or headed by a mixed financial holding company having its head office in the EU, it is subject to the requirements of supplementary supervision of capital adequacy; if one of such non-EU-regulated entities is part of a financial conglomerate headed by a non-EU-regulated entity or by a mixed financial holding company having its head office outside the EU, it is only subject to equivalent supervision by the home country of the non-EU head of the financial conglomerate or to analogous or appropriate supplementary supervision by a Member State pursuant to Art. 18, Supplementary Supervision Directive. *See supra* notes 181 & 182 and accompanying text and *infra* C.IV.

²⁵⁵ See Annex I, *sub* II, Method 1, fourth paragraph, Method 2, third paragraph, and Method 3, third paragraph, Supplementary Supervision Directive. *Notional solvency requirement* means the capital requirement with which such an entity would have to comply under the relevant sectoral rules as if it were a regulated entity of that particular financial sector; a mixed financial holding company shall be treated according to the sectoral rules of the most important financial sector in the financial conglomerate. In the case of asset management companies, solvency requirements means the capital requirement set out in Art. 5a(1)(a), UCITS Directive. Annex I, *sub* I, 2(ii), last paragraph, Supplementary Supervision Directive.

²⁵⁶ Annex I, *sub* I, 2(ii), first paragraph, Supplementary Supervision Directive.

²⁵⁷ Annex I, *sub* I, 2(ii), first and second paragraphs, Supplementary Supervision Directive.

²⁵⁸ It would have been desirable to leave the choice of the calculation method to the financial conglomerate in order to give companies more flexibility. *See* Committee on Economic and Monetary Affairs of the European Parliament, Report on the proposal for a European Parliament and Council directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate [*herein* Report of Committee on Economic and Monetary Affairs], available at http://www2.europarl.eu.int/omk/sipade2?PROG=REPORT&L=EN&SORT_ORDER=D&LEG_ID=5&COM_ID=620&LEVEL=2&SAME_LEVEL=1&SV=60&NAV=X (last visited on December 1, 2003), at 28 & 34; Position Paper of the Banking Federation of the European Union on the Supplementary Supervision of Financial Conglomerates of October 3, 2001, available at http://www.fbe.be/docs_superhtml (last visited on December 1, 2003), at 11.

also apply a combination of the three methods.²⁵⁹ These methods are (1) accounting consolidation, (2) deduction and aggregation, and (3) requirement deduction.

One can question the rationale for requiring adequate capital for a financial conglomerate on the group level, because in case of need of a regulated entity in the group, the group capital is not available to the needy regulated entity. The Supplementary Supervision Directive does not establish a *source of strength doctrine*. Under that doctrine a U.S. bank holding company and indirectly its subsidiaries are expected to support a deposit-taking subsidiary in case of need. The GLBA amendments to the BHCA affirm this doctrine with certain limitations.²⁶⁰

a) *Method 1: “Accounting Consolidation” Method*

Method 1 uses the consolidated accounts as a basis for calculating the supplementary capital adequacy. Thus, it is only applicable for consolidated groups. According to this method, the supplementary capital adequacy shall be calculated as the difference between:

- (x) the own funds of the financial conglomerate calculated on the basis of the consolidated position of the group,²⁶¹ and
- (y) the sum of the solvency requirements for each different financial sector represented in the group.²⁶²

²⁵⁹ See Annex I, second and third paragraphs, and Annex I, *sub II*, Method 4, Supplementary Supervision Directive. See also Opinion of the Economic and Social Committee, *supra* note 209, at 2 & 4; Report of Committee on Economic and Monetary Affairs, *supra* note 258, at 34.

A Member State may require that the calculation be carried out according to one particular method among those described in Annex I if a financial conglomerate is headed by a regulated entity that has been authorized in that Member State, Annex I, third paragraph, first sentence, Supplementary Supervision Directive. However, where a financial conglomerate is not headed by an EU-regulated entity, Member States may authorize the application of any of the methods described in Annex I, except in situations where the relevant competent authorities are located in the same Member State, in which case the Member State may require the application of one of the methods, Annex I, third paragraph, second sentence, Supplementary Supervision Directive. Member States shall allow their competent authorities, where they assume the role of coordinator with regard to a particular financial conglomerate, to decide, after consultation with the other relevant competent authorities and the financial conglomerate itself, which method shall be applied by that financial conglomerate, Annex I, second paragraph, Supplementary Supervision Directive.

²⁶⁰ Michael Gruson, *Foreign Banks and the Financial Holding Company*, § 10.07[1] in Gruson & Reisner, *supra* note 9; Jeffrey D. Berman, Arthur S. Long & Tomer Seifan, *U.S. Law Conditions Applicable to Foreign Bank Acquisitions of U.S. Banking Institutions*, § 3.06[2] in Gruson & Reisner, *supra* note 9.

²⁶¹ The own funds are those that qualify in accordance with the relevant sectoral rules, Annex I, *sub II*, Method 1(i), Supplementary Supervision Directive. See also Art. 6(4), Supplementary Supervision Directive.

²⁶² The solvency requirements for each different financial sector are calculated in accordance with the relevant sectoral rules, Annex I, *sub II*, Method 1(ii) and third paragraph, Supplementary Supervision Directive. See also Art. 6(4), Supplementary Supervision Directive. In the case of nonregulated financial sector entities that are not included in the sectoral solvency requirement calculations, a notional solvency

Formula for calculating the supplementary capital adequacy according to Method 1:

$$\text{Supp.CA} = \text{OF}_{\text{Consolidated}} - (\text{S}_{\text{Bank}} + \text{S}_{\text{Insurance}} + \text{S}_{\text{Investment}} + \text{S}_{\text{Non-Regulated}})^{263}$$

The difference shall not be negative.²⁶⁴ Because this method's starting point and basis are the fully consolidated accounts of the financial conglomerate, by definition, all intra-group on- and off-balance sheet accounts or exposures have been eliminated and the effects of double or multiple gearing and excessive leverage are equated. Thus, calculating the group-wide capital adequacy simply consists in the deduction of the solvency requirements of the group's financial sectors from the consolidated own funds.

b) Method 2: "Deduction and Aggregation" Method

The calculation of the supplementary capital adequacy pursuant to Method 2 is carried out on the basis of the separate accounts of each entity in the group that is included in the calculation of capital adequacy.²⁶⁵ According to this method, the supplementary capital adequacy shall be calculated on the basis of the accounts of each of the entities in the group as the difference between:

- (x) the sum of the own funds of each regulated and nonregulated entity in the financial conglomerate,²⁶⁶ and
- (y) the sum of:
 - the solvency requirements for each regulated and nonregulated entity in the group,²⁶⁷ and

requirement shall be calculated. Annex I, *sub* II, Method 1, fourth paragraph, Supplementary Supervision Directive. *See supra* note 255.

²⁶³ *Supp.CA* shall mean the supplementary capital adequacy, *i.e.*, the surplus or deficit of the group-wide capital, *OF* shall mean own funds, and *S* shall mean the solvency requirements of a financial sector.

²⁶⁴ Annex I, *sub* II, Method 1, ultimate paragraph, Supplementary Supervision Directive. If the difference is negative, the group faces a capital deficit.

²⁶⁵ *See supra* note 254.

²⁶⁶ The elements eligible are those that qualify in accordance with the relevant sectoral rules, Annex I, *sub* II, Method 2(i), Supplementary Supervision Directive.

²⁶⁷ The solvency requirements shall be calculated in accordance with the relevant sectoral rules, Annex I, *sub* II, Method 2(ii), Supplementary Supervision Directive.

The calculation of own funds and solvency requirement shall take account of the proportional share held by a parent undertaking in a subsidiary or by an undertaking that holds a participation in another entity of the group. *Proportional share* means the proportion of the subscribed capital that is held, directly or indirectly,

- the book value of the participations in other entities of the group.²⁶⁸

Formula for calculating the supplementary capital adequacy according to Method 2:

$$\text{Supp.CA} = (\text{OF}_1 + \text{OF}_2 + \text{OF}_3 + \dots) - [(\text{S}_1 + \text{S}_2 + \text{S}_3 + \dots) + (\text{BV}_1 + \text{BV}_2 + \text{BV}_3 \dots)]^{269}$$

The difference shall not be negative.²⁷⁰ The effect of this method is to pretend the situation of consolidated accounts, and therefore to eliminate multiple gearing, excessive leverage and the misuse of accounting margins relating to the book value of participations by deducting those participations.

c) *Method 3: “Book Value/Requirement Deduction” Method*

Method 3 is based on the balance sheet of each entity within the group. According to this method, the calculation of the supplementary capital adequacy shall be carried out on the basis of the accounts of each of the entities in the group as the difference between:

- (x) the own funds of the parent undertaking or the entity at the head of the financial conglomerate,²⁷¹ and
- (y) the sum of
 - the solvency requirement of the parent undertaking or the head referred to in clause (x); and

by that undertaking. Art. 6(4), second subparagraph, and Annex I, *sub II*, Method 2, third paragraph, Supplementary Supervision Directive.

In the case of nonregulated entities, a notional solvency requirement shall be calculated. Annex I, *sub II*, Method 2, third paragraph, Supplementary Supervision Directive. *See supra* note 255.

²⁶⁸ Although the wording in this point is not very clear, *participations in other entities of the group* means any participation that is held within the group, e.g., participations of the parent in its subsidiaries or cross-participations of the subsidiaries. *See* Joint Forum Report, *Capital Adequacy Principles Paper*, *supra* note 124, at 14, *sub* no. 20.

²⁶⁹ *Supp.CA* shall mean the supplementary capital adequacy, i.e., the surplus or deficit of the group-wide capital, *OF* shall mean own funds, *S* shall mean the solvency requirements of an entity of the group and *BV* shall mean the book value of a participation.

²⁷⁰ Annex I, *sub II*, Method 2, ultimate paragraph, Supplementary Supervision Directive. If the difference is negative, the group faces a capital deficit.

²⁷¹ The elements eligible are those that qualify in accordance with the relevant sectoral rules, Annex I, *sub II*, Method 3(i), Supplementary Supervision Directive.

