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The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact on Thrifts

BY V. GERARD COMIZIO & LAWRENCE D. KAPLAN

Introduction

The Dodd-Frank Act: Landmark Financial Legislation

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[1] is landmark financial legislation that represents the most profound restructuring of financial regulation since the Great Depression. With the primary goal to "restore responsibility and accountability in our financial system to give Americans confidence that there is a system in place that works for and protects them," the Dodd-Frank Act will have broad impact on the financial services industry for years to come.

Born out of the financial crisis that erupted in early 2008, the Dodd-Frank Act, composed of a series of new laws is, in the aggregate, breathtaking in its scope. Particularly significant is that the new law: 1) creates the Bureau of Consumer Financial Protection ("BCFP"), a new independent consumer watchdog agency housed within the Federal Reserve Board ("FRB"), 2) grants to the U.S. Department of the Treasury, Federal Deposit Insurance Corporation ("FDIC") and the FRB broad new powers to seize, close and wind down "too big to fail" financial (including non-bank) institutions in an orderly fashion, 3) establishes a new Financial Stability Oversight Council ("FSOC"), charged with identifying and responding to emerging risks throughout the financial system, composed primarily of federal financial services regulators and chaired by the Secretary of the Treasury Department, 4) restructures the federal regulatory jurisdiction over banks and their parent companies, and abolishes the Office of Thrift Supervision ("OTS"), 5) adopts new federal oversight of the insurance industry, 6) adopts new standards and rules for the mortgage industry, 7) adopts new bank, thrift and holding company regulation, 8) adopts new federal regulation of the derivatives market, 9) adopts the so-called Volcker Rule, substantially restricting proprietary trading by depository institutions and their holding companies, 10) imposes requirements for "funeral plans" by large, complex financial companies, 11) establishes new regulation of the securitization market through "skin in the game" and enhanced disclosure requirements, 12) establishes new regulation of interchange fees, 13) establishes new and enhanced compensation and corporate governance oversight for the financial services industry, 14) provides enhanced oversight of municipal securities, 15) provides a specific framework for payment, clearing and settlement regulation, 16) adopts new federal hedge fund regulation, 17) adopts new fiduciary duties and regulation of broker dealers, investment companies and investment advisors, 18) tasks the federal banking agencies with adopting new and enhanced capital standards for all depository institutions, 19) significantly narrows the scope of federal preemption for

national banks and federal thrifts, and 20) places a moratorium on ownership of industrial loan banks by non-financial companies.

Furthermore, the Dodd-Frank Act provides broad and substantial delegations to various federal agencies the task of implementing its many provisions through regulation. Hundreds of new federal regulations, studies and reports addressing all of the major areas of the new law will be required, ensuring that federal rules and policies in this area will be further developing for years to come.

The Dodd-Frank Act: Impact

The Dodd-Frank Act profoundly impacts all major segments of the financial services industry, including 1) banks, 2) thrifts, 3) bank, financial and savings and loan holding companies, 4) mortgage businesses that include mortgage brokers, mortgage bankers and direct lenders, 5) insurance companies, 6) industrial loan companies and their parent companies, 7) investment company, broker-dealer and investment advisor firms, 8) hedge funds and private equity funds, and 9) payment systems companies.

This Stay*Current* bulletin addresses the impact of the Dodd-Frank Act on thrift institutions and their holding companies. Thrift institutions, also known as savings associations, are a type of insured depository institution that is focused on mortgage or what is known as "qualified thrift" lending, and are chartered either under the laws of the United States under the Home Owners' Loan Act ("HOLA")[2] or else under state law. The current federal regulator of thrifts is the OTS. Holding companies of thrifts, known as "savings and loan holding companies" ("SLHCs") are also currently regulated by the OTS. As described below, the Dodd-Frank Act imposes significant changes on the supervision and operations of thrifts and their holding companies. Please note that additional Paul Hastings Stay*Current* articles address the impact of the Dodd-Frank Act on banks, mortgage businesses and other financial services providers.

Supervisory and Rulemaking Authority of OTS Delegated to OCC, FDIC and FRB

Title III of the Dodd-Frank Act -- Enhancing Financial Institution Safety and Soundness Act of 2010 -- restructures the allocation of powers and functions among the various prudential bank regulators. While not a comprehensive restructuring of all federal bank regulators, the primary effect of Title III is to abolish the OTS and delegate its supervisory and rulemaking functions relating to:

- Federal savings associations primarily to the Office of the Comptroller of the Currency (the "OCC"), under the direction of a Deputy Comptroller, who shall be responsible for the "supervision and examination of Federal savings associations;" the OCC will have rulemaking authority with respect to all savings associations;

- State savings associations to the FDIC;

- SLHCs and their non-depository institution subsidiaries (excluding subsidiaries of their thrift) to the FRB, along with rulemaking authority with respect to transactions with affiliates and insiders, and anti-tying prohibitions.

As a result, all thrift institutions, whether federally or state-chartered, will have a new federal safety and soundness regulator. Rulemaking with respect to consumer financial protection functions will be transferred to the BCFP, while examination and enforcement of banks' compliance with federal consumer financial laws will be with the OCC for federal thrifts and the FDIC for state chartered thrifts with assets of $10 billion or less. The newly established BCFP will, however, have primary responsibility for examination and enforcement of federal consumer financial laws for thrifts with assets in excess of $10 billion. In addition, all SLHCs will be regulated by the FRB, bifurcating the safety and soundness supervision of thrifts into a regime that mirrors the regulatory oversight structure with respect to banks and their holding companies.

