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DODD-FRANK CONSUMER PROTECTION AND WALL STREET REFORM ACT

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was enacted into law on July 21, 2010. The new law addresses perceived gaps and weaknesses in the financial regulatory system that caused or contributed to the financial crisis of 2007-2009—often said to be the worst financial crisis since the Great Depression. The Act resulted from lengthy Congressional deliberations on how to prevent such a crisis from ever happening again and adopts sweeping reforms on a scale not seen since the early 1930's.

Many of the Act's provisions will change the way bank holding companies and their affiliates are regulated by the Federal Reserve Board under the Bank Holding Company Act. In addition, the new law subjects new types of financial organizations to Board supervision and regulation and greatly expands the Board's responsibility for oversight of the financial system as a whole.

As a result of the Dodd-Frank Act, the Bank Holding Company Act will touch every systemically important financial institution operating in the United States. The BHC Act already comprehensively regulates bank holding companies and gives the Federal Reserve substantial supervisory authority over their activities and operations. The Dodd-Frank Act expands the Board's authority further and extends key provisions of the BHC Act to financial companies not traditionally subject to bank holding company regulation. Nonbank financial companies also will be subject to significant regulation by the Board outside the BHC Act framework.

A forthcoming new edition of my treatise on ***Federal Bank Holding Company Law*** will provide in-depth analysis of the Dodd-Frank Act and the numerous rulemakings required by the law as they unfold in the months and years ahead. Pending publication of the new edition, the attached summary highlights important provisions of the Dodd-Frank Act as they affect bank holding companies and other financial companies.

I. OVERVIEW 1

II. FINANCIAL STABILITY OVERSIGHT COUNCIL 2
- A. Purposes and Duties of the Council 3
- B. Designation of Nonbank Financial Companies 5
- C. Definition of "Nonbank Financial Company" 7
- D. Recommendations for "More Stringent" Supervision 8
- E. Differentiation Among Companies 8
- F. Regulation of Financial Activities 8
- G. Reporting Requirements 8

III. "MORE STRINGENT" PRUDENTIAL STANDARDS 9
- A. Liquidity Requirements 10
- B. Risk Management Requirements 10
- C. Requirement for Risk Committee 10
- D. Stress Tests 11
- E. Examinations and Reports 11
- F. Limits on Concentration and Credit Exposures 11
- G. Enhanced Public Disclosures 12
- H. Limits on Short-Term Debt 12
- I. Leverage Limits 12
- J. Off-Balance Sheet Activities 12
- K. Enforcement 13
- L. Resolution Plans 13
- M. Early Remediation of Financial Distress 13
- N. Intermediate Holding Companies 14
- O. Limits on Transactions with Affiliates 14
- P. Limitations on Activities 14
- Q. Acquisitions of Banks 15
- R. Prior Review of Acquisitions 15
- S. Prohibition Against Management Interlocks 15

IV. ENHANCED FEDERAL RESERVE SUPERVISORY POWERS 15

V. OTHER AMENDMENTS AFFECTING BHCS 17
- A. Additional Approval Factors 17
- B. Concentration Limits 18
- C. Prior Approval for Large Acquisitions 18
- D. Well-Capitalized and Well-Managed Requirement 18
- E. New Supervisory Fees and Assessments 19
- F. Source of Strength Requirement 19
- G. Limits on Companies That Cease To Be BHCs 19

H. **Moratorium on Nonbank Banks** 20

VI. CAPITAL REQUIREMENTS 20
A. **Countercyclical Capital Rules** 20
B. **Risk-Based Capital and Leverage Limits** 21
C. **Minimum Leverage and Activity Risk Capital** 21
D. **Contingent Capital** 22

VII. LIMITS ON PROPRIETARY TRADING AND HEDGE FUNDS 23

VIII. SAVINGS AND LOAN HOLDING COMPANIES 24

IX. SECURITIES HOLDING COMPANIES 26

X. RESOLUTION PROCESS FOR FINANCIAL COMPANIES 26

I. OVERVIEW

The Dodd-Frank Act includes the following key provisions affecting bank holding companies and nonbank financial firms:

Bank holding companies with total consolidated assets of $50 billion or more are subject to more stringent prudential standards, including increased capital and liquidity standards, credit concentration limits, leverage limits, risk controls, and other standards.