- the higher of the book value of the parent undertaking's or the head's participation in other entities in the group and these entities' solvency requirement.²⁷²

Formula for calculating the supplementary capital adequacy according to Method 3:

$$\text{Supp.CA} = \text{OF}_{\text{Parent}} - [\text{S}_{\text{Parent}} + (\text{BV}_1 \text{ or } \text{S}_1 + \text{BV}_2 \text{ or } \text{S}_2 + \text{BV}_3 \text{ or } \text{S}_3 + \dots)]^{273}$$

The difference shall not be negative.²⁷⁴ This method, which does not take into account the own funds of the subsidiaries, provides for an easy way to assess potential double gearing within the group.²⁷⁵

Whichever Method is used, when a regulated entity subsidiary has a solvency deficit or, in the case of a non-regulated financial sector entity subsidiary, a notional solvency deficit, the total solvency deficit of the subsidiary (and not only a proportional amount) has to be taken into account. However, if in the opinion of the coordinator, the responsibility of the parent undertaking is limited strictly and unambiguously to the parent's share in the capital of the subsidiary, the coordinator may permit the solvency deficit of the subsidiary undertaking to be taken into account on a proportional basis.²⁷⁶

²⁷² The calculation of own funds and solvency requirements shall take account of the proportional share held by a parent undertaking in a subsidiary or by an undertaking that holds a participation in another entity of the group. *Proportional share* means the proportion of the subscribed capital that is held, directly or indirectly, by that undertaking. Art. 6(4), second subparagraph, and Annex I, *sub* II, Method 3, (iii), Supplementary Supervision Directive.

When evaluating the elements eligible for the calculation of supplementary capital adequacy requirements, participations may be valued by the equity method in accordance with the options set out in Art. 59(2)(b), Annual Accounts Directive. Annex I, *sub* II, Method 3, third paragraph, Supplementary Supervision Directive.

In the case of nonregulated entities, a notional solvency requirement shall be calculated. Annex I, *sub* II, Method 3, third paragraph, Supplementary Supervision Directive. *See supra* note 255.

²⁷³ *Supp.CA* shall mean the supplementary capital adequacy, *i.e.*, the surplus or deficit of the group-wide capital, *OF* shall mean the own funds of the parent on the basis of the single account, *S* shall mean the solvency requirements and *BV* shall mean the book value of the parent's participation.

²⁷⁴ Annex I, *sub* II, Method 3, ultimate paragraph, Supplementary Supervision Directive. If the difference is negative, the group faces a capital deficit.

²⁷⁵ See Joint Forum Report, *Capital Adequacy Principles*, *supra* note 124, at 21 & 26, Annex 1 & 2.

²⁷⁶ Annex I, *sub* I (1), Supplementary Supervision Directive. Where there are no capital ties between entities in a financial conglomerate, the coordinator may determine which proportional share will have to be taken into account, bearing in mind the liability to which the existing relationship gives rise. *Id.*, second paragraph.

d) *Capital Policies and Supervision*

The Member States shall require regulated entities to have in place adequate capital adequacy policies at the level of the financial conglomerate.²⁷⁷ The requirement that regulated entities in financial conglomerates must ensure that on the level of the financial conglomerates the capital adequacy requirements of Annex I are met²⁷⁸ and that regulated entities have in place adequate capital adequacy policies on the level of the financial conglomerate²⁷⁹ must be subject to supervisory overview by the coordinator.²⁸⁰ The regulated entities or the mixed financial holding company must calculate the sufficiency of own funds on the level of the financial conglomerate at least annually.²⁸¹ The EU-regulated entity at the head of the financial conglomerate or the mixed financial holding company at the head of the financial conglomerate must submit the results of the calculation to the coordinator.²⁸² When calculating own funds at the level of the financial conglomerate, the competent authorities shall take into account the effectiveness of the transferability and availability of the own funds across the different legal entities in the group.²⁸³

The coordinator may decide not to include a particular entity for the purpose of calculating the capital adequacy requirements in the following cases:²⁸⁴

- (a) if the entity is situated in a third country where there are legal impediments to the transfer of the necessary information;²⁸⁵
- (b) if the entity is of negligible interest with respect to the objective of the supplementary supervision of regulated entities in a financial conglomerate;²⁸⁶ or

²⁷⁷ Art. 6(2), second subparagraph, Supplementary Supervision Directive.

²⁷⁸ Art. 6(2), first subparagraph, Supplementary Supervision Directive. *See supra* notes 250 & 252 and accompanying text.

²⁷⁹ Art. 6(2), second subparagraph, Supplementary Supervision Directive.

²⁸⁰ Art. 6(2), third subparagraph, Supplementary Supervision Directive.

²⁸¹ Art. 6(2), fourth subparagraph, Supplementary Supervision Directive.

²⁸² Art. 6(2), fifth subparagraph, Supplementary Supervision Directive. The coordinator may designate a regulated entity in the financial conglomerate as the entity required to submit the results of the calculation instead of the mixed financial holding company. Art. 6(2), fifth subparagraph, Supplementary Supervision Directive. Before such designation, the coordinator must consult with the other relevant competent authorities and with the financial conglomerate.

²⁸³ Annex I, *sub* I, 2(ii), third paragraph, Supplemental Supervision Directive.

²⁸⁴ Art. 6(5), Supplementary Supervision Directive.

²⁸⁵ This exception must be without prejudice to the sectoral rules regarding the obligation of competent authorities to refuse authorization where the effective exercise of their supervisory functions is prevented. Art. 6(5)(a), Supplementary Supervision Directive.

- (c) if the inclusion of the entity would be inappropriate or misleading with respect to the objectives of supplementary supervision.

2. *Intra-Group Transactions and Risk Concentration*

Another core regulation of the Supplementary Supervision Directive is the requirement of supplementary supervision on *intra-group transactions* and *risk concentration* of regulated entities in a financial conglomerate.²⁸⁷

a) *Intra-Group Transactions*

Intra-group transactions may cause supervisory concerns when they: (1) result in capital or income being inappropriately transferred from the regulated entity; (2) are on terms or under circumstances which parties operating at arm's length would not allow and may be disadvantageous to a regulated entity; (3) can adversely affect the solvency, the liquidity and the profitability of individual entities within a group; or (4) are used as a means of supervisory arbitrage, thereby evading capital or other regulatory requirements altogether.²⁸⁸ Monitoring intra-group transactions is also an important factor in dealing with the risk of contagion within a financial conglomerate. Contagion entails the risk that, if certain parts of a conglomerate are experiencing financial difficulties, they may infect other healthy parts of the conglomerate as a result of which the operation of the healthy parts may be hampered or even made impossible.²⁸⁹ Therefore, intra-group transactions can significantly exacerbate problems for a regulated entity once contagion spreads.²⁹⁰

Intra-group transactions as defined in the Supplementary Supervision Directive are transactions by a regulated entity in a financial conglomerate with any other undertaking in

²⁸⁶ If several entities are intended to be excluded because of such negligible interest, they must nevertheless be included when collectively they are of non-negligible interest. Art. 6(5), second subparagraph, Supplementary Supervision Directive.

²⁸⁷ Arts. 7(1) & 8(1), in connection with Annex II, Supplementary Supervision Directive.

²⁸⁸ The Joint Forum Report, *Intra-Group Transactions and Exposure Principles*, *supra* note 124, at 134, *sub* no. 12. *See also* Tripartite Report, *supra* note 124, at 21, *sub* no. 55.

²⁸⁹ Tripartite Report, *supra* note 124, at 18, *sub* no. 47.

²⁹⁰ Tripartite Report, *supra* note 124, at 19, *sub* no. 50. According to the Joint Forum Report, *Intra-Group Transaction and Exposure Principles*, *supra* note 124, at 131, *sub* no. 4, *intra-group transactions and exposures* take the form of direct and indirect claims between entities within a financial conglomerate. They can originate in a variety of ways, for example, through: (1) cross shareholdings, (2) trading operations whereby one group company deals with, or on behalf of, another group company, (3) central management of short-term liquidity within the conglomerate, (4) guarantees, loans and commitments provided to, or received from, other companies in the group, (5) the provision of management and other service arrangements, *e.g.*, pension arrangements or back office services, (6) exposures to major shareholders (including loans and off-balance sheet exposures such as commitments and guarantees), (7) exposures arising through the placement of client assets with other group companies, (8) purchase or sales of assets with other group companies, (9) transfer of risk through reinsurance, and (10) transactions to shift third-party-related risk exposures between entities within the conglomerate. *Id.*

the financial conglomerate.²⁹¹ However, intra-group transactions go beyond transactions with members of the group. Intra-group transactions include transactions *with natural or legal persons linked to the undertakings within the group* by close links, even though such linked persons are not members of the group, and, consequently, not members of the financial conglomerate.²⁹² The intra-group transactions are not limited to transactions of EU-regulated entities within a financial conglomerate but are transactions of any regulated entity.²⁹³ The Supplementary Supervision Directive does not provide for quantitative limits or qualitative requirements with regard to intra-group transactions within a financial conglomerate. The introduction of such limits and requirements or the introduction of other supervisory measures that would achieve the objectives of supplementary supervision with regard to intra-group transactions is left to the Member States.²⁹⁴

The scope of the provisions in the Supplementary Supervision Directive that deals with intra-group transactions is broader than the scope of the equivalent U.S. rules, Sections 23A and 23B, Federal Reserve Act,²⁹⁵ because the Supplementary Supervision Directive applies to all

²⁹¹ Art. 2(18), Supplementary Supervision Directive. *Intra-group transactions* mean all transactions by which regulated entities within a financial conglomerate rely either directly or indirectly upon other undertakings within the same group or upon any natural or legal person linked to the undertaking within that group by “close links” for the fulfillment of an obligation, whether or not contractual, and whether or not for payment. *Id.*

²⁹² Art. 2(18), Supplementary Supervision Directive. *Close link* is defined as a situation in which two or more natural or legal persons are linked by (1) a *participation*, which means the ownership, direct or by way of control, of 20 percent or more of the voting rights or capital of an undertaking, or (2) *control*, which means the relationship between a parent and a direct or indirect subsidiary, in all the cases referred to in Art. 1(1) & (2), Consolidated Accounts Directive, or a similar relationship between any natural or legal person and an undertaking. Art. 2(13), Supplementary Supervision Directive. *See supra* note 11 and accompanying text for a discussion of Art. 1(1), Consolidated Accounts Directive and note 150 and accompanying text for a discussion of Art. 1(2), Consolidated Accounts Directive. Art. 2(13), Supplementary Supervision Directive adds that a situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship shall also be regarded as constituting a *close link* between such persons. Thus, a close link goes beyond the parent-subsidiary (“control”) relationship by including *similar relationships* and the relationship of two persons to each other caused by the fact that they are under common control (permanently linked to one and the same person by a control relationship).

