A New Era: Depository Institutions and Their Holding Companies Face a Deluge of Regulatory Changes

K&L Gates originally published this alert prior to July 21, 2010, the date on which President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law.

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “Act”), which restructures the regulatory framework for most banking organizations. Although the full impact of the Dodd-Frank Act cannot be assessed until implementing regulations are released, depository institutions and their affiliates face new regulators, increased activities restrictions and capital requirements, and numerous other fundamental changes in how they are regulated.

The most significant changes promised by the Dodd-Frank Act that directly affect most depository institutions are the abolition of the Office of Thrift Supervision (“OTS”) with reallocation of supervisory responsibilities among the remaining regulators and the Volcker Rule. The Volcker Rule imposes new limitations on proprietary trading and permissible private equity fund and hedge fund activities of regulated organizations. The Dodd-Frank Act also provides for many more less significant changes to affiliations among commercial and non-commercial firms, expansionary activities, lending limits, capital rules, deposit rules, stress test requirements, and modification of savings and loan holding company rules.

Abolition of the OTS and Changes to Supervisory Authority

The transfer of OTS powers will take place within one year to 18 months after enactment of the Dodd-Frank Act, and the OTS will be officially abolished 90 days after the transfer. Consequently, supervisory responsibilities for depository institutions and their holding companies will be reordered to reflect a simpler, more logical scheme. The Board of Governors of the Federal Reserve System (“Federal Reserve”) will become the federal regulator of all holding companies—financial holding companies, bank holding companies, and savings and loan holding companies. All depository institutions chartered under federal law (i.e., national banks and federal thrifts) will be regulated by the Office of the Comptroller of the Currency (“OCC”), where a Deputy Comptroller will be appointed to oversee federal thrifts. All state thrifts and state non-member banks will be appointed to oversee federal thrifts. All state thrifts and state non-member banks will be regulated by the Federal Deposit Insurance Corporation (“FDIC”).

1 Sections 311 and 313.
2 Section 314.
3 Section 312.
4 Id. The FDIC will have supervisory authority over state-chartered savings associations but the regulatory authority of the OTS, with regard to state-chartered savings associations, will be transferred to the OCC.
The Federal Reserve will retain regulatory and supervisory authority over state-chartered banks that are members of the Federal Reserve System. All existing OTS regulations and orders will remain in effect, until modified, terminated or superseded, but they will be enforceable by the agencies regulating the affected institutions.\(^5\)

The Dodd-Frank Act also provides increased authority and autonomy for the remaining federal bank regulators. The OCC will have discretion to set fees and keep the revenues, which are not subject to the appropriation process.\(^6\) The FDIC will no longer have to obtain the agreement of the other federal banking agencies in order to require reports from insured institutions. Instead, the FDIC will only have to consult with the other agencies prior to requiring such reports.

The Federal Reserve will have increased supervisory powers over financial holding companies, bank holding companies, and savings and loan holding companies, including increased examination and reporting authority over all subsidiaries.\(^7\) If the Federal Reserve fails to conduct examinations of a nonbank subsidiary, the federal bank regulator with supervisory authority over the lead depository institution of the organization has back-up authority to examine and take enforcement action against the nonbank subsidiary. Thus, activities of bank affiliates that have previously been subjected only to the umbrella regulation of the Federal Reserve may now become subject to more stringent supervision and examination.

In order to pay for its additional supervisory authority over large holding companies, the Federal Reserve will be required to assess fees from holding companies having assets of $50 billion or more, as well as systemically significant nonbank financial companies.\(^8\)

### Volcker Rule

The “Volcker Rule,” which refers to a new Section 13 of the Bank Holding Company Act (“BHCA”),\(^9\) is perhaps one of the most discussed reforms governing banking organizations in the Act. These provisions place significant limitations, including capital requirements, on proprietary trading, sponsoring or investing in hedge funds, private equity funds or similar funds by “banking entities” and other systemically significant organizations regulated by the Federal Reserve.

