TITLE VI: Enhanced Regulation of Depository Institution Holding Companies

Title VI, the "Bank and Savings Association Holding Company and Depository Institution Regulatory Improvement Act of 2010," includes a significant number of new provisions and amendments to existing law that add financial and supervisory requirements and restrictions on depository institutions and their holding companies; and in some cases, those provisions also extend to Supervised NBFCs. For nonfinancial firms, it provides a new structure allowing transfer of regulation of SLHCs with nonfinancial activities to an IHC subsidiary, while barring a "commercial" firm from acquiring an industrial bank or credit card bank for at least three years. While most of the Title VI requirements tighten regulation of depository organizations, the title does provide two long-sought liberalizations—*de novo* interstate branching and interest-bearing demand deposit accounts for depository institutions.

Significantly, the title enhances capital requirements and includes an expansive version of the much discussed "Volcker Rule," based on proposals made by former Fed Chairman Paul Volcker. Provisions constituting the Volcker Rule include restrictions on capital markets activity by banks and BHCs, restrictions on proprietary trading, and limitations on relationships with hedge funds and private equity funds. Title VI also adds or amends a number of other provisions, including:

i. Requirements concerning examinations;

ii. A requirement that financial holding companies remain well capitalized and well managed;

iii. A source of strength requirement;

iv. A provision relating to interstate acquisitions;

v. Provisions relating to affiliate transactions;

vi. Lending limits applicable to credit exposure on derivative transactions, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions;

vii. Insider transactions;

viii. Securities holding companies; and

ix. Concentration limits.

A. New Credit Card Banks, Industrial Loan Companies, and Trust Banks Controlled by a Commercial Firm

1. Moratorium on New Commercial Firm Control of Credit Card Banks, Industrial Banks, and Trusts Banks

Title VI establishes a three-year moratorium during which "commercial firms" cannot establish new or acquire existing credit card banks, industrial banks, or trust banks.[15] **Sec. 603(a) (pp. 226-227)**. Under Section 602, a company is a "commercial firm" if the annual gross revenues derived by the company from control of insured depository institutions represent less than 15 percent of the consolidated gross revenues of the company. This definition limits the effect of the moratorium by not barring acquisitions by commercial firms that have significant financial activities. **Sec. 602 (p. 226)**.

The FDIC is barred from approving an application for deposit insurance for a industrial bank, a credit card bank, or a trust bank that is directly or indirectly owned or controlled by a commercial firm if the application was received after November 23, 2009. Federal banking agencies would be required to disapprove any change of control (under Section 7(j) of the FDI Act) over an industrial bank, credit card bank, or trust bank if the change would result in direct or indirect control of the bank shifting to a commercial firm. **Sec. 603(a) (p. 226)**. Note that the provision is silent with respect to merger acquisitions and does not appear to limit a merger in which the resulting institution is an institution that was previously controlled by a commercial firm.

The title provides three limited exceptions to the prohibition on a commercial firm gaining control of a credit card bank, industrial bank, or trust bank. A commercial firm can acquire such a bank when the bank is (1) in danger of default (as determined by the appropriate federal banking agency), (2) the change of control results from the acquisition of a commercial firm that controls the bank by another commercial firm (so that the bank was owned by a commercial firm both before and after the transaction), or (3) the change of control results from the acquisition of voting shares of a publicly traded company that controls the bank if, after the acquisition, the acquiring shareholders hold less than 25% of any class of voting shares of the company. **Sec. 603(a)(3)(B) (pp. 226-227)**.

---

15 Dodd-Frank defines each of "credit card bank," "industrial bank," and "trust bank" by reference to the BHC Act, specifically BHC Act Sections 2(c)(2)(D), (F), and (H). **Sec. 603(a)(1)(A)-(C) (pp. 226)**.

2. GAO Study of SLHCs and Future Control of Credit Card Banks, Industrial Loan Companies, and Trust Banks by a Commercial Firm

During the three year moratorium discussed above, the Government Accountability Office ("GAO") is required to conduct a study of whether commercial companies should be permitted to own credit card banks, industrial banks, and trust banks. Specifically, the GAO is required to study whether it is necessary to eliminate these exceptions to the BHC definition in BHC Act Sections 2(a) and 2(c). **Sec. 603(b)(1) (p. 227)**. The study will not be required to address the implications of such a change for a company that already controls such institutions. If these exception are eliminated, then all future acquisitions of such institutions by a commercial firm will be barred and the ability of existing commercial firms to control such banking institutions would be subject to termination (unless grandfathered). The GAO study will identify the types and number of institutions excepted from BHC Act Section 2, determine the adequacy of the federal bank regulatory framework applicable to these institutions, and evaluate the potential consequences of subjecting these banks to the BHC Act. **Sec. 603(b)(2)(A) (pp. 227-228)**.

The study also will address eliminating the BHC Act exception for savings associations, which excludes companies controlling a savings association from being regulated as BHCs. ***See*** **BHC Act § 2(c)(2)(B).** In addition, the GAO study will make specific determinations with regard to the adequacy of the federal bank regulatory framework and the potential consequences of subjecting SLHCs to the BHC Act, including with respect to the availability and allocation of credit, economic stability and safety and soundness of such institutions. **Sec. 603(b)(2)(B) (p. 228)**.

The title requires that the Comptroller General submit the report of the GAO study to the Senate Banking Committee and the House Financial Services Committee within 18 months after the legislation is enacted. **Sec. 603(b)(3) (p. 228)**. This schedule provides Congress 18 months to enact legislation before the end of the moratorium.

B. Reports and Examinations of Holding Companies

1. Reports

The title amends the BHC Act to extend the existing requirement that regulators rely on information provided in externally audited financial statements and publicly available information to the OCC, FDIC, and Fed as supervisors of BHCs. **Sec. 604(a)(2) (p. 229)**. In addition, the Act adds a new BHC Act Section 5(c)(1)(C), extending the existing requirement that any BHC (or subsidiary) promptly provide any of the information described in BHC Act Section 5(c)(1)(B) to any "appropriate Federal banking agency," rather than, currently, the Fed. **Sec. 604(a)(3) (pp. 228-229)**.

2. Examinations

Title VI amends BHC Act Section 5(c)(2) to provide that the Fed is authorized to conduct examinations of the bank holding company (and its subsidiaries) in order to determine the nature of the companies' operations and financial conditions as well as to assess risks within the BHC that may pose a threat to the safety and soundness of the BHC's depository institution subsidiaries or the stability of the U.S. financial system. **Sec. 604(b) (pp. 229-230)**. In doing so, the Fed is directed to "the fullest extent possible" to rely on reports the company has had to file with regulators or examination reports that were made by other federal or state agencies relating the BHC (and its subsidiaries), to use externally audited financial statements, and to coordinate with those other regulators. **Sec. 604(b) (pp. 229-230)**.

The Act amends the Home Owners' Loan Act (12 U.S.C. 1461 *et seq.*) ("HOLA") Section 2 to reflect the transfer of OTS authority, granting the appropriate federal banking agency for a savings and loan holding company authority to conduct examinations of functionally regulated subsidiaries. **Sec. 604(h) (pp. 232-233)**. The Act strikes existing HOLA Section 10(b)(4) relating to examinations. This paragraph provided that each SLHC (and each of its subsidiaries) is subject to examination, the cost of which is to be paid by the holding company, with the Director obligated to use reports filed with or examinations made by other federal or state supervisory authorities to the extent feasible. The amendment substitutes the Fed for the OTS and list the purposes of such examinations, specifically: to inform regulators of the nature of the operations and financial condition of the holding company and its subsidiaries; to inform the Fed of the financial, operational, and other risk within the holding company that may pose a risk to safety and soundness or financial stability; and to inform regulators about the systems the holding company uses to monitor risk, as well as to enforce compliance with federal law. **Sec. 604(h) (pp. 232-233)**.

The new HOLA Section 10(b) preserves the preexisting requirement to use reports made by other Federal and State agencies "to the fullest extent possible" (rather than the previous "to the extent deemed feasible") and requires that the appropriate Federal banking agency coordinate with other regulators with regard to providing reasonable notice before requesting a report and avoiding duplicative examinations. **Sec. 604(h) (pp. 232-233)**.

These provisions are effective as of the transfer date.

C. Increased Fed Authority Over Functionally Regulated Subsidiaries of BHCs

Title VI strikes BHC Act Section 10A, under which the Fed generally could not "prescribe regulations, issue or seek entry of orders, impose restraints, restrictions, guidelines, requirements, safeguards, or standards, or otherwise take action under or pursuant to any provision of [the BHC Act] or Section 8 of the [FDI Act] against or with respect to" a functionally regulated subsidiary. **BHC Act § 10A(a)**. Thus, the Fed was prohibited from issuing regulations or guidance that specifies policies for subsidiaries engaging in regulated activities. At the same time, Section 10A provided two potentially significant exceptions to these prohibitions:

i. <u>The material risk exception</u>, under which the Fed may take supervisory action that "is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty" that poses a material risk to the financial safety, soundness or stability of an affiliated depository institution; or the domestic or international payment system, ***see*** **BHC Act § 10A(a)**; and

ii. The statutory compliance exception, under which the Fed could take supervisory action "to enforce compliance by a functionally regulated subsidiary of a bank holding company with Federal law that the Fed has specific jurisdiction to enforce against such subsidiary," ***see* BHC Act § 10A(c)**.

