CADWALADER

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

One World Financial Center, New York, NY 10281
Tel 212 504 6000 Fax 212 504 6666
www.cadwalader.com

Clients&FriendsMemo

Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*

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The focus of this Memorandum is on the material changes to U.S. banking regulation made by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**" or the "**Dodd-Frank Act**"), including the potential regulation by the Board of Governors of the Federal Reserve System of nonbank financial companies deemed systemically significant.[1]

The organization of the Memorandum is as follows:

> Section I describes the procedure for designating a nonbank company as subject to Federal Reserve supervision.
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> Section II describes the new regulatory requirements imposed on bank holding companies and on those nonbank companies designated for Federal Reserve supervision.
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> Section III describes the new capital obligations on depository institutions and BHCs, regardless of size.
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> Section IV describes the elimination of the Office of Thrift Supervision and the realignment of regulatory responsibilities among the remaining banking agencies and the Securities &

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* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at http://www.cadwalader.com/list_client_friend.php.

1 This memorandum reflects portions of Titles I, III, VI, and VII of the Act as passed by the House of Representatives and the Senate.

Title I will also subject systemically significant nonbank financial companies to Federal Reserve supervision and regulation. This memorandum is particularly focused on the regulation of banks and banking organizations. Our separate memorandum, *Regulation of Systemically Significant NonBanks Under the Dodd-Frank Wall Street Reform and Consumer Protection Act,* is focused on Title I's application to nonbanking organizations.

Exchange Commission, including the shift in authority over certain investment bank holding companies from the SEC to the Federal Reserve.

Section V describes the changes to the Federal Deposit Insurance system, including changes to the deposit assessment process and the reserve ratios of the Deposit Insurance Fund.

Section VI describes the Act's provisions designed to restrain the growth of certain financial services companies , including the application of growth caps applicable to nonbank financial companies subject to Federal Reserve supervision.

Section VII discusses the Act's prohibition on an insured depository institution acting as a swaps dealer.

Section VIII describes the requirements of the "Volcker Rule".

Section IX describes changes to bank lending limits.

Section X discusses the tightening of the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act.

Finally, Section XI discusses the changes to the insider transaction restrictions of Section 22 of the Federal Reserve Act.

I. Supervision of Systemically Significant Firms

Title I of the Act contains sweeping provisions that authorize the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") to supervise previously unregulated (or under-regulated) firms – including those firms that are neither banks nor affiliated with banks – engaged in various financial activities where those firms' activities are deemed systemically significant with respect to the U.S. financial system. Firms so designated (the Act refers to such firms as "Nonbank financial companies supervised by the Board of Governors"[2] – herein we refer to them as "systemically significant nonbank financial companies" or "**SSNFs**") would then be subjected to heightened supervision and prudential regulation by the Federal Reserve, as explained below.

Creation of the FSOC. Title I of the Act establishes the Financial Services Oversight Council ("**FSOC**"), whose voting members include each of the heads of the Federal Reserve, OCC, Bureau of Consumer Financial Protection ("**BCFP**"), CFTC, SEC, FDIC, Federal Housing Finance Agency

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2 *See* Dodd-Frank Act § 102(a)(4)(D).

("**FHFA**"), and National Credit Union Administration ("**NCUA**"), as well as an independent member appointed by the President.[3] The FSOC has general authority to issue recommendations to the "primary financial regulatory agencies"[4] regarding heightened standards and safeguards as to the conduct of financial activities that "create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies ("**BHCs**") and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities."[5] The primary regulatory agencies are generally obligated to implement an FSOC recommendation by rule within ninety days.[6]

Process for Designation as Systemically Significant. The most significant power that the FSOC will exercise directly, rather than through "recommendations," is to designate a nonbank firm an SSNF. The FSOC is empowered to impose such a designation if it finds that (i) the nonbank firm is "predominantly engaged" in activities that are "financial in nature" under Section 4(k) of the Bank Holding Company Act (the "**BHC Act**"); and (ii) "material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company, could pose a threat to the financial stability of the United States."[7]

A nonbank firm is deemed "predominantly engaged" in activities that are "financial in nature"[8] if such activities (i) contribute 85% or more of annual gross revenues of the firm, or (ii) account for

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3 *See* Dodd-Frank Act § 111. Title I also establishes the Office of Financial Research ("**OFiR**"), which is generally tasked with facilitating the management of data that the FSOC collects in connection with FSOC reporting requirements imposed on Large BHCs and SSNFs under Section 116. See Dodd-Frank Act § 152.

4 Note that "primary financial regulatory agency" is a defined term referring, generally, to the federal or state regulatory authority having "primary" supervisory jurisdiction over an entity. *See* Dodd-Frank Act § 2(12). Note also that the various titles of the legislation contain variations on this defined term, and each variation operates to confer jurisdiction with respect to certain activities on one or another "primary" regulatory agency.

5 *See* Dodd-Frank Act § 120.

6 *See* Dodd-Frank Act § 120(c)(2).

7 *See* Dodd-Frank Act § 113; *see also Some Concerns with the Regulation of Large Nonbank Holding Companies* (Cadwalader, June 3, 2010), *available at* http://www.cadwalader.com/assets/client_friend/060310RegLargeNonBankHoldingCos.pdf.

8 *See* Dodd-Frank Act § 163(b). The Gramm-Leach-Bliley Act of 1999 established the category of activities that are "financial in nature." *See* BHC Act Section 4(k) (12 U.S.C. § 1843(k)). Generally, "financial in nature" activities 'emanate from the penumbra' of permissible additional activities allowed to a bank holding company ("**BHC**") that qualifies as and has elected to become a "financial holding company" ("**FHC**"). "Financial in nature" encompasses a fairly sweeping list of activities, some of which would seem unlikely to be fundamental to the financial stability of the United States, including:

- lending
- trust and safekeeping activities
- securitization of assets
- merchant banking
- underwriting and dealing in securities

85% or more of the firm's total consolidated assets.[9] SSNF designation can be applied to a foreign firm if its US operations are deemed significant.[10] Further, a subsidiary may be designated a SSNF if the parent company is not, which means that the calculation of the 85% test is not required to be made at the ultimate parent level. Thus, the population of entities that could potentially be designated as SSNFs is extremely large.

SSNF Criteria. When deciding whether to designate a firm an SSNF, the FSOC must consider a series of factors, including its:

- leverage;
- off-balance-sheet exposures;
- transactions and relationships with other significant firms;
- the importance of the firm as a source of credit and liquidity for the United States financial system;
- the importance of the firm as a source of credit for low-income, minority, or underserved communities in the United States;
- whether the firm is a manager rather than owner of assets;
- the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;

- mutual fund activities
- check cashing and money transmitting
- insurance agency and underwriting
- investment advisory services
- "finder" activities
- activities permissible for a BHC outside of the United States and which the Federal Reserve has determined is "usual in connection with the transaction of banking" abroad (such as management consulting, general data processing, and travel agency), and
- activities that are "closely related to banking" under Section 4(c)(8) of the BHC Act, including:[8] servicing loans; real estate and personal property appraising; arranging commercial real estate equity financing; real estate settlement servicing; leasing personal or real property; check guaranty services; credit bureau services; collection agency services; acquiring debt in default; asset management, servicing, and collection activities; management consulting and counseling activities; employee benefits consulting services; career counseling services; courier services; printing and selling certain encoded items; and data processing services.

[9] *See* Dodd-Frank Act § 102(a)(6).

[10] *See* Dodd-Frank Act §113(i). The FSOC must consult with the appropriate foreign regulatory authorities when designating foreign firms SSNFs.

- whether the firm is subject to prudential standards on a consolidated basis in its home country; or already regulated by a U.S. financial regulatory agency;

- the amount and nature of the firm's U.S. financial assets;

- how the firm funds its operations.

The FSOC must notify a firm of its determination and provide the firm an opportunity for a hearing to contest its findings.[11] In the event of an unsuccessful contest (we assume most firms will contest designation as an SSNF given the substantial burdens that will follow from it), judicial recourse is limited. The firm may appeal the determination in federal district court, but the court may only overturn the FSOC's determination if it finds the determination "arbitrary and capricious."[12] Designated firms must register with the Federal Reserve within 180 days after receiving a final FSOC determination.[13]

II. Regulation of SSNFs and Large BHCs

Mandatory Heightened Prudential Standards. SSNFs and those BHCs with total consolidated assets of $50 billion or more ("**Large BHCs**") will be required to comply with "prudential standards" that would be stricter than those imposed on existing banks and BHCs. Certain "prudential standards" *must* be adopted by rule, including:

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[11] *See* Dodd-Frank Act § 113(e).

[12] *See* Dodd-Frank Act § 113(h). Note that the Act requires the Federal Reserve to issue regulations that provide a "safe harbor" from designation as an SSNF for certain "types or classes" of nonbank financial companies. *See* Dodd-Frank Act § 170.

[13] *See* Dodd-Frank Act § 114.