### Banking Entities

The Volker Rule’s restrictions are styled as general prohibitions on “banking entities” and additional capital requirements and possible quantitative limits for systemically significant organizations regulated by the Federal Reserve. Banking entities are defined broadly to include FDIC-insured institutions, any entity that controls an FDIC-insured institution, entities treated as bank holding companies (i.e., certain foreign banks), or any affiliates of the foregoing.

FDIC-insured institutions include not only commercial banks, savings banks, cooperative banks and thrifts, but also industrial loan companies and credit card banks. Non-depository trust companies, which are not FDIC-insured, or those FDIC-insured trust companies that comply with the trust company exemption under the BHCA, are not included within the definition, unless they are affiliated with a banking entity.

In addition, a “banking entity” includes any company that controls an insured institution. Thus along with bank and savings and loan holding companies, the parent holding companies of industrial loan companies and credit card banks are included within the definition of “banking entity.”

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5. *Id.*
6. Section 318.
7. Section 605 requires the Federal Reserve to conduct examinations of holding company subsidiaries that are not insured depository institutions (excluding functionally regulated entities) that are engaged in activities permissible for insured institutions. Section 604 authorizes the Federal Reserve to take a more active role in examining functionally regulated subsidiaries.
8. Section 318.
9. See Section 619 of the Dodd-Frank Act, which contains the Volcker Rule provisions. The Volcker Rule provisions generally apply as well to systemically important nonbank financial companies, as designated under the Dodd-Frank Act. Under the Act, the authority of the Federal Reserve with respect to a non-U.S. nonbank financial company generally includes only its U.S. activities and subsidiaries.
Any company that “is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978” also is a “banking entity.” This includes any foreign banking organization with a U.S. branch, agency, commercial lending company or depository institution subsidiary. It would not include a foreign banking company with only a representative office in the United States.

Finally, a “banking entity” includes any affiliate or subsidiary of any of the foregoing entities, which means that all subsidiaries and affiliates of any of the “banking entities” are themselves “banking entities.”

Proprietary Trading Restrictions

The Volcker Rule would generally prohibit “engaging as a principal for the trading account of the banking entity . . . in any transaction to purchase or sell, or otherwise acquire or dispose of any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or other security or financial instrument that the appropriate agencies have determined, by rule, to be covered instruments.” For purposes of this prohibition, a “trading account” is defined as “any account used for acquiring or taking positions in the securities and instruments (described above) principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements) and any such other accounts as the appropriate agency may determine by regulation.” Nonbank financial companies that engage in proprietary trading will be subject to additional capital requirements and quantitative limits to be determined by regulation. Given the breadth of the regulatory discretion and scope of regulatory interpretation, it will be some time before the full impact of the proprietary trading rules will be known.

Notwithstanding this prohibition on proprietary trading, and subject to certain conflict of interest rules (described below), certain limited proprietary trading is allowed. More specifically, to the extent otherwise authorized under federal or state law, a banking entity may:

- Purchase, sell, acquire and dispose of:
  - obligations of the United States or any agency thereof,
  - obligations, participations, or other instruments of or issued by a Federal Home Loan Bank, Farmer Mac, Farm Credit System institution, Ginnie Mae, Fannie Mae, or Freddie Mac (including mortgage-backed securities issued by any of these entities), or
  - obligations of a state or of any political subdivision thereof;
- Purchase, sell, acquire, and dispose of securities or other instruments in connection with underwriting or market-making related activities, to the extent that any such activities are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties;
- Engage in risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce specific risks;
- Purchase, sell, acquire, and dispose of securities and instruments on behalf of customers; and
- Invest in one or more small business investment companies as defined in the Small Business Investment Act of 1958, investments designed to promote the public welfare, of the type permitted for national banks, or instruments that are qualified rehabilitation expenditures with respect to historic properties. It appears that the investments permitted under this exception pertain to domestically-chartered small business investment companies, and U.S. public welfare and historic preservation.