It is difficult to imagine cases in which an undertaking in a group has a close link to another undertaking by means of a participation or control but the other undertaking is not a member of the group. However, the link with a natural person and the link created through permanent control relationships by two natural or legal persons to a third person does not create a group relationship.

²⁹³ *See* Arts. 2(18) and 8(1) & (2), Supplementary Supervision Directive referring generally to regulated entities.

²⁹⁴ Art. 8(3), Supplementary Supervision Directive.

²⁹⁵ Sections 23A & 23B, Federal Reserve Act, 12 U.S.C. § 371c & 371c-1 (2000), apply only to transactions between an insured depository institution, *i.e.*, a U.S. bank, and its affiliates. *See* Robert E. Mannion & Lisa R. Chavarria, *Transactions Between Banks and Affiliated Enterprises*, ch. 12, in Gruson & Reisner, *supra* note 9; Michael Gruson, *Foreign Banks and the Financial Holding Company*, § 10.07[4], in Gruson & Reisner, *supra* note 9.

transactions between all regulated entities within a financial conglomerate and other entities in the group.²⁹⁶

b) Risk Concentration

As to the problem of risk concentration,²⁹⁷ supervisors of the different financial sectors use various approaches to monitor large exposures, due to the different risks they are facing.²⁹⁸ In all three sectors, financial institutions face an increased risk of loss when their assets, liabilities or business activities are not diversified.²⁹⁹ As not all risk concentrations are inherently bad (a certain degree of concentration is the inevitable result of a well-articulated business strategy as well as product specialization, the targeting of a customer base or a sound strategy of outsourcing data processing activities), supervisors need to balance the benefits against the risks of concentrations at the conglomerate level.³⁰⁰ In identifying risks, the competent authorities have to take into account the different ways in which large losses can develop in a conglomerate as a result of risk concentration.³⁰¹

²⁹⁶ Art. 2(18), Supplementary Supervision Directive. *See also* Art. 55a, first subparagraph, Banking Directive, added by Art. 29(9), Supplementary Supervision Directive (transactions between a credit institution and its mixed-activity holding company), *see supra* note 55 and accompanying text.

²⁹⁷ *Risk concentration* means all exposures with a loss potential borne by entities [note that the exposures are not limited to those borne by regulated entities] within a financial conglomerate that are large enough to threaten the solvency or the financial position in general of the regulated entities in the financial conglomerate; such exposures may be caused by counterparty risk/credit risk, investment risk, insurance risk, market risk, other risks, or a combination or interaction of these risks. Art. 2(19), Supplementary Supervision Directive.

Pursuant to the Joint Forum Report, *Risk Concentrations Principles*, *supra* note 124, at 141, *sub* no. 4, risk concentration can take many forms, including exposures to: (1) individual counterparties, (2) groups of individual counterparties or related entities, (3) counterparties in specific geographical locations, (3) industry sectors, (5) specific products, (6) service providers, *e.g.*, back office services, and (7) natural disasters or catastrophes.

²⁹⁸ The Joint Forum Report, *Risk Concentrations Principles*, *supra* note 124, at 143, *sub* nos. 8–10.

²⁹⁹ The Joint Forum Report, *Risk Concentrations Principles*, *supra* note 124, at 144, *sub* no. 11.

³⁰⁰ The Joint Forum Report, *Risk Concentrations Principles*, *supra* note 124, at 145, *sub* nos. 22 & 23.

³⁰¹ The Joint Forum Report, *Risk Concentrations Principles*, *supra* note 124, at 146, *sub* no. 23. The Joint Forum Report addresses some of the losses as follows:

- Losses at the conglomerate level can reflect the aggregate of losses on similar types of exposures (*e.g.*, bonds, loans and investments with the same obligor) across the sectors.
- Losses could reflect risk factors that have consequences for different types of exposures in different entities (*e.g.*, a natural disaster could cause insurance losses in a conglomerate's insurance operation and credit losses in its banking operation if both offered products in the affected region).
- Losses could reflect the interaction of risk factors (*e.g.*, the loss potential in a derivative or exchange rate contract resulting from an exchange rate depreciation may be intensified if the same price movement adversely affects the repayment ability of a counterparty or the financial stability of the counterparty's country of residence).

Like in the case of intra-group transactions, the Supplementary Supervision Directive does not provide for quantitative limits or quantitative requirements with regard to risk concentration at the level of the financial conglomerate. The introduction of such limits and requirements or the introduction of other supervisory measures that would achieve the objectives of supplementary supervision with regard to risk concentration is left to the Member States.³⁰²

c) Common Provisions

To avoid the risks resulting from intra-group transactions and risk concentration, the Member States shall require regulated entities to have in place at the level of the financial conglomerate³⁰³ adequate risk management processes³⁰⁴ and internal control mechanisms³⁰⁵ – including sound reporting and accounting procedures.³⁰⁶ In addition, regulated entities that are Responsible Entities³⁰⁷ must have adequate internal control mechanism for the production of any data and information that would be relevant for the purpose of supplementary supervision.³⁰⁸

In addition, the Member States shall require regulated entities or mixed financial holding companies to report on a regular basis and at least annually to the coordinator³⁰⁹ any

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- Losses could also reflect the breakdown of previously observed correlations, such as occurs in a flight to quality in which all risky assets decline in value, where previously many of them were measured to be uncorrelated.

³⁰² Art. 7(3), Supplementary Supervision Directive.

³⁰³ See *supra* notes 211–219 and accompanying text for a discussion of the term *at the level of the financial conglomerate*.

³⁰⁴ The risk management processes shall include (1) sound governance and management with the approval and periodic review of the strategies and policies by the appropriate governing bodies at the level of the financial conglomerate with respect to all the risks they assume; (2) capital adequacy policies in order to anticipate the impact of their business strategy on risk profile and capital requirements; and (3) procedures to ensure that their risk monitoring systems are well integrated into their organization and that all measures are taken to ensure that the systems implemented by all undertakings included in the scope of supplementary supervision are consistent so that the risks can be measured, monitored and controlled at the level of the financial conglomerate. Art. 9(2), Supplementary Supervision Directive.

³⁰⁵ The internal control mechanism shall include (1) a mechanism as regards capital adequacy to identify and measure all material risks incurred and to appropriately relate own funds to risks; and (2) reporting and accounting procedures to identify, measure, monitor and control the intra-group transactions and the risk concentration. Art 9(3), Supplementary Supervision Directive.

³⁰⁶ Art. 9(1), Supplementary Supervision Directive. The processes and mechanism shall be subject to supervisory overview by the coordinator. Art. 9(5), Supplementary Supervision Directive. According to the second paragraph of Annex II, Supplementary Supervision Directive, the competent authorities responsible for supplementary supervision shall in particular monitor the possible risk of contagion in the financial conglomerate, the risk of a conflict of interests, the risk of circumvention of sectoral rules, and the level or volume of risks.

³⁰⁷ See *supra* text accompanying note 215.

³⁰⁸ Art. 9(4), Supplementary Supervision Directive.

³⁰⁹ See *infra* C.III.4. for a discussion of the coordinator.

significant risk concentration at the level of the financial conglomerate and significant intra-group transactions of regulated entities within a financial conglomerate.³¹⁰ The necessary information shall be submitted to the coordinator by the EU-regulated entity which is at the head of the financial conglomerate or, where the financial conglomerate is not headed by an EU-regulated entity, by the mixed financial holding company or by the regulated entity in the financial conglomerate identified by the coordinator after consultation with the other relevant competent authorities and with the financial conglomerate.³¹¹ The intra-group transactions and risk concentrations shall be subject to supervisory overview by the coordinator.³¹² Therefore, the coordinator, after consultation with the other relevant competent authorities, shall identify the type of transactions and risks regulated entities in a particular financial conglomerate shall report in accordance with the provisions on reporting of intra-group transactions and risk concentration.³¹³ Thus, the Supplementary Supervision Directive provides for the development of reporting requirements that are specific for each financial conglomerate.

Where a financial conglomerate is headed by a mixed financial holding company, the sectoral rules regarding intra-group transactions and risk concentration of the most important financial sector in the financial conglomerate shall apply to that sector as a whole, including the mixed financial holding company.³¹⁴

3. *Management Qualifications*

The Supplementary Supervision Directive requires the Member States to provide that persons who effectively direct the business of a mixed financial holding company are of sufficiently good repute and have sufficient experience to perform their duties.³¹⁵ This provision is intended to ensure that a manager of a non-regulated entity having a dominant influence on the

³¹⁰ Arts. 7(2), second subparagraph & 8(2), in connection with Annex II, Supplementary Supervision Directive.

³¹¹ Arts. 7(2) & 8(2), second subparagraph, Supplementary Supervision Directive.

³¹² Arts. 7(2), second subparagraph & 8(2), third subparagraph, Supplementary Supervision Directive.