Striking BHC Act Section 10A enhances Fed authority but does not supplant the functional regulators. Title VI will continue limits on the Fed's power with respect to functionally regulated subsidiaries and preserves the role of the agencies primarily responsible for regulating them. Under the title, the Fed would be required to provide notice to and consult with the appropriate federal or state regulatory agency of a functionally regulated subsidiary before requesting a report or commencing an examination of the subsidiary. **Sec. 604(b) (pp. 229-230)**. In addition, Title I, Section 162(b) provides that if the Fed finds a condition, practice, or activity of a functionally regulated subsidiary which does not comply with the Fed's regulations or orders, the Fed may recommend that the primary financial regulatory agency for the subsidiary initiate a supervisory action or enforcement proceeding. **Sec. 162(b) (p. 48)**. The Act provides that if during the 60 days following the date the primary financial regulatory agency receives a recommendation it does not take supervisory or enforcement action against the subsidiary that is "acceptable" to the Fed, the Fed may take the recommended supervisory or enforcement action "as if the subsidiary were a bank holding company subject to supervision by the Board of Governors." **Sec. 162(b)(2) (p. 48)**.

These provisions are effective as of the transfer date.

D. Acquisitions of Banks and Nonbanks under the BHC Act

1. Acquisitions of Banks

Title VI amends BHC Act Section 3(c) to require the Fed to consider whether a proposed acquisition, merger, or consolidation between banks (or a bank and a nonbank) would result in greater or more concentrated risks to the stability of the U.S. banking or financial system. **Sec. 604(d) (p. 230)**.

The new law also provides that, for purposes of BHC Act Section 3, a nonbank financial company supervised by the Fed is deemed to be, and is treated as, a BHC. **Sec. 163(a) (p. 48)**.

2. Acquisitions of Nonbanks

Under the previous BHC Act Section 4(j)(1), a bank holding company must provide the Fed at least 60 days written notice before engaging in any transaction or activity that would cause it to engage in a nonbanking activity. Under Regulation Y, a bank holding company that is well-capitalized and well-managed and that meets certain other criteria can file an after-the-fact notice. BHC Act Section 4(j)(2)(A) currently provides that, in connection with such a notice, the Fed must consider whether the performance of the activity by the BHC can reasonably be expected to produce public benefits that outweigh possible adverse effects.

Title VI amends the BHC Act Section 4(j)(2)(A), to require that the Fed consider the "risk to the stability of the U.S. banking or financial system" as a consequences of a transaction or engaging in an activity. The former criteria were undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices. **Sec. 604(e)(1) (pp. 230-231)**.

Title VI also amends BHC Act Section 4(k)(6)(B) to require that a financial holding company receive prior approval from the Fed to acquire a company with total consolidated assets above $25 billion. **Sec. 604(e)(2) (p. 231)**. Such acquisitions would still be subject to antitrust merger review in addition to requiring approval from the Fed. For smaller acquisitions, present law would not change, allowing a financial holding company to engage in activities that are financial in nature and acquire shares in financial companies that engage in financial activities without Fed approval.

In addition, Title VI amends BHC Act Section 4(k)(6)(B) to require prior notice of large acquisitions to the Fed. A BHC with total consolidated assets of $50 billion or more or a NBFC supervised by the Fed would need to provide written notice to the Fed before gaining direct or indirect control over a company engaged in BHC Act Section 4(k) financial activities with total consolidated assets of $10 billion or more. **Sec. 163(b) (pp. 48-49)**.

These provisions are effective as of the transfer date.

E. SLHCs

1. Provision of Information

Title VI amends Section 10(b)(2) of HOLA to apply to SLHCs provisions now applicable to BHCs under Section 5 of the BHC Act. It provides that on request SLHCs must provide the Fed information, but that the Fed is to use existing reports and information from other regulatory agencies to the extent possible. **Sec. 604(g) (pp. 231-232)**. HOLA is also amended to add the same provisions with respect to Fed examinations of SLHCs and their subsidiaries. **Sec. 604(h) (pp. 232-233)**. These provisions is effective as of the transfer date.

2. New Exclusion from SLHC Status

The title adds a new exclusion from the definition of an SLHC for a grandfathered Unitary SLHC—as provided in HOLA Section 10(c)(9)(C) added by the Gramm-Leach-Bliley Act—(a "Unitary") that is required by the Fed to establish an IHC. The exclusion applies to a company described in HOLA Section 10(c)(9)(C) "solely by virtue of" its control of an IHC "established under" new Section 10A of HOLA (See Section 626 below). Under HOLA Section 10A, the Fed must make a determination before an SLHC can establish a qualifying IHC. If the Fed makes that determination, the IHC would be an SLHC and its Unitary parent would cease to be an SLHC. **Sec. 604(i) (p. 233)**. This provision is effective as of the transfer date.

3. Intermediate Holding Companies Under the New HOLA Act

A companion amendment to the exclusion from the definition of SLHC in Section 604(i) is the addition of new Section 10A to HOLA concerning IHCs. Parallel to the Title I IHC provisions, this IHC provision is intended to ensure that nonfinancial activities are not subject to financial regulation. Nothing in Section 10A is to be construed to require a Unitary to "conform its activities to permissible activities" under HOLA. This provision does not specify an effective date; while it therefore is effective as of the Act's enactment, the companion SLHC exclusion provision is not effective until after the transfer date. **Sec. 626 (pp. 268-271)**.

The Fed may require a Unitary to establish an IHC in which to conduct "all or a portion" of its financial activities, not including internal financial activities. The Fed must require a Unitary to establish an IHC if necessary to appropriately supervise activities that are determined to be financial activities, or to ensure that supervision by the Fed does not extend to the activities of such company that are not financial in nature. **Sec. 626 (pp. 268-271)**. It should be noted that the Title I IHC provisions closely parallel these IHC provisions and that a grandfathered SLHC under Title VI might also be a Supervised NBFC and subject to both sets of IHC provisions. House Financial Services Chairman Frank addressed this possibility in a Floor colloquy at the time of the House's final passage of the legislation. He stated that these provisions are intended to be applied "in harmony" so that affected firms will not be subject to inconsistent requirements.

The Fed "may" adopt affiliate transaction rules for IHCs "as necessary to prevent unsafe and unsound practices in connection with transactions between such company, or any subsidiary thereof, and its parent company or affiliates that are not subsidiaries of such company, except that such regulations shall not restrict or limit any transaction in connection with the *bona fide* acquisition or lease by an unaffiliated person of assets, goods, or services." **Sec. 626 (pp. 268-271)**.

A company that directly or indirectly controls such an IHC must serve as a source of strength to its subsidiary IHC. The parent of an IHC may be required to file reports, as the Fed determines, to allow assessment of compliance and ability to serve as a source of strength. The title also states expressly that the parent company will be subject to the enforcement provisions of Section 8 of the FDI Act, as if it were a bank or SLHC. **Sec. 626 (pp. 268-271)**.

F. Oversight of Depository Institutions and Their Subsidiaries' Activities

Title VI adds a new BHC Act Section 26, entitled "Assuring Consistent Oversight of Subsidiaries of Holding Companies." The new section provides for the Fed to examine the activities of a non-depository institution subsidiary of a holding company in the same manner and according to the same standards as if the activities were conducted within the holding company's largest insured depository institution subsidiary. If the Fed fails to conduct such examinations as required by BHC Act Section 26, the OCC or FDIC (whichever agency is responsible for supervising the holding company's largest insured subsidiary) may issue a recommendation to the Fed to conduct such an examination. If the Fed fails to follow the recommendation within 60 days, the OCC or FDIC may conduct its own examination. These provisions seem intended to provide that the same standards applied to a bank's activities, *e.g.*, mortgage lending, will be applied to a similar subsidiary of the holding company (and possibly to relieve the Fed of the need to conduct these exams). Title VI also includes provisions calling for inter-agency coordination when such exams take place. This provision is effective as of the transfer date. **Sec. 605 (pp. 233-234)**.

G. Recommendation and Back-Up Authority

Based on the information collected in such examinations, the FDIC or OCC can submit a recommendation to the Fed that it take enforcement action against a nondepository subsidiary of the depository institution if it determines that the subsidiary's activities pose a material threat to the safety and soundness of any insured depository institution subsidiary of the holding company. If the Fed does not take such recommended enforcement action or provide a plan for enforcement action that is acceptable to the lead federal banking agency within sixty days of receipt of the recommendation, the lead federal banking agency can then take such action as if the subsidiary were an insured depository. This provision is effective as of the transfer date. **Sec. 605 (pp. 233-234)**.

H. Requirement for Financial Holding Companies to Remain Well Capitalized and Well Managed

Title VI amends BHC Act Section 4(l)(1) to require a BHC engaging in any Section 4(k) financial activity to be well capitalized and well managed—in addition to the present requirement that the banks in a financial holding company be well capitalized and well managed. **Sec. 606 (pp. 236)**. Thus, the amendment would extend the well capitalized and well managed requirement from the depository subsidiary to the bank holding company level. This provision is effective as of the transfer date.