In addition, a banking entity may engage in such other activity as the appropriate federal banking agencies, the Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (“CFTC”) may determine by rule to promote and protect the safety and soundness of the banking entity.

An insurance company that is affiliated with a banking entity (and is therefore a banking entity)
and is directly engaged in the business of insurance and any affiliate may, for the general account of the company, purchase, sell, acquire, or dispose of securities and other instruments if such activities are conducted in compliance with the insurance law of the state in which the company is domiciled and the appropriate federal banking agencies have not jointly determined that the insurance law of the state is insufficient to protect the safety and soundness of the banking entity or financial stability of the United States.

Notwithstanding the general prohibition, proprietary trading may be conducted by certain foreign banking entities as permitted by the BHCA if the trading occurs solely outside of the United States and if the banking entity is not directly or indirectly controlled by a U.S. banking entity.10

Hedge Funds and Private Equity Funds (“Private Funds”)
The Volcker Rule generally prohibits banking entities from sponsoring or investing in hedge funds or private equity funds (collectively referred to as “Private Funds”), and subjects other systemically significant organizations regulated by the Federal Reserve to increased capital requirements and quantitative limits for engaging in such activities, subject to exemptions.

The terms “hedge funds” and “private equity funds” that are the object of Volcker Rule restrictions are defined to mean any issuer that would be an investment company under the Investment Company Act of 1940, but for Sections 3(c)(1) or 3(c)(7) thereof,11 or “such similar funds” as certain federal agencies may determine by rule. These definitions are potentially broader than the colloquial meanings of the terms “hedge funds” and “private equity funds” because of the absence in the statutory definition of any qualitative criteria (e.g., redemption structure, investment policies, etc.) often implied in the colloquial meanings, and the authority of the agencies to define “similar funds” as Private Funds. Notwithstanding the regulatory agencies’ authority to define “similar funds,” it seems clear that funds exempt from the definition of “investment company” under other sections of the Investment Company Act of 1940, such as bank common and collective investment funds organized under Sections 3(c)(3) and 3(c)(11), respectively, should not be covered as Private Funds subject to the restrictions under the Volcker Rule.

“Sponsoring” a Private Fund would include: (1) serving as a general partner, managing member or trustee of a Private Fund; (2) selecting or controlling in any manner a majority of the directors, trustees or management of a Private Fund; or (3) sharing with the Private Fund the same name or variant of a name, which is used for corporate, marketing, promotional, or other purposes.

Permissible Private Fund Sponsorship and Investments
While the Act contains a general prohibition on a banking entity acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring any Private Fund, a banking entity, to the extent permitted by any other provision of federal or state law and any restrictions or limitations that the appropriate federal regulators may determine, may organize and offer a Private Fund, and sponsor it, if all of the following conditions are met:

- The banking entity provides bona fide trust, fiduciary, or investment advisory services;
- The Private Fund is organized and offered only in connection with the provision of bona fide trust, fiduciary or investment advisory services and only to customers of such services of the banking entity;
- The banking entity does not, directly or indirectly, guarantee, or assume or otherwise insure the obligations or performance of the
Private Fund or of any other Private Fund in which the Private Fund invests;

- The banking entity does not share the same name, or variation thereof, with the Private Fund;
- No director or employee of the banking entity takes or retains an equity interest, partnership interest or other ownership interest in the Private Fund, except for any director or employee who is directly engaged in providing investment advisory or other services to the Private Fund;
- The banking entity discloses to prospective and actual investors in the Private Fund, in writing, that any losses in such Private Fund are borne solely by investors in the Private Fund and not by the banking entity, and otherwise complies with any additional regulatory requirements; and
- The banking entity does not acquire or retain an equity interest, partnership interest or other ownership interest in the Private Fund, other than:
  - A seed investment, in connection with establishing a Private Fund, for a period of up to one year, which may be up to 100 percent of the ownership interests; and
  - De minimis longer-term investments, which after one year are reduced to an amount that is not more than 3 percent of the total ownership, and the investment is “immaterial” to the banking entity.