Nonbank financial companies that meet certain criteria are subject to similar prudential standards and oversight by the Federal Reserve Board.

S&L holding companies are subject to Federal Reserve supervision and regulation under the BHC Act.

Limits on the Board's supervision of functionally regulated subsidiaries of bank holding companies (e.g., securities firms and insurance companies) are modified or eliminated.

A new entity called a "securities holding company" is created under the BHC Act and subjected to Board supervision.

New concentration limits on mergers and acquisitions are established under the BHC Act.

Restrictions on proprietary trading by bank holding companies and Board-supervised nonbank financial companies are mandated.

Certain companies that cease to be bank holding companies will be subject to continued restrictions under the BHC Act.

A 3-year moratorium is imposed on new applications for FDIC insurance by industrial banks, credit card banks, and trust banks exempt from the definition of "bank" under the BHC Act if they are directly or indirectly owned or controlled by a commercial firm.

In addition to the above reforms, the Dodd-Frank Act significantly modifies the financial regulatory architecture. Among other things, the Office of Thrift Supervision is abolished and its functions are transferred to the Office of the Comptroller of the Currency and the Federal Reserve Board. The SEC's supervisory functions are diminished but its investor protection and enforcement roles are significantly enhanced. A new Bureau of Consumer Protection is created. The FDIC is given resolution authority for the orderly liquidation of bank holding companies and other financial companies.

Potentially the biggest change in the regulatory landscape affecting bank holding company regulation is the creation of a new Financial Stability Oversight Council. Many of the reforms in the Dodd-Frank Act will occur under the oversight of this new interagency body. The Council's principal regulatory function is to designate nonbank financial companies for supervision by the Federal Reserve Board and to make recommendations for enhanced prudential standards applicable to such companies as well as large, interconnected bank holding companies. The Council also will act in a non-regulatory capacity gathering information, reporting to Congress, and making recommendations on supervisory and regulatory matters of systemic concern.

The Dodd-Frank Act calls for numerous rulemakings, studies and reports on regulatory matters where Congress elected not to prescribe specific statutory provisions. The outcome of these rulemakings and related activities likely will result in additional reforms and clarifications that could further alter the regulatory framework for bank holding companies and other financial companies.

These and other provisions of the Dodd-Frank Act will be analyzed in detail in a forthcoming new edition of ***Federal Bank Holding Company Law.*** The following summary highlights certain of the Act's provisions that will affect bank holding companies and their affiliates going forward.

II. FINANCIAL STABILITY OVERSIGHT COUNCIL

Title I of the Act, titled the "Financial Stability Act of 2010," creates a Financial Stability Oversight Council comprised of the following as voting members:

- Secretary of the Treasury (designated as Council chairman)
- Chairman of the Federal Reserve Board
- Comptroller of the Currency
- Chairman of the Securities and Exchange Commission

- Director of the Bureau of Consumer Protection
- Chairman of the Federal Trade Commission
- Chairman of the Federal Deposit Insurance Corporation
- Chairman of the Commodity Futures Trading Commission
- Chairman of the National Credit Union Administration
- Director of the Federal Housing Agency, and
- An independent member having insurance expertise and appointed by the President.

The Council also will have nonvoting members, including state securities and insurance commissioners and banking supervisors. The Council is authorized to appoint special advisory, technical, or professional committees and is required to meet at least quarterly.

A. Purposes and Duties of the Council

The purposes of the Council are the following:

- To identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;

- To promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and

- To respond to emerging threats to the stability of the United States financial system.