Initially, the OCC, FDIC and FRB will implement existing OTS regulations, orders, resolutions, determinations and agreements. The HOLA technically will continue to govern the regulations applicable to thrifts and SLHCs until such time as the OCC advises the U.S. Congress that no thrift charters remain in the United States, at which point the HOLA will be repealed by operation of law. We expect, however, that each of the agencies on its own, or through implementation of the Dodd-Frank Act, will alter how thrifts operate and are supervised, homogenizing the separate but similar regime of regulations and agency guidance under the HOLA into a common federal scheme for similarly situated federally-chartered depository institutions and state-chartered depository institutions, as well as the holding companies of each. While it is contemplated that the functions of the OTS will formally be transferred one year from the date of enactment, in July 2011 (or else January 2012 if a six month extension is required) (the "Transfer Date"), thrifts and their holding companies likely will begin to see changes in the way they are supervised sooner, with the OCC and FRB taking an active role early in the transition process in order to be better prepared for the formal transition. Ninety days following the "Transfer Date," the OTS will be officially abolished.

Examinations and Fees

Federally-chartered thrifts will be subject to safety and soundness examination and supervision by the OCC as their primary federal regulator, while state savings associations will be subject to examination and supervision by the FDIC, which will retain back-up examination and enforcement authority over federal thrifts. The substance of the safety and soundness examination function likely will not change tremendously. However, prior to the formal transfer of OTS's powers and functions to the OCC and FDIC, thrift examinations likely will appear to be more stringent as OTS examiners attempt to demonstrate to their new supervisors at the OCC and FDIC that they are thorough when conducting examinations. Moreover, we expect that examinations may appear to be more stringent than examinations conducted by the OTS as new members of the examination teams will lack long-standing "institutional memories" of a particular thrift and its operations.

Examination and enforcement of thrifts' compliance with federal consumer financial laws will be with the OCC or FDIC for thrifts with assets of $10 billion or less. However, the newly established BCFP will have primary responsibility for examination and enforcement of federal consumer financial laws for thrifts with assets in excess of $10 billion. As the BCFP will have primary enforcement powers with respect to consumer financial laws for larger thrifts, based upon their safety and soundness examinations the OCC or FDIC, as the primary prudential regulator, will be authorized to recommend that the BCFP initiate a compliance enforcement action against a larger thrift. The OCC or FDIC would be authorized to commence their own enforcement action if the BCFP does not commence an action within 120 days. Although the BCFP will not have enforcement powers over thrifts with $10 billion or less in assets, the BCFP is authorized to require that such thrifts file reports with it, which has the

potential of placing new burdens on all thrifts. For further information on the BCFP, *see* Paul Hastings Stay*Current*—The Dodd-Frank Act: The Bureau of Consumer Financial Protection.

Currently, thrifts and SLHCs are subject to assessments by the OTS and the FDIC does not assess fees for its examination functions – either as primary regulator or under its back-up examination authority. As a result of the Dodd-Frank Act, both the OCC and FDIC are authorized to assess fees or charges on any entity for which it carries out its supervisory responsibilities. Thrifts subject to the BCFP jurisdiction will not be subject to a separate examination assessment, as the BCFP's budget is drawn from the FRB. Nonetheless, as a result of the Dodd-Frank Act, thrifts will be subject to a greater assessment burden. Moreover, as discussed below, SLHCs also will be subject to regulatory assessment by the FRB.

Capital Requirements for Thrifts Have Nowhere to Go But Up

General

Thrifts and, for the first time, their holding companies with greater than $500 million in assets, will be subject to minimum leverage and minimum risk-based capital ratios that must be no less than the ratios currently imposed by the current federal bank regulatory agencies under the prompt corrective action provisions of the Federal Deposit Insurance Act ("FDIA").[3] Future capital ratios also cannot be quantitatively lower than the generally applicable ratios in effect as of the date of enactment of the Dodd-Frank Act. As a result, capital ratios for thrifts have nowhere to go but up from the following current rates:

		Well capitalized	Adequately capitalized
Minimum risk-based capital ratios:	Tier 1 capital:	6%	4%
	Total capital:	10%	8%
Minimum Leverage		5%/3%	4%

While Title I of the Dodd-Frank Act imposes more stringent capital standards on all depository institutions and holding companies, Title VI seeks to implement a relief valve, requiring that capital standards be "countercyclical" so that the amount of capital required to be held by an insured depository institution increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the insured depository institution. As a result, insured depository institutions are more likely in the future to become subject to individual capital requirements, through which regulators adopt capital ratios for each specific institution, rather than the current one-size fits all system. The form of these institution-specific determinations will need to be examined closely, because if set forth in an enforcement order or prompt corrective action directive, an institution will no longer be deemed to be well capitalized, thereby triggering a series of restrictions including a prohibition on the acceptance of brokered deposits as well as increased deposit insurance premiums.

The Collins Amendment

The Dodd-Frank Act, through the so-called Collins Amendment, modifies the types of securities that can be included by depository institutions and holding companies as Tier 1 capital, favoring common equity over trust-preferred and cumulative-preferred securities (other than TARP-preferred securities) currently issued by many institutions ("Impermissible Capital Instruments"). Recognizing that such new standards would eliminate billions of dollars in current capital, the Dodd-Frank Act provides for various phase-in periods for institutions to comply with the new Tier 1 capital requirements, depending upon an institution's size, the instrument's issue date and for holding companies, and whether an entity is currently regulated by the FRB.