³¹³ Annex II, first paragraph, Supplementary Supervision Directive referring to the reporting provision of Arts. 7(2) & 8(2), Supplementary Supervision Directive. When defining the type of transactions and risks, the coordinator and the relevant competent authorities shall take into account the specific group and risk management structure of the financial conglomerate. In particular, the coordinator, after consultation with the other relevant competent authorities and the financial conglomerate itself, shall define appropriate reporting thresholds based on regulatory own funds and/or technical provisions. Annex II, first paragraph, Supplementary Supervision Directive. If no definition of the reporting threshold has been drawn up in accordance with Annex II, an intra-group transaction shall be presumed to be significant if its amount exceeds at least 5 percent of the total amount of the capital adequacy requirements at the level of a financial conglomerate. Art. 8(2), first subparagraph, Supplementary Supervision Directive.

³¹⁴ Arts. 7(4) & 8(4), Supplementary Supervision Directive. According to the wording of Arts. 7(4) & 8(4), Supplementary Supervision Directive, the sectoral rules of the largest sector in the financial conglomerate shall apply “to that [most important] sector”. However, that does not seem to make sense. Arts. 7(4) & 8(4), Supplementary Supervision Directive probably mean that the sectoral rules of the most important financial sector shall apply to the whole group.

³¹⁵ Art. 13, Supplementary Supervision Directive.

performance of a regulated entity is reliable, like a manager of the regulated entity, in particular as regards the management of the mixed financial holding company. This provision responds to the recent tendency to manage financial conglomerates along the different business lines of conglomerates instead of the traditional legal entity based approaches.³¹⁶ The Supplementary Supervision Directive also provides that the Member States shall require that persons who effectively direct the business of an insurance holding company or a financial holding company are of sufficiently good repute and have sufficient experience to perform their duties.³¹⁷

4. *Measures to Facilitate Supplementary Supervision*

One of the principal objectives of the Supplementary Supervision Directive is the introduction of measures to facilitate supplementary supervision.³¹⁸ Supplementary supervision requires the exchange of information among the entities in the financial conglomerate and exchange of information and cooperation among the competent authorities involved in the supervision of regulated entities in a particular financial conglomerate.³¹⁹

The Supplementary Supervision Directive introduces the so-called *coordinator*. The competent authorities of the Member States concerned shall appoint from amongst them a coordinator responsible for the coordination and exercise of the supplementary supervision of the regulated entities in a financial conglomerate.³²⁰ The Supplementary Supervision Directive provides for the automatic identification of the coordinator on the basis of objective criteria.³²¹ However, the relevant competent authorities may waive by agreement these criteria if their application would be inappropriate and appoint a different competent authority as coordinator.³²² The competent authorities shall give the financial conglomerate an opportunity to state its opinion on that decision.³²³ The coordinator functions merely as a *primus inter pares* of the competent authorities of the Member States involved with the regulated entities of a financial conglomerate.³²⁴ A coordinator must be nominated not only for cross-border financial

³¹⁶ See recital clause No. 8, Supplementary Supervision Directive. See also 2001 Explanatory Memorandum, *supra* note 122, at 7, *sub* 2 (Arts. 5 & 6).

³¹⁷ Art. 28(4), Supplementary Supervision Directive amending the Insurance Group Directive by adding Art. 10b, *supra* note 115; Art. 29(8), Supplementary Supervision Directive amending the Banking Directive by adding Art. 54a, *supra* note 61. See Art. 6, Banking Directive, establishing management qualifications for managers of credit institutions. See *supra* A.III.4. & B.II.4.

³¹⁸ Arts. 10–17, Supplementary Supervision Directive.

³¹⁹ 2001 Explanatory Memorandum, *supra* note 122, at 7, *sub* 2 (Arts. 7–13).

³²⁰ Art. 10(1), Supplementary Supervision Directive. The competent authorities of a Member State in which a mixed financial holding company has its head office participate in the selection of the coordinator. Art. 10(1), Supplementary Supervision Directive.

³²¹ Art. 10(2), Supplementary Supervision Directive.

³²² Art. 10(3), Supplementary Supervision Directive.

³²³ Art. 10(3), Supplementary Supervision Directive.

³²⁴ See Economic and Financial Committee, *Report on Financial Stability* (Apr. 2000), EFC/ECFIN/240/00–Final, available at

conglomerates but also for financial conglomerates that have several regulated entities in one Member State and at least two supervisory authorities are involved.³²⁵

The tasks of the coordinator with regard to supplementary supervision are:³²⁶ (1) the coordination of gathering and disseminating of relevant or essential information in going concern and emergency situations, (2) the supervisory overview and assessment of the financial situation of a financial conglomerate, (3) the assessment of compliance with the rules on capital adequacy, risk concentration and intra-group transactions,³²⁷ (4) the assessment of the financial conglomerate's structure, organization and internal control systems,³²⁸ (5) the planning and coordination of supervisory activities in going concern as well as in emergency situations, in cooperation with the relevant competent authorities involved, and (6) other tasks assigned to the coordinator by the Supplementary Supervision Directive or by coordination arrangements between the coordinator and other relevant competent authorities.³²⁹

The coordinator has no decision-making or enforcement authority to impose measures and sanctions.³³⁰ The presence of a coordinator entrusted with specific tasks concerning the supplementary supervision does not affect the tasks and responsibilities of the competent authorities responsible for the regulated entities in a financial conglomerate as provided for by the sectoral rules.³³¹

To ensure proper supplementary supervision, the competent authorities responsible for the supervision of regulated entities in a financial conglomerate and the coordinator are required to cooperate closely with each other.³³² The coordinator and the relevant competent authorities may enter into coordination agreements to specify the procedures for the decision-making process and for cooperation among them.³³³ They shall provide each other with

http://europa.eu.int/comm/economy_finance/publications/economic_papers/2001/ecp143en.pdf (last visited December 1, 2003) [*herein* Brouwer Report], at 17, *sub* V.1.

³²⁵ Although the language of the Supplementary Supervision Directive is not clear, it follows from Art. 10(2)(b)(ii), second subparagraph, Supplementary Supervision Directive, that the competent authorities that appoint a coordinator may all be located in one Member State.

³²⁶ Art. 11(1), Supplementary Supervision Directive.

³²⁷ *See* Arts. 6, 7 & 8, Supplementary Supervision Directive.

³²⁸ *See* Art. 9, Supplementary Supervision Directive.

³²⁹ *See* Art. 11(1)(f) and second subparagraph, Supplementary Supervision Directive.

³³⁰ *See* Presidency of the Council of the European Union, Report No. 14140/1/01 to the Permanent Representatives Committee/Council on the Proposal for a Directive of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (Brussels, Nov. 30, 2001), available at <http://register.consilium.eu.int/pdf/en/01/st14/14140en1.pdf> (last visited December 1, 2003), at 4, *sub* 2.

³³¹ Art. 11(3), Supplementary Supervision Directive.

³³² Art. 12(1), Supplementary Supervision Directive.

³³³ Art. 11(1), second subparagraph, Supplementary Supervision Directive.

any information that is essential or relevant for the exercise of the other competent authorities' supervisory tasks under the sectoral rules and under the Supplementary Supervision Directive.³³⁴ The competent authorities and the coordinator shall communicate on request all relevant information and shall communicate on their own initiative all essential information.³³⁵ The competent authorities shall consult with each other prior to their decision with regard to the following items, where these decisions are important for the supervisory tasks of other competent authorities: (1) changes in the shareholder, organizational or management structure of regulated entities in a financial conglomerate, that require the approval or authorization of competent authorities, and (2) major sanctions or exceptional measures taken by the competent authorities.³³⁶

If a competent authority wishes to verify information concerning an entity in a financial conglomerate, whether or not it is a regulated entity, that is situated in another Member State, it may ask the competent authorities of the other Member State to carry out the verification.³³⁷ The requested competent authority must carry out the verification or permit experts or the requesting authority to carry out the verification.³³⁸

5. *Enforcement Measures*

If the regulated entity in a financial conglomerate does not comply with the capital adequacy requirements,³³⁹ the requirements concerning risk concentration,³⁴⁰ the requirements concerning intra-group transactions³⁴¹ or the requirements concerning adequate risk management provisions and internal control mechanisms,³⁴² or where the requirements are met but solvency may nevertheless be jeopardized, or where the intra-group transactions or the risk concentrations are a threat to the regulated entities' financial position, the coordinator, with respect to a mixed financial holding company, or the competent authorities, with respect to the

³³⁴ Art. 12(1), Supplementary Supervision Directive.

³³⁵ Art. 12(1), Supplementary Supervision Directive. Art. 12(1), Supplementary Supervision Directive enumerates eight categories of information that shall be gathered and exchanged. Member States shall authorize the exchange of information between their competent authorities and between their competent authorities and certain other authorities, as referred to in Art. 12(1), (2) & (3), Supplementary Supervision Directive. Art. 12(4), Supplementary Supervision Directive.

³³⁶ Art. 12(2), Supplementary Supervision Directive.

³³⁷ Art. 15, first subparagraph, Supplementary Supervision Directive.

³³⁸ Art. 15, second subparagraph, Supplementary Supervision Directive. The requesting authority may participate in the verification when it does not carry out the verification itself. Art. 15, third subparagraph, Supplementary Supervision Directive.

³³⁹ See Art. 6, Supplementary Supervision Directive.

³⁴⁰ See Art. 7, Supplementary Supervision Directive.

³⁴¹ See Art. 8, Supplementary Supervision Directive.

³⁴² See Art. 9, Supplementary Supervision Directive.

regulated entity, shall take the necessary measures in order to rectify the situation as soon as possible.³⁴³

IV. Equivalent Supplemental Supervision for Parent Undertakings Outside the European Union

If the parent of a financial conglomerate is a regulated entity or a mixed financial holding company having its head office outside the EU,³⁴⁴ the EU-regulated entities belonging to such a “non-EU group” are not directly subject to the rules on supplementary supervision.³⁴⁵ The Supplementary Supervision Directive, however, attempts to apply as much supplementary supervision as possible.³⁴⁶

The Supplementary Supervision Directive requires a verification whether the EU-regulated entity, the parent of which has its head office outside the EU, is subject to supervision by the home country of the parent that is equivalent to the supplementary supervision of regulated entities provided for in the Supplementary Supervision Directive.³⁴⁷ The verification shall be carried out by the competent authority that would be the coordinator if the criteria for the appointment of the coordinator as set forth in Art. 10(2), Supplementary Supervision Directive were to apply [*herein* the hypothetical coordinator].³⁴⁸ The verification shall be carried out on the request of the parent of the financial conglomerate, by an EU-regulated entity in such financial conglomerate or by the hypothetical coordinator.³⁴⁹ The hypothetical coordinator shall consult the other relevant competent authorities and the Financial Conglomerates Committee,³⁵⁰ and shall take into account any applicable guidance prepared by the Financial Conglomerates Committee.³⁵¹

³⁴³ Art. 16, Supplementary Supervision Directive.