I. Regulations Regarding Capital Levels for BHCs and SLHCs

Express language is added to BHC Act Section 5(b) and HOLA to provide that the Fed may establish capital standards by regulation and order. It further specifies that the Fed is to make these requirements countercyclical so that the amount of capital required to be maintained increases in times of economic expansion and decreases in times of economic contraction. This provision is effective as of the transfer date. **Sec. 616(a)-(b) (p. 245)**.

Title VI also amends Section 908 of the International Lending Supervision Act of 1983 to require federal banking agencies to make capital standards countercyclical with respect to insured depository institutions. This provision is effective as of the transfer date. **Sec. 616(c) (p. 245)**.

J. Source of Strength Requirements

Under current Regulation Y, the Fed expects a BHC to "serve as a source of financial and managerial strength" to its affiliated depository institutions. 12 C.F.R. § 225.4(a). Under this policy, the Fed maintains that it may order a BHC, through a capital directive or by other means, such as the sale of a nonbank subsidiary, to provide funds to its subsidiary depository institutions. As a supervisory matter and with applications, the Fed may look with disfavor on capital structures that inhibit a BHC's ability to raise funds. Also, the Fed may object to the issuance of capital or debt instruments to fund the expansion of nonbank operations, if in its opinion, such action may hamper a BHC's future ability to supply needed funds to a depository institution subsidiary.

Title VI adds a "source of strength" requirement to the FDI Act as a new Section 38A.

This section requires that a BHC or SLHC serve as a source of financial strength for its depository institution subsidiary. "Source of financial strength" is defined to mean "the ability of a company that directly or indirectly 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." Any other company that controls an insured depository institution but is not a bank holding company or savings and loan holding company, would be required to serve as a source of financial strength for it. Such "other companies" could also be required to submit reports on their ability to serve as a source of strength. The federal banking agencies would jointly issue final rules within one year of passage to carry out this new section. **Sec. 616(d) (pp. 245-246)**.

These provisions are effective as of the transfer date. **Sec 616(e) (p. 246)**.

K. Interstate Acquisitions

Title VI amends the BHC Act and the FDI Act to provide that banks engaging in interstate acquisitions be "well capitalized and well managed" rather than the current "adequately capitalized and adequately managed." This provision is effective as of the transfer date. **Sec. 607 (p. 237)**.

L. Interstate Branching

The Riegle-Neal Act is amended to allow national and state banks to establish *de novo* interstate branches at any location where a bank based in that state could establish a branch. This provision is effective on the day following enactment of the Act. **Sec. 613 (p. 243-244)**.

M. Interstate Merger Transactions

Title VI amends the FDI Act, BHC Act, and HOLA, with a provision that the responsible agency may not approve an application for an interstate merger transaction, or an application to acquire an insured depository institution, if the home state of the acquired insured depository institution is different than the home state of the holding company and if the resulting insured depository institution (including all affiliates) would control more than 10% of the total amount of deposits in insured depository institutions in the United States. An exception is made if the merger involves an insured depository institution in default or in danger of default, or for which the FDIC provided assistance under FDI Act Section 13. This provision is effective on the day following enactment of the Act. **Sec. 623 (p. 264-266)**.

N. Enhancing Restrictions on Bank Transitions with Affiliates—Securities Lending and Derivatives Transactions

Title VI would enhance existing restrictions on bank transactions with affiliates by amending FR Act Section 23A(b) to include securities lending and derivative transactions. First, the term "affiliate" is redefined to broadly include "any investment funds with respect to which a member bank or affiliate thereof is an investment advisor," replacing a more complex provision that includes as an affiliate any company that is sponsored or advised on a contractual basis by a member bank or that is an investment company for which a member bank is an investment advisor as defined in the 1940 Act. Affiliates are considered an "investment fund" (*e.g.*, a hedge or private equity fund) even if organized and managed outside the Investment Company and Advisers Act. **Sec. 608(a)(1) (pp. 237-238)**. Significantly, securities lending transactions would be added to the "covered transactions" definition, as are derivative transactions to the extent either type of transaction "causes a member bank or a subsidiary to have credit exposure to the affiliate." It also makes a technical amendment to the definition of "covered transactions" in which the reference to repurchase agreements—defined as "a purchase of assets subject to an agreement to repurchase" —is moved from its current position in a provision relating to the purchase of assets to a provision relating to loans and extensions of credit. **Sec. 608(a)(1) (pp. 237-238)**.

Title VI makes several additional changes which expand the definition of "covered transactions." It expands the Section 23A(c)(1) collateral requirements to include "any credit exposure of a member bank or a subsidiary to an affiliate resulting from a securities borrowing or lending transaction or a derivative transaction . . . ." Also, Title VI expands the Section 23A(c)(1) references to "a letter of credit" to include "letter of credit, or credit exposure" in each case. **Sec. 608(a)(2) (p. 238)**. Consistent with the expansion of the "covered transaction" definition, Title VI amends Section 23A(d)(4) dealing with exceptions to the affiliate transactions rule to add that the section does not apply to "having credit exposure resulting from a securities borrowing or lending transaction, or derivative transaction to" an affiliate that is fully secured by either obligations of the United States that are guaranteed by the United States or a segregated, earmarked deposit account with the member bank. **Sec. 608(a)(3) (p. 238)**.

Further changes are related to the "covered transaction" definition. Title VI, for example, strikes Section 23A(c)(2), currently providing that any collateral subsequently retired or amortized must be replaced by additional collateral where needed to keep the ratio of collateral to outstanding loan value at a minimum level. The new law also amends Section 23A(c)(3) (redesignated as paragraph 2) to add that a low quality asset is not acceptable as collateral for, credit exposure to an affiliate resulting from a securities borrowing or lending transaction. **Sec. 608(a)(2) (p. 238)**.

Note that Title VI also amends Section 23A(f), the rulemaking and additional exemptions provisions, to the following effect:

i. The Fed can no longer exempt transactions or relationships from the affiliate transactions rules "by order" but rather would need to do so "by regulation";

ii. The Board must find any exemption to be in the public interest and consistent with the purposes of the affiliate transactions rules (as it must under current law), as at present. The Act adds the requirement that the FDIC would need to receive notice of the Fed's finding that the exception was in the public interest and "not object, in writing" to the finding within 60 days of receiving notice. **Sec. 608(a)(4) (pp. 238-239)**.

Exemptions will no longer be the sole province of the Board. Rather, the OCC and the

FDIC will have a parallel role with the Board. Specifically, the Comptroller will have the power to exempt a transaction of a national bank from the affiliate transaction rules if the Fed and the Comptroller jointly find the exemption is in the public interest and notify the FDIC. The FDIC must not object in writing to the exemption within 60 days of receiving notice of the proposed exemption. **Sec. 608(a)(4) (pp. 238-239)**. Also, the FDIC will have the authority to exempt transactions of a state bank if the Fed and the FDIC jointly find the exemption is in the public interest and the FDIC finds the exemption does not present an unacceptable risk to the Deposit Insurance Fund. **Sec. 608(a)(4) (pp. 238-239)**.

Title VI amends FR Act Section 23B(e), relating to restrictions on transactions with affiliates and the power of the Fed to issue regulations exempting transactions or relationships from the section. Parallel to the Section 23A exemptions, the Fed will be required to find any exemption or exclusion to be in the public interest and consistent with the section, and also notify the FDIC. The FDIC must not object in writing within 60 days of receiving notice. **Sec. 608(b) (pp. 239-240)**.

Title VI amends HOLA Section 11 to add that the Comptroller could exempt transactions of a Federal savings association if the Fed and the Comptroller jointly find the exemption is in the public interest and the FDIC does not object to the exemption within a 60 day notice period. Similarly, Title VI provides that the FDIC could exempt a state savings association from the requirements of the section if the Fed and the FDIC jointly find the exemption is in the public interest and the exemption does not present an unacceptable risk to the Deposit Insurance Fund. **Sec. 608(c) (p. 240)**.

These provisions are effective one year after the transfer date. **Sec. 608(d) (p. 240)**.

O. Eliminating Section 23A Exceptions for Bank Transactions with Financial Subsidiaries

Section 609 strikes FR Act Section 23A(e)(3) to end the exception for transactions between a bank and a financial subsidiary. **Sec. 609 (p. 241)**. Under the previous FR Act, the restrictions regarding transactions with affiliates did not apply to covered transactions between a bank and any individual financial subsidiary of the bank. The new provision is effective one year after the transfer date.

P. Lending Limits on Credit Exposure on Derivative Transactions, Repurchase Agreements, Reverse Repurchase Agreements, and Securities Lending and Borrowing Transactions

Title VI amends Section 5200 of the Revised Statutes of the United States (12 U.S.C. § 84) controlling loans by member banks to their executive officers, directors, and principal shareholders by specifying that the term "loans and extensions of credit" includes all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds; any liability of a national banking association to advance funds to or on behalf of a person pursuant to a contractual commitment; and credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction between the national banking association and the person. The provision defines the term "derivative transaction" 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." This provision is effective one year after the transfer date. **Sec. 610 (p. 241)**. Additionally, Title VI amends FDI Act Section 18 to apply lending limits to derivatives transactions of state banks and is effective 18 months after the transfer date. **Sec. 611 (pp. 241-242)**.