In no case may the banking entity’s seed and de minimis investments in Private Funds exceed 3 percent of the banking entity’s tangible common equity.

The de minimis exception has generally been reported as permitting investments in Private Funds as to which the banking entity has no sponsorship role, i.e., a pure investment, as well as in Private Funds sponsored by the banking entity. However, under the actual wording of the Act, it appears that the de minimis exception is available only for investments in Private Funds organized and offered by the banking entity and sold only to customers subject to the limitations listed above.

However, no transaction, class of transactions or activity may be deemed to be a permitted activity if it would:

- Involve or result in a material conflict of interest (to be defined by the appropriate regulatory agencies) between the banking entity and its clients, customers or counterparties;
- Result directly or indirectly in an unsafe and unsound exposure (to be defined by the appropriate regulatory agencies) by the banking entity to high-risk assets or high-risk trading strategies;
- Pose a threat to the safety and soundness of such banking entity; or
- Pose a threat to the financial stability of the United States.

**Offshore Funds**

The Volcker Rule provisions also contain an exception for the acquisition or retention of any equity, partnership, or other ownership interest in, or sponsorship of, a Private Fund by certain foreign banking organizations if the Private Fund is located solely outside of the United States and no ownership interest in such Private Fund is offered for sale or sold to a resident of the United States. This exemption would be available only to banking entities that are (a) foreign companies, the greater part of whose business is conducted outside of the United States or (b) companies that do no business in the United States, except as incidental to their international or foreign business. Further, the banking entity may not be directly or indirectly controlled by a U.S. banking entity. This exemption will not be of use to sponsors of offshore funds that have both U.S. and non-U.S. investors. Moreover, foreign banking entities may still be restricted in dealing with Private Funds by the rules governing transactions with affiliates discussed below.

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12 A banking entity is required to seek unaffiliated investors to reduce or dilute its seed investment.

13 See Sections 4(c)(9) and 4(c)(13) of the BHCA.
Transactions with Affiliates Restrictions

Application of the restrictions on transactions with affiliates to Private Funds appears to reflect a desire to create a firewall around Private Funds, in the same manner such limitations were originally enacted to create a firewall around insured depository institutions, albeit for slightly different purposes. In the case of Private Funds, the firewall appears intended to completely isolate risk associated with Private Fund activities and not allow it to infect a banking organization, whereas in the case of banks, the firewall is intended to limit insured depository institutions’ exposure to risks arising out of nonbanking activities of affiliates.

The rule is stated as a prohibition on any banking entity that serves, directly or indirectly, as the investment manager, investment adviser of a Private Fund, or organizes and offers a Private Fund under the rules described above, and any affiliate of such banking entity, from entering into a transaction with such Private Fund (or any other Private Fund controlled by such Private Fund) that would be a “covered transaction” under Section 23A of the Federal Reserve Act. A “covered transaction” in this context would include (1) a loan or extension of credit to the Private Fund, (2) a purchase of, or an investment in, securities issued by the Private Fund, (3) a purchase of assets, including assets subject to repurchase, from the Private Fund, (4) the acceptance of securities issued by the Private Fund as collateral security for a loan, or (5) the issuance of a guarantee, acceptance, or letter of credit on behalf of the Private Fund.

Under the provisions of the Volcker Rule noted above, it is permissible for a banking entity to make an investment in a Private Fund in the form of a seed or de minimis investment. This provision is inconsistent with a prohibition against entering into a transaction that would be a prohibited Section 23A covered transaction, which includes investing in securities issued by an affiliate. Still, Congress’s clear intent was to permit seed and other de minimis investments, which should supersede the application of Section 23A. Nevertheless, we may need to wait for the federal regulatory agencies’ interpretation of these provisions.