- **Risk-based capital and leverage requirements;**[14]

- **Liquidity requirements;**[15]

- **Risk management requirements**, including the establishment of board-level "risk committees";[16]

- **Resolution plan (or "living will") requirements**, including the obligation of the SSNF or Large BHC to report periodically to the Federal Reserve, the FSOC, and the FDIC its plan for its own "rapid and orderly resolution in the event of material financial distress or failure";[17]

- **Periodic credit exposure reporting requirements**, including reports of exposures *to or from* other SSNFs or Large BHCs;[18] and

- **Concentration limits.**[19]

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[14] Although the leverage ratio requirement is to be defined in the Federal Reserve rulemaking, the Federal Reserve is required to apply a debt-to-equity ratio limit of 15-to-1 for Large BHCs and SSNFs that are found to pose a "grave" threat to U.S. financial stability. In addition, any leverage or risk-based capital provisions adopted by the Federal Reserve must require that certain "off-balance-sheet activities" must be included in the capital computations. "Off-balance-sheet activity" means an existing liability of a company that is not currently a balance sheet liability, but may become one upon the happening of some future event, including the following transactions, to the extent that they may create a liability:

- Direct credit substitutes in which a bank substitutes its own credit for a third party, including standby letters of credit.
- Irrevocable letters of credit that guarantee repayment of commercial paper or tax-exempt securities.
- Risk participations in bankers' acceptances.
- Sale and repurchase agreements.
- Asset sales with recourse against the seller.
- Interest rate swaps.
- Credit swaps.
- Commodities contracts.
- Forward contracts.
- Securities contracts.
- Such other activities or transactions as the Federal Reserve may, by rule, define.

Dodd-Frank Act § 165(j), (k).

[15] Dodd-Frank Act § 165(b)(1)(A)(ii).

[16] Dodd-Frank Act § 165(b)(1)(A)(iii). The regulations to be adopted by the Federal Reserve *must* require that BHCs with assets of $10 billion or more would be required to establish a risk committee composed of a certain number of independent directors and at least one "risk management expert"; such regulations *may* require that BHCs with assets of less than $10 billion establish such a committee. Irrespective of the regulations, the Dodd-Frank Act states that publicly traded SSNFs *must* establish a risk committee within one year after becoming an SSNF. Dodd-Frank Act, § 165(h).

[17] *See* Dodd-Frank Act § 165(b)(1)(A)(iv), (d)(1).

[18] Dodd-Frank Act § 165(b)(1)(A)(iv), (d)(2).

Potential Heightened Prudential Standards. In addition, the Federal Reserve *may*, but is not *required* to, adopt prudential standards regulations applicable to SSNFs and Large BHCs relating to:

- **Contingent capital requirements**, including the requirement that SSNFS and Large BHCs hold a minimum amount of contingent capital that is convertible into equity in times of financial stress;[20]

- **Short-term debt limits**, to be calculated as a percentage of the SSNF's or Large BHC's capital and surplus;[21]

- **Enhanced public disclosures**;[22] and

- Other prudential standards recommended by the FSOC or deemed appropriate by the Federal Reserve.

Early Remediation Regulations. In addition, the Federal Reserve, after consultation with the FSOC and the FDIC, is required to adopt regulations regarding early remediation requirements, involving a series of specific remedial actions to be taken by a SSNF or Large BHC that is experiencing financial distress[23]

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[19] Dodd-Frank Act § 165(b)(1)(A)(v). In addition, the Act provides for a hard credit exposure limit of 25% of capital stock and surplus of the SSNF to any "unaffiliated company." "Credit exposure" is defined as:

- all extensions of credit to the company, including loans, deposits, and lines of credit;
- all repurchase agreements and reverse repurchase agreements with the company, and all securities borrowing and lending transactions with the company, to the extent that such transactions create credit exposure for the SSNF or Large BHC;
- all guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit) issued on behalf of the company;
- all purchases of or investment in securities issued by the company;
- counterparty credit exposure to the company in connection with a derivative transaction between the company and the SSNF or Large BHC; and
- any other similar transactions that the Federal Reserve, by regulation, determines to be a credit exposure.

Section 165(e) also contains an "attribution rule" similar to that found in Section 23A of the Federal Reserve Act (12 U.S.C. § 371c), such that transactions with one party in which the proceeds of the transaction are ultimately transferred to, or that benefit, a second party are treated as a transaction directly with the second party for purposes of the credit concentration limits. The credit concentration limits (including the 25% cap) are not effective until three years after enactment.

[20] *See* Dodd-Frank Act § 165(b)(1)(B)(i), (c). However, the Federal Reserve may adopt contingent capital requirements only following the FSOC's completion of its study regarding contingent capital.

[21] *See* Dodd-Frank Act § 165(b)(1)(B)(ii), (g).

[22] *See* Dodd-Frank Act § 165(b)(1)(B)(iii), (f).

[23] *See* Dodd-Frank Act § 166 (mandatory and subject to Federal Reserve rulemaking). Early remediation regulations issued by the Federal Reserve are likely to generally resemble the FDIC's "prompt corrective action" requirements. The Federal

Reporting. SSNFs and Large BHCs must submit certain reports to the Federal Reserve and FSOC, which in some cases may be duplicates of reports already provided to foreign authorities or other U.S. federal or state regulatory authorities.[24] The reports are intended to keep the Federal Reserve and FSOC informed as to the reporting entity's financial condition, risk control systems, transactions with depository institution subsidiaries, and "activities and operations [that] could, under adverse circumstances, have the potential to disrupt financial markets or affect the overall financial stability of the United States."

Examination and Enforcement. The Act subjects an SSNF and its subsidiaries to Federal Reserve examination authority with respect to (1) the nature of the operations and financial condition of the SSNF and its subsidiaries; (2) the financial, operational, and other risks of the SSNF and its subsidiaries that may pose a threat to the safety and soundness of the SSNF and its subsidiaries or to the financial stability of the United States; (3) the systems for monitoring and controlling such risks; and (4) compliance by the SSNF and its subsidiaries with the requirements of the Act.[25] The Federal Reserve is also granted authority to issue cease-and-desist orders against an SSNF for engaging in unsafe and unsound practices.[26] In addition, if the Federal Reserve determines that the primary financial regulatory agency having supervisory authority over a functionally regulated subsidiary of an SSNF has not done enough to force the subsidiary to cease the unsafe and unsound practice, the Federal Reserve may initiate enforcement action against the subsidiary *as if the subsidiary were a BHC* subject to Federal Reserve supervision.[27] Finally, the Federal Reserve is required to conduct annual "stress tests" of SSNFs and Large BHCs that evaluate whether such entities have capital that is adequate on a total consolidated basis to absorb losses resulting from adverse economic conditions.[28]

Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") mandated that banking regulators take "prompt corrective action" ("PCA") when an institution's capitalization rating falls below the top two capitalization categories. *See* 12 U.S.C. § 1831o. PCA may include an increase in the monitoring of the institution, requiring the institution to raise more capital, requiring the institution to merge with a more highly capitalized institution, or closure of the institution. Similarly, the Federal Reserve's early remediation regulations must establish requirements for (i) limits on capital distributions, acquisitions, and asset growth; (ii) capital restoration plan and capital-raising requirements; (iii) limits on transactions with affiliates; (iv) management changes; and (v) asset sales. Dodd-Frank Act § 166(c).

[24] *See* Dodd-Frank Act §§ 116(b); 161(c).

[25] *See* Dodd-Frank Act §161(b) (subjecting SSNFs to Federal Reserve examination).

[26] *See* Dodd-Frank Act §162. The SSNF would be treated as if it were a BHC for purposes of FDIA cease-and-desist authority.

[27] *See* Dodd-Frank Act § 162(b)(2).

[28] *See* Dodd-Frank Act § 165(i). Note that the Act appears to confer very broad discretionary authority on the Federal Reserve to require stress testing of any "nonbank financial company," which as the term is defined in the act would include any U.S. or non-U.S. company that is engaged "predominantly" in activities that are "financial in nature" under BHC Act § 4(k).

Financial Silos for SSNFs. Bank regulation is largely premised on the concept of "the separation of banking and commerce" – banks are confined to a fairly narrow range of activities, and companies that control banks (*i.e.*, in most cases, Federal Reserve –regulated BHCs) and the other nonbank affiliates of banks are also confined to a limited range of activities permitted under the BHC Act.[29] SSNFs (which, by their nature, are not BHCs and therefore typically engage in a broader range of activities permitted to corporations generally) could not comply with the BHC Act's activity restrictions without significant divestitures or changes in their activities.

The Act does not require an SSNF (or its parent) to conform its activities to Section 4 of the BHC Act or otherwise shed any activities not permissible for a BHC.[30] The Act does, however, authorize the Federal Reserve to require the "siloing" of any of the SSNF's BHC-eligible activities from the remainder of its activities. The Federal Reserve is authorized to issue regulations that would require any SSNF to create an intermediate holding company to "silo" all or a part of the activities of the SSNF that are deemed to be "financial in nature" under BHC Act Section 4(k) – potentially compelling a significant restructuring of the SSNF. The Act further states that such "siloing" is mandatory where the Federal Reserve determines that, essentially, it would be difficult to properly supervise the "financial in nature" activities of the SSNF if such an intermediate holding company was not created.[31] The Act carves-out from the siloing requirement any "internal financial activities" that are engaged in on behalf of the SSNF or an affiliate (such as the SSNF's internal treasury or accounts payable functions). Further, the Act extends the Federal Reserve's "source of strength" doctrine to the SSNF's parent company, which would require the SSNF's parent company to provide financial support to the intermediate holding company.[32]

Any forced siloing may have significant burdens associated with it, even beyond the need to undergo a corporate reorganization, and the variety of legal, accounting and tax issues that the reorganization itself may raise. For example, personnel, systems, facilities, licenses, documents,

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29 *See Some Concerns with the Regulation of Large Nonbank Holding Companies* (Cadwalader, June 3, 2010), *available at* http://www.cadwalader.com/assets/client_friend/060310RegLargeNonBankHoldingCos.pdf.