Q. Insider Transactions

Title VI amends FR Act Section 22(h)(9)(D) dealing with extensions of credit to executive officers, directors, and principal shareholders of member banks by expanding the scope of "extension of credit" to include cases where the member bank has credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction. This provision is effective one year after the transfer date. **Sec. 614 (p. 244)**.

In addition, Title VI amends FDI Act Section 18 by inserting a new subsection that would prohibit an insured depository institution from purchasing an asset from or selling an asset to one of its executive officers, directors, or principal shareholders (or any related interest of such person) unless: (1) the transaction is on market terms; and (2) the transaction is approved by the majority of the institution's uninterested directors if the transaction comprises of more than 10% of the institution's capital stock and surplus. The amendment would also empower the Fed to issue rules needed to define terms and carry out the new subsection. This provision is effective on the transfer date. **Sec. 615 (pp. 244-245)**.

R. Conversions of Troubled Banks and Savings Associations

Title VI prohibits conversions of national banks to state banks and state banks to national banks at any time when the banks are subject to enforcement orders including a cease and desist order. This would be accomplished in two ways: first, by amending 12 U.S.C. Section 214 *et seq.* relating to the conversion of national banks to a state bank by inserting a new section that would prohibit conversions to a state bank or state savings association if a national bank is subject to a cease and desist order or other formal enforcement order and, second, by amending 12 U.S.C. Section 35 relating to the conversion of a state bank to a national bank by prohibiting the Comptroller from approving the conversion when the state bank is subject to a cease and desist order or other enforcement order. **Sec. 612(a)-(b) (pp. 241-242)**. Similarly, the Act would amend HOLA Section 5(i) to provide that a federal savings association cannot convert to a national bank or state bank or state savings association if it is subject to a cease and desist order or other formal enforcement order. **Sec. 612(c)(p. 242)**. An exception permits conversion to take place if the agency that would be the appropriate federal banking agency after conversion: (1) notifies the authority that issued the cease and desist order; (2) submits a plan to the authority that issued the order which addressed the problem "in a manner consistent with the safe and sound operation of the institution"; and (3) the authority which issued the order does not object within 30 days. **Sec. 612(d) (pp. 242-243)**.

These provisions are effective on the day following enactment of the law.

S. Elimination of Elective Investment Bank Holding Company Framework

Title VI eliminates the elective investment banking holding company framework, which had allowed the SEC to serve as a "holding company" regulator for such companies as Bear Sterns and Lehman Brothers. The Exchange Act Section 17(i) provided for the elective supervision of an investment bank holding company that does not have a bank or savings association affiliate. This provision allowed an investment bank holding company that is not an affiliate of an insured bank to become supervised as an investment bank holding company by filing a notice of intention with the SEC. Title VI amends the Exchange Act Section 17 by striking subsection (i), eliminating the elective investment bank holding company framework. This provision is effective on the transfer date. **Sec. 617 (p. 246)**.

T. Securities Holding Companies

Title VI provides for the recognition of supervised "securities holding companies." Under the supervision of the Board, these companies would be subject to regulation under FDI Act Section 8(b), (c) through (s), and (u) and under the BHC Act to the same extent as if they were BHCs, except that they are not deemed BHCs for purposes of BHC Act Section 4. **Sec. 618(e) (pp. 249-250)**. The provision defines "securities holding company" to mean an entity that owns or controls one or more registered broker dealers but excludes a NBFC supervised by the Fed, an insured bank (except for those institutions described in BHC Act Sections 2(c)(2)(D), (F), and (H)), an affiliate of an insured bank, and supervised foreign banks. **Sec. 618(a) (pp. 246-247)**.

Title VI provides that a securities holding company subject to comprehensive consolidated supervision under foreign law can register with the Fed to become a supervised securities holding company. The provision also provides that all supervised securities holding companies (and each affiliate) must make and maintain records the Fed determines are needed to monitor compliance. Records required to be kept include balance sheet or income statements, assessments of consolidated capital and liquidity, a report by an independent auditor attesting to compliance, and a report concerning the extent the company has complied with regulations and orders. **Sec. 618(b)-(c) (pp. 247-249)**. Title VI also grants the Fed examination authority over any supervised securities holding company and any affiliate, but requires the Fed to use reports and examinations made by other federal and state regulators to the fullest extent possible. **Sec. 618(c)(3) (p. 248-249)**. The Fed would have authority to prescribe capital adequacy and other risk management standards for supervised securities holding companies, which could be differentiated on an individual basis or by category. **Sec. 618(d) (p. 249)**. These provisions take effect on the day after enactment of the Act.

U. The "Volcker Rule"

1. Overview

The Act contains a version of the "Volcker Rule" (the "Rule")—so named for former Fed Chairman Paul Volcker—that differs in material respects from the version originally introduced from the Senate bill into the House-Senate Conference. As in earlier versions, the Rule invokes Chairman Volcker's core concept of separating certain risk activities from the federal bank subsidy.

In its final form, the Rule follows the approach of the Merkley-Levin Amendment (S.A. 4101) that was introduced into (but not acted on by) the Senate.

As Senators Levin and Merkley explained in their colloquy of July 15, 2010, Sections 619, 620 and 621 of the Act are intended to do three things: prohibit high risk proprietary trading at banks, limit the systemic risk of such activities at systemically significant NBFCs, and prohibit material conflicts of interest in asset-backed securities ("ABS"). Sections 619 and 620, what we refer to herein as the "Volcker Rule," amend the BHC Act. The Senators also explained that Section 619 is intended "to restore the purpose of the Glass-Steagall barrier between commercial and investment banks" and to "update that barrier to reflect the modern financial world and permit a broad array of low-risk, client-oriented financial services."

The provision prohibits a class of defined "banking entities" from engaging in private capital fund investing and proprietary trading and require that regulators apply quantitative limits and capital requirements to any Supervised NBFC that engages in these same activities. "Banking entities" for this purpose include any entity that controls a depository institution and any of its affiliates. A company that is both a banking entity and a Supervised NBFC is subject to the outright prohibition on banking entities engaging in the activities.

The Rule establishes a series of exemptions from these prohibitions, restrictions, and limitations—exemptions that both allow banking entities to participate in the activities and free Supervised NBFCs from otherwise applicable capital requirements and quantitative limits. The Rule also grants considerable discretion to regulators—discretion to clarify very broad core definitions, grant further exemptions, and subject even activities that are "permitted" under the statute to regulations and restrictions. Thus, the true impact of the Rule will not be clear until regulations are written, terms more clearly defined, and exceptions considered and granted.

While there is no doubt the Rule will have a meaningful impact on the extent to which companies benefiting from the federal bank subsidy can engage in risk activities, it is not yet clear where the final lines will be drawn. For example, while "hedge fund" and "private equity fund" are defined to mean any issuer that would be an investment company under the 1940 Act but is excluded from such coverage by the provisions of Sections 3(c)(1) and 3(c)(7), during the colloquy of House Financial Services Chairman Frank and Congressman Jim Himes, Congressman Himes made the point that the intent was not to prohibit investment in subsidiaries or joint ventures that hold investment but rather to "prohibit firms from investing in traditional private equity funds and hedge funds" and Chairman Frank confirmed that "[t]he point the gentleman makes is absolutely correct."[16] The Chairman's statement underscores the task of the regulators to adopt implementing rules that reflect the intent expressed in legislative history when addressing the at times broad statutory language.

The final Rule offers a number of complexities and unresolved issues, as more fully discussed below. However, consider the following core structural elements of the Rule:

i. *Entities Covered*. Prohibitions on proprietary trading and engaging in covered transactions with sponsored hedge funds and private equity funds extends not only to insured depository institutions but also to any company that "controls" an insured depository institution, foreign firms treated as BHCs under the International Banking Act, and any of their affiliates or subsidiaries;

ii. *Council Study*. The Council will conduct a study and make recommendations on implementing the Rule, but unlike some earlier versions of the Rule considered by the Senate, it would not have clear authority to overrule any of the statutory provisions of the Rule;

iii. *Supervised NBFCs*. Only a very narrow set of entities will be Supervised NBFCs subject to the capital requirements and quantitative limits but not within the definition of "banking entities." In fact, in the beginning, there will be no such companies. Companies covered by the limitations will come into

16 Cong. Record, June 30, 2010, p. H5226 (Chairman Frank went on to stated that "We do not want these overdone. We don't want there to be excessive regulation. And the distinction the gentleman draws is very much in this bill, and we are confident that the regulators will appreciate that distinction, maintain it, and we will be there to make sure that they do."). Also, while in the Senate the colloquy of Senators Merkley and Levin on July 15, 2010 discussed that the definition of hedge and private equity fund is "a broad definition," unlike the Frank-Himes colloquy it does not address placing limitations on the definition.