In addition, any banking entity that serves, directly or indirectly, as the investment manager or investment adviser—but not sponsor—of a Private Fund, or that organizes and offers a Private Fund as a permissible activity, will be subject to Section 23B of the Federal Reserve Act. Section 23B of the Federal Reserve Act generally requires that all transactions between a member bank and its affiliates be conducted on terms that are at least as favorable to the bank as those prevailing at the time for comparable transactions with unaffiliated companies. This could mean, for example, that, when a banking entity is serving as investment adviser to a Private Fund that uses bank affiliated service providers for the Private Fund, the Private Fund would have to pay the bank affiliated adviser and other service providers no less than market rates. Banking entities might also be restricted in the extent to which they could provide waivers of service fees.

The Federal Reserve may grant an exemption from the transactions with affiliates rules found in Section 23A of the Federal Reserve Act to allow a banking entity to enter into a prime brokerage transaction with a Private Fund managed, sponsored, or advised by such banking entity if the banking entity is in compliance with the permissible activities provisions, the banking entity enters into an enforceable undertaking that the transaction will not be used to avoid losses to any investor in a Private Fund, and the Federal Reserve has determined that such transaction is consistent with the safe and sound operation of the banking entity.

Capital

The appropriate federal bank regulatory agencies, the SEC, and the CFTC are also obligated to adopt rules imposing additional capital requirements and quantitative limitations on permissible activities as necessary to protect the safety and soundness of banking entities and systemically significant nonbank financial companies that are supervised by the Federal Reserve. For purposes of determining compliance with any such rules, the aggregate amount of outstanding investment in seed capital and de minimis investments in a Private Fund must be deducted from the assets and the tangible capital of the banking entity.
Nonbank financial companies supervised by the Federal Reserve may engage in activities that would be subject to the Volcker Rule’s general prohibitions if conducted by a banking entity, but will be subject to capital requirements and quantitative limits. These too will be determined by regulations issued by the federal regulatory agencies. Nonbank financial companies supervised by the Federal Reserve that engage in activities in which a banking entity may engage (i.e., activities not subject to the Volcker Rule’s general prohibition) will be subject to the same capital requirements and quantitative limits applicable to banking entities.

**Exceptions and Anti-Evasion**

The federal regulatory agencies may determine that other activities are permissible that would “promote and protect” the safety and soundness of banking entities and the financial stability of the United States. The federal regulatory agencies must issue rules regarding internal controls and recordkeeping to insure compliance with the Volcker Rule. In addition, the federal regulatory agencies are required to order termination of an investment or activity that functions as an evasion of the rules.

**Effective Date, Rulemaking and Transition**

Regulations implementing the Volcker Rule must be promulgated by the appropriate federal banking agencies (with regard to insured depository institutions), the Federal Reserve (with regard to holding companies and affected nonbank financial companies), the SEC (with respect to any entity for which the SEC is the primary regulatory agency) and the CFTC (with respect to entities for which the CFTC is the primary federal agency), after coordination among the agencies and with the intent of adopting comparable regulations. In addition, the Chair of the Financial Stability Oversight Council (the “FSOC”) has responsibility for coordinating the regulations issued by the agencies. The agencies are required to act within nine months after the completion of a six-month study by the FSOC on implementation of the Volcker Rule.

In any event, the Volcker Rule provisions will take effect on the earlier of 12 months after the issuance of final rules implementing the legislation, or two years after the date of enactment. Within two years after the effective date of the requirements, banking entities must bring their investments and activities into compliance with the statute. The Federal Reserve may extend the two-year period for not more than one year at a time for a total of three years in the aggregate. With regard to divestiture of illiquid Private Funds, the Federal Reserve may extend the transition period for up to a maximum of five years on a case-by-case basis. An illiquid Private Fund is a Private Fund that, as of May 1, 2010, was principally invested in and contractually committed to principally invest in illiquid assets, such as portfolio companies, real estate investments and venture capital investments, and that makes all investments pursuant to and consistent with an investment strategy to invest in illiquid assets.

**Other Reforms in the Dodd-Frank Act**

**New Barriers between Financial and Commercial Activities**

The Dodd-Frank Act addresses the potential for mixing of financial and commercial activities at both grandfathered unitary savings and loan holding companies and certain depository institutions that are not treated as banks for purposes of bank holding company registration.