The duties of the Council are non-regulatory in nature and include the following:

- To collect information and assess risks to the United States financial system;

- To provide direction to a new Office of Financial Research;

- To monitor the financial services marketplace in order to identify potential threats to the financial stability of the United States;

- To monitor domestic and international financial regulatory proposals and developments and to make recommendations to enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets;

- To facilitate information sharing and coordination among the financial regulatory agencies regarding policy, rulemaking, examinations, reporting requirements, and enforcement actions;

- To recommend general supervisory priorities and principles;

- To identify gaps in regulation that could pose risks to financial stability;

- To require supervision by the Federal Reserve Board for nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure or because of their activities;

- To make recommendations to the Federal Reserve Board concerning the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies;

- To identify systemically important financial market utilities and payment, clearing and settlement activities;

- To make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or

other problems spreading among bank holding companies, nonbank financial companies, and U.S. financial markets;

- To review and submit comments to the SEC and any standard-setting body with respect to accounting principles, standards, or procedures;

- To provide a forum for discussion and analysis of emerging market developments and financial regulatory issues and resolution of jurisdictional disputes; and

- To report annually to Congress on its activities, significant financial market and regulatory developments, and potential emerging threats to the financial stability of the United States.

B. Designation of Nonbank Financial Companies

A key responsibility of the Financial Stability Oversight Council is to designate nonbank financial companies that shall be subject to supervision and regulation by the Federal Reserve Board.

By a 2/3's vote, the Council is authorized to determine that a U.S. nonbank financial company shall be supervised by the Federal Reserve Board and shall be subject to prudential standards imposed by the Board. Any such determination must be based on a finding by the Council that material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities, could pose a threat to the financial stability of the United States.

The language of the Act appears to contemplate that the determination will be made on a company-by-company basis rather than by industry sector or class of institutions. The Council would not necessarily be precluded from making categorical determinations, however, based on a tailoring of the relevant criteria to like-institutions in particular industry sectors.

In making such a determination, the Council is required to consider the following factors:

- The extent of the leverage of the company;
- The extent and nature of the company's off-balance sheet exposures;
- The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- The importance of the company as a source of credit for households, business, and state and local governments and as a source of liquidity for the United States financial system;
- The importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
- The extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the company's activities;
- The degree to which the company is already regulated by one or more primary financial regulatory agencies;
- The amount and nature of the financial assets of the company;
- The amount and types of liabilities of the company, including the degree of reliance on short-term funding; and
- Any other risk-related factors that the Council deems appropriate.

If the Council is unable to determine whether the financial activities of a nonbank financial company pose a threat to the financial stability of the United States, the Council may request the Federal Reserve Board to conduct an

examination of the company for the purpose of determining whether the company should be supervised by the Board.

If the Council determines that a nonbank financial company should be subject to Board supervision under the Act, the company is entitled to an opportunity for a hearing to dispute the determination. Judicial review is available but is limited to whether the determination was arbitrary and capricious.

If the Council determines that a nonbank financial company meets the test for supervision by the Federal Reserve Board, the company then must register with the Board and becomes subject to enhanced supervision and prudential standards.

The Act requires the Federal Reserve Board to promulgate regulations setting forth criteria for exempting certain types or classes of nonbank financial companies from supervision by the Board. In developing the relevant criteria, the Board is required to take into account the statutory factors used by the Council in determining whether a nonbank financial company should be Board supervised.

C. Definition of "Nonbank Financial Company"

A "nonbank financial company" is defined to mean, with certain exceptions, a company that is "predominantly engaged in financial activities."[1] A company is "predominantly engaged in financial activities" if:

> the annual gross revenues derived by the company and all of its subsidiaries from activities that are "financial in nature" (as defined in the Bank Holding Company Act) represents 85 percent or more of the company's consolidated annual gross revenues, or
>
> the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature represents 85 percent or more of the company's consolidated assets.

The Federal Reserve Board is required to adopt regulations establishing requirements for determining if a company is predominantly engaged in financial activities.