existence only over time. This can happen either as NBFCs are designated for Fed supervision because they are systemically significant (under Section 113 of the Act) or as former BHCs with consolidated assets of $50 billion or more that received federal assistance under the Emergency Economic Stabilization Act of 2008 dispose of their insured depository institution subsidiaries and become Supervised NBFCs (under Section 117 of the Act) — and even then such entities may appeal the designation;

iv. *Exemptions*. Exemptions apply to "permitted activities" that include investments in obligations of the United States and various government sponsored entities, such as the Federal National Mortgage Association ("Fannie Mae") and the Federal Home loan Mortgage Corporation ("Freddie Mac"), investments in a small business investment company, and the sponsorship of a hedge or private equity fund for sale to customers that entails a *de minimis* investment by the organizing banking entity;

v. *Broad Regulator Discretion*. Federal banking agencies, the SEC, and the CFTC (collectively the "Regulators") have broad authority to adopt rules imposing additional capital requirements and quantitative limits (as well as diversification requirements) on fund ownership and proprietary trading activities even if these activities are "permitted" and regardless of whether it is a banking entity or a Supervised NBFC that does not control a depository institution engaging in the activity, as well as authority to authorize additional exemptions;

vi. *Affiliate Transactions*. Affiliate transaction rules apply to relationships between banking entities and sponsored funds, with federal agencies required to place limits on the relationships that banks, their affiliates, and BHCs can have with sponsored hedge funds and private equity funds; and

vii. *Foreign Companies*. Prohibitions will not apply to investments or activities conducted by foreign-organized companies whose businesses are conducted outside the United States or companies that do no business inside the United States except that are incidental to their international business, provided the companies are not directly or indirectly controlled by companies organized under U.S. laws.

viii. *Asset-Backed Securities*. While not technically a part of the Rule, Section 621 of the Act is related and is similarly based on language from Senators Merkley and Levin. It prohibits firms that package and sell asset-backed securities (including synthetic ABS) from engaging in transactions that involve or result in material conflicts of interests.

2. Entities Covered

a. "Banking Entities"

"Banking entities" subject to the Rule's prohibitions are defined to mean any insured depository institution (including both banks and thrifts), any company that controls an insured depository institution, or any company treated as a BHC for purposes of Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of such an entity.[17] Thus, for example, the term includes SLHCs.

However, the term "insured depository institution" is defined not to include any institution that functions solely in a trust or fiduciary capacity if:

i. Substantially all the deposits of the institution are in trust funds and are received in a *bona fide* fiduciary capacity;

ii. No deposits are insured by the FDIC or marketed through an affiliate of an FDIC insured institution;

iii. The institution does not accept demand deposits (or similar deposits); and

iv. The institution does not obtain payment related services from any Federal Reserve bank or exercise discount or borrowing privileges under the FR Act.[18]

---

17 Section 8(a) of the International Banking Act of 1978 provides that "(1) any foreign bank that maintains a branch or agency in a State, (2) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under State law, and (3) any company of which any foreign bank or company referred to in (1) and (2) is a subsidiary shall be subject to the provisions of the Bank Holding Company Act." Thus, while Section 8 of the International Banking Act does not "treat as a bank holding company" such foreign banks, it does "subject" them to the act. Note also that where the Act mentions this provision in other sections it refers specifically to Section "8(a)" rather than to Section 8.

18 In their July 15, 2010 colloquy, Senators Merkley and Levin explained that this is "a narrow exception for insured depository institutions that function principally for trust purposes and do not hold public depository money, make loans, or access Federal

[Footnote continued on next page]

b. Supervised Nonbank Financial Companies

Supervised NBFCs are nonbank financial companies that are determined to be systemically important and therefore subject to Fed supervision. The Act requires that Supervised NBFCs that do not control a depository institution and that engage in covered activities meet additional capital requirements and additional quantitative limits (to be set by the Fed by rule) even though they are not strictly "prohibited" from engaging in such activities. Engaging in proprietary trading and taking an ownership interest in or sponsoring a hedge fund or private equity fund are covered activities. Supervised NBFCs that do not own a depository institution may engage in activities permitted to banking entities under the Rule without these restrictions, except that they must comply with the capital requirements and quantitative limits that the Regulators place on permitted activities "to protect the safety and soundness of banking entities engaged in these activities."[19]

In their colloquy of July 15, 2010, Senators Merkley and Levin explained that Supervised NBFCs are required "to keep additional capital for their proprietary trading activities and subject them to quantitative limits on those activities" in order to account for the additional risks posed by proprietary trading. The Senators also explained that an outright prohibition on proprietary trading was not appropriate for Supervised NBFCs given their "varied nature" but noted that the trading risks are to be addressed through "robust capital charges and quantitative limits that increase with the size, [leverage], interconnectedness, and systemic importance of the business functions of the nonbank financial firm." The Senators also commented that "these restrictions should also help reduce the size and risk of these financial firms."

[Footnote continued from previous page]

Reserve lending or payment services" and commented that these entities could still be considered Supervised NBFCs if they qualify and would then be subject to regulation under the Volcker provisions.

19 The Volcker Rule is set out in Section 619 of the Act. Note that paragraph (a)(2) of Section 619 establishing the obligations of Supervised NBFC refers to paragraph "(d)(3)." This subparagraph refers only to protecting the safety and soundness of "banking entities" but arguably should include protecting the safety and soundness of Supervised NBFCs as well. This may be a candidate for technical amendment.

3. Activities Covered

a. Proprietary Trading

The Rule prohibits a banking entity from engaging in proprietary trading,[20] and requires the Fed to set capital requirements and quantitative limits on a Supervised NBFC that does not control a depository institution that does so. The rules regarding these restrictions and limitations are subject to certain exceptions.

"Proprietary trading" means, with respect to covered entities, "engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Federal Reserve 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 Regulators by rule determine.

In their July 15, 2010 colloquy, Senators Merkley and Levin commented that there are "essentially three key elements to the definition" of proprietary trading: "(1) the firm must be acting 'as a principal,' (2) the trading must be in its 'trading account' or another similar account, and (3) the restrictions apply to the full range of its financial instruments."

"Trading account" means "any account used for acquiring or taking positions in" the listed securities and instruments "principally for the purpose of selling in the near term (or otherwise with the intent to sell in order to profit from short-term price movements)" and otherwise as regulators determine by rule. Senators Merkley and Levin explained in their colloquy of July 15, 2010 that the term "trading account" was adopted over the term "trading book" —a term originally proposed in the Administration's version of the Rule— "to ensure that all types of accounts used for proprietary trading are covered by the section." In fact, in anticipation that some banks may not segregate short-term trading and long-term investments into distinct accounts (and perhaps to encourage them to do so), the Senators commented that "[f]or banking entity subsidiaries that do not maintain a distinction between a trading account and an investment account, all accounts should be presumed to be trading accounts and converted by the restriction."

---

20 Insight into why this is a "prohibition" rather than a limitation with regard to banking entities can be gained from the colloquy of Senators Merkley and Levin on July 15, 2010, in which they explain that, given banks' increasing use of leverage and short term funding, Congress was concerned that in environments where liquidity suddenly evaporates and financial firms become insolvent very rapidly, "[n]o amount of capital could provide a sufficient buffer in such situations."

Not all activities that could be considered "proprietary trading" are covered. In their colloquy of July 15, 2010, Senators Merkley and Levin clarified that activities "that may technically fall within the definition of proprietary trading but which are, in fact, safer, client-oriented financial services" are permitted activities. These exceptions are set out as "permitted activities" and are discussed below.

b. Activities Relating to "Hedge Funds" and "Private Equity Funds"

The Rule prohibits a banking entity from acquiring or retaining an equity, partnership, or other ownership interest in, or "sponsoring" a hedge fund or private equity fund. It also requires the Fed to set capital requirements and quantitative limits on the activities of a Supervised NBFC that does not control a depository institution related to such funds. In their colloquy of July 15, 2010, Senators Merkley and Levin position this fund-based prohibition as an extension of the prohibition on proprietary trading, explaining that "if a financial firm were able to structure its proprietary positions simply as an investment in a hedge fund or private equity fund, the prohibition on proprietary trading would be easily avoided, and the risks to the firm and its subsidiaries and affiliates would continue." The fund ownership and sponsorship prohibition is subject to certain exceptions.

"Sponsor" is defined broadly (as it was in previous iterations of the Act) to include serving as a general partner, managing member, or trustee of a fund; controlling a majority of the directors, trustees or management of a fund; or sharing with the fund for any purpose the same (or a very similar) name.

"Hedge fund" and "private equity fund" have a common definition: all issuers that are exempt from being considered investment companies under the 1940 Act by virtue of Section 3(c)(1) or Section 3(c)(7) of that Act,[21] as well as to "such similar funds" as the Regulators by rule determine. As Senators Merkley and Levin note in their July 15, 2010 colloquy, while hedge funds tend to be trading vehicles and private equity funds tend to own entire companies, the Rule's provisions do not distinguish between them for definitional purposes because "both types of funds can engage in high risk activities." The joint definition is very broad and could be interpreted to apply to many structures that would not be commonly considered hedge funds and private equity funds even under the broadest commonly understood meanings and even though Congress may not have intended such an expansive result.