³⁴⁴ See Art. 5(3), Supplementary Supervision Directive.

³⁴⁵ See Art. 5(3), Supplementary Supervision Directive. Other than the BHCA, the Supplementary Supervision Directive does not regulate non-EU holding companies that control EU-regulated entities.

³⁴⁶ Arts. 5(3) & 18, Supplementary Supervision Directive. See 2001 Explanatory Memorandum, *supra* note 122, at 7, *sub* 2, Art. 14.

³⁴⁷ Art. 18(1), Supplementary Supervision Directive.

³⁴⁸ Art. 18(1), Supplementary Supervision Directive.

³⁴⁹ Art. 18(1), Supplementary Supervision Directive.

³⁵⁰ The Financial Conglomerate Committee established under Art. 21, Supplementary Supervision Directive assists the EU Commission. It may give general guidance as to whether the supplementary supervision arrangements in third countries are likely to achieve the objectives of the Supplementary Supervision Directive, in relation to the regulated entities in a financial conglomerate, the head of which has its head office outside the EU. Art. 21(5), Supplementary Supervision Directive.

³⁵¹ Art. 18(1), Supplementary Supervision Directive.

When the U.S. regulations under the BHCA require foreign banks to demonstrate that they are subject to comprehensive supervision on a consolidated basis,³⁵² they address the questions whether the foreign bank itself is properly supervised by its home country. The Supplementary Supervision Directive, on the other hand, asks whether the EU-regulated entities are subject to supervision by the non-EU home country of the non-EU parent of the financial conglomerate and whether such supervision is equivalent to the supervision under the Supplementary Supervision Directive.

If the supervision by the home country of the non-EU-regulated entity or the mixed financial holding company that has its head office outside the EU over the EU-regulated entities in such group is found to be equivalent to the supplementary supervision of the Supplementary Supervision Directive, the Supplementary Supervision Directive will yield to the foreign supervision.

In the absence of such equivalent supervision, the Member States shall by analogy apply to the EU-regulated entities the provision with regard to supplementary supervision.³⁵³ In the alternative, the Member States shall allow their competent authorities to apply other methods that ensure an appropriate supplementary supervision of the EU-regulated entities in a financial conglomerate.³⁵⁴ In particular, the competent authorities may require the creation of a sub-holding company (which would be a mixed financial holding company) that has its head office in the EU, and apply the supplementary supervision required by the Supplementary Supervision Directive to the regulated entities in the financial conglomerate headed by the European sub-holding company.³⁵⁵ In any event, the methods selected by the competent authorities to ensure an appropriate supplementary supervision “must achieve the objectives of the supplementary supervision as defined in the [Supplementary Supervision Directive]”³⁵⁶ and must be notified to the competent authorities involved and the Commission.³⁵⁷

For a U.S. observer, it is quite surprising to note that the Supplementary Supervision Directive hesitates to regulate directly non-EU holding companies of EU-regulated entities. The United States banking legislation does not show such hesitation with respect to

³⁵² See 12 C.F.R. § 225.92(e)(1) & (2) (2003) (Regulation Y) (election by foreign bank to become financial holding company); 12 C.F.R. § 211.24(c)(1)(i)(A) (2003) (Regulation K) (establishment of U.S. office by foreign bank); 12 C.F.R. § 225.13(a)(4) (2003) (Regulation Y) (acquisition of U.S. bank by foreign bank).

³⁵³ Art. 18(2), Supplementary Supervision Directive. Art. 18(2), Supplementary Supervision Directive refers to “the provisions concerning the supplementary supervision of regulated entities referred to in Art. 5(2) [Supplementary Supervision Directive]”. *Analogy* means “similarity in some respects between things that are otherwise dissimilar”. AMERICAN HERITAGE DICTIONARY, 4th ed. (2000). In the context of the Supplementary Supervision Directive, this presumably means “to the extent possible”.

³⁵⁴ Art. 18(3), Supplementary Supervision Directive. According to Art. 18(3), second sentence, Supplementary Supervision Directive, those methods must be agreed on by the coordinator, after consultation with the other relevant competent authorities.

³⁵⁵ Art. 18(3), third sentence, Supplementary Supervision Directive.

³⁵⁶ Art. 18(3), ultimate sentence, Supplementary Supervision Directive.

³⁵⁷ Art. 18(3), ultimate sentence, Supplementary Supervision Directive.

foreign holding companies. For example, the BHCA applies not only to U.S. banks but also to foreign banks that control a U.S. bank subsidiary³⁵⁸ and foreign banks that maintain a branch, agency or commercial lending company in the United States.³⁵⁹

The EU Commission may also negotiate agreements with third countries regarding the means of exercising supplementary supervision of regulated entities in a financial conglomerate.³⁶⁰ In this context, the Commission may submit proposals to the Council, either at the request of a Member State or on its own initiative, for the negotiation of such agreements.³⁶¹ The agreements would cover supplementary supervision of financial conglomerates whose parent is situated outside the EU but which have regulated entities in the EU and of financial conglomerates whose parent is situated in the EU but which have regulated entities outside the EU.³⁶²

D. Equivalent Consolidated Supervision and Supplementary Supervision of Groups Headed by U.S. Entities.

I. The Issue

If an EU-authorized credit institution is a subsidiary of a non-EU credit institution or financial institution, the competent authorities must verify whether the EU-authorized credit institution is subject to consolidated supervision by the home country of the non-EU parent that is equivalent to that required by the Banking Directive.³⁶³ Similarly, if the parent of a financial conglomerate is a regulated entity or a mixed financial holding company having its head office outside the EU, the competent authorities must verify whether the EU-regulated entities in the financial conglomerate are subject to supplementary supervision by the home country of the parent that is equivalent to the supplementary supervision required by the Supplementary Supervision Directive.³⁶⁴

The question arises whether EU-authorized credit institutions that are subsidiaries of U.S. based parents are subject to equivalent consolidated supervision under U.S. law and whether an EU-regulated credit institution, investment firm or insurance undertaking subsidiary that is part of a cross-sectoral financial conglomerate headed by a U.S. parent is subject to equivalent supplementary supervision under U.S. law.

³⁵⁸ The BHCA applies directly to such foreign banks.

³⁵⁹ Section 8(a), International Banking Act of 1978, 12 U.S.C. § 3106(a) (2000).

³⁶⁰ Art. 19, Supplementary Supervision Directive makes Art. 25(1) &(2), Banking Directive applicable *mutatis mutandis* to the negotiation of such agreements. *See supra* A.V. for a discussion of Art. 25, Banking Directive.

³⁶¹ Art. 19(1), Supplementary Supervision Directive in connection with Art. 25(1), Banking Directive.

³⁶² Art. 19(1), Supplementary Supervision Directive in connection with Art. 25(1), Banking Directive.

³⁶³ Art. 56a, Banking Directive, added by Art. 29(11), Supplementary Supervision Directive. *See supra* A.V.

³⁶⁴ Art. 18, Supplementary Supervision Directive. *See supra* C.IV.

II. Equivalent Consolidated Supervision of EU-Credit Institutions

1. U.S. Non-Regulated Entity as Parent

The U.S. parent of an EU-authorized credit institution may be a non-regulated entity. For instance, large financial institutions such as GE Capital Corporation or GE Consumer Finance that do not take deposits but are engaged in other financial activities do not need a banking license under most states of the United States and their holding companies are not BHCs.³⁶⁵ These entities are not subject to any supervision in the United States and, consequently, if they acquire credit institutions located in EU Member States, the EU credit institutions are not subject to consolidated supervision.

2. U.S. BHC as Parent

If a U.S. BHC acquires directly or indirectly an EU-authorized credit institution,³⁶⁶ the BHC and the EU-authorized credit institution are subject to consolidated supervision in most of the areas in which the Banking Directive requires consolidated supervision.

The Banking Directive requires consolidated supervision of the capital, the solvency ratio and the adequacy of capital to cover market risks.³⁶⁷ Regulation Y imposes on BHCs the Basel Capital Standards on a consolidated basis.³⁶⁸

³⁶⁵ Section 2(a)(1) in connection with § 2(c)(2), BHCA, 12 U.S.C. § 1841(a)(1) & (c)(2) (2000). For instance, GE Consumer Finance operates banks in Austria, Denmark, France, Germany, Spain, Sweden and the United Kingdom.

³⁶⁶ A foreign bank is not a “bank” as defined in § 2(c), BHCA, 12 U.S.C. § 1841(c) (2000), and therefore the acquisition of a foreign bank by a BHC must meet the requirements of § 4(c)(13), BHCA, 12 U.S.C. § 1843(c)(13) (2000), one of the exceptions to § 4(a), BHCA, 12 U.S.C. § 1843(a) (2000). Consequently, the acquisition of a foreign bank by an Edge Act corporation, an agreement corporation, a member bank, or a U.S. BHC must be made in accordance with 12 C.F.R. § 211.8(c) in connection with § 211.10(a)(1) (2003) (Regulation K). See Michael Gruson, *Nonbanking Activities of Foreign Banks Operating in the United States*, § 9.04[10][e] in Gruson & Reisner, *supra* note 9 [herein Gruson, *Nonbanking Activities*]; Derek M. Bush & Paul E. Glatzer, *U.S. Regulation of International Activities of U.S. Banking Organizations*, § 14.04 in Gruson & Reisner, *supra* note 9.

Every national bank is a member bank, 12 U.S.C §221 (2001). For a definition of Edge Act corporation and agreement corporation, see Gruson, *Nonbanking Activities*, *supra*, §9.02[1] note 45.