30 *See* Dodd-Frank Act § 167(a).

31 *See* Dodd-Frank Act § 167(b)(1)(B).

32 The Act states, "A company that directly or indirectly controls an intermediate holding company established under this section shall serve as a source of strength to its subsidiary intermediate holding company." Dodd-Frank Act § 167(b)(3). "Source of strength" is not defined in Section 167. Prior to the enactment of the Dodd-Frank Act, a "source of strength" doctrine was reflected solely in Federal Reserve Board regulations and not in the banking statutes; the regulations provide that "A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks ...." 12 C.F.R. § 225.4(a)(1). A separate provision of the Dodd-Frank Act codifies source of strength doctrine with respect to traditional bank holding companies, savings and loan holding companies, and holding companies for nonbank banks, but explicitly limits the obligation to serving as a "source of *financial* strength" to its depository institution subsidiaries. Dodd-Frank Act § 616(d).

intercompany and third party agreements, expenses, etc. may need to be realigned to be consistent with the newly siloed financial activities.

Limitation on Certain Acquisitions. Section 163 of The Act subjects SSNFs to the prior approval requirements of the BHC Act with respect to certain transactions by the SSNF, including acquisition of shares or assets of a bank or BHC.[33] Thus, the Act effectively lowers the maximum ownership interest a SSNF can hold in a bank or thrift, from 24.9% (without filing a Section 3 application under the BHC Act) or 9.9% (without filing a Change-in-Bank Control Act application) to 4.9%. A further limitation that the Act imposes on SSNFs and Large BHCs is a requirement that SSNFs and Large BHCs give prior notice to the Federal Reserve if the company to be acquired has assets in excess of $10 billion. In short, this gives the Federal Reserve the authority to oversee the acquisition by a nonbank SSNF of another large nonbank financial company, a regulatory hurdle that would have to be accounted for in the accomplishment of virtually any strategic acquisition by an SSNF.

Cessation of Activities. The Act grants the Federal Reserve broad authority to require Large BHCs and SSNFs to terminate certain activities and divest certain assets if the Federal Reserve determines that the Large BHC or SSNF poses a "grave threat" to U.S. financial stability.[34] Specifically, the Federal Reserve may: (1) limit the ability of the firm to merge with, acquire, consolidate with, or otherwise become affiliated with another company; (2) restrict the ability of the firm to offer a financial product or products; (3) require the company to terminate one or more activities; (4) impose conditions on the manner in which the company conducts 1 or more activities; or (5) require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities. The exercise of such powers with respect to nonbank financial companies does not have a precedent and there is no way to know how the procedure by which they may be exercised, how frequently, or the criteria to be used in deciding to exercise the authority.

No De-banking. Section 117 of the Act (often referred to as the "*Hotel California*" provision) applies to entities that were, as of January 1, 2010, BHCs with consolidated assets of $50 billion or more and received assistance under the Capital Purchase Program. Section 117 provides that these entities (or their successors) will automatically be regulated by the Federal Reserve as SSNFs if they ever cease to be a BHC. As a result, such entities (or their successors) will remain subject to the SSNF provisions of the Act, including Federal Reserve supervision and examination and the capital requirements and quantitative limits of the Volcker Rule, regardless of their size at any time or whether they continue as to be BHCs.

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33 *See* Dodd-Frank Act § 163(a).

34 *See* Dodd-Frank Act § 121.

III. Increased Capital Obligations on all Depository Institutions and BHCs

The Collins Amendment. Section 171 of the Act (known as the "**Collins Amendment**") eliminates the ability of BHCs to utilize hybrid securities as an element of Tier 1 capital.[35] The provision achieves this result by requiring the federal banking agencies to utilize presently existing capital requirements applicable to FDIC-insured banks as a benchmark in establishing the minimum requirements applicable to BHCs and SSNFs.[36] The effect of eliminating hybrid securities as an element of Tier 1 capital is that trust preferred and cumulative preferred securities will no longer count as Tier 1 capital for BHCs.[37]

The limitation on Tier 1 capital will not apply to existing hybrid capital instruments issued by BHCs with assets of less than $15 billion. Hybrid capital instruments issued by such entities prior to May 19th, 2010 will continue to count as Tier 1 capital. In addition, BHCs subject to the Federal Reserve's Small Bank Holding Company Policy Statement (generally, BHCs with assets of less than $500 million)[38] will be exempt from the Collins Amendment's limitation on Tier 1 capital. Existing hybrid capital instruments will be gradually excluded (there is a 3 year phase-in period) from the Tier 1 capital calculations of BHCs and SSNFs beginning on January 1, 2013.

The Collins Amendment does not apply to SSNFs.

No Procyclical Capital Requirements. In addition, Section 616 requires the agencies adopt, by regulation, capital requirements that are countercyclical in nature (*i.e.,* which require increases in capital in times of economic expansion and decreases in time of economic contraction) with respect to BHCs, SLHCs, and foreign branches operating within the U.S.

Source of Strength Doctrine Codified. Section 616 codifies the "source of strength doctrine," the Federal Reserve's policy that a BHC be equipped to act as a source of financial support for its subsidiary banks.[39] Section 616 extends the source of strength doctrine to apply to nonbank BHCs and thrift holding companies. Section 616 also requires holding companies to provide periodic

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[35] Note that the Basel III negotiations have included a proposal to eliminate hybrid capital instruments as an element of Tier 1 capital. *See* Speech by Hervé Hannoun at the 45th SEACEN Governor's Conference, *Towards a Global Financial Stability Framework* (Feb. 26, 2010), *available at* http://www.bis.org/speeches/sp100303.pdf. This memorandum was published before the Act was adopted and some of the specific concerns raised in the memorandum were addressed in the final version of the Act. Nonetheless, the general policy concern raised by the memorandum; *i.e.,* the absence of a clear policy justification for regulating entities that were neither banks nor controlled banks under a scheme of regulations designed for banks remains an issue.

[36] The leverage and risk-based capital requirements applicable to insured state chartered banks is found at 12 C.F.R. Part 325.

[37] *Compare* 12 C.F.R. Part 225, App. A, Section II(A)(1)(a) *with* 12 C.F.R. Part 325, App. A, Section I(A)(1).

[38] 12 C.F.R. Part 225, App. C.

[39] *See* 12 C.F.R. § 225.4(a).

reports to the appropriate federal banking agencies assessing its ability to act as a source of strength, and requires joint agency rules implementing the source of strength requirements.

IV. Regulatory Realignment

The Act significantly alters the financial regulatory agency jurisdictional landscape, with one agency (the Office of Thrift Supervision ("**OTS**")) eliminated, another agency (the BCFP) established, and existing responsibilities shifted – and in many cases overlapping – between the remaining three federal banking agencies (the OCC, the FDIC and the Federal Reserve).[40]

OTS Eliminated. Sections 311 through 313 of The Act eliminate the OTS. The supervisory and rulemaking authority of the OTS over savings and loan holding companies ("**SLHCs**") is transferred to the Federal Reserve. The supervisory and rulemaking authority of the OTS over federal thrifts is transferred to a newly created deputy comptroller position within the OCC, while the supervisory (but not rulemaking) authority of the OTS over state thrifts is transferred to the FDIC.[41]

These responsibilities will be transferred one year after the enactment of the Act, but may be delayed an additional six months by the Secretary of the Treasury, after consultation with the Director of the OTS, the Comptroller of the Currency, the Chairman of the Board of Governors, and the Chairperson of the FDIC. The OTS will be eliminated 90 days after the transfer date. The seat of the Director of the OTS on the FDIC board of directors will be re-assigned to the new Director of the BCFP.[42]

Thrift Charter Preserved. While the thrift charter is not eliminated (as was contemplated by the original Senate bill), the elimination of the OTS as an agency dedicated to thrifts diminishes the value and separate identity of the thrift charter, especially following the elimination of the standalone Savings Association Insurance Fund in 2006 and the curtailment of thrift holding company activities in 1999 with the elimination of the "unitary thrift holding company" exemption.[43]

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[40] The Dodd-Frank Act also provides a mechanism for addressing disputes among FSOC member agencies regarding their respective jurisdiction over certain entities, activities, or products. In the event of a dispute, a member agency may apply to the Financial Services Oversight Council and request a nonbinding recommendation as to which agency may properly exercise jurisdiction over the entity, activity, or product. *See* Dodd-Frank Act § 116. The membership of the FSOC generally includes all the federal financial regulatory authorities, including the Secretary of the Treasury.

[41] Rulemaking authority (but not supervisory authority) over state thrifts would be transferred to the OCC.

[42] The Dodd-Frank Act, § 336.