[1] Exempt companies include bank holding companies, securities exchanges and clearing agencies, and Farm Credit System institutions.

D. Recommendations for "More Stringent" Supervision

The Council may make recommendations for "more stringent" supervision of Board-supervised nonbank financial companies and large, interconnected bank holding companies "in order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, failure, or ongoing activities of large, interconnected financial institutions." The Council's recommendations may include risk-based capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure reporting requirements, concentration limits, a contingent capital requirement, enhanced public disclosures, short-term debt limits, and overall risk management requirements.

E. Differentiation Among Companies

The Council may differentiate among companies on an individual or category basis, taking into consideration their capital structure, riskiness, complexity, financial activities (including activities of their subsidiaries), size, and any other risk-related factors the Council deems appropriate.

The Council may recommend an asset threshold higher than $50 billion for the application of any prudential standard and may adapt its recommendations as appropriate "in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate."

F. Regulation of Financial Activities

The Council may recommend that that the primary financial regulatory agencies apply new or heightened standards and safeguards to financial activities conducted by institutions under their supervision. Each primary agency must impose the standards recommended by the Council or explain in writing why it has determined not to do so.

G. Reporting Requirements

The Act creates an Office of Financial Research to collect and analyze data for the Council through a Data Center and Research and Analysis Center. The Office may require the submission of periodic and other reports from any financial company for the purpose of assessing the extent to which a financial activity or financial market in which the financial company participates, or the

financial company itself, poses a threat to the financial stability of the United States. The Office may not publish any confidential information.

The Office will be funded by assessments imposed on bank holding companies with total assets of $50 billion or more and nonbank financial companies supervised by the Federal Reserve Board.

The Council, acting through the Office of Financial Research, may require a Board-supervised nonbank financial company or a bank holding company with total assets of $50 billion or more to submit certified reports on the company's financial condition, risk controls, transactions with depository institution subsidiaries, and the extent to which its activities could potentially disrupt financial markets or affect the overall financial stability of the United States. The Council must rely to the fullest extent possible on reports that these companies already are required to file with federal regulators and externally audited financial statements.

III. "More Stringent" Prudential Standards

The Federal Reserve Board is required to establish prudential standards for bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies that have been designated by the Council for Board supervision. The prudential standards must be "more stringent" than normally applicable standards and must increase in stringency with increased risk levels. Approximately 36 bank holding companies had $50 billion in total consolidated assets as of March 31, 2010 and thus would be subject to the enhanced prudential standards. (These bank holding companies are referred to herein as "mega" bank holding companies.)

The Board also is authorized in its discretion to establish enhanced public disclosure requirements, short-term debt limits, and such other prudential standards as the Board deems appropriate.

In prescribing more stringent prudential standards for nonbank financial companies, the Board is authorized to differentiate among companies on an individual or category basis, taking into consideration capital structure, riskiness, complexity, financial activities, size, and other risk-related factors. The Board may establish an asset threshold above $50 billion for the application of enhanced prudential standards.

The Board also is required to take into account differences among Board-supervised nonbank financial companies and large bank holding companies,

including the factors that are used to determine whether a nonbank financial company should be Board supervised. The Board also is required to adapt the required standards "as appropriate in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate."

Before imposing prudential standards, the Board is required to consult with the primary supervisor for a nonbank financial company that is a "functionally regulated subsidiary" of a nonbank financial company. That would be the Securities and Exchange Commission in the case of a securities broker-dealer, for example, or the appropriate state insurance commissioner for an insurance company.

The legal authority for the enhanced prudential standards is the Dodd-Frank Act itself and not the BHC Act, making it uncertain whether the new standards will be imposed on mega bank holding companies under Regulation Y implementing the BHC Act or under a new regulation adopted by the Board to be applicable to both mega bank holding companies and Board-supervised nonbank financial companies.

A. Liquidity Requirements

The Board is required to adopt liquidity requirements for mega bank holding companies and Board-supervised nonbank financial companies. The Act does not specify what these requirements shall consist of.