In sum, thrifts that held consolidated assets of less than $15 billion as of December 31, 2009 will not be subject to any new restrictions on the elements of their capital. However, thrifts with greater than $15 billion in consolidated assets that have Impermissible Capital Instruments issued prior to May 19, 2010 (a grandfather date set after the initial introduction of the Collins Amendment), will have a three-year phase-in period beginning January 1, 2013 to comply with the new requirements for regulatory capital deductions. Impermissible Capital Instruments issued after May 19, 2010 will immediately be discounted from Tier 1 capital. SLHCs will have a five-year period from the date of enactment to conform their capital structures to meet minimum leverage and risk-based capital requirements. Given the uncertainty of market fluctuations, meeting the new requirements could be a difficult task for some institutions or their holding companies. Moreover, as the phase-in deadline approaches, we expect that the markets will be crowded with various offerings by depository institution holding companies and significant nonbank financial companies seeking to meet the enhanced capital requirements.

Qualified Thrift Lender Test Maintained and Consequences Tightened

Notwithstanding that a significant portion of the financial crisis leading to enactment of the Dodd-Frank Act was caused by real estate lending, the Dodd-Frank Act retains the qualified thrift lender test provisions of the HOLA, requiring thrifts to have large amounts of real estate exposure (the "QTL Test"). Moreover, the Dodd-Frank Act increases the consequences for failing the QTL Test. Currently, a thrift that fails the QTL Test must either convert to a bank or become subject to national bank activities limitations, national bank branching restrictions, and national bank dividend limitations. The Dodd-Frank Act, however eliminates the choice of converting to a bank (but does not ultimately prohibit such a transaction) and pending such conversion imposes national bank activities limitations and national bank branching restrictions immediately upon a thrift's failure to satisfy the QTL Test. Moreover, a thrift would be prohibited from paying dividends, except under circumstances that are permissible for a national bank; are necessary to meet the obligations of the thrift's holding company; and are specifically approved by both the OCC and FRB after a written request submitted by the thrift at least 30 days in advance of the proposed payment. Moreover, failure of the QTL Test will be considered to be a violation of Section 5 of the HOLA, causing a thrift to be subject to an enforcement action under Section 8 of the FDIA. Subjecting a thrift to an enforcement action for a QTL Test violation creates an interesting interplay between provisions of the Dodd-Frank Act, as thrifts subject to a cease and desist order (or other formal enforcement order) or a memorandum of understanding (collectively, an "Enforcement Order") generally is prohibited from undertaking a charter conversion, as discussed below.

Charter Conversions

Many federally-chartered banks and thrifts currently avail themselves of the benefits of federal preemption with respect to their activities that are conducted directly or through subordinate

organizations. In light of the various limitations imposed under the Dodd-Frank Act with respect to federal preemption of state consumer financial laws (as described in a separate Paul Hastings Stay*Current* article), the continuation of the HOLA's QTL Test, as well as assessments and fees imposed by the OCC, it is appropriate and prudent for thrift institutions to examine whether their current charter remains an optimal charter for their ongoing and future operations. Prior to enactment of the Dodd-Frank Act, several institutions have already converted to national banks or have announced plans to do so, and we would expect the outflow of federal thrift charters to various state or national charters to increase as the benefits of the federal thrift charter become outweighed by its various costs. Further, a number of community and regional banks are considering the relative merits of state bank charters in light of the provisions of the Dodd-Frank Act that reduce the advantages of preemption relating to the national bank and federal thrift charters. *See* Paul Hastings Stay*Current*—The Dodd-Frank Act: Impact on Federal Preemption for National Banks and Federal Thrifts.

To eliminate the perceived problems related to charter-arbitrage with respect to what is perceived to be more lenient regulation, the Dodd-Frank Act generally precludes charter conversions from: a national bank to a state bank or a state savings association; a state bank or state savings association to a national bank; or a federal savings bank to a state bank or state savings bank, whenever the converting institution is subject to an Enforcement Order by its current regulator. Notwithstanding the general prohibition, conversions are permissible if the agency that issued the Enforcement Order does not object to the conversion after the converting institution provides a written plan to address the supervisory matters giving rise to the Enforcement Order that is consistent with the safe and sound operation of the converting institution and the resulting regulator implements the plan.

Risk Retention of Loans Originated for Sale

Mortgage lending practices of thrifts could be altered by the Dodd-Frank Act, which seeks to mitigate a practice that was perceived to have led to the financial crisis whereby some lenders would "pass the trash" by originating loans to borrowers of questionable credit-worthiness primarily to generate fee income. As a result, the Dodd-Frank Act requires the Federal banking agencies (defined as the OCC, FRB, and FDIC), the Securities and Exchange Commission ("SEC"), the Secretary of Housing and Urban Development ("HUD"), and the Federal Housing Finance Agency ("FHFA") to engage in joint rulemaking that imposes certain credit risk retention obligations on securitizers and certain originators by requiring "any securitizer to retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party." Final rules shall become effective 1 year after they are published in the *Federal Register*. Substantially similar but separate regulations will also be issued within the same timeframe for all asset classes other than residential mortgages, however only the Federal banking agencies and the SEC will engage in such rulemaking. Where a securitizer purchases assets from an originator, the Federal banking agencies and the SEC will have the discretion to allocate risk retention requirements between a securitizer and an originator, although it is unclear how this allocation among securitizers and originators will affect the rulemaking with respect to residential mortgage assets because only the Federal banking agencies and the SEC were given power to exercise such discretion, and not the HUD or the FHFA.

