

ClientAlert

Financial Markets Developments

July 2010

Dodd-Frank Wall Street Reform and Consumer Protection Act

Improved Holding Company and Depository Institution Supervision

1. Will the Federal Deposit Insurance Corporation insure new nonbank banks?

The term “nonbank banks” typically refers to credit card banks, industrial banks and trust banks.¹ The Federal Deposit Insurance Corporation (“FDIC”) is prohibited from approving an application for deposit insurance received after November 23, 2009 from such a nonbank bank controlled by a commercial firm.² Prior moratoria were temporary.³ Commercial firms include companies whose annual gross revenues from activities that are financial in nature⁴ and from the ownership of depository institutions is less than 15 percent of annual consolidated gross revenues.

This is the opposite of nonbank financial companies that may become subject to supervision by the Board of Governor of the Federal Reserve System (“Federal Reserve”). If 85 percent or more of such a nonbank company’s consolidated assets or revenues are financial in nature, the nonbank company will be subject to Federal Reserve supervision.⁵

2. Can a federal bank supervisor approve a change in control of a nonbank bank?

As a general rule, a federal bank supervisor is required to disapprove a change in control of a nonbank bank of the type referred to above.⁶ Three exceptions are provided.⁷ The first is for a failing nonbank bank. The second is the situation where the “commercial firm” controlling the nonbank bank is merged or acquired by another “commercial firm,” as determined by the appropriate federal bank supervisor. The third is the case where an acquiring shareholder or group of shareholders acting in concert acquires less than 25 percent of any class of the voting shares of a **publicly held company** controlling a nonbank bank. In the case of these three exceptions, the change in control notice must not be disapproved, and any other required federal or state approval for a change in control is obtained.

3. Are these new moratoria permanent?

No. They expire three years from the date of enactment.⁸ The purpose of the moratoria is to provide the Government Accountability Office time to study the nonbank bank and other exemptions under the BHC Act and report on them to Congress within 18 months of enactment.⁹



Client Alerts on topics covered in the Dodd-Frank Act are available by clicking on the links below:

- [Systemic Nonbank Financial Companies](#)
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- [Expansion of SEC Enforcement Powers](#)

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4. Can a credit card bank make commercial loans?

Somewhat. A credit card bank can now make certain credit card loans to small businesses.¹⁰

5. Has the Federal Reserve's authority to obtain reports from BHCs been enhanced?

Yes. Under the Gramm-Leach-Bliley Act, the Federal Reserve was limited in its ability to obtain reports from a bank holding company or any subsidiary. Those limits have been removed. The Federal Reserve will have the authority to obtain reports relating to any provision of federal law applicable to a BHC or subsidiary that is not an insured depository institution or a functionally regulated subsidiary.¹¹

In addition, the Federal Reserve's authority to examine BHCs and their subsidiaries is enhanced.¹² The Federal Reserve's authority over all subsidiaries that were not functionally supervised subsidiaries was broad. That authority has been broadened to eliminate certain requirements regarding functionally regulated subsidiaries.

6. Savings and loan holding company reports and examinations

The Federal Reserve will become the supervisor of savings and loan holding companies. Provisions of the statute address reports and examinations of these companies.¹³

7. Will the Federal Reserve supervise securities holding companies?

The construct of investment bank holding company is eliminated.¹⁴ One major criticism is that the Securities and Exchange Commission (the "SEC") was not granted sufficient authority to supervise such companies. The eliminated construct is being replaced by the concept of supervision of securities holding companies.¹⁵

An SEC registered broker/dealer may be required by a foreign supervisor to be subject to comprehensive consolidated supervision in the United States. This is what the US requires, for example, of a foreign bank seeking to acquire a domestic bank. Such a broker/dealer may elect to become a securities holding company supervised on a comprehensive consolidated basis by the Federal Reserve.¹⁶

The securities holding company and its **affiliates** would provide reports to and be subject to examination by the Federal Reserve.¹⁷ "Affiliate" is given its BHC Act definition—any company that controls, is controlled by, or is under common control with another company. This would include the parent of the securities holding company and the other subsidiaries of that parent company.

The Federal Reserve is granted broad discretion in imposing capital adequacy and risk management standards on securities holding companies.¹⁸ It may also impose these requirements on an individual basis or by category.

A Federal Reserve supervised securities holding company will be subject to the provisions of the BHC Act in the same manner and to the same extent as a BHC.¹⁹ This would appear to include Federal Reserve remedial actions. However, a supervised securities holding company will not be subject to the nonbank prohibitions of Section 4 of the BHC Act.