[43] Prior to the enactment of GLBA in 1999, unitary thrift holding companies – holding companies that controlled only one thrift – were exempt from the activity restrictions of the Home Owners' Loan Act and therefore were permitted to engage in, or be affiliated with, commercial entities. GLBA grandfathered existing unitary thrift holding companies but required any newly created unitary thrift holding company to comply with the activity restrictions of HOLA. *See* 12 U.S.C. § 1467a(c)(9)(A).

Federal Reserve Supervision of Functionally Regulated Subsidiaries. Section 604 of the Act moderately expands the Federal Reserve's authority over "functionally regulated subsidiaries" – in essence, certain federally or state regulated securities companies or state regulated insurance companies – that are owned by a BHC or financial holding company ("FHC").[44] Existing law requires the Federal Reserve to limit its examination of functionally regulated subsidiaries to certain extraordinary situations, for example, if the Federal Reserve believes the subsidiary poses material risk to the holding company.[45] Section 604 removes some of these restrictions and grants the Federal Reserve examination and supervisory authority over a functionally regulatory subsidiary of a BHC to ensure compliance with the BHC Act, but requires the Federal Reserve to rely on examination reports prepared by the functional regulator and to notify the functional regulator before conducting an examination of the functionally regulated subsidiary. In addition, Section 604 repeals a provision that barred the Federal Reserve from exercising enforcement or rulemaking authority over functionally regulated subsidiaries except in extraordinary situations.[46]

OCC and FDIC Given Back-Up Examination Authority over Non-Bank Affiliates. Section 605 of the Act confers on the OCC and the FDIC the responsibility to conduct back-up examinations of holding company subsidiaries engaged in bank-eligible activities. Under existing law, the Federal Reserve has exclusive examination authority over the nonbank subsidiaries of a BHC or FHC (other than functionally regulated subsidiaries), and the Federal Reserve was free to examine (or not) these subsidiaries as it saw fit. Section 605 now requires the Federal Reserve to conduct examinations of a BHC's nonbank subsidiaries engaged in bank-eligible activities "in the same manner, subject to the same standards, and with the same frequency as would be required if such activities were conducted in the [BHC's] lead insured depository institution." Section 605 further provides that, if the Federal Reserve fails to conduct the required examination of the nonbank subsidiary, the regulator of the lead insured depository institution (*i.e.,* the OCC in the case of national banks or federal thrifts, or the FDIC in the case of state non-Member banks or state thrifts)

Thus, after the enactment of GLBA, commercial entities were effectively prohibited from acquiring or establishing a thrift unless the commercial entity conformed its activities to the restrictions imposed by HOLA.

A third competitive advantage of the federal thrift charter – the ability to branch nationwide – is also diluted by a separate provision of the Dodd-Frank Act, Section 613, which confers on banks the ability to branch *de novo* into any state, provided that the law of that state permits a bank chartered by that state to establish a branch at that same location. Under existing law, a bank can *de novo* branch into a new state only if that state expressly has opted into *de novo* interstate branching, and thus banks had been at a competitive disadvantage to federal thrifts which were permitted to branch across state lines regardless of whether the state had authorized *de novo* interstate branching. *See* 12 U.S.C. § 36(g)(1)(A); 12 U.S.C. § 1828(d)(4)(A).

[44] A "functionally regulated subsidiary" included a registered broker-dealer, a registered investment adviser, a registered investment company, a commodities company regulated by the CFTC, or a state regulated insurance company. 12 U.S.C. § 1844(c)(5).

[45] *See* 12 U.S.C. § 1844(c).

[46] *See* 12 U.S.C. 1848a.

may recommend in writing that the Federal Reserve do so.[47] If the Federal Reserve fails provide a written explanation or begin the examination within 60 days after receiving such a written recommendation, the OCC or the FDIC may conduct its own examination to ensure compliance with law, to determine whether the subsidiary presents safety and soundness risks to any insured depository institution subsidiary, and to determine whether the subsidiary is subject to appropriate risk management systems. Further, the OCC and the FDIC may recommend to the Federal Reserve that it take enforcement action, and if the Federal Reserve does not do so within 60 days, the OCC or the FDIC have the authority to take independent enforcement action against the subsidiary.

Given that the scope of *bank*-eligible activities has greatly expanded in recent years to be nearly as broad as the scope of *holding company*-eligible activities, most holding company subsidiaries – other than those engaged in bank-ineligible securities and insurance activities – would be subject to potential separate back-up examination (and potential enforcement) under Section 605.

Shared Responsibility for Anti-Tying Regulations. Section 355 of the Act requires the Federal Reserve to consult with the FDIC and the OCC before promulgating regulations under the anti-tying statute.[48] Existing law requires no such consultation.

Agency Assessments. Section 318 of the Act confers on the Federal Reserve, the FDIC, and the OCC the specific authority to impose regulatory assessments. Note, however, that the Federal Reserve's assessment authority under the provision is limited to Large BHCs and SSNFs.

Investment Bank Holding Company vs. Securities Holding Company. Section 617 would eliminate the ability of a foreign entity to become "investment bank holding company" subject to supervision by the SEC. In its stead, Section 618 would create an elective "securities holding company" that would be supervised by the Federal Reserve. The purpose of these provisions is to create a framework for foreign securities companies operating in the U.S. to satisfy non-U.S. legal obligations that the foreign securities companies be subject to comprehensive consolidated supervision within the U.S.

To qualify as a "securities holding company," the entity must control one or more broker-dealers registered with the SEC, and must not otherwise be subject to supervision by the Federal Reserve or another federal banking agency. Section 618 directs the Federal Reserve to establish record

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[47] The Dodd-Frank Act does not confer back-up examination authority if the lead insured depository institution is a state Member bank – which is otherwise supervised by the Federal Reserve. Thus, if the Federal Reserve fails to examine the nonbank subsidiaries of a BHC in which the lead institution is a state Member bank, no other agency can assert back-up examination or enforcement authority over those nonbank subsidiaries.

[48] 12 U.S.C. § 1972.

keeping, reporting, examination, capital, and risk management requirements applicable to securities holding companies. Section 618 further subjects a securities holding company to the provisions of the BHC Act as if it were a BHC, with the exclusion of the activity and ownership restrictions of Section 4 of the BHC Act.[49] This provision does not apply to the regulation of any existing broker-dealers; *i.e.,* all of the existing broker-dealers that are subject to consolidated supervision are part of BHCs that are already regulated by the Federal Reserve and not by the SEC.

V. Changes to the Federal Deposit Insurance System

Liability-Based Assessments. Section 331 of the Act requires that the FDIC amend its regulations regarding deposit assessments so that an insured institution's assessments are based not on its deposits but instead on the difference between the insured institution's (i) average consolidated total assets and (ii) average tangible equity (in general, the institution's consolidated liabilities). This change has the effect of shifting the cost of maintaining the Deposit Insurance Fund away from traditional banks that are funded largely by deposits, to larger banks that rely more heavily on non-deposit sources of funds. Coupled with Section 627's repeal of Regulation Q (effectively allowing interest to be paid on transaction accounts held by businesses, as further described below), this will likely diminish the attractiveness of non-insured interest-bearing accounts located offshore.

Risk Categorization based on Size. Section 331 also repeals a provision of the Federal Deposit Insurance Act that bars the FDIC from excluding an insured institution from the lowest-risk category based solely on its size.[50] Thus, in theory the FDIC could now charge the highest assessment rate on an insured institution merely because it is big.

Deposit Insurance Fund Replenishment. Sections 332 and 334 address the Deposit Insurance Fund's reserve ratio. Section 334 of the Act raises the minimum designated reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35%,[51] eliminates the maximize reserve ratio of 1.50%, and requires the FDIC to achieve the 1.35% minimum designated reserve ratio by 2020. In achieving the new minimum, the FDIC is required to offset the effect of any higher assessments on insured depository institutions with assets of less than $10 billion – thus effectively shifting the costs of recapitalizing the Fund to depository institutions with assets of $10 billion or more. Section 332 of the Act eliminates the obligation of the FDIC to pay a dividend equal to half of the amount by which the Deposit Insurance Fund exceeds the designated reserve ratio of 1.35%; in lieu thereof, the FDIC has the authority, in its sole discretion, to suspend or eliminate such a dividend.

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[49] 12 U.S.C. § 1843.

[50] *See* 12 U.S.C. § 1817(b)(2)(D).

[51] *See* 12 U.S.C. § 1817(b)(3)(B).

Permanent Increase in Deposit Insurance Coverage Amount. Section 335 of the Act makes permanent the May 2009 temporary increase in the deposit (and credit union share) insurance coverage limit from $100,000 to $250,000.

Extension of TAG Program. Section 343 of the Act extends the October 2008 Transaction Account Guarantee program through December 31, 2012, which program affords deposit insurance coverage without limit on certain non-interest bearing transaction accounts.

Repeal of Regulation Q. Section 627 of the Act repeals the provisions of the Federal Reserve Act, the Home Owners' Loan Act, and the Federal Deposit Insurance Act that prohibit the payment of interest on demand deposits (commonly referred to as "Regulation Q"). As a result, banks and thrifts will be permitted to offer interest-bearing demand deposit accounts to business customers, which were previously forbidden under Regulation Q. In addition, banks and thrifts may offer interest-bearing demand deposit accounts to consumer customers without complying with the "NOW account" provisions of the Federal Reserve's Regulation D.[52] The repeal is effective one year after enactment of the Act.