The term "qualified residential mortgage" will be defined in regulations, and will include mortgages with underwriting and product features for which historical loan performance data indicate a lower risk of default, such as documentation and verification of financial resources relied upon to qualify the borrower; the ratio of the borrower's housing debt to income; the ratio of the borrower's total monthly debt payments to income; underwriting to a fully indexed adjustable rate mortgage; and mortgage

guarantee insurance or other credit enhancement at the time of origination. Factors that have been demonstrated to exhibit a higher risk of default, *e.g.,* balloon payments, negative amortization features, prepayment penalties and interest-only payments, would disqualify a mortgage from being deemed to be a "qualified residential mortgage" that would be exempt from the risk-retention requirement.

The effect of the "skin in the game" risk-retention provisions results in an increase in assets that will need to be held on a thrift's balance sheet, and increases the amount of risk-based capital that a thrift must hold against such assets. For example, for each $1.0 million in non-exempt loans originated-for-sale, a thrift would potentially be required to hold at least 5% or $50,000, reflecting its "skin in the game." Assuming a 100% risk-weighting and a 10% risk-based capital requirement, the thrift would have to hold an additional $5,000 in capital to support these assets – capital that, prior to the Dodd-Frank Act, a thrift would not have been required to hold. Accordingly, in addition to having a stake in loans that are originated and securitized, the risk-retention provisions of the Dodd-Frank Act will also impact thrifts by increasing their capital requirements.

Regulations implementing the risk-retention rules and exemptions thereto, are due within 270 days of enactment of the section, in April 2011, to become effective: (a) one year after final rules are published in the *Federal Register* with respect to residential mortgages, and (b) two years after the date of publication in the *Federal Register* for other classes of asset-backed securities. It remains to be seen whether the BCFP or the federal banking agencies will grant any industry wide exemptions or relief from these requirements. *See* Paul Hastings Stay*Current*—The Dodd-Frank Act: Impact on Mortgage Businesses.

Key Changes to Deposit Insurance

The Dodd-Frank Act codifies two important FDIC programs adopted under the Emergency Economic Stabilization Act of 2008 ("EESA"), by permanently increasing the federal deposit insurance limit to $250,000 retroactive to January 1, 2008, and by effectively extending for two years significant portions of the FDIC's Transaction Account Guarantee ("TAG") program, providing for unlimited federal deposit insurance for "noninterest-bearing transaction accounts."

The increase in the federal deposit insurance limit under EESA reflected Congress' recognition that many depositors, including small businesses, had more than $100,000 of funds on deposit at insured depository institutions and, therefore, had more to lose if their bank or thrift were to fail. To avoid irrational deposit withdrawals by customers fearful that their institution could fail, Congress raised the deposit insurance limit from $100,000 to $250,000 as part of the EESA but only on a temporary basis. The Dodd-Frank Act makes this temporary change (a) retroactive to January 1, 2008, so as to provide deposit coverage to all depositors at institutions for which the FDIC was appointed as receiver since the beginning of the financial crisis; and (b) permanent. The retroactivity provision only applies to deposits held at 13 institutions that failed during the first nine months of 2008, including IndyMac Bank and Washington Mutual Bank. The permanent increase in the insurance limit to $250,000, per depositor, per institution for each account ownership category will also help to avoid irrational shifts of deposits based on rumors or fear with respect to the stability of a depository institution.

The two-year extension of the significant portions of the TAG program commencing on December 31, 2010 differs from the current TAG program developed by the FDIC, as it includes a more restrictive definition of "noninterest-bearing transaction account" than is currently used by the FDIC by excluding accounts that earn *de minimis* interest. Moreover, the revised TAG program excludes accounts on which institutions reserve a right to require advance notice of withdrawals, specifically NOW accounts.

Finally, unlike the current TAG program, thrifts have no ability to opt out of participation in the program, which requires the payment of higher insurance premiums for TAG-deposits.

The Dodd-Frank Act also implements several important changes to the management and capitalization of the FDIC's Deposit Insurance Fund ("DIF"), which has become underfunded during the financial crisis, generally imposing a greater burden on insured depository institutions with greater than $10 billion in assets. First, the FDIC is required to redefine the assessment base on which deposit insurance premiums are assessed to an insured depository institution, so as to equal the average total consolidated assets of an insured depository institution minus the sum of average tangible equity of the insured depository institution during the assessment period, subject to possible adjustments from total consolidated assets for custodial banks and banker's banks. This shift imposes a greater burden on larger banks, which hold more non-deposit liabilities than smaller banks. Second, the Dodd-Frank Act raises the floor on the DIF reserve ratio from 1.15% to 1.35%, or a comparable percentage of the FDIC assessment base. Full implementation of the revised reserve ratio is required to be achieved by September 30, 2020, offsetting for the impact of deposit insurance assessments on institutions with less than $10 billion in consolidated assets, meaning that assessments on larger institutions will be responsible for the 20 basis point increase. Finally, to minimize the chance of the DIF being underfunded in the future, the Dodd-Frank Act eliminates the requirement that the FDIC pay dividends to insured depository institutions whenever the DIF exceeds a reserve ratio of 1.35% equal to one-half of the amount the DIF exceeded 1.35%, and the entire amount if the DIF exceeded 1.5%. This repeal permits the FDIC to allow the DIF to grow in periods of economic expansion when there may be fewer bank failures.