8. Consistent oversight.

The Federal Reserve may examine a nonbank subsidiary of a holding company that is not functionally regulated in the same manner and with the same frequency as the holding company's lead depository institution.²⁰ If the lead institution is examined every other year, that same schedule would apply to the Federal Reserve's examination of non-functionally regulated subsidiaries. The Federal Reserve must coordinate its examinations with relevant state authorities, and its examination authority is subject to that of the Consumer Financial Protection Bureau.

If the Federal Reserve does not examine the non-functionally regulated nonbank subsidiary in that manner or frequency, the federal bank supervisor for the lead depository may, after complying with procedural requirements, examine that nonbank subsidiary. That examination would be for the purposes of determining whether the nonbank subsidiary posed a material threat to the safety and soundness of the depository institution and complied with applicable law. The federal supervisor may recommend that the Federal Reserve take remedial action against the nonbank subsidiary. The federal supervisor may take remedial action if the Federal Reserve refuses to act and the supervisor complies with various procedures. This is one of the features of the new era of belt-and-suspenders supervision.

9. Is the source of strength doctrine now law?

Yes. To date, the source of strength doctrine has been set forth in a policy statement.²¹ In litigation involving MCorp, the court of appeals found that the Federal Reserve did not have the authority to require a BHC to inject capital into a subsidiary bank. That opinion was reversed on other grounds by the United States Supreme Court. Now, the doctrine is encapsulated in federal law and applies to BHCs and savings and loan holding companies.²² In addition, if an insured depository institution (a nonbank bank) is controlled by a company that is not a bank or savings and loan holding company, the appropriate federal bank supervisor may require the controlling company to serve as a source of strength to its subsidiary depository institution.

Some companies controlling nonbank banks have provided their federal bank supervisory agencies with limited undertakings of support. Now, companies that are not bank or savings and loan holding companies may be required to submit a report under oath for the purpose of complying with the source of strength doctrine.²³

The source of strength doctrine becomes effective one year after the time the functions of the Office of Thrift Supervision are transferred to the Federal Reserve and the Comptroller of the Currency.²⁴

10. Must the federal bank supervisors implement countercyclical capital requirements?

Perhaps.²⁵ The federal depository institution and depository institution holding company supervisors **must seek** to make capital-adequacy requirements countercyclical. Capital-adequacy requirements could be increased in times of economic expansion and decreased in times of economic contraction.

Some believe this could be done by adjusting capital adequacy ratios; others have suggested that this could be done by raising or lowering risk weights on particular assets.

11. Have the standards applied in bank acquisitions or bank mergers been enhanced?

Yes.

Stability of the financial system

In considering applications to become BHCs, for BHCs to acquire shares in additional banks, and for bank mergers, the federal bank supervisors must now also consider whether the transaction would result in greater or more concentrated risks to the stability of the United States banking or financial system.²⁶ The intent seems to be to reduce the potential for BHCs or banks that are too big to fail. This is not an antitrust criterion but a “bigness” criterion in addition to the deposit cap. The federal banking agencies are given no guidance on how this standard is to be applied.

Nationwide deposit cap

A federal bank supervisory agency cannot approve an insured depository institution interstate merger or acquisition if the resultant institution and its institution affiliates would control more than 10 percent of the total of depository institution deposits in the United States.²⁷ This new cap now includes thrifts and industrial banks. This deposit cap limit will not apply in the case of an institution in, or in danger of, default or if the FDIC is providing assistance.

Financial and managerial considerations

In an interstate bank acquisition or merger, the BHC or resultant bank must be well capitalized and well managed instead of adequately capitalized and adequately managed.²⁸

12. Has the standard for financial holding companies been changed?

Yes. Financial holding companies (“FHCs”) are BHCs that meet certain standards and are thereby permitted to engage in a broader range of nonbanking activities than BHCs. Prior to enactment, only FHC subsidiary banks had to be well capitalized and well managed. Now, the FHC itself must be well capitalized and well managed.²⁹ While it may be unlikely, it is possible that an FHC’s banks meet the criteria but the FHC itself does not. An FHC that does not meet these standards must curtail its activities, as prescribed by the Federal Reserve.³⁰

At the time the functions of the Office of Thrift Supervision are transferred to the Federal Reserve and the Comptroller of the Currency, a savings and loan holding company may engage in activities permissible for FHCs if the savings and loan holding company meets the FHC criteria and conducts these FHC activities under the same requirements applicable to FHCs.³¹

13. Is there a constraint on the size of FHC acquisitions?

Yes. An FHC must obtain Federal Reserve approval prior to acquiring a company with total consolidated assets of over US\$10 billion.³²

However, the Hart-Scott-Rodino filing for such a transaction is still required, with the transaction being treated for Hart-Scott-Rodino purposes as if no Federal Reserve approval were required.