VI. Limits on Expansionary Activities

The Act contains a number of provisions designed to restrain the growth of certain financial services companies or to restrict their ability to engage in activities deemed to pose more risk to the system and to the Fund.

Tightening of "Financial Holding Company" Eligibility. Section 606 of the Act precludes a BHC from electing to become a "financial holding company" – and thereby engage in the broader range of activities permitted under the Gramm-Leach-Bliley Act, such as merchant banking, securities underwriting and dealing, or insurance agency and underwriting – unless the BHC is both "well managed" and "well capitalized."[53] Existing law requires only that the *depository institution subsidiaries* of the BHC – and not the BHC itself – meet these requirements.[54] Section 606 thus raises the bar for BHCs seeking to engage in expanded activities.

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52 *See* 12 C.F.R. Part 204.

53 A "well capitalized" BHC is one that maintains a total risk-based capital ratio of at least 10% and a Tier 1 risk-based capital ratio of at least 6%, and is not subject to a capital-related administrative order from the federal banking agencies. A "well-managed" BHC is one that has a composite rating of "2" or better on the Federal Reserve's RFI(C)/D examination rating and at least a satisfactory rating for management. 12 C.F.R. § 225.2(r), (s).

54 *See* 12 U.S.C. § 1843(l); 12 C.F.R. § 225.83. In addition, the depository institution subsidiaries must have a CRA rating of "Satisfactory" or better. *Id*.

Section 606 does not address the implications for existing FHCs that fail to satisfy the new standard. Pre-existing law imposes fairly severe regulatory sanctions on financial holding companies that fail to maintain the statutory requirements for financial holding company status, including entry into a written agreement within 45 days and potential divestiture of expanded activities within 180 days. **Section 606 thus could be construed to place some existing financial holding companies immediately into noncompliance.**[55]

Limitations on Interstate Acquisitions and Mergers. Similarly, Section 607 of the Act precludes a BHC from engaging in an interstate acquisition – the acquisition of a bank outside its home state – unless the BHC is both *well* capitalized and *well* managed. Existing law allows such acquisitions provided the holding company is *adequately* capitalized and *adequately* managed.[56] Thus, unless a BHC is both well-capitalized and well-managed, it must confine its ongoing bank acquisitions to its single home state.

A parallel provision in Section 607 precludes a bank from engaging in an interstate merger with another bank headquartered in a separate state unless the surviving bank will be well-capitalized and well-managed following the merger transaction. Existing law requires only that the survivor be adequately managed and adequately capitalized.[57] This parallel provision ensures that banks that are not in a holding company structure are subject to the new heightened requirements.

No Charter Conversions During Enforcement Actions. Section 612 of the Act forbids an insured depository institution from converting its charter form (*e.g.,* national bank, state bank, federal thrift, or state thrift) if the insured depository institution is subject to a cease and desist order or other formal order, or an informal memorandum of understanding, with its current regulator "with respect to a significant supervisory matter," unless the current regulator consents to the conversion. Section 612 does not, by its terms, forbid a change in regulator that doesn't entail a charter conversion (for example, when a state non-Member bank seeks membership in the Federal Reserve System). However, both charter conversions and changes in regulatory agencies for institutions subject to such administrative action are already discouraged, if not altogether precluded, by an existing interagency policy statement.[58] Thus, Section 612 largely codifies existing regulatory practice.

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55 *See* 12 U.S.C. § 1843(m).

56 *See* 12 U.S.C. § 1842(d)(1)(A). A BHC's "home state" is determined by predominance of its banking subsidiary's(ies') deposits at the time it first became a BHC or July 1, 1966, whichever occurred later. 12 U.S.C. § 1841(o)(4).

57 *See* 12 U.S.C. § 1831u(b)(4).

58 *See FFIEC Statement on Regulatory Conversions* (July 1, 2009).

Prior Approval for Large Acquisitions by FHCs. Section 604 requires that a financial holding company seek Federal Reserve approval before acquiring any company with total consolidated assets in excess of $10 billion. Existing law requires no prior approval, only after-the-fact notice.[59]

Thrift Acquisitions Now Subject to Deposit Cap. The Act expands the nationwide "concentration limits" first introduced upon the enactment of the Riegle-Neal Interstate Banking and Branching Act of 1994. That Act instituted a "nationwide deposit cap," precluding the Federal Reserve from approving any interstate acquisition of a bank or BHC if the resulting bank or BHC would hold more than 10% of nationwide deposits.[60] Under pre-Act law, a BHC's acquisition of a *thrift* had not been subject to this limitation. Section 623 closes this loophole, subjecting a BHC's interstate acquisition of thrift to the same 10% nationwide deposit cap. Section 623 also extends the 10% nationwide deposit cap to interstate depository institution *merger* transactions involving a thrift; pre-Act law applied the deposit cap only to interstate mergers involving two banks.[61]

New Nationwide Liability-Based Cap. Section 622 creates an entirely new concentration limit cap, calculated based on total liabilities and imposed on any acquisition (whether or not interstate) and applicable not only to BHCs but also to companies that control a nonbank bank or SSNF. Section 622 prohibits such a financial company from acquiring, acquiring substantially all the assets of, or merging or consolidating with, *any* other company (financial or otherwise) if, as a result of the transaction, the surviving financial company's total consolidated liabilities will exceed 10% of all of the consolidated liabilities of all financial companies. "Liabilities" is defined as the difference between the entity's risk-weighted assets and its total regulatory capital, and includes all consolidated liabilities of U.S.-based financial companies (including liabilities abroad) and all consolidated liabilities of foreign-based financial companies' U.S. operations. Within six months following enactment of the Act, the FSOC is required to conduct a study and render recommendations regarding any modifications to the liability-based concentration limit. The Federal Reserve is required to promulgate regulations implementing the new concentration limit within nine months thereafter.

Moratorium on Certain Nonbank Banks. Under existing law, BHCs generally are prohibited from engaging in (or owning more than 5% of a company engaged in) activities that are not "closely related to banking" as defined by the Federal Reserve's Regulation Y.[62] Although financial holding

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59 *See* 12 U.S.C. § 1843(k)(6). Section 163(a) of the Dodd-Frank Act imposes a similar advance notice requirement on SSNFs and on Large BHCs. Under current law, nonbank financial companies have no such prior notice obligation. Traditional BHCs are required to submit an advance notice (in essence, an application) to the Federal Reserve pursuant to Regulation Y.

60 *See* 12 U.S.C. § 1842(d)(2).

61 *See* 12 U.S.C. § 1828(c); 12 U.S.C. § 1831u.

62 *See* 12 U.S.C. § 1843(a), (c), (k).

companies have broader authority, financial holding companies are nonetheless prohibited from engaging in (or owning more than 5% of a company engaged in) activities that are not "financial in nature" as defined by the Federal Reserve. As a result, entities that itself are, or that own subsidiaries that are engaged in commercial activities which are neither "closely related to banking" nor "financial in nature" – with certain exemptions – are prohibited from owning a bank.

Sections 602 and 603 of the Act place a partial moratorium on expansion of one of these exemptions. Existing law allows a company to own a bank, without regard to the activity restrictions outlined above and without being regulated as a BHC, provided the bank is a limited purpose "nonbank bank" (such as an industrial loan company, trust bank, or credit card bank).[63] Section 603 places a three-year moratorium on the FDIC approving insurance applications for any such nonbank banks if the nonbank bank would be controlled by a "commercial firm" – defined as a company less than 15% of the consolidated gross revenues of which are derived from financial-in-nature activities. The moratorium also precludes any change of control of an existing nonbank bank that would result in its acquisition by a commercial firm. Section 603 requires the GAO to conduct a study regarding the appropriateness of continuing the nonbank bank exemptions from the BHC Act (as well as the exemptions afforded for thrifts and thrift holding companies), which GAO study is due eighteen months following the enactment of the Act.

Section 603's moratorium does not apply to applications for nonbank banks held by companies that are *not* "commercial firms," *i.e.,* that have 15% or more of their consolidated gross revenues derived from financial-in-nature activities but otherwise do not qualify as a BHC. Thus, a company having, for example, 25% of its consolidated gross revenues derived from financial activities could in theory acquire control of or establish a *de novo* charter for a nonbank bank, subject to FDIC approval.

VII. Swaps Push-Out Rule

Section 716 of the Act (the "**Swaps Push-Out Rule**" or the "**Lincoln Amendment**") effectively prohibits an insured depository institution (*i.e.*, a bank or a thrift) from acting as a Swap Dealer.[64] The Rule achieves this result in a somewhat backward fashion, meaning that it prohibits a Swap

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[63] *See* 12 U.S.C. § 1841(c)(2).

[64] Note that the term "Swap Dealer" is used in this Memorandum generally to refer to "Swap Dealers" and "Security-based Swap Dealers." For further detail on the distinction between the two categories, please refer to the Title VII summary.

Generally, a "Swap Dealer" is "any person who - (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." *See* Dodd-Frank Act § 721(a)(49).