Other Provisions Impacting Thrifts

Transactions with Insiders

The Dodd-Frank Act fills a perceived regulatory vacuum by prohibiting non-credit transactions between an insured depository institution and its executive officers, directors or principal shareholders unless the transaction (i) is on market terms and (ii) if the transaction represents more than 10% of the capital stock and surplus of the insured depository institution and the transaction has been approved in advance by a majority of the disinterested members of the board of directors of the institution. This restriction is intended to prevent "sweetheart" non-credit transactions between insiders and institutions. The FRB is authorized to consult with the OCC and FDIC and promulgate regulations to implement this provision. New limits are imposed on loans to insiders with respect to derivatives transactions, repurchase and reverse-repurchase agreements, as well as securities lending and borrowing transactions, subject to regulations to be adopted.

The Dodd-Frank Act also expands the definition of "covered transactions" as used in Section 23A of the Federal Reserve Act ("FRA")[4] to include credit exposure on derivatives transactions and securities lending and borrowing transactions, as well as the acceptance of affiliate-issued debt obligations as collateral for a loan or an extension of credit. Moreover, the Dodd-Frank Act clarifies that collateral must be maintained at all times for covered transactions, rather than only at the time of the transaction. The new law also restricts the use of debt obligations issued by an affiliate to satisfy collateral obligations.

The Dodd-Frank Act also authorizes the OCC (with respect to federal thrifts) and FDIC (with respect to state-chartered thrifts), in conjunction with the FRB, to grant exemptions under Section 23A, subject to the FDIC's determination (or non-objection within a 60-day notice period) that the exemption does not present an unacceptable risk to the DIF. Accordingly, transactions requiring a 23A exemption will

not be accomplished on an expedited basis. For further discussion on the impact of the Dodd-Frank Act with respect to transactions with affiliates, *see* Paul Hastings Stay*Current*—The Dodd-Frank Act: Affiliate Transaction and Insider Lending Restrictions.

Limits on Proprietary Trading

Through the so-called Volcker Rule, the Dodd-Frank Act amends the Bank Holding Company Act of 1956 ("BHC Act")[5] by generally prohibiting a "banking entity" from: (A) engaging in proprietary trading;[6] and (B) investing in or sponsoring[7] a private equity or hedge fund.[8] The term "banking entity" covers insured depository institutions, their holding companies, and any company that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity. Accordingly, the activities of SLHCs, as well as their affiliates and subsidiaries, would be impacted under the Volcker Rule to the same extent as for any BHC that controls an insured bank.

Exceptions to the general prohibition on proprietary trading are provided for certain permitted activities that include:

- purchasing, selling, acquiring or disposing of U.S. government or agency securities, including obligations or instruments issued by Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Banks, and state, municipal and other political subdivision obligations;
- purchasing, selling, acquiring or disposing of securities in connection with underwriting or market-making type activities, but only to the extent reasonably expected to fulfill near term customer demand;
- risk-mitigating hedging transactions designed to reduce specific risks to the banking entity in connection with holding such positions; and
- engaging in such other activities the regulators (federal banking agencies, SEC or CFTC, as appropriate) determine, by rule, would promote/protect the safety and soundness of the banking entity and U.S. financial stability.

All permitted activities are subject to applicable federal or state laws, any restrictions or limitations that may be imposed by the applicable regulator (including capital and quantitative limitations as well as diversification requirements), and must not: (i) present a material conflict of interest between the banking entity and its clients, customers or counterparties; (ii) result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as such terms will be defined by rulemaking); or (iii) pose a threat to the safety and soundness of the banking entity or the financial stability of the U.S.

With respect to the general prohibition on investing in a hedge fund or private equity fund, exceptions are provided for:

- "seed" investments, whereby a banking entity may make and retain an investment in a hedge fund or private equity fund that the banking entity organizes or offers for the purpose of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund the attract unaffiliated investors; and
- *de minimis* investments.

In each case, the banking entity's investment must: (i) be reduced to less than 3% of fund ownership within 1 year after the fund is established (which may be extended an additional 2 years); (ii) must be

"immaterial" (to be defined by rulemaking) to the banking entity; and (iii) the aggregate of the banking entity's investments in all such funds may not exceed 3% of the banking entity's Tier 1 capital.

The FSOC is directed to conduct a study and make recommendations on implementing the Volcker Rule within 6 months of enactment of the Dodd-Frank Act, with final rules to be adopted by the agencies within 9 months thereafter. In general, the Volcker Rule provisions shall take effect on the earlier of: (a) 12 months after the date of the issuance of the final rules; or (b) 2 years after the date of enactment of Section 619 of the Dodd-Frank Act. Two exceptions are provided with respect to: (i) a conformance period for divestiture, where a banking entity shall bring its activities and investments into compliance with the new restrictions not later than 2 years after the date on which the requirements become generally effective; and (ii) an extended transition period for illiquid funds, where upon application by a banking entity, the FRB may extend the period during which the banking entity may take or retain its equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an illiquid fund, however only to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010. Notwithstanding the conformance period that is allowed for divesture, the appropriate agency may impose additional capital requirements and other restrictions deemed appropriate on a banking entity's investment in or sponsorship of a private equity or hedge fund.

Transactions between a banking entity and a hedge fund or private equity fund that the banking entity serves as the investment manager, investment adviser, or sponsor to, or is organized or offered by the banking entity, are subject to restrictions applicable to transactions between banks and their affiliates under Sections 23A and 23B of the FRA.