B. Risk Management Requirements

The Board is required to adopt "overall risk management" requirements for mega bank holding companies and Board-supervised nonbank financial companies. The Act does not specify what such requirements shall consist of. As noted *infra*, each mega bank holding company and Board-supervised nonbank financial company is required to establish a risk management committee.

C. Requirement for Risk Committee

Each Board-supervised nonbank financial company that is a publicly-traded company and each bank holding company that has total consolidated assets of $10 billion or more and is publicly-traded is required to establish a risk committee responsible for the oversight of enterprise-wide risk management practices of the nonbank or bank holding company. The committee must have independent directors and include at least one management expert having

experience in identifying, assessing, and managing risk exposures of large, complex firms.

D. Stress Tests

The Board is required to conduct annual stress tests of each mega bank holding company and Board-supervised nonbank financial company to determine whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. Each such company is required to conduct its own semiannual stress tests. All other financial companies (including securities firms and insurance companies) that have total consolidated assets of $10 billion or more and are regulated by a primary federal financial regulatory agency are required to conduct annual stress tests.

E. Examinations and Reports

The Board may examine any nonbank financial company supervised by it to determine the nature of the operations and financial condition of the company or any of its subsidiaries, the company's financial and other risks that may pose a threat to the safety and soundness of the company or its subsidiaries, the systems for monitoring and controlling such risks, and the company's state of compliance. The Board is required to rely to the fullest extent possible on existing examinations by the company's primary regulator.

The Board may require each nonbank financial company to submit reports under oath concerning the company's financial condition, risk monitoring and control systems, the extent to which its activities pose a threat to the financial stability of the United States, and its state of compliance. The Board must use existing regulatory reports to the fullest extent possible.

Each Board-supervised nonbank financial company and mega bank holding company is required to report to the Board, the Council, and the FDIC on the nature and extent to which the company has credit exposure to other significant nonbank financial companies and significant bank holding companies, and the nature and extent to which other significant nonbank financial companies and bank holding companies have credit exposure to it.

F. Limits on Concentration and Credit Exposures

The Board is required to prescribe standards to limit the risks that the failure of any individual company could pose to a mega bank holding company or Board-supervised nonbank financial company. Such standards must prohibit each

mega bank holding company or Board-supervised nonbank financial company from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus (or lower amount as determined by the Board) of the company. "Credit exposure" includes all extensions of credit to the company, including loans, deposits, and lines of credit; repurchase agreements and reverse repurchase agreements, securities borrowing and lending; guarantees, acceptances, or letter of credits; all purchases of or investment in securities issued by the company; counterparty credit exposure in connection with derivative transactions; and any other similar transactions.

G. Enhanced Public Disclosures

The Board is authorized to adopt rules prescribing disclosures by mega bank holding companies and Board-supervised nonbank financial companies in order to support market evaluation of the risk profile, capital adequacy, and risk management capabilities thereof.

H. Limits on Short-Term Debt

The Board also may adopt rules limiting the amount of short-term debt, including off-balance sheet exposures, that may be accumulated by any mega bank holding company or Board-supervised nonbank financial company. Any such limit must be based on short-term debt as a percentage of a company's capital stock and surplus.

I. Leverage Limits

The Board is required to impose leverage limits under which a mega bank holding company or Board-supervised nonbank financial company will be required to maintain a debt to equity ratio of no more than 15 to 1, if the Council determines that the company poses a "grave threat" to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk such company poses to the financial stability of the United States.

J. Off-Balance Sheet Activities

The Dodd-Frank Act requires that, for purposes of meeting applicable capital requirements, a mega bank holding company or Board-supervised nonbank financial company must take into account off-balance sheet activities, including direct credit substitutes, irrevocable letter of credits, 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, and securities contracts.