14. Is a concentration limit placed on certain financial company transactions?

Yes. A financial company for the purpose of this limit is defined as an insured depository institution, a bank or a savings and loan holding company, a company that controls an insured depository institution, a nonbank financial company supervised by the Federal Reserve, and a foreign bank treated as a bank holding company.³³ A financial company cannot merge or consolidate with or acquire control of another company if the total consolidated assets of the resulting company exceed 10 percent of the aggregate consolidated assets of all financial companies measured as of the end of the calendar year preceding the transaction.³⁴ One question here is the extent to which non-US assets will be taken into account.

This concentration limit may be altered after a study by the Financial Stability Oversight Council (the "Council"), which must be completed within six months of enactment. That study must consider the extent to which this limit would affect financial stability, the efficiency and competitiveness of US financial firms and markets, and the cost and availability of credit and other financial services to US businesses and households. The Council will make a recommendation regarding the limit to the Federal Reserve which must issue final regulations reflecting that recommendation within nine months of completion of the Council's study.

15. Have the limitations on transactions with affiliates been tightened?

Yes. A common theme regarding the ownership of supervised and regulated financial organizations is to prevent upstream and cross-stream affiliates from abusing the financial resources of the supervised/regulated firm. In banking, this is the function of Section 23A of the Federal Reserve Act. Section 23A places an amount limitation on certain transactions with an upstream or cross-stream affiliate and an aggregate limitation on transactions with all up-stream and cross-stream affiliates. Certain of these covered transactions must be collateralized with eligible collateral. These requirements are tightened.³⁵ While Section 23A by its terms applies to banks that are members of the Federal Reserve System, it also applies to all insured bank and thrifts.

Affiliate

The definition of "affiliate" is expanded to include an investment fund for which a member bank or an affiliate is an investment adviser.³⁶ The qualification that the affiliated investment adviser be an investment adviser as defined in Section 2(a)(20) of the Investment Company Act of 1940 is eliminated.

Covered transactions

Section 23A deals with "covered transactions" with affiliates. The definition of covered transactions has been altered to include assets subject to repurchase agreements as loans as opposed to purchases.³⁷ In addition, "purchases of securities of an affiliate" is expanded to include purchases of other debt obligations of an affiliate.³⁸ A securities lending or borrowing transaction with an affiliate is now a covered transaction if the member bank has a credit exposure to the affiliate as a result of the transaction.³⁹

Another significant change is to bring derivatives transactions within the scope of covered transactions in a broader way.⁴⁰ The term "derivative transaction" for this purpose is defined to include any transaction that is a contract, agreement, swap, warrant, note or option that is based, in whole or in part, on the value of, any interest in or any quantitative measure or the occurrence of any event relating to one or more commodities, securities, currencies, interest or other rates, indices or other assets.⁴¹ Previously, a credit derivative between a member bank and a non-affiliate in which the member bank provides credit protection to the non-affiliate with respect to an obligation of an affiliate of the member bank is treated as a guarantee by a member bank on behalf of an affiliate. Such a guarantee is a covered transaction.

Collateral

To reflect the above changes, collateral requirements have been expanded to include credit exposures resulting from securities lending and borrowing, repurchase agreements and derivatives transactions.⁴²

Exemptions

Previously, the Federal Reserve was the only federal depository institution supervisor that could issue case-by-case exemptions from Section 23A. Now, an exemption may be granted by the insured depository institution's federal supervisor with the concurrence of the Federal Reserve and the non-objection of the FDIC.⁴³ The standard for granting these exemptions remains unchanged—be in the public interest and consistent with the purposes of Section 23A. Most of the exemptions granted by the Federal Reserve relate to corporate reorganizations involving a one-time transfer of assets to an affiliated depository institution.

The Federal Reserve is granted the express authority to determine, by regulation or interpretation, the extent to which a netting agreement between a member bank and an affiliate may be taken into account for the purposes of determining the amount of credit exposure and required collateral.⁴⁴ Any interpretation with respect to a specific member bank must be jointly issued by the Federal Reserve and the member bank's federal banking agency.

One existing exemption has been eliminated. Previously, covered transactions with a "financial subsidiary" of a depository institution were excluded from Section 23A. That is no longer the case.⁴⁵

Section 23B

Section 23B requires that transactions with affiliates be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other non-affiliated companies.⁴⁶ Certain transactions with affiliates and some advertisements are prohibited. Exceptions may be granted applying the same process discussed above with regard to Section 23A.⁴⁷

16. Have lending limits been narrowed?

Yes. National bank lending limits are tightened. This is done by including within such limits derivatives transactions, repurchase agreements, and securities lending and borrowing transactions.⁴⁸

An insured state bank can engage in derivatives transactions of the type covered in the national bank lending limit only if the lending limit statutes of the bank's chartering state take such a credit exposure into consideration.⁴⁹

In addition, limits on lending to insiders have also been expanded to include derivatives transactions, repurchase agreements, and securities lending and borrowing transactions.⁵⁰

17. Can an insured depository institution purchase assets from or sell them to a director, executive officer or principal shareholder?