---

21 Section 3(c)(1) of the 1940 Act exempts from being an investment company an issuer whose outstanding securities are beneficially owned by not more than 100 people and that does not make a public offering of its securities. Section 3(c)(7) exempts an issuer whose outstanding securities are owned by persons who are qualified purchasers and does not make a public offering of its securities.

4. Permitted Activities

Banking entities are permitted to engage in ten categories of activity described in the Act that, as explained by Senators Merkley and Levin in their July 15, 2010 colloquy, "do not pose unreasonable risks." In addition, a Supervised NBFC that does not control a depository institution may engage in these "permitted activities" without being subject to additional capital requirements or quantitative limits. If otherwise allowed by federal and state law, and if the Regulators do not set restrictions or limits on these activities, then the following ten categories of activities are permitted:

i. *Trading in Government Securities*. Transactions in obligations of the United States or any agency of the United States, or any instruments issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a federally chartered Farm Credit System institution, or obligations of any state or a political division of any state;

ii. *Underwriting and Market-Making-Related Activities*. The purchase or sale of securities described in the definition of "proprietary trading" that is "in connection with an underwriting or market-making-related[22] activities" to the extent that such activities "are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties"[23];

iii. *Trading for Risk Mitigation*. Risk mitigating hedging activities in

22 The term "market-making-related" activities was substituted into the final version of the Act instead of the previous term "market-making" activities, according to Senators Merkley and Levin in their July 15, 2010 colloquy, in order to "permit certain legitimate client-oriented services, such as pre-market-making accumulation of small positions that might not rise to the level of fully 'market making' in a security or financial instrument, but are intended to nonetheless meet expected near term client liquidity needs" and the term is intended to "provide the regulators with limited additional flexibility to incorporate those types of transactions to meet client needs" but not without limits.

23 In their July 15, 2010 colloquy, Senators Merkley and Levin urge that "'[v]igorous' and robust regulatory oversight of this issue will be essential to prevent market-making from being used as a loophole in the ban on proprietary trading."

connection with holdings of the banking entity that are designed to reduce risks to the banking entity;

iv. *Trading for Customers*. The purchase, sale or disposition of securities described in the definition of “proprietary trading” (that is, any security, derivative, commodities futures contract, option, derivative, or other security or financial instrument that Regulators determine) that are “on behalf of customers”;

v. *Small Business Investment Company Investing*. Investments in “small business investment companies,” investments designed primarily to promote the public welfare of the type permitted in paragraph (11) of Section 5136 of the United States Code, or (and this final point was added by the House conferees during the final House-Senate Conference session) investments that are qualified rehabilitation expenditures on qualified historic structures;

vi. *Insurance Company Trading*. The purchase, sale or disposition of securities in the definition of “proprietary trading” by a regulated insurance company (or an affiliate) for the general account of the company if the transaction is conducted in compliance with insurance company investment laws and the appropriate Federal banking agencies, after consulting with the Council and other regulators, have not determined that the insurance company investment law being relied upon is insufficient to protect safety and soundness of the banking entity or of U.S. financial stability;

vii. *Fund Offering as Investment Advisor/Fiduciary*.[24] Organizing and offering a private equity fund or hedge fund (including serving as a general partner or controlling a majority of directors or management) if:

A) The banking entity provides *bona fide* trust, fiduciary, or investment advisory services;

---

24 In their July 15, 2010, colloquy, Senators Merkley and Levin point out that “[i]t is important to remember that nothing in section 619 otherwise prohibits a bank from serving as an investment adviser to an independent hedge fund or private equity fund” and explain that this exception sets out the criteria that must be met in order for a bank to do so.

B) The fund is organized and offered only in connection with the provision of *bona fide* trust, fiduciary, or investment advisory services only to customers of such services of the banking entity; and

C) The banking entity acquires only a *de minimis* investment;

(1) A "*de minimis* investment" is defined to be no more than 3% of a single fund's total ownership interest within a transition period of one to three years.

(2) A second element of the *de minimis* requirement is that all investments in hedge funds and private equity funds in the aggregate be "immaterial to the banking entity," which will be defined by rule but may by statute be no more than 3% of the banking entity's tier 1 capital.

(3) Also, note that the scope of this provision will not be clear until the terms "trust, fiduciary or investment advisory services" and "customers" are defined by regulation.

D) The banking entity complies with the restrictions on affiliate transactions with any fund it sponsors consistent with Sections 23A and 23B of the FR Act;

E) The banking entity does not guarantee, assume, or insure the obligations or performance of the fund, or any fund in which such fund invests;

F) The banking entity does not share the same name (or a variation of the name) with the fund for corporate, marketing, promotional, or any other purpose;

G) No director or employee of the banking entity takes or retains an ownership interest in the fund (except one that is "directly engaged in providing investment advisory or other services" to the fund); and

H) The banking entity discloses to investors in writing that losses in the fund are borne solely by investors in the fund and not by the banking entity, and complies with rules designed to ensure that losses in the fund are not in fact borne by the banking entity.

viii. Outside the United States;

A) *Proprietary Trading*. Proprietary trading conducted by a banking entity pursuant to paragraph (9) and (13) of Section 4(c) of the BHC Act provided the trading occurs solely outside of the United States and the banking entity is not controlled (either directly or indirectly) by a banking entity organized under the laws of the United States;

B) Paragraph (9) of Section 4(c) of the BHC Act exempts from the restrictions on a bank holding company owning or controlling a nonbanking organization a "company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of [the BHC Act] and would be in the public interest";

C) Paragraph (13) of Section 4(c) of the BHC Act exempts from the restrictions on a bank holding company owning or controlling a nonbanking organization a "company which does no business in the United States except as an incident to its international or foreign business, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of [the BHC Act] and would be in the public interest."

D) *Fund Investing*. The acquisition or retention of an ownership interest in a hedge fund or private equity fund by a banking entity pursuant to paragraph (9) or (13) of Section 4(c) of the BHC Act solely outside of the United States provided no ownership interest in the fund is offered to residents of the United States and the banking entity is not controlled (directly or indirectly) by a banking entity organized under the laws of the United States; and

ix. *Other Activities*. Other activities the Regulators determine by rule would promote safety and soundness of the banking entity and U.S. financial stability.

5. Limits on Permitted Activities

a. "Permitted activities" are not allowed under all circumstances.

An activity that is "permitted" is still not allowed if the activity:

i. Would result in a "material" conflict of interest (as will be defined by rule) between the banking entity and its clients or counterparties;

ii. Would result (directly or indirectly) in a "material" exposure (as will be defined by rule) by the banking entity to high-risk assets or trading strategies;

iii. Would pose a threat to safety and soundness of the banking entity; or

iv. Would pose a threat to the financial stability of the United States.

b. Capital and Quantitative Limits on Permitted Activities

The Regulators are required to adopt rules that impose additional capital requirements and quantitative limits (including diversification requirements) on "permitted activities" engaged in by either banking entities or Supervised NBFCs if the regulators determine these limitations are appropriate to protect safety and soundness of the entities engaged in the "permitted activities." Thus, even if an activity is permitted and not otherwise subject to limitations, if the Regulators elect to set limits they may do so. Senators Merkley and Levin explained in their July 15, 2010 colloquy that regulators have the discretion to determine whether these restrictions should apply to banking entities and Supervised NBFCs equally or "whether there may appropriately be a distinction."[25]

---

25 Senators Merkley and Levin also read in this provision a mandate for regulators to require diversification—specifically, that banking entities should be prohibited from

[Footnote continued on next page]

6. Permitted *De Minimis* Investments in Funds

Notwithstanding the general restriction on banking entities owning private equity and hedge funds, a banking entity can make and retain an investment in a hedge fund or private equity fund that it "organizes and offers" for the purpose of establishing the fund and providing it with sufficient initial equity to permit the fund to attract unaffiliated investors. Several conditions must be met to utilize this provision:

i. The banking entity must seek unaffiliated investors to reduce or dilute its own interest;

ii. The investments in the fund must be reduced through redemption, sale, or dilution to no more than 3% of the total ownership interest in the fund within a year of the date the banking entity establishes the fund (which deadline the Fed has the authority to extend upon the application of the banking entity for up to 2 additional years); and

iii. The investment in the fund must be "immaterial to the banking entity," as will be defined by rule.[26] However, note that under the statute an investment in a fund will not be considered "immaterial" if it causes the aggregate of all interests a banking entity holds in all hedge funds and private equity funds to exceed 3% of the banking entity's own tier 1 capital.[27]

[Footnote continued from previous page]

deploying "their entire permitted amount of de minimis investments into a small number of hedge funds and private equity funds" resulting in over-concentration.

26 In their colloquy of July 15, 2010, Senators Merkley and Levin threw some light on their intention with regard to this requirement, stating that "[a]s a general rule, firms taking advantage of this provision should maintain only small seed funds, likely to be $5 to $10 million or less" and further explaining that "[l]arge funds or funds that are not effectively marketed to investors would be evasions of the restrictions of this section".