The Dodd-Frank Act addresses commercial activities conducted by grandfathered unitary savings and loan holding companies by permitting the Federal Reserve to require them to create intermediate holding companies, through which all financial activities are conducted. This would force grandfathered unitary savings and loan holding companies to segregate financial activities from non-financial ones. Most internal financial activities, such as treasury, investment, and employee benefit functions, may remain outside of the intermediate holding company. Although intermediate holding companies are permitted, not required, under the Dodd-Frank Act, it is likely that the Federal Reserve’s implementing regulations will require their creation generally.

Additionally, the Federal Reserve could prohibit internal financial activities of grandfathered unitary savings and loan holding companies.
savings and loan holding companies if they present undue risk. The Federal Reserve may also restrict, by regulation, transactions with the intermediate holding company as necessary to prevent unsafe and unsound practices. The Federal Reserve’s “source of strength” doctrine will not only be codified, but will also be applied to grandfathered unitary savings and loan holding companies. Consequently, the ultimate parent of the grandfathered unitary savings and loan holding company would be able to continue to engage in any commercial activities in which it was previously engaged, notwithstanding the BHCA limitations on nonbank activities, but would have to serve as a source of strength, would have to file reports with the Federal Reserve, and would be subject to enforcement action by the Federal Reserve.  

The Dodd-Frank Act also addresses the potential for mixing financial and commercial activities by subjecting proposals by commercial firms to charter or acquire industrial loan companies, credit card banks, and trust companies that are FDIC-insured to a three-year moratorium. During that time, the FDIC is prohibited from approving applications for deposit insurance or change in control for these types of institutions if they are, or will be, controlled by companies that receive less than 15 percent of their gross revenues from activities that are banking or “financial in nature,” as that phrase is defined in the BHCA. During the moratorium, a study will be conducted to determine whether companies owning these types of institutions (including thrifts that are not among the BHCA exempt organizations) should be subjected to the restrictions of the BHCA. Meanwhile, credit card bank power is expanded slightly by allowing credit card banks to issue credit cards to small businesses.

**Acquisitions and Expansionary Activities**

The Dodd-Frank Act will also reconfigure the framework for expansionary activities by imposing new concentration limits based upon liabilities, imposing new approval requirements on certain acquisitions by financial holding companies, liberalizing de novo interstate branching, and limiting charter conversions by institutions subject to regulatory orders.

The Dodd-Frank Act imposes a general concentration limit on all financial companies (defined similarly to “banking entities” under the Volcker Rule) prohibiting any acquisition that would result in a financial company having more than 10 percent of the aggregate consolidated liabilities of all financial companies. Liabilities are defined as risk-weighted assets less regulatory capital. The Federal Reserve can permit exceptions for acquiring failed banks, FDIC-assisted transactions, and de minimis increases in a financial company’s liabilities. The FSOC will study the impact of the concentration limit and must recommend modifications to the limit within six months of enactment. The Federal Reserve is required to promulgate regulations within nine months of the study’s completion.

The concentration limits under existing law with respect to insured deposits are retained by the Dodd-Frank Act and enlarged. Interstate merger transactions involving depository institutions and interstate acquisitions by holding companies, including an acquisition of a savings association by a bank holding company, will generally be prohibited if they would result in the applicant having more than 10 percent of all deposits held by insured institutions in the United States. Exceptions are made for the acquisition of failed banks and for FDIC-assisted transactions.

Financial holding companies will have to seek prior Federal Reserve approval for transactions involving the acquisition of a company engaged solely in

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15 In addition, under Section 606, a unitary thrift holding company could become a financial holding company if it meets the criteria. However, there seems to be little reason to do so because, unlike a financial holding company, at the ultimate parent level such a holding company presumably is not subject to any limitations on activities.

16 Section 603.

17 “Financial in nature” broadly to include lending, exchanging, insuring, providing financial and investment services, offering pooled investments, underwriting, providing insurance, and securities services. 12 U.S.C. § 1843(k).