K. Enforcement

Board-supervised nonbank financial companies are treated as if they were bank holding companies for purposes of the enforcement tools available to the Board pursuant to 12 U.S.C. § 1818. That section authorizes the Board to issue cease and desist orders, impose civil money penalties, and take other enforcement action to forestall unsafe and unsound practices. In the case of a functionally regulated subsidiary, the Board is required first to recommend that the primary financial regulatory agency initiate supervisory action and may itself do so if the primary regulator does not act within 60 days.

L. Resolution Plans

Each mega bank holding company and Board-supervised nonbank financial company is required to prepare and report to the Board, the Council and the FDIC a plan for the company's rapid and orderly resolution in the event of its material financial distress or failure (a "living will"). The plan must include information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of the company or its nonbank subsidiaries and a full description of the ownership structure, assets, liabilities, and contractual obligations of the company. The plan also must identify any cross-guarantees tied to different securities and major counterparties and describe a process for determining to whom the collateral of the company is pledged.

If the resolution plan is deemed to be not credible or would not facilitate an orderly resolution of the company, the Board may impose more stringent requirements on the company and may require divestiture of assets or operations.

M. Early Remediation of Financial Distress

The Board is required to prescribe regulations establishing requirements for early remediation of financial distress of a mega bank holding company or Board-supervised nonbank financial company, other than financial assistance from the government. The regulations must establish a series of specific remedial actions to be taken by a distressed company in order to minimize the probability that the company will become insolvent and the potential harm of such insolvency to the financial stability of the United States.

N. Intermediate Holding Companies

Board-supervised nonbank financial companies are not subject to the limitations on nonfinancial activities in section 4 of the BHC Act. If such a company engages in nonfinancial activities, the Board may require the company to establish and conduct all or a portion of its permissible financial activities in or through an intermediate holding company. The Board also may require any Board-supervised nonbank financial company to establish an intermediate holding company if the Board determines it necessary for appropriate supervision of the company's financial activities or to ensure that Board supervision does not extend to the commercial activities of the nonbank company. The Board is required to promulgate regulations to establish criteria for determining when intermediate holding companies will be required.

A company that directly or indirectly controls an intermediate holding company is required to serve as a source of strength to its subsidiary intermediate holding company. The Board may require reports from the parent company of an intermediate holding company solely for purposes of assessing the company's ability to serve as a source of strength to its subsidiary and to enforce compliance.

O. Limits on Transactions with Affiliates

The Board may promulgate regulations to establish any restrictions or limitations on transactions between an intermediate holding company and its affiliates, or a Board-supervised nonbank financial company and its affiliates, as necessary to prevent unsafe and unsound practices. Such regulations may not restrict or limit any transaction in connection with the bona fide acquisition or lease by an unaffiliated person of assets, goods, or services.

P. Limitations on Activities

If the Board determines that a mega bank holding company or Board-supervised nonbank financial company poses a "grave threat" to the financial stability of the United States, the Board may, after a 2/3 vote by the Council, limit the ability of the company to merge with another company, restrict its ability to offer a financial product, require the company to terminate activities, impose conditions, or require the company to sell or transfer assets or off-balance sheet items.

Q. Acquisitions of Banks

A Board-supervised nonbank financial company is treated as a bank holding company for purposes of section 3 of the BHC Act. Consequently, such a company must obtain prior Board approval before acquiring 5 percent or more of the voting shares of a bank (as opposed to 25 percent under prior law). A practical effect of this requirement is that the Change in Bank Control Act will no longer apply to such transactions.

R. Prior Review of Acquisitions

With respect to activities of the type permissible under section 4(k) of the BHC Act (i.e., nearly all financial activities), a mega bank holding company or Board-supervised nonbank financial company is required to provide written notice to the Board before acquiring any voting shares of any company engaged in such activities having total assets of $10 billion or more. The Board is required to review the extent to which the proposed acquisition would result in greater or more concentrated risks to global or U.S. financial stability or the U.S. economy.