Dealer from obtaining FDIC insurance, rather than by prohibiting a bank that received FDIC insurance from acting as a Swap Dealer.

More specifically, Section 716 prohibits the federal government from providing "federal assistance" to any "swaps entity." Under the Rule, "federal assistance" includes federal deposit insurance, and "swaps entity" includes a bank registered as a Swap Dealer. The result is that a bank would effectively have its FDIC deposit insurance coverage revoked by reason of Section 716 if the bank were to act as a Swap Dealer. As maintenance of federal deposit insurance is a condition for national banks, federal thrifts, and virtually all state chartered banks and thrifts, this revocation of FDIC deposit insurance coverage would grounds for appointment of the FDIC as receiver of a bank under the Federal Deposit Insurance Act ("**FDIA**").[65] The Rule essentially prohibits a bank from *acting* as a Swap Dealer. In this Memorandum, we refer to the prohibition on provision of federal assistance to swaps entities as the "Push-Out requirement."

The proprietary trading restrictions of the Volcker Rule (discussed below) also act as an overall limitation on the swaps activities of banks and BHCs, and as such the Swaps Push-Out Rule must be read in light of the limits imposed by the Volcker Rule.[66]

Definitions. For purposes of the Swaps Push-Out Rule:

> *"Federal assistance"* mean "any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act, [or] Federal Deposit Insurance Corporation insurance or guarantees for the purpose of
>
> (A) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;
>
> (B) purchasing the assets of any swaps entity;
>
> (C) guaranteeing any loan or debt issuance of any swaps entity; or
>
> (D) entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity."[67]

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[65] *See* 12 U.S.C. § 1821(c)(5)(J).

[66] *See* Dodd-Frank Act § 716(m). For more detail on the effect of the Volcker Rule, see Section VIII below.

[67] Dodd-Frank Act § 716(b)(1).

The Rule thus does not prohibit the Federal Reserve from lending to institutions in "unusual and exigent circumstances" (*i.e.,* the emergency lending authority) so long as such lending is part of a program with "broad-based eligibility."

"Swaps Entity" means any entity registered as a Swap Dealer or MSP. Insured depository institutions registered only as a major swap participant (and not as a Swap Dealer) are exempt from the "swaps entity" definition and thus from the Push-Out requirement. Thus, banks and thrifts engaged in activities that do not require registration as a Swap Dealer are not subject to the Push-Out requirement. Note, however, that such banks and thrifts would remain subject to the Volcker Rule's prohibition against proprietary trading, which would limit the ability of such institutions to engage in swaps transactions for their own account.

Exempted entities and activities. The Swaps Push-Out Rule excludes several types of institutions or transactions from its Push-Out requirement:

FDIC-Operated Institutions. Bridge banks, "covered financial companies," and depository institutions that are subject to an FDIC conservatorship or receivership are exempt from the Push-Out requirement.[68]

Bona Fide Hedging and Traditional Bank Activities. An insured depository institution (regardless of whether it is registered as a Swap Dealer) that limits its swap activities to any of the following is exempt from the Push-Out requirement:[69]

- swaps hedging "direct" risks;
- swaps on interest rates;
- swaps referencing assets that are permissible for investment by a national bank (except for uncleared credit default swaps or uncleared swaps referencing the credit risk of asset-backed securities).[70]

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[68] Dodd-Frank Act § 716(g). "Covered financial company" is defined in Title II, § 201(a)(8). Note that Title II substantially amends the extent to which a nonbank institution may be subject to an "orderly liquidation" proceeding.

[69] Note again that banks and BHCs may only engage in these activities to the extent permitted under the proprietary trading restrictions of the Volcker Rule.

[70] Generally, national bank-permissible investments include the following instruments: U.S. government and agency securities; certain investment-grade debt securities; certain mutual fund securities; foreign currency; and certain precious metals; *See generally* 12 U.S.C. § 24(Seventh); 12 C.F.R. Part 1.

Existing Swaps Exempt. The Rule does not require wind-down or termination of swaps entered into prior to the date the Rule becomes effective, which generally is 3 years following the date the Act becomes law.[71] Note, however, the Volcker Rule will require "banking entities" to dispose of swaps not held for hedging purposes within 4 years of the date the Act becomes law (subject to possible extensions), unless the swap falls within the narrow exception of instruments allowed by the Volcker Rule (generally, federal or agency securities, GSE securities, and state or state agency securities).[72]

Pushing Out Swaps Activities. Institutions subject to the Push-Out requirement must either "push" the relevant activities to an affiliate, subject to regulations that the CFTC, SEC, and Federal Reserve are authorized to issue, or cease the activities altogether.[73] The Rule does not prohibit an FDIC insured institution from affiliating with a Swap Dealer so long as the Swap Dealer affiliate is part of a BHC or savings and loan holding company ("**SLHC**").[74] **This safe harbor therefore would not encompass an insured institution that does not have a BHC or SLHC parent.** For example, the safe harbor language of the Swaps Push-Out Rule suggests that a commercial firm that owns an FDIC insured institution, but is not itself a BHC, will be prohibited (i) from registering the FDIC insured institution as a Swap Dealer; and (ii) from having a separate subsidiary registered as a Swap Dealer. **The narrow scope of the safe harbor promises to be particularly problematic for foreign banks and firms that own nonbank banks.**

VIII. The Volcker Rule

Section 619 of the Act enacts the so-called "Volcker Rule." The Volcker Rule has two prongs: (i) prohibiting "banking entities" from engaging in proprietary trading in certain securities (the "**Prop Trading Restriction**"); and (ii) prohibiting "banking entities" from sponsoring or investing in a hedge fund or private equity fund (the "**Sponsoring and Investing Restriction**").

Key Definitions

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71 *See* Dodd-Frank Act §§ 716(e), (f).

72 For more detail on the effect of the Volcker Rule, see Section VIII below.

73 *See* Dodd-Frank Act §§ 716(c), (j) and (k). The Swaps Push-Out Rule requires the primary federal prudential regulator of banks and BHCs to establish standards for safe and sound conduct of swaps activities (§ 716(k)), but note that Title VII contains duplicative requirements on this point. *See, e.g.,* Dodd-Frank Act § 731 (margin, capital, and business conduct requirements for entities registered as Swap Dealers or MSPs).

74 *See* Dodd-Frank Act § 716(c); 12 U.S.C. §§ 371c, 371c-1.

"Banking Entity" includes insured depository institutions,[75] institutions that control an insured depository institution (i.e., BHCs), entities treated as BHCs for purposes of the Act (such as foreign banks with a U.S. banking presence), and holding companies of nonbank banks, and any affiliates of the preceding entities.

"Proprietary trading" is defined generally as "engaging as principal for the trading account[76] of the banking entity ... in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that" the federal banking agencies, the SEC, and the CFTC determine by rule to include within the scope of the Prop Trading Restriction.

For purposes of the Sponsoring and Investing Restriction, a "*hedge fund*" or "*private equity fund*" would include any fund exempt from registration as an investment company under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act, or any "similar" fund that the federal banking agencies, the SEC, and the CFTC may, by rule, include within the scope of the Sponsoring and Investing Restriction.

"Sponsoring" would include serving as the general partner, managing partner or trustee, selecting or controlling a majority of the directors or trustees or management of the fund, or sharing the same or similar name with the fund for marketing, promotion, or other purposes.

Exemptions. There are a number of exemptions to the Volcker Rule restrictions:

- *governments* - the purchase, sale, or disposition of U.S. or agency obligations, GSE obligations, and obligations of any State or political subdivision;[77]

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75 Banks limited to the exercise of trust or fiduciary powers ("**Trust Banks**") are deemed not to be a "banking entity" for purposes of the Volcker Rule if the Trust Bank: (i) receives "substantially all" of its deposits in a *bona fide* fiduciary capacity; (ii) does not cross-market its deposit taking activities through affiliates; (iii) does not accept demand deposits, provide checking services, or make commercial loans; (iv) does not utilize payment related services at any Federal Reserve Bank; and (v) does not access the Fed's discount window.

76 "Trading account" is defined as "any account used for acquiring or taking positions in the securities or instruments [described in the Volcker Rule] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such accounts" as determined by the federal banking agencies, the SEC, and the CFTC by rule. "Near term" and "short-term price movements" are not defined in the Act.