27 The Senate substituted "tier 1 capital" for the previous "tangible common equity" during the final hours of the House-Senate Conference. Tier 1 capital generally includes common shares, preferred shares, and deferred tax assets whereas tangible common equity, a less commonly used measure, includes only common shares. Thus, the late Senate switch should, all else being equal, allow for expanded investment by smaller banking entities and those employing preferred shares in their capital structures.

A plain reading of this provision suggests that meeting the *de minimis* requirements alone is sufficient to let a banking entity organize and offer a fund and continue to hold a small investment in that fund. However, a colloquy by Senators Merkley, Levin, and Dodd on July 15, 2010 states that these *de minimis* provisions "complement" the "permitted activity" exception allowing an entity to organize and offer a fund only in connection with the provision of *bona fide* trust, fiduciary, or investment advisory services to customers. Thus, there is an open question as to whether an entity would need to provide "trust, fiduciary or investment advisory" services to the fund (and meet other conditions of that "permitted activity" exception) in order to avail itself of the *de minimis* exception. Note, for example, that while the "permitted activity" exception for offering a fund in connection with trust, fiduciary, or investment advisory services references the *de minimis* standard, there is no reference in the "*de minimis*" provision back to any of the earlier "permitted activities" exceptions.[28]

As commented above, a banking entity can apply to the Fed to extend for 2 additional years the time it has to reduce its ownership in a fund to 3% of the total ownership interest in the fund.[29]

The *de minimis* provision also contains a final subparagraph providing that the aggregate amount of the outstanding investment by a banking entity, including retained earnings, must be deducted from the assets and tangible equity of the banking entity, and that the amount of the deduction must increase with the leverage of the hedge or private equity fund.[30]

---

28 The relationship between paragraph (d)(4) and subparagraph (d)(1)(G) of Section 619 will need to be resolved through rulemaking. In the interim, a conservative approach would be to presume that the requirements of both provisions must be met (i.e., that a fund must be offered as a trust or investment advisory service to customers, not share a common name with the offeror, and that the offeror may not guaranty the fund, PLUS that the investment must be reduced to no more than 3% of fund equity within 1-3 years and that the aggregate of all fund investments must not exceed 3% of the offeror's tier 1 capital).

29 There appears to be a minor error in this provision in that it refers to subparagraph "(B)(i)(I)" when subparagraph "(B)(ii)(I)" was clearly intended.

30 In their colloquy of July 15, 2010, Senators Merkley and Levin explain that this provision requires that "investments in hedge funds and private equity funds shall be deducted on, at a minimum, a one to one basis from capital" and that "[a]s the leverage of a fund increases, the capital charges shall be increased to reflect the greater risk of loss." The Senators go on to explain that "[t]his is specifically intended to discourage these high-risk

[Footnote continued on next page]

7. Anti-Evasion

The Regulators are required to issue regulations requiring internal controls and recordkeeping to insure compliance with the Rule. If the Regulators have reasonable cause to believe a banking entity or Supervised NBFC has made an investment or engaged in an activity that "functions as an evasion of the requirements of" the Rule "or otherwise violates the restrictions of" the Rule, then they must order, after notice and opportunity for hearing, the banking entity or Supervised NBFC to terminate the activity <u>and</u> (as relevant) dispose of the investment.

8. Affiliate Transaction Rules Applied to Advised, Managed or Sponsored Funds

Section 23A Applied. No banking entity that serves, directly or indirectly, as the investment manager, advisor, or sponsor of a hedge fund or private equity fund or that organizes and offers a fund (or any affiliate of such a company) may enter into a transaction with the fund (or any fund controlled by the fund) which transaction is a "covered transaction" under Section 23A of the FR Act.

Exempted Activities Covered. Note that Section 23A applies to relationships between banking entities and the funds they organize and offer even if this is done in connection with *bona fide* trust, fiduciary, or investment advisory services even though organizing such funds is otherwise exempt from the Rule prohibitions.

Section 23B Applied. A banking entity will also be subject to Section 23B of the FR Act as if the banking entity were a member bank and the fund were an affiliate. Among other things, this means that transactions must be on terms substantially the same (or at least as favorable) as those prevailing for comparable transactions with nonaffiliated companies.

Affiliates Not Covered. Note the Section 23B restrictions do not expressly apply to transactions between a fund and affiliates of the banking entity.

9. Exception for Prime Brokerage Transactions with Funds

Notwithstanding the restrictions on affiliate transactions, the Fed may permit a banking

---

[Footnote continued from previous page]

investments, and should be used to limit these investments to the size only necessary to facilitate asset management businesses for clients."

entity or a Supervised NBFC to enter into a "prime brokerage transaction"[31] with any hedge fund or private equity fund in which another hedge fund or private equity fund managed, sponsored, or advised by it has taken an equity, partnership, or other ownership interest (but the Rule does not allow a banking entity or Supervised NBFC to engage in prime brokerage transactions with a hedge fund or private equity fund that it directly manages, sponsors, or advises)[32] if:

i. The banking entity or Supervised NBFC is in compliance with the requirements for organizing and offering a private equity or hedge fund;

ii. The CEO (or equivalent) of the banking entity certifies in writing annually that it does not guarantee the obligations of any fund it organizes, offers, or controls;

iii. The Fed has determined that the transaction is consistent with the safe and sound operation and condition of the banking entity or Supervised NBFC. Note, however, that it is unclear how the Fed is to make this determination, whether by rule or otherwise; and

iv. The transaction complies with the requirements of 23B as if the counterparty were an affiliate of the banking entity.

10. Additional Capital Charges and Restrictions on Supervised NBFCs Not Controlling a Depository Institution

Supervised NBFCs that do not control a depository institution are not subject to the prohibition on proprietary trading or sponsoring or investing in hedge funds or private equity

---

31 The term "prime brokerage transaction" is not defined in the Act. The related term "prime brokerage services" is considered a generic term for a bundle of services provided to hedge funds and professional investors that require the ability to borrow securities and capital and be able to invest on a net basis, and in which the "prime broker" generally provides a centralized securities clearing facility in which a fund's or investor's collateral requirements are netted across all transactions handled by that prime broker.

32 In their July 15, 2010 colloquy, Senators Merkley and Levin explained that this provision is intended to allow a banking entity to provide "limited services to unaffiliated funds, but in which its own advised fund may invest" and that it therefore "is intended to only cover third party funds" with no tolerance for tiered structures designed to evade the affiliate transactions restrictions.

funds. Nevertheless, the Regulators must adopt rules imposing additional capital requirements and other restrictions on Supervised NBFCs that do not control a depository institution as follows:

i. *General Restrictions*. Supervised NBFCs that do not control a depository institution engaging in proprietary trading or sponsoring or investing in hedge funds or private equity funds must generally meet additional capital requirements and quantitative limits even though they are not "prohibited" from engaging in these activities; and

ii. *Affiliate Transaction and Prime Brokerage Restrictions*. Additional capital charges or other restrictions must be placed on Supervised NBFCs that engage in the kinds of affiliate transactions and prime brokerage transactions described above (in the context of banking entities) "to address the risks to and conflicts of interest of banking entities."[33]

11. Rules of Construction

The prohibitions and restrictions of the Rule apply even if the activities of a banking entity or a Supervised NBFC are approved by the Fed. Nothing in the Rule limits the ability of a banking entity or Supervised NBFC to sell or securitize loans. Nothing in the Rule limits the authority of any regulator under applicable law.

12. Timeline

Council Study: Within <u>6 months</u> of enactment the Council must study and make recommendations on implementing the Rule.

Rulemaking: Within <u>9 months</u> of the completion of the study the Regulators and the Fed[34] must consider the study and adopt regulations to carry out the Rule. Note that the Fed is to

---

33 It is unclear why this provision refers to "banking entities" when it concerns the activities of Supervised NBFCs. It may reflects that the 23A and 23B limits apply only to banking entities and not to Supervised NBFCs. However, because additional capital charges and other restrictions are to be applied to Supervised NBFCs to address 23A and 23B concerns, the wording may need to be changed in a technical amendment.

34 The primary financial regulatory agencies are to jointly issue rules with respect to insured depository institutions. The Fed is to do so with respect to any company that controls an

[Footnote continued on next page]

issue regulations with respect to any company that controls an insured depository or that is "treated as a bank holding company" for purposes of the International Banking Act, for any Supervised NBFC, and any of their subsidiaries. The agencies writing the Rules are required to consult and coordinate with the Chairperson of the Council coordinating regulations to provide consistent application.[35]

Rules must include:

i. Regulations implementing the permitted transactions provisions and any limitations on permitted transactions;

ii. Regulations imposing additional capital requirements and quantitative limits (including diversification requirements) on permitted activities if the Regulators determine these limitations are appropriate to protect safety and soundness of banking entities engaged in permitted activities;

iii. Regulations setting the ownership level in a fund that is "immaterial to the banking entity" which in any event cannot be more than 3% of the banking entity's own tier 1 capital;

iv. Regulations regarding internal controls and recordkeeping to insure compliance with the Rule;

v. Rules determining what "similar funds" are to be included in the definition of "hedge fund" and "private equity fund";

vi. Rules defining the full extent of the definition of "trading account"

[Footnote continued from previous page]

insured depository institution or that is treated as a BHC for purposes of Section 8 of the International Banking Act, any Supervised NBFC, and any of their subsidiaries other than subsidiaries of which another agency is the primary financial regulatory agency issuing rules. The CFTC and SEC are to issue rules with respect to entities for which they are the primary financial regulatory agency.