Yes, but by complying with the relevant requirements—the transaction must be on market terms and, if the amount of the transaction exceeds 10 percent of the institution's capital and surplus, the transaction must be approved in advance by a majority of disinterested directors of the institution.⁵¹ In consultation with the other federal bank supervisors, the Federal Reserve will issue implementing regulations.

18. Is a depository institution still able to convert its charter to escape an enforcement action?

No, unless the new required procedures are followed.⁵²

19. Has full interstate branch banking arrived?

Yes.⁵³

20. Is Regulation Q dead?

Yes. The prohibition on the payment of interest on demand deposits is repealed.⁵⁴ This may change the way banks use their Cayman branches or sweep funds into money market accounts. Its major impact will be on business demand deposit accounts.

Dodd-Frank Wall Street Reform and Consumer Protection Act

1. Title VI of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is titled the Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010 ("Regulatory Improvements Act") § 603(a)(1).
2. Regulatory Improvements Act § 603(a)(2).
3. An example can be found in 72 Fed. Reg. 5293 (Feb. 5, 2007).
4. "Activities in nature" is defined in Section 4(k) of the Bank Holding Company Act of 1956 ("BHC Act)."
5. <http://events.whitecase.com/fmd/alerts-Systemic-Nonbank-Financial-Companies.pdf>.
6. Regulatory Improvements Act § 603(a)(3)(A).
7. Regulatory Improvements Act § 603(a)(3)(B).
8. Regulatory Improvements Act § 603(a)(4).
9. Regulatory Improvements Act § 603(b).
10. BHC Act § 2(c)(2)(F)(v).
11. BHC Act § 5(c)(1)(A)(iii). The term "functionally regulated subsidiary" is defined in Section 5(c)(5) of the BHC Act and includes an SEC registered broker/dealer, an SEC or state registered investment adviser, an SEC registered investment company, and an entity regulated by the Commodity Futures Trading Commission with respect to a number of stated activities, including swap dealers, major swap participants, and swap execution facilities.
12. BHC Act § 5(c)(2).
13. 12 U.S.C. § 1467a(b)(2); 12 U.S.C. § 1462; 12 U.S.C. § 1467a(b)(4).
14. Regulatory Improvements Act § 617(a).
15. Regulatory Improvements Act § 618.
16. Regulatory Improvements Act § 618(b).
17. Regulatory Improvements Act § 618(c).
18. Regulatory Improvements Act § 618(d).
19. Regulatory Improvements Act § 618(e).
20. 12 U.S.C. § 1831(c).
21. 12 C.F.R. § 225.142.
22. 12 U.S.C. § 1831p.
23. 12 U.S.C. § 1831p(c)(2).
24. Regulatory Improvements Act § 616(e).
25. 12 U.S.C. § 1844(b); 12 U.S.C. § 1467a(g)(1).
26. BHC Act § 3(c)(7); 12 U.S.C. § 1825(c)(5)(B).
27. BHC Act § 4(i)(8); 12 U.S.C. § 1828(c)(13)(A); 12 U.S.C. § 1467a(e)(2)(e).
28. BHC Act § 3(d)(1)(A); 12 U.S.C. § 1831u(b)(4)(B).
29. BHC Act § 4 (l)(1)(C).
30. BHC Act § 4 (m).
31. 12 U.S.C. § 1467a(c)(2)(H).
32. BHC Act § 4(k)(6)(B).
33. BHC Act § 14(a).
34. BHC Act § 14(b).
35. Regulatory Improvements Act § 608.
36. 12 U.S.C. § 371c(b)(1)(D).
37. 12 U.S.C. § 371c(b)(7)(A).
38. 12 U.S.C. § 371c(b)(7)(C).
39. 12 U.S.C. § 371c(b)(7)(F).
40. 12 U.S.C. § 371c(b)(7)(G).
41. 12 U.S.C. § 84(b)(3).
42. 12 U.S.C. § 371c(c)(1).
43. 12 U.S.C. § 371c(f).
44. 12 U.S.C. § 371c(f)(4).
45. 12 U.S.C. § 371c(e).
46. 12 U.S.C. § 371c-1.
47. 12 U.S.C. § 371c-1(e).
48. 12 U.S.C. § 84(b)(1)(C).
49. 12 U.S.C. § 1828(w).
50. 12 U.S.C. § 375b(9)(D)(iii).
51. 12 U.S.C. § 1828(z).
52. Regulatory Improvements Act § 612.
53. Regulatory Improvements Act § 613.
54. Regulatory Improvements Act § 627.

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