77 The exempted securities reflect a small subset of the current bank-eligible securities, and thus the Rule reflects a significant rollback in the investing and trading authority of banks. *See generally* 12 C.F.R. Part 1. While BHCs (and their affiliates) currently enjoy broader authority to trade in securities (such as equities below the 5% ownership limit afforded to BHCs under Section 4(c)(6) of the BHC Act and unrestricted securities trading authority afforded to securities subsidiaries of

- *"near term" underwriting and market-making activities* - the purchase, sale, acquisition, or disposition of securities and instruments in connection with "underwriting or market-making-related activities, to the extent that any such activities . . . are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties";

- *hedging direct risks* - risk-mitigating hedging activities (either on an individual transaction basis or on an aggregate portfolio basis) "that are designed to reduce the specific risks of the banking entity";

- *customer facilitation* - the purchase, sale, acquisition, or disposition of securities or instruments on behalf of customers;

- *public welfare investments* - investments in Small Business Investment Companies, investments designed primarily to promote the public welfare (as defined by Section 24 (Eleventh) of the National Bank Act), and investments relating to qualified rehabilitated buildings or certified historic structures;

- *insurer investments* - the purchase, sale, acquisition, or disposition of securities and instruments by a regulated insurance company, if such transactions are solely for the benefit of the insurance company and are conducted pursuant to insurance company investment laws, regulations, and written guidance provided by the State insurance authority;

- *organizing and sponsoring a fund* - organizing or sponsoring a private equity or hedge fund (including serving as a general partner, managing member, or trustee), and in any matter controlling (or having employees, officers, directors or agents serving as) a majority of the fund's directors, trustees, or management, provided that a number of additional conditions are satisfied:

    - the banking entity must provide "*bona fide* trust, fiduciary, or investment advisory services" to the fund;

    - the fund may only be offered to trust, fiduciary, or investment advisory customers of the banking entity;

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financial holding companies), no such latitude is conferred by the Volcker Rule, and holding company trading authority would be no broader than the narrow authority conferred on their subsidiary banks.

- the banking entity may not acquire any ownership interest in the fund except for a *de minimis* investment otherwise authorized by the Act (*see infra* for detail on this limitation);

- the banking entity must comply with the newly imposed Section 23A restrictions applicable to transactions between a banking entity and a fund advised, managed, sponsored, or organized by a banking entity, or in which a banking entity maintains an investment (*see infra* for detail on related party transaction restrictions);

- the banking entity may not assume, guarantee, otherwise insure the obligations of the fund (or any private equity or hedge fund in which the fund in turn has invested);

- the banking entity must disclose in writing to its prospective and actual investors that any losses in the fund are borne solely by the fund investors and not by the banking entity;

- the banking entity and the fund may not share, whether for corporate, marketing, promotional, or other purposes, the same name or a variation thereof; and

- no director or employee of the banking entity may take or retain any ownership interest in the fund, except for those directors or employees that are directly engaged in providing investment advisory or other services to the fund.[78]

Limitation on Exemptions. All of the above exemptions are subject to prudential limitations to be defined further by the regulatory agencies. Under Section 619, no transaction, class of transactions, or activity may be deemed permissible (even if otherwise exempted by Section 619) if the transaction(s) or activity would:

- "involve or result in a material conflict of interest";

- "would result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies";

- "would pose a threat to the safety and soundness of such banking entity"; or

[78] In addition, investments in funds pursuant to the *bona fide* services exemption are subject to special Section 23A affiliate transaction restrictions (discussed *infra*). The federal banking agencies, the SEC, and the CFTC have authority to impose additional activity restrictions in the coordinated final regulations to be adopted under the Volcker Rule.

- "would pose a threat to the financial stability of the United States."

  The federal banking agencies, the SEC, and the CFTC are required to adopt coordinated final regulations implementing these limitations (including defining the terms used, such as "material conflict of interest," "high-risk assets," and "high-risk trading strategies").

De Minimis Investments in Funds. The Volcker Rule permits a banking entity to "establish[a] fund and provid[e] the fund with sufficient initial equity capital for investment to permit the fund to attract unaffiliated investors." Thus, a banking entity (i) may only invest in a fund that the banking entity has itself organized; (ii) may provide "seed money" for one year; (iii) may only retain a "**Permitted Investment**" in a fund beyond the "seed" money period.

The "seed" money rule requires the banking entity to actively seek unaffiliated investors such that, within one year after establishment of the fund, the banking entity's investment has been reduced (whether by redemption, sale, or dilution) to the level of a Permitted Investment, as described below. Banking entities may seek a two-year extension of the "seed money" period from the Federal Reserve "if consistent with safety and soundness and the public interest."

A banking entity's "Permitted Investment" in a fund is subject to the following limitations:

- *All* fund investments of the banking entity taken together may not exceed, on a consolidated basis, 3% of the Tier 1 capital of the banking entity;

- An investment in an *individual* fund may not exceed 3% of "the total ownership interests" of the fund;

- An investment must be "immaterial to the banking entity." "Materiality" is to be defined in coordinated final regulations of the banking agencies, the SEC, and the CFTC;

- For purposes of calculating the new capital requirements applicable to fund investments (discussed *infra*), a banking entity's aggregate investment in funds must be deducted from the banking entity's assets and tangible equity for purposes of determining compliance with these new capital requirements. The amount of the deduction is required to increase as the fund becomes more leveraged.[79]

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[79] In other words, the deduction is calculated based on the percentage of fund assets deemed "owned" by the banking entity; as a fund become more leveraged, the deduction (and hence the capital charge) will increase.

Prudential Limits on Exempted Activities. Section 619 requires the federal banking agencies, the SEC, and the CFTC, as part of the coordinated final regulations, to adopt rules regarding additional capital requirements, diversification, and quantitative limits (including diversification requirements) for banking entities engaged in proprietary trading or sponsoring or investing in private equity or hedge funds, if the agencies determine that such additional capital requirements and quantitative limits are appropriate for safety and soundness reasons. [80]

SSNFs not Subject to Bar but Subject to Prudential Limits. An SSNF that is not otherwise a "banking entity" is not subject to the Volcker Rule. However, the Federal Reserve is required to adopt rules regarding capital requirements and quantitative limits with respect to the proprietary trading and fund investment activities of SSNFs. If any divestitures are required in accordance with such rules, an SSNF would have a two-year phase-in period for disposal of the investments (with extensions of up to three years) from the date the firm is designated an SSNF.

Foreign Entities. The Volcker Rule would treat U.S. banking entities – *i.e.,* banking entities owned or controlled by an entity organized under U.S. federal or state law – different from their foreign counterparts, allowing a foreign banking entity with affiliates engaged in U.S. operations to engage abroad both in proprietary trading and in sponsoring or investing in funds, provided that the transactions are solely with non-U.S. residents. U.S. banking entities would have no such authority to engage in these activities abroad.

FSOC Study. Within six months after the Act's enactment, the FSOC is required to conduct a study regarding the limits imposed by the Volcker Rule and provide recommendations on implementing the Volcker Rule's provisions. Within nine months after the FSOC study, the federal banking agencies, the SEC, and the CFTC would be required to adopt coordinated final regulations implementing the Volcker Rule, consistent with the recommendations and modifications of the FSOC.

Effective Dates. The provisions of the Volcker Rule become effective twelve months after the adoption of these coordinated final regulations, but in no case later than two years after enactment of the Act.

Extensions for Existing Investments and Illiquid Funds. Section 619 confers a grandfather period for any required divestitures, allowing a banking entity to retain any impermissible holdings for an

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80 The capital and diversification requirements would apply across the board, to any investment, sponsoring, or proprietary trading activity conducted under Section 619. The same is not true regarding the prudential limitations. The prudential limitations regarding conflicts of interest, high-risk-assets or high-risk trading strategies, safety and soundness, and financial stability, which apply to activities falling under one of the statutory exemptions to the Volcker Rule's general prohibition, do not appear to apply to investments made under the seed money or *de minimis* investing authorities.

additional two years after the effective date, with the possibility of up to three additional one-year extensions granted by the Federal Reserve, either by regulation or by order. In addition, a banking entity may apply for an extension of up to five years for any investment in an "illiquid fund" if "necessary to fulfill a contractual obligation that was in effect on May 1, 2010."[81] It is unclear whether this five-year extension is in addition to, or in lieu of, the two-year grandfather period and/or the three one-year extensions otherwise available. During any transitional period in which impermissible holdings are retained (whether under the initial two-year period, the three one-year extensions, or the one-time five-year extension for investments in illiquid funds), the banking entity is subject to additional capital requirements and other restrictions, to be adopted in the coordinated final regulations.

Affiliate Transaction Restrictions. In addition, the Volcker Rule would impose heightened affiliate transaction restrictions on companies subject to the Volcker Rule (discussed *infra*).

IX. Lending Limits

Expansion of Lending Limits to Credit Substitutes. Section 610 of the Act would amend the national bank lending limits to encompass any direct or indirect advance by the bank pursuant to a repurchase arrangement or any credit exposure resulting from a securities lending, securities borrowing, repo, reverse repo, or derivative transaction. In addition, Section 610 authorizes the OCC to include in the lending limit calculation any "contractual commitments" made by the bank.

State Bank Lending Limits Must Capture Derivatives. Section 611 of the Act forbids any state-chartered bank from engaging in a derivatives transaction unless the applicable state lending limit encompasses derivative transactions to the same extent as under the National Bank Act.[82]

Effective Dates. Sections 610 and 611 would become effective one year and eighteen months, respectively, after the OTS' responsibilities are transferred to the OCC.

X. Affiliate Transactions

Expansion of "Covered Transactions" Definition. The affiliate transaction restrictions in Sections 23A and 23B of the Federal Reserve Act impose quantitative and qualitative limits on bank's "covered transactions" (*i.e.,* extensions of credit to, asset purchases, investments in) and other

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[81] "Illiquid fund" is defined as a fund which, as of May 1, 2010, was principally invested in (or was principally invested in and contractually committed to invest in) illiquid assets "such as portfolio companies, real estate investments, and venture capital investments," and makes all investment pursuant to a strategy to invest in illiquid assets. Further definition of an "illiquid fund" is left to the Federal Reserve rulemaking process.