³⁶⁷ See Arts. 34–47 in connection with Art. 52(5), first subparagraph, Banking Directive. See *supra* A.III.1.

³⁶⁸ A U.S. BHC is subject to the capital requirements set forth in app. A (Capital Adequacy Guidelines for BHCS: Risk-Based Measure (see attachment VI), app. B (Capital Adequacy Guidelines for BHCs and State Member Banks: Leverage Measure), app. D (Capital Adequacy Guidelines for BHCs: Tier 1 Leverage Measure), and app. E (Capital Adequacy Guidelines for BHCs: Market Risk Measures) to 12 C.F.R. pt. 225 (2003). See Gruson, *Financial Holding Company*, § 10.02 [7][b], *supra* note 9; Joyce M. Hansen, Ivan J. Hurwitz & Diane L. Virzera, *Capital Regulation and Supervision of International Banking Organizations*, § 4.03[4] in Gruson & Reisner, *supra* note 9 [herein Hansen, et al., *Capital Regulation*].

See Committee on Banking Regulation and Supervisory Practices [now: Basel Committee on Banking Supervision], *International Convergence of Capital Measurement and Capital Standards* (July 1988, as

The Banking Directive also requires consolidated supervision of investments in the non-financial sector.³⁶⁹ Section 4(a), BHCA generally prohibits investments by a BHC in shares of companies other than banks.³⁷⁰ This prohibition applies to direct and indirect investments.³⁷¹ Thus, the prohibition on equity investments in companies other than banks and the limited exceptions from the prohibition apply on a group-wide basis. Regulation K is more liberal with respect to investments by BHCs, Edge Act corporations, agreement corporations or member banks in foreign companies, but the various restrictions on such investments are computed by aggregating investments made “by the investor or by an affiliate of the investor”.³⁷² The prohibition of Section 4(a), BHCA does not apply to shares in a U.S. company acquired by a U.S. bank subsidiary of a BHC although such shares are indirectly acquired by the BHC.³⁷³ Thus, these U.S. investments by bank subsidiaries of BHCs are not taken into account when computing the permissible investments of the BHC. However, because the investment powers of U.S. banks are extremely limited,³⁷⁴ the failure to aggregate investments by the bank with the investments of its BHC is not of significance. Furthermore, the capital charges on equity investments, discussed below, apply to most direct or indirect equity investments of BHCs and banks.³⁷⁵

If a BHC qualifies as an FHC, the U.S. bank subsidiary of the BHC may make equity investments under the merchant banking investment authority.³⁷⁶ There is no absolute ceiling on the amount of merchant banking investments that a BHC/FHC may make, nor is there a limitation based on a percentage of the capital of the BHC/FHC. However, Regulation Y provides for a progression of Tier 1 marginal capital charges on equity investments in nonfinancial companies, including merchant banking investments, that increase with the size

amended) [*herein* Basel Capital Standards]. For a discussion of the Basel Capital Standards, *see* Hansen, et al., *supra*, § 4.02.

³⁶⁹ *See* Art. 51 in connection with Art. 52(5), second subparagraph, Banking Directive. *See supra* A.III.1.

³⁷⁰ Section 4(a), BHCA, 12 U.S.C. § 1843(a) (2002). *See* Gruson, *Nonbanking Activities*, *supra* note 366, § 9.01.

³⁷¹ Section 4(a), BHCA, 12 U.S.C. § 1843(a) (2002). *See* Gruson, *Nonbanking Activities*, *supra* note 366, § 9.03[1][c].

³⁷² *See, e.g.*, 12 C.F.R. § 211.2(m)(4), § 211.2(p), § 211.2(w), § 211.8(c)(3)(i), § 211.8(d) (2003) (Regulation K). *Affiliate* is defined in 12 C.F.R. § 211.2(a) (2003) (Regulation K).

³⁷³ *See* Gruson, *Nonbanking Activities*, *supra* note 366, § 9.01[1] note 11 and accompanying text.

³⁷⁴ *See, e.g.*, § 5136, Revised Statutes (National Bank Act of 1864), 12 U.S.C. § 24 (seventh) (2000) (prohibiting the ownership of stock) and, as an example of state law, §§ 96 & 97, N.Y. Banking Law (McKinney 2001). The GLBA, however, expands the investment authority of BHCs that qualify as FHCs. *See* Gruson, *Financial Holding Company*, *supra* note 9, § 10.04.

³⁷⁵ *See* Gruson, *Financial Holding Company*, *supra* note 9, § 10.04[2][I] note 593.

³⁷⁶ Section 4(k)(4)(H), BHCA, 12 U.S.C. § 1843(k)(4)(H) (2000). *See* Gruson, *Financial Holding Company*, *supra* note 9, § 10.04[2].

of the aggregate equity investment portfolio for the BHC relative to its Tier 1 capital.³⁷⁷ The rule requires a parent BHC to deduct from its Tier 1 capital the sum of the appropriate percentage of the adjusted carrying value of all equity investments in nonfinancial companies held by it or by its direct or indirect subsidiaries.³⁷⁸ It would seem that the capital charge on equity investments in nonfinancial companies by a BHC and its subsidiaries has a similar effect as an investment ceiling.

Lastly, consolidated supervision under the Banking Directive applies to lending limits (control of large exposures).³⁷⁹ U.S. law, however, does not compute lending limits on a group-wide basis.³⁸⁰

3. Member Bank as Parent

If a member bank (national bank or state member bank) acquires an EU-authorized credit institution,³⁸¹ the national bank or state member bank and the EU-authorized

³⁷⁷ App. A (II. B.5.a. & b.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs). The rule applies the same capital treatment to all equity investments by BHCs (including FHCs) in nonfinancial companies regardless of the authority under which they are held. *See* Gruson, *Financial Holding Company*, *supra* note 9, § 10.04[2][I].

The capital charge does not apply to investments made prior to March 13, 2000. *Id.* The capital charge does not apply to securities held by subsidiaries of the FHC that are registered broker-dealers and to equity investments by insurance company affiliates of an FHC under § 4(k)(4)(I), BHCA, 12 U.S.C. § 1843(k)(4)(I) (2000). *Id.*

³⁷⁸ App. A (II.B.5.a. & c.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs).

The following diagram shows the deduction for nonfinancial equity investments, App. A (II. B.c.) to 12 C.F.R. pt. 225 (Capital Adequacy Guidelines for BHCs):

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the BHC (as a percentage of the Tier 1 capital of the BHC)	Deduction from Tier 1 capital (as a percentage of the adjusted carrying value of the investment)
Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

Each tier of charges applies, on a marginal basis, to the portions of the adjusted carrying value of the BHC's nonfinancial equity investments that fall within the specified ranges of the BHC's Tier 1 capital. Gruson, *Financial Holding Company*, *supra* note 9, § 10.04[2][I].

³⁷⁹ Arts. 48–50 in connection with Art. 52(5), Banking Directive.

³⁸⁰ *See, e.g.*, 12 C.F.R. § 32 et seq. (2003) (national banks); § 103, New York Banking Law (McKinney 2001) (N.Y. banks).

credit institution are subject to consolidated supervision in all areas in which the Banking Directive requires consolidated supervision. U.S. law imposes on all U.S. banks the Basel Capital Standards on a consolidated basis.³⁸² The authority of national banks and state member banks to invest in the equity of foreign nonbanks is regulated by Regulation K³⁸³ on a group-wide basis.³⁸⁴ For purposes of computing the lending limits for loans and extensions of credit to any person, the total loans and extensions of credit by a foreign bank or Edge Act corporation subsidiary of a member bank, and by majority-owned subsidiaries of a foreign bank or Edge Act corporation must be combined with the total loans and extensions of credit to the same person by the member bank and its majority-owned foreign subsidiaries.³⁸⁵

III. Equivalent Supplementary Supervision

Supplementary supervision applies to financial conglomerates that straddle several financial sectors. Supplementary supervision under the Supplementary Supervision Directive applies to capital adequacy at the level of the financial conglomerate, intra-group transactions by regulated entities in a financial conglomerate with other undertakings in the financial conglomerate, and risk concentration in the financial conglomerate.³⁸⁶

I. FHCs

In the United States financial conglomerates are permitted subject to various restrictions by the GLBA amendments to the BHCA. These amendments permit the creation of FHCs that have investments in several financial sectors, mainly the banking, insurance and broker-dealer sectors.³⁸⁷

Whereas the Supplementary Supervision Directive was promulgated to impose additional supervision or cross-sectoral financial conglomerates to deal with the specific risks of such financial conglomerates, the BHCA was enacted to prevent circumvention of the

³⁸¹ For the power of national banks, state member banks, Edge Act corporations and agreement corporations to invest in shares of a foreign bank, *see* Gruson, *Nonbanking Activities*, *supra* note 366, § 9.04[10][e][i] note 704; Michael Gruson, *Investment in Foreign Equity Securities and Debt-Equity Conversions by U.S. Banks, Bank Holding Companies and Foreign Bank Holding Companies*, 1988 COLUM. BUS. L. REV. 441, at 490 (national banks), 494 (member banks) and 498 (Edge Act corporations and agreement corporations).

³⁸² *See* Hansen, et al., *Capital Regulations*, *supra* note 368, § 4.03[3].

³⁸³ 12 C.F.R. § 211.5–211.13 (2000) (Regulation K). Although 12 C.F.R. § 211.8 (2003) (Regulation K) is applicable to investments and to activities abroad by member banks, it does not expand the limits of investment powers of national banks. *See* 12 C.F.R. § 211.8(b) & (c) (2003) (Regulation K) (“subject to the limitations set out in paragraphs (b) and (d) of this section”). A member bank can invest in foreign equity securities only through an Edge Act corporation, an agreement corporation or a foreign bank. *See* Gruson, *Nonbanking Activities*, *supra* note 366, § 9.04[10][e][i] note 704.

³⁸⁴ *See supra* note 372 and accompanying text.