35 The effective date for the Rule keys off of the date final rules are issued. However, as noted above, multiple agencies will be issuing rules. While the statute requires that these agencies coordinate for "consistency and comparability" there is no requirement that the agencies issue rules on the same date. If the agencies don't issue their rules simultaneously there may be confusion regarding the effective date, or multiple effective dates may result for different classes of regulated entities.

for purposes of purposes of determining the scope of prohibitions on proprietary trading;

vii. Rules defining additional securities that, if traded by a covered entity as a principal for its own trading account, constitute proprietary trading; and

viii. Rules defining additional accounts that count as "trading accounts" for purposes of determining the scope of the prohibition on proprietary trading.

Effective Date: The rule takes effect on the earlier of (i) 12 months after the issuance of final rules or (ii) 2 years after enactment of the Rule. Thus, if the study and rulemaking take their full 15 months, then the section goes effective just 9 months after the issuance of final rules.

Divestiture: Banking entities and Supervised NBFCs must divest to bring their activities in compliance with the Rule within 2 years of the effective date or 2 years (in the case of a new Supervised NBFC) after the date the entity becomes a Supervised NBFC. The Fed can extend this period 1 year at a time (if determined not to be detrimental to the public interest) for a total of 3 additional years. This means that divestiture could be extended out a total of 7 years after the date of enactment—2 years for the effective date plus an initial 2 year transition period plus three additional single year extensions.

Within 6 months of enactment the Fed must issue the rules that will implement this divestiture provision.

Extension for Illiquid Funds: If a banking entity had a contract in place as of 5/1/10 obligating it to retain an interest in or provide capital to an illiquid fund,[36] then it can petition the Fed for an extension of the transition period. The Fed can grant a single extension of not more than 5 years. The most likely interpretation for this provision is that the maximum time for divestiture could be as long as 9 years after the date of enactment—based on the single 5 year extension being a substitute for the otherwise available three single year extensions. However, note that if it were interpreted that this extension is available in addition to the three one-year extensions allowed for regular divestitures, then the transition period could be extended to as long as 12 years after enactment (note that, in favor of arguing for the consecutive interpretation,

---

36 "Illiquid fund" is a defined term in the section and means a hedge or private equity fund that, as of May 1, 2010 was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets and that makes all investments consistent with an investment strategy to principally invest in illiquid assets.

the three 1 year extensions can be granted by the Fed "by rule" and are considered part of the "conformance period" in contrast to the "extended transition for illiquid funds" period that can only be granted by the Fed upon application). Regardless of this interpretive issue, however, if the contractual obligation to invest in the illiquid fund terminates before the end of the extension period then the banking entity must immediately exit the investment.

Within 6 months of enactment the Fed must issues rules that will implement the extension provision for illiquid funds.

Limits on Additional Capital: Notwithstanding that divestiture is not required until 2 years after the effective date (at earliest) on the date rules are issued (9 months after the study is completed, or at most 15 months after enactment), the Regulators are required to issue rules imposing additional capital requirements and "any other restrictions, as appropriate, on any equity, partnership, or ownership interest in or sponsorship of a hedge fund or private equity fund by a banking entity." <u>Thus, even before divestiture is required there likely will be additional requirements and restrictions placed on ownership by a banking entity.</u>

13. Studies

a. Council Study and Rulemaking

The Council must conduct a study and make recommendations on rules implementing the section within 6 months of enactment. This is a critical study because it will set the tone for the rulemaking by Regulators. Many of the timeline dates also key off of when the study and recommendations are completed. The Council is to recommend measure that would:

i. Promote the safety and soundness of banking entities;

ii. Protect taxpayers, consumers, enhance financial stability, and reduce risk that depository institutions and their affiliates will engage in unsafe activities;

iii. Limit inappropriate transfer of federal subsidies (i.e., deposit insurance);

iv. Reduce conflicts of interest between banking entities and Supervised NBFCs and their customers;

v. Limit activities that have cause undue risk of loss or "that might reasonably be expected to create undue risk of loss";

vi. Accommodate the business of insurance wile protecting safety and soundness of any banking entity with which an insurance company is affiliated; and

vii. "Appropriately time the divestiture of illiquid assets."

b. Study of Bank Investment Activities

Section 620 (renumbered in the House-Senate Conference but still related to the Rule) requires a second study for completion within 18 months of enactment under which the appropriate federal banking agencies are required to jointly review and report on the activities a banking entity may engage in under federal and state law. The report is to include recommendations on the potential negative effect of banking activities on safety and soundness of the U.S. financial system, the appropriateness of such activities, and any additional restrictions that may be needed to address safety and soundness.

V. Prohibition on Conflicts of Interest in Certain Securitizations

While not technically a part of the Rule, a late House-Senate Conference addition to Act was Section 621 addressing conflicts of interest relating to securitizations of ABS. The provision prohibits an underwriter, placement agent, sponsor, or initial purchaser (or any affiliate or subsidiary) from engaging in a transaction that would involve or result in a material conflict of interest with an investor for 1 year after the initial closing of the sale of an ABS (including a synthetic). Exceptions include transactions that are risk mitigating hedging activities designed to reduce specific risks relating to the initial sale and transactions in ABS that are consistent with the commitments of the underwriter, placement agent, sponsor, or initial purchaser (as applicable), or that are *bona fide* market making activities.

W. Conflicts of Interest

Title VI amends the 1933 Act to add a Section 27B, prohibiting conflicts of interest relating to securitizations. The provision prohibits an underwriter, placement agent, or sponsor of an ABS, within a year after the date of the first sale of the ABS, from engaging in transactions that would "result in any material conflict of interest with respect to any investor." Several exceptions to the prohibition, including relating to risk-mitigating hedging activities, underwriting, and market making, are described. This provision is effective on the date final rules are issued by the SEC, which, in any event, must be within 270 days of the date of enactment of the Act. **Sec. 621 (pp. 261-262)**.

X. Concentration Limits on Large Financial Firms

Title VI amends the BHC Act by adding a new Section 13 titled "Concentration Limits on Large Financial Firms" that would place a concentration limit on large financial firms such that, subject to recommendations by the Council, a financial company may not merge or consolidate with, acquire all or substantially all of the assets of, or otherwise acquire control of another company if the total consolidated liabilities of the acquiring financial company would exceed 10% of the aggregate consolidated liabilities of all financial companies at the end of the year, as a result of the transaction. This limit will not, however, apply to an acquisition of a bank in default or in danger of default, or transactions for which the FDIC provides assistance, or those that would result only in a *de minimis* increase in liabilities. **Sec. 622 (p. 262-264)**.

This provision is effective on the day after enactment of the Act, but implementing rules may not be issued for as long as 15 months following the effective date. The Council is to complete a study of concentration limits within 6 months of the Act's enactment, and the Fed has an additional 9 months following completion of this study to issue implementing rules. **Sec. 622 (pp. 262-264)**.

Y. Qualified Thrift Lenders

Title VI amends HOLA Section 10(m)(3) to require that a savings association that fails to become or remain a qualified thrift lender will immediately be subject to restrictions, including a restriction that the association may not pay dividends except for dividends that would be permissible for a national bank, that are necessary to meet the obligations of the company that controls the savings association, and are specifically approved 30 days before payment by the Comptroller and the Fed after a written request. This provision is effective the day after the Act's enactment. **Sec. 624 (p. 266)**.

Z. Treatment of Dividends by Certain Mutual Holding Companies

Title VI amends Section 10(o) of HOLA's treatment of dividends, requiring that each subsidiary of a mutual holding company that is a savings association give the appropriate federal banking agency and the Fed 30 days' notice of any proposed declaration of any dividend on the guaranty, permanent, or other non-withdrawable stock of the savings association. Any dividends granted without notice will be invalid. Further, a mutual holding company may waive the right to dividends if no employee stock benefit program or insider holds any shares of applicable stock, or if the company gives written notice to the Fed 30 days before the proposed date of dividend payment and the Fed does not object. This provision is effective as of the transfer date. **Sec. 625 (pp. 267-268)**.

AA. Interest-Bearing Transaction Accounts Authorized

The prohibition on payment of interest on demand deposits is repealed by amending Section 19(i) of the FR Act, Section 5(b)(1)(B) of HOLA, and Section 18(g) of the FDI Act. These amendments will take effect one year after the transfer date. **Sec. 627 (pp. 270-271)**.

BB. Credit Card Bank Small Business Lending

Title VI authorizes small business credit card lending for credit card banks. It amends BHC Act Section 2(c)(2)(F)(v) to read "other than credit card loans that are made to businesses that meet criteria for a small business concern to be eligible for business loans" under regulations established by the Small Business Administration. This provision is effective on the day after the Act is enacted. **Sec. 628 (p. 271)**.