An important aspect of the Volcker Rule is its anti-evasion authority, which requires the appropriate regulators to include in their implementing regulations internal controls and recordkeeping requirements to insure compliance with the rule. Further, the regulators are authorized to require termination of activities and investments of a banking entity, subject to due notice and an opportunity for a hearing, that are not in compliance with, or that the appropriate regulator determines is an evasion of, the requirements of the Volcker Rule.

For a more comprehensive discussion of the Volcker Rule, *see* Paul Hastings Stay*Current*—The Dodd Frank Act: Impact, Issues and Concerns in Implementing the Volcker Rule.

Interest on Demand Deposits Authorized

Notwithstanding the two-year extension and modification of the TAG program as described above, the Dodd-Frank Act provides a small sliver of regulatory relief, particularly for commercial depositors, by repealing the long-standing prohibition on depository institutions paying interest on demand deposits. Accordingly, commercial depositors will no longer have to structure their deposits in sweep arrangements in order to earn interest on idle funds.

Branching

The broad grant of interstate branching authority currently contained in the HOLA for thrifts satisfying the QTL Test is retained for federal thrifts. Moreover, any savings association that converts its charter to a bank charter will be authorized to continue to operate any branch or agency office that it operated immediately before becoming a bank and will be able to continue to establish, acquire and operate branches in the state(s) in which such branches and agencies are currently located, if the applicable state law would permit a state chartered bank to do so. Accordingly, a charter conversion has no impact on a thrift's current branch network.

Modifications to the Regulation of SLHCs

The Dodd-Frank Act amends the HOLA to provide the FRB with examination and reporting authority over SLHCs and their subsidiaries. While maintaining a distinction between SLHCs and bank holding companies, FRB supervision, examination and enforcement of SLHCs and their subsidiaries clearly will become more aligned with the FRB's existing supervision and examination of bank holding companies. (See below concerning a required GAO study of SLHCs.) As a result, subject to BCFP examinations, each SLHC and its nonbank subsidiaries will be subject to reporting and examination by the FRB in order to inform the FRB of:

(1) the nature of the operations of the SLHC and its subsidiaries;

(2) the financial, operational and other risks within the SLHC system that may pose a threat to its safety and soundness or that of any depository institution subsidiary of the SLHC or the stability of the U.S. financial system;

(3) the SLHC's systems for monitoring and controlling these risks; and

(4) the SLHC's compliance with the HOLA, federal laws that the FRB has specific authority to enforce against a SLHC or its subsidiaries and, other than a functionally regulated subsidiary or a depository institution, any other applicable provision of federal law.

In general, non-bank subsidiary examinations of a SLHC must be conducted in the same manner and frequency, and be subject to the same standards, as if the activities are conducted by the largest insured depository institution at any time, based on a comparison of the average total risk-weighted assets controlled by each insured depository institution during the previous 12-month period. The OCC and FDIC are each authorized to advise the FRB of issues raised by a non-bank subsidiary requiring examination by the FRB and recommend that the FRB examine such subsidiary. In order to provide a system of checks and balances, in the event the FRB does not conduct an examination of such subsidiary, the agency that recommended that the FRB conduct such examination may conduct its own examination if the FRB does not commence an examination within 60 days or otherwise provide a written explanation or plan responding to the concerns initially raised. Such agency must then coordinate with the FRB and may, as a result of the examination, recommend that the FRB take enforcement action based on the examination or other relevant information.

Enhanced Supervision of Functionally-Regulated Subsidiaries of SLHCs

Functionally-regulated subsidiaries of SLHCs, including brokers and dealers; registered investment advisors and investment companies regulated by the SEC; state-regulated companies; and entities regulated by the Commodities Futures Trading Commission, are no longer entitled to so-called "regulation-light" oversight as permitted by the Gramm-Leach-Bliley Act of 1999 ("GLBA"), as the FRB has been granted full authority to examine non-bank subsidiaries in accordance with its new supervisory authority over SLHCs, as described above. While granting the FRB greater authority to examine functionally-regulated subsidiaries of SLHCs, the FRB still must coordinate its supervisory activities and limit its information and reporting requests to conform with the manner specified for bank holding companies, in order to avoid duplication of these activities. For example, the FRB must provide reasonable notice to and consult with the appropriate federal or state regulatory agency of a subsidiary depository institution or functionally-regulated subsidiary of a SLHC.

Capital Requirements

As discussed above, the Dodd-Frank Act imposes capital requirements on all depository institutions and holding companies with greater than $500 million in assets. Accordingly, for the first time, commencing in July 2015, SLHCs will be subject to formal capital requirements. That is, SLHCs will be required to hold capital in the same amount and of the same type that is required of capital required for insured depository institutions. In addition, trust-preferred and cumulative preferred securities (other than TARP-preferred securities) issued by a SLHC will be precluded from counting as capital for any SLHC with over $15 billion in consolidated assets, subject to the three-year phase-in period described above commencing January 1, 2013.

Moreover, compliance with holding company capital requirements will also be a critical component in permitting SLHCs to continue to engage in financial activities, because, as described below, SLHCs will be required to be well capitalized and well managed like financial holding companies in order to engage in activities permissible for financial holding companies.

Finally, similar to thrift-level capital, requirements for SLHC capital will be countercyclical, so that the amount of capital required to be maintained by a SLHC will increase in times of economic expansion and decrease in times of contraction, consistent with the safety and soundness of the company.