This requirement does not apply to the acquisition of voting shares in connection with securities underwriting and dealing activities or if the acquisition of shares would be permissible for a national bank or bank holding company without notice (e.g., acquisitions of less than 5 percent of voting shares of a company).

S. Prohibition Against Management Interlocks

A nonbank financial company supervised by the Board is treated as a bank holding company for purposes of the Depository Institution Management Interlocks Act. No interlocks will be permitted between Board-supervised nonbank financial companies and bank holding companies with $50 billion in assets or more.

IV. ENHANCED FEDERAL RESERVE SUPERVISORY POWERS

The Dodd-Frank Act requires that one of the seven Board members be designated as "Vice Chairman for Supervision." This vice chairman is to be responsible for developing policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board, and overseeing the supervision and regulation of such firms.

In addition to authorizing the Federal Reserve Board to establish more stringent prudential standards for mega bank holding companies and Board supervised nonbank companies, the Dodd-Frank Act enhances the Board's general supervisory authority under the BHC Act.

The Board's examination authority under the BHC Act is significantly broadened and previous limitations on the scope of its examinations are eliminated. The Board may examine any bank holding company and any of its subsidiaries in order to inform the Board of the nature of the operations and financial condition of the company and subsidiaries; the financial, operational, and other risks within the bank holding company system that may pose a threat to the safety and soundness of the company or of any depository institution subsidiary thereof *or the stability of the financial system*; and the bank holding company's internal systems for monitoring and controlling such risks.

The Board also may use the examination process to monitor the compliance of a bank holding company and its subsidiaries with the BHC Act, federal laws that the Board has specific jurisdiction to enforce against the company or subsidiary, and (other than in the case of an insured depository institution or functionally regulated subsidiary), any other applicable provisions of federal law. The Board is required to rely to the fullest extent possible on examination reports made by other federal or state regulators.

The Gramm-Leach-Bliley Act imposed restrictions on the Board's authority to supervise "functionally regulated subsidiaries" of bank holding companies—i.e., securities and insurance subsidiaries for which the SEC or state insurance commissioners are the primary regulators. The Dodd-Frank Act removes many of these restrictions. For example, under the Gramm-Leach-Bliley Act, the Board was authorized to examine a functionally regulated subsidiary only if the Board had reasonable cause to believe that the subsidiary was engaged in activities that posed a material risk to an affiliated depository institution. This limitation has been repealed. Before examining a functionally regulated subsidiary, however, the Board is required to provide reasonable notice to and consult with the primary regulator of the subsidiary and avoid duplication of examinations.

The Dodd-Frank Act also repeals section 10A of the BHC Act which had limited the Board's direct and indirect rulemaking and enforcement authority over functionally regulated subsidiaries. Formerly, section 10A provided that the Board could not prescribe regulations, issue or seek entry of orders, impose restraints, restrictions, guidelines, requirements, safeguards, or standards, or otherwise take any action under or pursuant to any provision of the BHC Act or

12 U.S.C. § 1818 with respect to a functionally regulated subsidiary of a bank holding company, unless certain conditions were met. Among other things, the Board's action had to be necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty by such subsidiary that posed a material risk to the financial safety, soundness, or stability of an affiliated depository institution, or the domestic or international payment system. These limitations on the Board's authority have been eliminated. The Board is not required to consult with the primary regulator of a functionally regulated subsidiary before taking enforcement action or adopting a prudential regulation, guideline, or standard (except in the case of a more stringent prudential standard applied to a mega bank holding company or Board supervised nonbank financial company).

The Dodd-Frank Act also authorizes and requires the Board to examine the activities of nonbank subsidiaries of bank holding companies engaged in certain bank-permissible activities (e.g., mortgage banking), with back-up examination and enforcement authority for the primary regulator of the company's lead bank.

V. OTHER AMENDMENTS AFFECTING BHCS

In addition to strengthening the Board's supervisory and regulatory authority, the Dodd-Frank Act makes other amendments to the BHC Act and other laws affecting bank holding companies and financial companies.