18 Section 628.

19 Section 622.

20 For foreign financial companies, risk-weighted assets will include only U.S. assets, and regulatory capital will be that generated from U.S. operations.

21 Section 623.
financial activities if the assets of the acquired company would exceed $10 billion or more. In addition, financial holding companies would have to be well managed and well capitalized, not just at the depository institution level but also at the holding company level, to engage in or acquire companies engaged in nonbanking activities.

The Dodd-Frank Act will permit national banks and state banks to open *de novo* branches in any state that permits its in-state banks to branch. Previously, interstate *de novo* branching was permitted only into states that had opted into interstate branching by passing laws that expressly permitted out-of-state banks to open *de novo* in-state branches. This section also permits foreign banks to branch outside of their home state since foreign banks have the same authority under the International Banking Act as domestic banks to branch interstate.

Under present bank regulatory policy, charter conversions involving institutions with supervisory problems are generally not favored. Under the Dodd-Frank Act, charter conversion would generally be prohibited for institutions subject to enforcement orders, such as cease and desist orders or memoranda of understanding, although an exception will allow conversion if both regulators agree.

### Additional Lending Limits and Restrictions on Transactions with Affiliates

Any credit exposure deriving from a derivative transaction, repurchase or reverse repurchase agreement, or a securities lending transaction will be treated as a loan or extension of credit for purposes of the transactions with affiliates restrictions and the lending limits applicable to national banks, state banks, and insiders. Insured depository institutions may not purchase an asset from or sell an asset to an insider unless the transaction is on market terms, and if in excess of 10 percent of the institution’s capital, is approved by the disinterested members of the board of directors.

Other changes to Sections 23A and 23B of the Federal Reserve Act will (i) amend the definition of a “covered transaction” to include securities borrowing or lending, and all derivative transactions with an affiliate to the extent that the transaction causes a depository institution or its affiliate to have credit exposure, (ii) require repurchase agreements to be secured by adequate collateral at all times, rather than just at the time of the transaction, (iii) cap all covered transactions between a bank and its financial subsidiary at 10 percent of the bank’s capital stock and surplus, and (iv) treat as transactions with an affiliate all transactions with “investment funds” advised by a bank or its affiliate. Although the scope is somewhat unclear, the term “investment funds” likely includes at least Private Funds. Further, in the future, exceptions to Sections 23A and 23B will have to be agreed upon by the federal banking agencies and the Federal Reserve, meaning that the Federal Reserve can no longer create exemptions by its order alone.

### Capital and Leverage Requirements

The Dodd-Frank Act imposes stricter capital requirements on all depository institutions, bank holding companies, financial holding companies, and savings and loan holding companies. All bank holding companies, financial holding companies, and savings and loan holding companies must remain at least “well capitalized” and “well managed.” Subject to the recommendations of the FSOC, the federal banking agencies may also develop additional capital requirements for systemic

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22 Section 604.
23 Section 606.
24 Section 613.
25 Section 612.
26 Section 610.
27 Section 615.
28 Sections 608 and 609. These provisions will be effective one year after the transfer date under Title III, affecting the transfer of OTS functions.
29 Sections 606 and 607.
risk purposes. Bank holding companies with assets of more than $50 billion will face additional, increased capital requirements and leverage limits.30

Significantly, trust-preferred securities ("TruPS") will no longer qualify as tier 1 capital for holding companies.31 A grandfather provision benefiting holding companies with less than $15 billion in assets will allow tier 1 capital treatment for existing (but not future) TruPS. Larger bank holding companies have three years to phase out existing TruPS, with the phase-out beginning on January 1, 2013. Larger savings and loan holding companies and certain bank holding company subsidiaries of foreign banking organizations will have five years before they are required to comply, but they do not benefit from an explicit phase-out period. There are also some exceptions, one of which is for small bank holding companies with assets of $500 million or less. Furthermore, the Dodd-Frank Act calls for a study on the potential impact of prohibiting the inclusion of all hybrid capital instruments in tier 1 capital.32