SLHCs are Formally Subjected to the FRB's Source of Strength Doctrine

While the OTS has suggested that SLHCs have to act as a "source of support" for their thrift subsidiaries, the Dodd-Frank Act codifies the FRB's long-standing "source of strength" doctrine, requiring that any company that controls an insured depository institution must serve as a source of financial strength for any depository institution subsidiary of the holding company. The phrase "source of financial strength" is defined to be "the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution." The FRB is authorized to adopt regulations implementing this requirement not later than one year after the Transfer Date.

Activities of Non-Banking Subsidiaries of SLHCs May Ultimately be Limited

Since enactment of GLBA, SLHCs have been permitted to engage in any activity permissible for a financial holding company under Section 4(k) of the Bank Holding Company Act ("BHC Act"), such as securities underwriting, insurance underwriting and merchant banking. The Dodd-Frank Act, however, qualifies this broad grant of authority by only permitting SLHCs that actually qualify and remain qualified as a financial holding company under the BHC Act to engage in activities that have been deemed "financial in nature" under Section 4(k) of the BHC Act. Accordingly, for non-bank subsidiaries of a SLHC to engage in non-banking activities that are deemed to be financial in nature under Section 4(k), a SLHC must first qualify as a financial holding company and certify that each depository institution subsidiary of the SLHC is well capitalized and well managed and has a Community Reinvestment Act rating of at least satisfactory. Noncompliance with these provisions would trigger remedial restrictions, including limitations on the commencement of new financial activities, restrictions on the acquisition of new subsidiaries engaged in Section 4(k) activities and potential divestiture of either non-banking activities or the holding company's depository institution.

Ring-Fencing of Financial Activities

In 1999, the GLBA grandfathered certain unitary SLHCs which were authorized to engage in a broad array of activities including activities that were made impermissible for holding companies of insured depository institutions. The Dodd-Frank Act does not alter this grandfathered authority, but the FRB has been authorized to require that these grandfathered SLHCs form intermediate holding companies for their thrift and other subsidiaries engaged in financial activities (each an "Intermediate Holding Company") such entities would thereafter be regulated under the SLHC. Such Intermediate Holding Companies would enable the FRB to appropriately supervise only the SLHC's financial activities and will ensure that FRB supervision does not extend to non-financial activities. Notably, the parent of an Intermediate Holding Company is exempt from the term "savings and loan holding company," thus is not subject to formal safety and soundness examination. Notwithstanding such exemption, a parent of an Intermediate Holding Company is required to serve as a source of strength to its Intermediate Holding Company subsidiaries and will remain subject to FRB examination to ensure compliance with Intermediate Holding Company requirements. The FRB also is authorized to issue regulations establishing affiliate transaction limits between an Intermediate Holding Company and its former parent SLHC, provided that these regulations do not restrict or limit *bona fide* acquisition or lease by an unaffiliated person of assets, goods or services.

Examination Fees

While all SLHCs are subject to examination fees from the OTS, the FRB currently does not assess fees for its examination functions. The Dodd-Frank Act, however, authorizes the FRB to assess fees for the supervision of SLHCs (as well as bank holding companies) with over $50 billion in assets. Accordingly, SLHCs with less than $50 billion in assets will see their regulatory compliance costs reduced, while entities with assets of $50 billion or more will be subject to an assessment.

Holding Companies of Trust-Only Thrifts Will No Longer Be Deemed SLHCs

Currently any company that controls a thrift is deemed to be a SLHC under the HOLA. However, similar to a current exemption in the BHC Act for companies that only control trust companies, the Dodd-Frank Act adds an exemption to the definition of a SLHC for a company that only controls a savings association whose activities are limited to trust or fiduciary activities. As a result, after the FRB assumes the OTS's holding company jurisdiction, companies deemed to be a SLHC merely because it controls a thrift subsidiary whose activities are limited to fiduciary or trust activities will no longer be deemed to be a SLHC, thereby eliminating a significant regulatory burden. Such holding companies, however, may not be excluded from regulation altogether especially if they are determined to be a significant nonbank financial company. *See also* Paul Hastings Stay*Current*—The Dodd-Frank Act: Impact on Insurance Companies.

GAO Study of SLHCs

The Dodd-Frank Act requires the performance of various studies and reports addressing aspects of the financial system in the United States. Among such studies is one to be conducted by the Government Accountability Office (the "GAO") within 18 months of enactment with respect to the various exceptions to the term "bank" under the BHC Act, 12 U.S.C. § 1841(c)(2), determine whether the exceptions are necessary in order to strengthen the safety and soundness of institutions or the stability of the financial system. The study should also consider whether to eliminate the various exceptions, including an exception for savings associations. Specifically with respect to savings associations and SLHCs, the GAO is authorized to determine the adequacy of the federal bank regulatory framework applicable to such entities, including any restrictions, such as limitations on

affiliate transactions or cross-marketing between an institution and its holding company or affiliate. More importantly, the GAO is required to evaluate the potential consequences of subjecting savings associations and SLHCs to the requirements of the BHC Act, by considering the availability and allocation of credit, the stability of the financial system and the economy, the safe and sound operations of savings associations, and the impact on the types of activities in which savings associations and SLHCs engage. Accordingly, the era of separate, but essentially equal, regulation of SLHCs and their bank holding company competitors appears to be drawing to a close.

Action Plan

Notwithstanding the delayed effective dates of the major provisions of the Dodd-Frank Act, thrifts and their holding companies should pro-actively prepare for these extensive changes. For example, thrifts and SLHCs should:

1. Review their capital structure, in light of the phase-out of trust-preferred and cumulative-preferred securities and various hybrid capital, and plan to raise additional capital early, in case of adverse changes in the market conditions.