³⁸⁵ 12 C.F.R. § 211.12(b)(2)(ii) (2003) (Regulation K).

³⁸⁶ *See supra* C.III.1. & 2.

³⁸⁷ *See supra* note 9.

rule of separation of banking from all other commercial activities through the creation of a holding company. Even the GLBA amendments to the BHCA, which permit financial holding companies, is more concerned with the careful delineation of this new permission of banks to affiliate with nonbank financial companies than with the supervision of the newly permitted financial conglomerates. Furthermore, different from the Supplementary Supervision Directive, the GLBA was written to protect the banks in financial holding company groups, not to deal with the specific risks of such groups. The GLBA gives the Federal Reserve Board an “umbrella supervision”³⁸⁸ over the financial holding company. It remains to be seen whether this umbrella authority will lead to a true supervision of the conglomerate as such.

a) *Capital Adequacy*

The Board of Governors of the Federal Reserve System [the Board] has the authority, based on its general supervisory power over BHCs, to impose capital and capital adequacy requirements on BHCs. This authority does not diminish once the BHC has effectively elected FHC status.³⁸⁹ Although Regulation Y does not contain any specific requirement that, as a condition to the effective election of FHC status, a U.S. BHC must meet the capital requirements applicable to all BHCs, there is no doubt that the Board under its general supervisory power over BHCs could deny the effectiveness of an FHC election by a BHC, if the BHC is in violation of applicable laws and regulations, including the rules of capital adequacy.³⁹⁰ The Board may impose capital requirements on a BHC/FHC, not only if it is a mere holding company without its own business activities, but, according to the BHCA, even if the BHC/FHC is a broker-dealer, insurance company, insurance agent or investment company.³⁹¹ It is not clear, however, how the capitalization of a company engaged in financial activities other than banking, *e.g.*, a broker-dealer or an insurance company, can be computed in accordance to the Basel Capital Standards, and – unlike the Supplementary Supervision Directive³⁹² – the Board has not attempted to develop capital adequacy standards for FHCs that are not mere BHCs.³⁹³

b) *Intra-Group Transactions*

The supplementary supervision of intra-group transactions under the Supplementary Supervision Directive covers all transactions in which EU-regulated or non-

³⁸⁸ See Gruson, *Financial Holding Company*, *supra* note 9, § 10.07[1].

³⁸⁹ See Gruson, *Financial Holding Company*, *supra* note 9, § 10.02[7][c]; Hansen, et al., *Capital Regulations*, *supra* note 368, § 4.03[5][b].

³⁹⁰ See Gruson, *Financial Holding Company*, *supra* note 9, § 10.02[7][b].

³⁹¹ This follows from § 5(c)(3), BHCA, 12 U.S.C. § 1844(c)(3) (2000), which prohibits the Board from prescribing capital requirements on functionally regulated *subsidiaries* of a BHC (not functionally regulated BHCs). See Hansen, et al., *Capital Regulations*, *supra* note 368, § 4.03[5][b].

³⁹² See *supra* C.III.1.

³⁹³ See Gruson, *Financial Holding Company*, *supra* note 9, § 10.02[7][d]; Hansen, et al., *Capital Regulations*, *supra* note 368, § 4.03[5][b].

EU regulated entities are involved.³⁹⁴ In the United States certain regulatory concerns, such as intra-group transactions and risk concentration, are left to the regulators of the constituent parts of the FHC. Transactions between an insured depository institution and its affiliates are subject to strict limitations under Sections 23A and 23B, Federal Reserve Act.³⁹⁵ A bank's direct and indirect parent companies, as well as companies controlled by or under common control with the banks are covered as affiliates.³⁹⁶ Sections 23A and 23B, Federal Reserve Act deal only with transactions in which the insured U.S. bank is involved.

Transactions between a U.S. insurance company and other companies in an insurance holding company system may be subject to supervision under state insurance laws. For instance, under the New York Insurance Law intra-group transactions of controlled insurers³⁹⁷ with other entities in an insurance holding company system³⁹⁸ are subject to certain substantive standards.³⁹⁹ Section 1505, N.Y. Insurance Law provides that transactions within a holding company system to which a controlled insurer is a party must be on fair and equitable terms, charges or fees for services performed must be reasonable, and expenses incurred and payments received must be allocated to the insurer on an equitable basis in accordance with customary insurance accounting practices consistently applied.⁴⁰⁰ Certain intra-group transactions between a domestic controlled insurer and any person in its holding company system require approval of the Superintendent of Insurance⁴⁰¹ and in the case of other transactions between a domestic controlled insurer and any person in its holding company system, prior notice to the Superintendent is required.⁴⁰² The books and records of each party to intra-group transactions must clearly and accurately disclose the nature and details of such transactions.⁴⁰³ Every controlled insurer must annually report to the Superintendent of Insurance

³⁹⁴ See *supra* C.III.2.

³⁹⁵ 12 U.S.C. §§ 371c, 371c-1 (member banks); 12 U.S.C. § 1828(j) (state nonmember banks); 12 U.S.C. § 1468(a) (federally insured savings associations) (2000).

³⁹⁶ For a discussion of *affiliates*, see Robert E. Mannion & Lisa R. Chavarria, *Transactions Between Banks and Affiliated Entities*, 12.02[3][a] in Gruson & Reisner, *supra* note 9. For these purposes, a foreign bank controlling a U.S. bank and the foreign bank's foreign and domestic subsidiaries would be affiliates of the U.S. bank. *Id.* Sections 23A & 23B, Federal Reserve Act also apply to U.S. branches and agencies of foreign banks. See Gruson, *Financial Holding Company*, *supra* note 9, § 10.07[4][d].

³⁹⁷ A *controlled insurer* is an authorized insurer controlled directly or indirectly by a holding company. § 1501(b)(4), N.Y. Insurance Law (McKinney 2000).

³⁹⁸ *Holding company system* is a holding company together with its controlled insurers and controlled persons. § 1501(6) in connection with (1)–(5), N.Y. Insurance Law .

³⁹⁹ Section 1505, N.Y. Insurance Law.

⁴⁰⁰ Section 1505(a), N.Y. Insurance Law.

⁴⁰¹ Section 1505(c), N.Y. Insurance Law. See § 80-1.5(a) & (b), N.Y. Codes, Rules and Regulations, title 11, pt. 75, ch. IV.

⁴⁰² Section 1505(d), N.Y. Insurance Law. See § 80-1.5(c), N.Y. Codes, Rules and Regulations, title 11, pt. 75, ch. IV.

⁴⁰³ Section 1505(b), N.Y. Insurance Law.

all transactions during the preceding fiscal year with persons within the holding company system.⁴⁰⁴ Again, some of these provisions only deal with intra-group transactions involving a U.S. insurer.⁴⁰⁵

There are no rules dealing with intra-group transactions of U.S. broker-dealers, *i.e.*, investment firms in the terminology of the Supplementary Supervision Directive.⁴⁰⁶

c) Risk Concentration

The Board has stated that as “umbrella supervisor” of FHCs⁴⁰⁷ it will assess capital adequacy of FHCs in relation to the risk profile of the consolidated organization and that the Board will review the FHC’s internal risk assessment and related capital analysis process for determining the adequacy of its overall capital position.⁴⁰⁸ Such review will include consideration of present and future economic conditions, future business development plans, possible stress scenarios, and Internet risk control and audit procedures.⁴⁰⁹

2. *CSEs*

The U.S. Securities and Exchange Commission [SEC] took a huge step in the direction of consolidated supervision of groups that include broker-dealers in two recently proposed sets of rules that would (1) permit alternative net capital requirements for broker-dealers that are part of a holding company system (the holding company and its affiliates are called a “consolidated supervised entity” [*herein* CSE])⁴¹⁰ and (2) create a new framework for supervising an investment bank holding company that voluntarily files a notice of intention with the SEC to become a supervised investment bank holding company and be subject to supervision

⁴⁰⁴ § 80-1.4(a), N.Y. Codes, Rules and Regulations, title 11, pt. 75, ch. IV.

⁴⁰⁵ However, a foreign life insurer which is authorized to do business in New York which is controlled by a person not authorized to do insurance business in New York shall be deemed under certain conditions a *domestic* insurer. Section 1501(d), N.Y. Insurance Law.

⁴⁰⁶ *But see* 17 C.F.R. § 240.17h-1T(2) (2003) & 2T. *See* Form 17-H, Fed. Sec. L. (CCH) ¶ 33,347.

⁴⁰⁷ Gruson, *Financial Holding Company*, *supra* note 9, § 10.07[1].

⁴⁰⁸ Hansen, et al., *Capital Regulations*, *supra* note 368, § 4.03[5][b]; Board, SR Letter No. 00-13 (SUP) (Aug. 15, 2000) [*herein* Supervision Letter].

⁴⁰⁹ Hansen, et al., *Capital Regulations*, *supra* note 368, § 4.03[5][b]; Supervision Letter, *supra* note 408.