In addition, federal regulators are required to “seek to make” capital standards countercyclical so that the amount of capital required to be maintained by an insured depository institution or holding company increases in times of economic expansion and decreases in times of economic contraction. It remains to be seen how such provisions will be implemented.33

Stress Tests and Reporting Requirements

In addition to increased capital and leverage requirements, depository institutions and their holding companies face additional restrictions relating to systemic risk. All depository institutions or holding companies with assets of over $10 billion are required to conduct annual stress tests and report the results to their primary federal regulator and the Federal Reserve. Holding companies with assets over $50 billion must conduct the stress tests semiannually, and submit to an additional, annual stress test conducted by the Federal Reserve. Bank holding companies with assets over $50 billion that pose a grave threat to financial stability may face even greater restrictions, including FSOC authority to order cessation of certain activities or divestiture of certain assets.34

All bank holding companies with assets over $50 billion may, and most likely will, be required to comply with additional reporting requirements established by the FSOC.35 All publicly traded bank holding companies with assets over $10 billion must establish risk committees to oversee risk management practices. The Federal Reserve has been granted the discretion to require risk committees at smaller publicly traded bank holding companies.36

Deposits

The Dodd-Frank Act makes permanent the temporary increase in the standard deposit insurance amount from $100,000 to $250,000.37 This increase is made retroactive from January 2008, benefiting the depositors of IndyMac Bank and other institutions that failed prior to the temporary increase. Unlimited insurance on all non-interest bearing transaction accounts has been extended through the end of 2012, despite considerable efforts to make such insurance permanent.38 The Dodd-Frank Act also authorizes insured depository institutions to pay interest on transaction accounts, effective one year after enactment of the Act.39 Despite the interest bearing-nature of the account, it is likely that such transaction accounts will continue to be subject to reserve requirements.

The Dodd-Frank Act raises the deposit insurance fund’s minimum reserve ratio from 1.15 percent to 1.35 percent.40 The FDIC is required to “offset the effect” of any related increase in assessments on institutions with assets of less than $10 billion.

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30 Section 165.
31 Section 171.
32 Section 174.
33 Section 616.
34 Section 165.
35 Section 335.
36 Section 165.
37 Section 335. The Dodd-Frank Act also increases the insurance limits for credit unions insured by the National Credit Union Administration to $250,000.
38 Section 343.
39 Section 627.
40 Section 334.
For insured institutions of all sizes, insurance premiums will no longer be based on the amount of deposits, but rather an assessment base defined as total assets minus tangible equity. The requirement that insurance premiums collected beyond a certain level of reserve be paid out in the form of dividends has been repealed, giving the FDIC sole discretion to determine when to suspend or limit dividend payments.

**Additional Restrictions on Certain Savings Banks and Savings Bank Holding Companies**

Savings associations that fail to meet the qualified thrift lender test will no longer have the possibility of becoming a bank. Instead, they will immediately be subjected to branching, activities, and dividend restrictions. The dividend restrictions have been further amended to require advance approval by the OCC.

Thrift subsidiaries of mutual holding companies will be required to notify the Federal Reserve and the OCC or FDIC at least 30 days prior to declaring a dividend. Mutual holding companies that have previously waived the right to receive dividends may continue to do so, subject to restrictions such as prior Federal Reserve approval.

**The Road Ahead**

Most of the significant reforms will not take effect until at least one year after enactment, and in many cases, significantly later. Regulators are given a multitude of rule-making tasks. In most cases, the rule-making will provide detail and substance to the broad mandates set forth in the Act. Institutions that are affected by the Act’s provisions should stay tuned during the rule-making process and be prepared to comment on proposals that would hinder their operations without advancing the Act’s purposes. The passage of the Act is only the beginning of what promises to be a long process to reorder financial services regulation.

*This client alert is part of a series of alerts focused on monitoring financial regulatory reform.*

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41 Section 624.
42 Section 625.

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