2. Evaluate whether their thrift is operating under the charter that is most optimal for their current and planned operations. Given limitations on federal preemption, continued compliance with the qualified thrift lender test and OCC assessments, the benefits of converting to a national bank or state-chartered bank may outweigh costs of remaining a thrift institution.

3. Determine whether their SLHC qualifies as a financial holding company under the BHC Act to permit the SLHC's continued engagement in activities only permissible for a financial holding company. Evaluate whether their SLHC needs to ring-fence its financial activities from non-financial activities. FRB regulations are due within 90 days after assuming SLHC jurisdiction.

4. Monitor the credit-risk retention rules and regulations and war-game how they impact originate-to-sell programs and how various exemptions are defined. Modify lending programs now to eliminate factors that would disqualify a residential mortgage from an applicable exemption under the risk-retention rules.

To view other thought leadership pieces on how this landmark legislation and the myriads of implementing regulations will affect your industry, please follow this link.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Barry A. Brooks
Mergers & Acquisitions, New York
212-318-6077
barrybrooks@paulhastings.com

Siobhan M. Burke
Private Equity, Los Angeles
213-683-6282
siobhanburke@paulhastings.com

Robert A. Claassen
Derivatives, Securities and Capital Markets, Palo Alto
650-320-1884
robertclaassen@paulhastings.com

V. Gerard Comizio
Global Banking and Financial Institutions, Washington, DC
202-551-1272
vgerardcomizio@paulhastings.com

Chris Daniel
Global Banking and Financial Institutions, Atlanta
404-815-2217
chrisdaniel@paulhastings.com

Conor W. Downey
Finance, Restructuring and Securitization, London
44-20-3023-5165
conordowney@paulhastings.com

Lawrence J. Hass
Private Investment Funds, New York
212-318-6401
larryhass@paulhastings.com

John F. Hilson
Finance and Restructuring, Los Angeles
213-683-6300
johnhilson@paulhastings.com

Mario J. Ippolito
Finance and Restructuring, New York
212-318-6420
marioippolito@paulhastings.com

Lawrence D. Kaplan
Global Banking and Financial Institutions, Washington, DC
202-551-1829
lawrencekaplan@paulhastings.com

Stanton Koppel
Global Banking and Financial Institutions, San Francisco
415-856-7284
stankoppel@paulhastings.com

Ronald Lanning
Securitization, New York
212-318-6850
ronaldlanning@paulhastings.com

Mitchell E. Nichter
Investment Management, Hedge Funds, San Francisco
415-856-7009
mitchellnichter@paulhastings.com

Elizabeth H. Noe
Securities and Capital Markets, Atlanta
404-815-2287
elizabethnoe@paulhastings.com

Joseph P. Opich
Tax, New York
212-318-6596
josephopich@paulhastings.com

Kevin L. Petrasic
Global Banking and Financial Institutions, Washington, DC
202-551-1896
kevinpetrasic@paulhastings.com

Mark Poerio
Employment, Washington, DC
202-551-1780
markpoerio@paulhastings.com

Charles G. Roberts
Securitization and Real Estate, London
44-20-3023-5164
charlesroberts@paulhastings.com

Michael R. Rosella
Investment Management, New York
212-318-6800
mikerosella@paulhastings.com

Barry G. Sher
Litigation, New York
212-318-6085
barrysher@paulhastings.com

William J. Simpson
Private Equity, Orange County
714-668-6205
billsimpson@paulhastings.com

Joshua H. Sternoff
Private Investment Funds, New York
212-318-6011
joshsternoff@paulhastings.com

William F. Sullivan
Litigation, Los Angeles
213-683-6252
williamsullivan@paulhastings.com

Thomas S. Wisialowski
Tax, Palo Alto
650-320-1820
thomaswisialowski@paulhastings.com

Jennifer Yount
Finance and Restructuring, Los Angeles
213-683-6008
jenniferyount@paulhastings.com

Michael L. Zuppone
Securities and Capital Markets, Corporate Governance, New York
212-318-6906
michaelzuppone@paulhastings.com

Arthur L. Zwickel
Investment Management, Hedge Funds, Los Angeles
213-683-6161
artzwickel@paulhastings.com

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (enacted on July 21, 2010). The general effective date of the Dodd-Frank Act is July 22, 2010.

[2] 12 U.S.C. § 1461 *et seq*.

[3] An exception is provided for "any small bank holding company that is subject to the Small Bank Holding Company Policy Statement of the Board of Governors, as in effect on May 19, 2010." *See* Appendix C to 12 C.F.R. Part 225, the Small Bank Holding Company Policy Statement, which applies only to bank holding companies with *pro forma* consolidated assets of less than $500 million that (i) are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) do not conduct significant off-balance sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; and (iii) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the SEC.

[4] 12 U.S.C. § 371c(b)(7).

[5] 12 U.S.C. §§ 1841 *et seq*.

[6] For purposes of the Volcker Rule, a banking entity that is engaged in "proprietary trading" means that it is 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 contract, or any other security or financial instrument that the appropriate federal banking agencies, the SEC, and the CFTC may determine by regulation.

The term "trading account" means any account used for acquiring or taking positions in the securities and instruments 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 federal banking agencies, the SEC and CFTC may determine by regulation.

[7] To "sponsor" a fund means: (A) to serve as a general partner, managing member, or trustee of a fund; (B) in any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a fund; or (C) to share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

[8] The terms "hedge fund" and "private equity fund" mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate federal banking agencies, the SEC and CFTC may determine by regulation.