⁴¹⁰ SEC Release No. 34-48690, ___ SEC Docket ___, 68 Fed. Reg. 62,872 (Nov. 6, 2003) (Alternative Net Capital Requirements For Broker-Dealers That Are Part of Consolidated Supervised Entities) [*herein* CSE Release].

on a group-wide basis.⁴¹¹ The proposals were made in response to the EU requirement of equivalent supplementary supervision in the Supplementary Supervision Directive.⁴¹²

The CSE rules would amend the net capital rules for broker-dealers⁴¹³ to establish a voluntary alternative method for computing net capital for broker-dealers that are part of a holding company which has a group-wide internal risk management control system and consents to group-wide SEC supervision.⁴¹⁴ A broker-dealer that maintains a certain net capital⁴¹⁵ could apply to the SEC for a conditional exemption from the application of the standard net capital rule calculation and, upon SEC approval, elect to calculate certain of its market and credit risk capital charges using the firm's own internal mathematical models for risk measurement, including internally developed value-at-risk models and scenario analysis. The SEC recognizes that large broker-dealers typically are owned by holding companies that also own other entities engaged in securities and non-securities activities worldwide and that the broker-dealer may incur many types of risks through its affiliates. The proposed alternative net capital provisions would be conditioned on the broker-dealer and its holding company documenting a comprehensive risk management system for identifying, measuring and managing risk, which would be subject to SEC review. Under the proposed rule, a broker-dealer could use its proprietary mathematical risk measurement models under prescribed circumstances to calculate its regulatory capital requirement. Broker-dealers wanting to take advantage of the alternative capital calculation would need to provide the SEC with access to group-wide information.⁴¹⁶

In most instances, the SEC's supervision on a group-wide basis would consist of analyzing records and reports provided by the holding company (or "CSE") of the broker-dealer. Nevertheless, a CSE that is not an entity that has a principal regulator would permit the SEC to examine its books and records. A CSE also would permit the SEC to examine the books and records of any affiliate of the broker-dealer that does not have a principal regulator. As a condition to the broker-dealer's exemption from the standard net capital rule, for a holding company that has a principal regulator, the holding company would make available to the SEC such information concerning the operations of the holding company that is necessary for the SEC to evaluate the financial and operational risk within the affiliate group of the broker-dealer (including any risks that could affect the reputation of the holding company or broker-dealer) and to evaluate compliance with the conditions of eligibility for computing the broker-dealer capital charges in accordance with the proposal. The SEC would not examine any holding company that is primarily in the insured depository institutions business (excluding its insurance and commercial businesses) and that arranges to provide the records necessary to meet the SEC's

⁴¹¹ SEC Release No. 34-48694, ___ SEC Docket ___, 68 Fed. Reg. 62,910 (Nov. 6, 2003) (Supervised Investment Bank Holding Companies) [*herein* SIBHC Release].

⁴¹² CSE Release, *supra* note 410, 68 Fed. Reg. 62,874; SIBHC Release, *supra* note 411, 62 Fed. Reg. at 62,911.

⁴¹³ Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2003).

⁴¹⁴ See CSE Release, *supra* note 410, at 68 Fed. Reg. at 62,872.

⁴¹⁵ See proposed rules 15c3-1(a)(7) & (c)(15).

⁴¹⁶ See CSE Release, *supra* note 410, 68 Fed. Reg. at 62,872–73.

supervisory purposes. The SEC also would not examine functionally regulated broker-dealer affiliates.⁴¹⁷

In the CSE rules the SEC carefully tries to walk the line between supervision of the group and deference to other regulatory agencies. The proposed CSE rules – different from the Supplementary Supervision Directive – do not envision the role of a coordinator to facilitate supervision of entities in different sectors of the financial industry.⁴¹⁸

A broker-dealer's use of the alternative net capital treatment of the CSE rules would be conditioned on the CSE complying with a series of requirements. The CSE would be required on a monthly and quarterly basis to compute group-wide capital and allowances for market, credit, and operational risk as if it were subject to the Basel Capital Standards. The CSE would be required to implement and maintain a consolidated internal risk management control system and procedures to monitor and manage group-wide risk, including market, credit, funding, operational and legal risks.⁴¹⁹

Major financial organizations that do not qualify for SIBHC treatment, discussed below, would have the option of becoming a CSE and thereby obtain the benefit of lower capital charges for their broker-dealer subsidiaries as well as a consolidated supervisor for EU purposes for those that are not BHCs subject to the BHCA.

3. *SIBHCs*

Section 231, GLBA amended Section 17, Securities and Exchange Act of 1934⁴²⁰ [*herein* Exchange Act] to create a regulatory framework under which a holding company of a broker-dealer may voluntarily be supervised by the SEC as a supervised investment bank holding company [*herein* SIBHC]. The proposed rules also would create a framework for the SEC to supervise SIBHCs. These rules also would enhance the SEC's supervision of the SIBHC's subsidiary broker-dealers through collection of additional information and examinations of affiliates of those broker-dealers. This framework would include qualification criteria for investment bank holding companies [*herein* IBHCs] that file notices of intention to be supervised by the SEC, as well as recordkeeping and reporting requirements for SIBHCs. An IBHC that meets the criteria set forth in the proposed rules would not be required to become an SIBHC; supervision as an SIBHC is voluntary. Taken as a whole, the proposed framework would permit the SEC to better monitor the financial condition, risk management, and activities of a broker-dealer's parent and affiliates on a group-wide basis. In particular, it would create a formal process through which the SEC could access important information regarding activities of a broker-dealer's affiliates that could impair the financial and operational stability of the broker-

⁴¹⁷ See CSE Release, *supra* note 410, 68 Fed. Reg. at 62,873.

⁴¹⁸ See *supra* C.III.4.

⁴¹⁹ See CSE Release, *supra* note 410, 68 Fed. Reg. at 62,875.

⁴²⁰ Pub. L. 106-102, 106th Cong., 1st Sess. (Nov. 12, 1999), 113 Stat. 1838 at 1402 (1999), amended § 17, Exchange Act, 15 U.S.C. § 78q (2000).

dealer or the SIBHC.⁴²¹ This regulatory framework for SIBHCs is intended to provide a basis for non-US. financial regulators to treat the SEC as the principal U.S. consolidated, home-country supervisor for SIBHCs and their affiliated broker-dealers.⁴²²

Pursuant to the definitions in the Exchange Act,⁴²³ the term *IBHC* means any person, other than a natural person, that owns or controls one or more broker-dealers and the associated persons of the IBHC. The term *associated person of an investment bank holding company* means any person directly or indirectly controlling, controlled by, or under common control with the IBHC.⁴²⁴ Thus, an IBHC includes the holding company and all other entities within the holding company structure that met the “control” test. A *supervised investment bank holding company* is an IBHC that is supervised by the SEC pursuant to Section 17(i), Exchange Act.⁴²⁵ In order to elect to become an SIBHC, an IBHC must file with the SEC a written notice of intention to become supervised by the SEC.⁴²⁶ Section 17(i)(1)(A), Exchange Act limits the entities that are eligible to become an SIBHC.⁴²⁷ Specifically, an IBHC that is (i) an affiliate of an insured bank (with certain exceptions) or a savings association,⁴²⁸ (ii) a foreign bank, foreign company, or a company that is described in Section 8(a), International Banking Act of 1978;⁴²⁹ or (iii) a foreign bank that controls, directly or indirectly an Edge Act corporation⁴³⁰ would not be eligible to file a notice of intention.⁴³¹ These exclusions of groups that include banks prevent FHCs from electing SIBHC status and substantially limit the number of financial groups that can elect SIBHC status.

Proposed rule 17i-4 would require an SIBHC to establish, document and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, operational, funding, and legal risks.⁴³²

⁴²¹ SIBHC Release, *supra* note 411, 68 Fed. Reg. at 62,911.

⁴²² SIBHC Release, *supra* note 411, 68 Fed. Reg. at 62,911.

⁴²³ Section 17(i)(5)(A), Exchange Act, 15 U.S.C. § 78q(i)(5)(A) (2000).

⁴²⁴ Section 17(i)(5)(F), Exchange Act, 15 U.S.C. § 78q(i)(5)(F) (2000).

⁴²⁵ Section 17(i)(5)(B), Exchange Act, 15 U.S.C. § 78q(i)(5)(B) (2000). *See* SIBHC Release, *supra* note 411, 68 Fed. Reg. at 68,912.

⁴²⁶ Section 17(i)(1)(B), Exchange Act, 15 U.S.C. § 78q(i)(1)(B) (2000). *See* proposed rule 17i-2.

⁴²⁷ 15 U.S.C. § 78q(i)(1)(A) (2000).

⁴²⁸ Section 17(i)(1)(A)(i), Exchange Act, 15 U.S.C. § 78q(i)(1)(A)(i) (2000).

⁴²⁹ Section 17(i)(1)(A)(ii), Exchange Act, 15 U.S.C. § 78q(i)(1)(A)(ii) (2000). Section 8(a), International Banking Act of 1978, 12 U.S.C. § 3106(a) (2000).

⁴³⁰ Section 17(i)(1)(A)(iii), Exchange Act, 15 U.S.C. § 78q(i)(1)(A)(iii) (2000). Section 25A, Federal Reserve Act, 12 U.S.C. § 611 et seq. (2000) (Edge Act corporations).

⁴³¹ SIBHC Release, *supra* note 411, 68 Fed. Reg. at 62,912. *See* proposed rule 17i-2(a).

⁴³² SIBHC Release, *supra* note 411, 68 Fed. Reg. at 62,914–15.

An SIBHC would have to comply with the net capital rules applicable to OTC derivative dealers⁴³³ as though it were a broker-dealer;⁴³⁴ however, it could also use the optional alternative net capital requirements proposed in the CSE Release.⁴³⁵

Pursuant to Section 17(i)(3)(A), Exchange Act,⁴³⁶ an SIBHC would be required to make and keep records, furnish copies thereof and make such reports as the SEC may require by rule.⁴³⁷

Proposed rule 17i-7 would require an SIBHC to calculate the affiliate group's allowable capital and allowances for certain types of risks. Proposed rule 17i-7 would not set minimum group-wide capital levels for SIBHCs; rather, it would require the SIBHC to perform certain calculations that the SEC could review to gain an understanding of the financial position of the affiliate group and identify any risks it poses to the broker-dealer.⁴³⁸ The proposed rules incorporate a capital computation for the SIBHC that is consistent with the Basel Capital Standards.⁴³⁹

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⁴³³ Rule 15c3-4, 15 C.F.R. 240.15c3-4 (2003).

⁴³⁴ Proposed rule 17i-4.

⁴³⁵ SIBHC Release, *supra* note 411, 68 Fed. Reg. at 62,915, note 51.

⁴³⁶ 15 U.S.C. § 78q(i)(3)(A) (2000).

⁴³⁷ These requirements of record creation and maintenance and access to records are set forth in proposed rule 17i-5. Proposed rule 17i-6 contains reporting requirements.

⁴³⁸ SIBHC Release, *supra* note 411, 68 Fed. Reg. at 62,918.

⁴³⁹ SIBHC Release, *supra* note 411, 68 Fed. Reg. at 62,918–23.

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