[82] *See* 12 U.S.C. § 84; 12 C.F.R. Part 32 (limiting national bank loans and extensions of credit to any single borrower to 15% of the bank's capital and surplus, with an additional 10% allowed if appropriately secured).

transactions with the bank's BHC, the bank's subsidiaries, and other companies under common control (such as other nonbank subsidiaries of the BHC)). Section 608 of the Act expands the scope of "covered transactions" subject to the quantitative and qualitative limits of Section 23A.[83] In particular, Section 608 provides that the acceptance of any debt obligation (such as a promissory note or contract) as collateral for a loan with a third party is deemed a covered transaction; current law provides only that accepting "securities" as collateral triggers Section 23A. Section 608 also provides that derivative transactions and transactions involving the borrowing or lending of securities with an affiliate constitute a "covered transaction" if the transaction results in the affiliate having credit exposure to the bank. Currently, only *credit* derivative transactions are deemed to trigger Section 23A.

Repos as Credit Transactions. Section 608 changes the characterization of asset repurchase transactions under Section 23A. While such repo transactions have been subject to Section 23A, they have been considered "asset purchases." Section 608 stipulates that, going forward they are considered "extensions of credit" (rather than asset purchases). As a result, repo transactions will become subject to the collateral requirements of Section 23A, which apply to extensions of credit (but not asset purchases).[84]

Ongoing Collateral Requirements. In addition, Section 608 provides that any collateral requirements must be satisfied on an on-going basis. Currently, the collateral requirements imposed by Section 23A on extensions of credit are calculated only at the transaction's inception and additional collateral is not required (unless the original collateral is retired or amortized).

Section 608 expands the scope of "affiliates" to include any investment fund (registered or otherwise) for which the bank or an affiliate of the bank is acting as an investment adviser. This provision expands existing law, which deems an investment fund to be an affiliate subject to Section 23A only if the bank or affiliate *both sponsors and advises* the fund, or if the bank or an affiliate is acting as a *registered* investment adviser.[85]

Repeal of Partial Fin Sub Exemption. Existing law provides that transactions between a national bank and a "financial subsidiary" – a firewalled subsidiary engaged in securities, insurance, or other

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[83] 'Covered transactions" include an insured bank's loans to an affiliate, purchases of assets from an affiliate, the purchase or investment of securities issued by an affiliate, the acceptance of securities of an affiliate as collateral for a loan to any person, or the issuance of a guarantee, acceptance, or letter of credit to any person on behalf of an affiliate. *See* 12 U.S.C. § 371c(b)(7).

[84] Under Section 23A, covered transactions in the form of extensions of credit must be collateralized in an amount equal to 100% to 130% of the amount of the extension of credit; the exact percentage is determined based on the nature of the collateral. Certain forms of collateral – such as securities issued by an affiliate or any "low quality asset"– are ineligible as collateral under Section 23A.

[85] 12 U.S.C. § 371c(b)(1)(D).

activities impermissible for the bank itself but otherwise deemed financial-in-nature – are exempt from Section 23A's 10% individual quantitative limit on affiliate transactions.[86] Section 609 of the Act repeals this exemption (effective one year after enactment), treating a national bank's financial subsidiary as a nonbank affiliate for all purposes under the affiliate transaction rules.

Section 23A Exemption Orders. Section 608 repeals the Federal Reserve's authority to grant exemptions from 23A by *order*. Section 608 permits the Federal Reserve to grant exemptions by *regulation* only if it notifies the FDIC in advance, and, within 60 days after notification, the FDIC does not object based on its conclusion that the exemption does not pose an unacceptable risk to the Deposit Insurance Fund. The Federal Reserve's authority to grant exemptions by *order* would be transferred to the respective primary federal regulators for the affected bank:

- The FDIC is given the authority to grant exemptions from Section 23A with respect to state non-Member banks and state thrifts, if, after consultation with the Federal Reserve, the exemption is deemed to be in the public interest and the FDIC determines that the exemption does not pose an unacceptable risk to the Deposit Insurance Fund.

- The Federal Reserve maintains the authority to grant exemptions with respect to state Member banks, provided, after consultation with the FDIC, the agencies concur that the exemption is in the public interest, and the FDIC determines that the exemption does not pose an unacceptable risk to the Deposit Insurance Fund.

- The OCC is given similar authority to grant exemptions with respect to national banks and federal thrifts, provided the OCC consults with the Federal Reserve and the agencies concur that the exemption is in the public interest. In addition, the OCC must provide 60 days' advance notice to the FDIC, and, within 60 days after notification, the FDIC does not object based on its conclusion that the exemption does not pose an unacceptable risk to the Deposit Insurance Fund.

Netting Agreements. Section 608 of the Act confers on the Federal Reserve the authority to promulgate regulations or interpretations regarding the treatment of netting agreements under Section 23A. If by interpretation, the Federal Reserve must do so jointly with the appropriate federal banking agency for the impacted bank or affiliate.

Section 23B Exemption Orders. Section 23B of the Federal Reserve Act generally requires that all transactions between a bank and its affiliates (not just "covered transactions") be on arms' length

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[86] *See* 12 U.S.C. § 371c(e)(3).

terms.[87] Under Section 608, the Federal Reserve retains the authority to grant exemptions from Section 23B by regulation, but again, only after notifying the FDIC and subject to the condition that the FDIC does not object within 60 days.

Effective Date. Section 608 would become effective one year after enactment of the Act.

The Volcker Rule. Section 619 – the Volcker Rule – also contains certain affiliate transaction restrictions:

> *Fund Relationships Subject to Covered Transactions Bar.* Section 619 would flatly prohibit any "banking entity" that serves as an investment manager, investment adviser, or sponsor of a hedge fund or private equity fund, or any banking entity that organizes or sponsors a hedge fund or private equity fund under the Volcker Rule's *bona fide* services exemption, or any of such banking entity's affiliates, from engaging a transaction with the fund if the transaction would be considered a "covered transaction" for purposes of Section 23A. For purposes of applying Section 23A, the banking entity or its affiliate would be treated as if it were a "bank", and the fund would treated as if it were an "affiliate." Thus, Section 619 extends the concept of "covered transactions" to arrangements not involving an insured bank, and applies a flat bar (rather than a quantitative limit, as is the normal situation in the case of Section 23A).
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> *Exemption for Prime Brokerage Transactions.* Notwithstanding the foregoing, Section 619 allows a banking entity (or its affiliate) to enter into "prime brokerage transactions"[88] with such a hedge fund or private equity fund, provided that the banking entity otherwise is in compliance with the conditions of the *bona fide* services exemption, the CEO of the banking entity annually certifies in writing that the banking entity has not guaranteed the obligations or performance of the fund (as is prohibited by the *bona fide* services exemption), and the Federal Reserve has determined that the provision of prime brokerage services to the fund would be consistent with safety and soundness.[89]

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[87] 12 U.S.C. § 371c-1.

[88] "Prime brokerage transaction" is not defined in the Act.

[89] This aspect of the Volcker Rule is somewhat poorly drafted. By its terms, the prime brokerage exemption applies to a variety of arrangements in which the banking entity is an investment adviser, manager, sponsor, or investor, and not just those arrangements in which the fund is organized or sponsored under the *bona fide* services exemption to the Volcker Rule. Thus, it is unclear whether the references were meant to extend certain elements of the *bona fide* services exemption to <u>all</u> arrangements in which prime brokerage services are offered, or instead only to those arrangements in which prime brokerage services are offered to a fund that is organized or sponsored by the banking entity under the *bona fide* services exemption.

All Transactions Must be at Arms' Length. In addition, under Section 619, *all* transactions between such entities would be subject to the arms' length requirements of Section 23B, including transactions between such entities made under the prime brokerage services exception discussed above.

XI. Insider Transactions

Credit Substitute Transactions Subject to Insider Transaction Restrictions. The insider restrictions of Section 22 of the Federal Reserve Act regulates a bank's asset purchases from its directors and a bank's loans to its insiders – its directors, executive officers, and 10% shareholders.[90] Existing law imposes quantitative and qualitative limits, as well as corporate governance requirements, on bank extensions of credit to insiders – *i.e.*, its directors, executive officers, and 10% shareholders. Section 614 provides that credit exposures resulting from derivative, repo, reverse repo, securities lending, or securities borrowing transaction are considered extension of credit for purposes of these insider lending limits.[91]

Extension of Section 375 to All Banks. Section 615 of the Act extends to *all* FDIC-insured banks and thrifts the restriction on asset and security purchases from, and sales to, directors; the current restriction is applicable to only state Member banks and national banks.[92] In addition, Section 615 of the Act expands the restriction to encompass transactions not only with directors but also with executive officers and 10% shareholders.

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

Scott Cammarn	+1 704 348 5363	scott.cammarn@cwt.com
Steven Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Maurine Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
Bryan Shipp	+1 212 504 5615	bryan.shipp@cwt.com

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90 *See* 12 U.S.C. §§ 375, 375a & ; 12 U.S.C. § 375b.

91 *See* 12 U.S.C. §§ 375a & 375b.

92 *See* 12 U.S.C. § 375.