A. Additional Approval Factors

Among other things, in reviewing an application by a bank holding company to acquire an additional bank under section 3(c), the Board is required to take into consideration "the extent to which a proposed acquisition, merger, or consolidation would result in greater or more concentrated risks to the stability of the United States banking or financial system."

In considering proposals by bank holding companies to engage in activities of a financial nature under section 4(j), the Board is required to take into consideration, in addition to the existing criteria, whether performance of the activity by the bank holding company can reasonably be expected to produce public benefits that are outweighed by "risk to the stability of the United States banking or financial system."

B. Concentration Limits

The Dodd-Frank Act amends the BHC Act to provide that a financial company may not merge or consolidate with another company if the total consolidated liabilities of the acquiring financial company upon consummation would exceed 10 percent of the aggregate consolidated liabilities of all financial companies. This limit applies to mergers among depository institutions, companies that control depository institutions, Board-supervised nonbank financial companies, and foreign banks with respect to their U.S. liabilities.

The concentration limit is based not on deposits but "liabilities" defined to mean (for a U.S. firm) the total risk-weighted assets of the financial company, as determined under the risk-based capital rules applicable to bank holding companies (as adjusted to reflect exposures that are deducted from regulatory capital) less the total regulatory capital of the financial company under the risk-based capital rules applicable to bank holding companies. A definition to be determined by Board regulation will apply to foreign companies, insurance companies, and Board-supervised nonbank financial companies.

The concentration limit generally will not apply to acquisitions of banks in danger of default, FDIC-assisted acquisitions, or acquisitions that would result in a *de minimis* increase in the liabilities of the financial company.

The Council is required to complete a study and make recommendations concerning the extent to which the concentration limit would affect financial stability, moral hazard in the financial system, the efficiency and competitiveness of U.S. financial firms and financial markets, and the cost and availability of credit and other financial services to households and businesses in the United States.

C. Prior Approval for Large Acquisitions

The Dodd-Frank Act further amends the BHC Act to provide that a financial holding company must obtain Board approval before acquiring a company engaged in financial activities under section 4(k) in any transaction in which the total consolidated assets to be acquired exceed $10 billion.

D. Well-Capitalized and Well-Managed Requirement

The BHC Act is further amended to require a bank holding company that elects to become a financial holding company to remain well-capitalized and well-managed. Currently, this requirements applies only to a bank holding

company's subsidiary depository institutions. The Dodd-Frank Act also adds a requirement that a bank holding company seeking to acquire shares of a bank located outside of the company's home state must be well-capitalized and well-managed.

E. New Supervisory Fees and Assessments

The Dodd-Frank Act amends the Federal Reserve Act to require the Board to collect a total amount of assessments, fees, or other charges from mega bank holding companies, S&L holding companies, and Board-supervised nonbank financial companies that is equal to the total expenses the Board estimates are necessary or appropriate to carry out its supervisory and regulatory responsibilities with respect to such companies.

F. Source of Strength Requirement

The Federal Deposit Insurance Act is amended to obligate the Federal Reserve Board to require bank holding companies and savings and loan holding companies to serve as a source of financial strength for any of their depository institution subsidiaries. The Board is authorized to require such a company to submit reports for the purpose of assessing the ability of the company to comply with the source of strength requirement and enforcing compliance with the requirement. The term "source of financial strength" is defined to mean the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to the institution in the event of the institution's "financial distress."

G. Limits on Companies That Cease To Be BHCs

The Act limits the ability of certain bank holding companies to avoid continued supervision by the Federal Reserve Board. The limits apply to any company that was a bank holding company with total consolidated assets of $50 billion or more as of January 1, 2010, and that received financial assistance under the Capital Purchase Program established pursuant to the Troubled Asset Relief Program (TARP) authorized by the Emergency Economic Stabilization Act of 2008. Such companies could include Goldman Sachs and Morgan Stanley, for example, but apparently not Merrill Lynch inasmuch as it did not become a bank holding company but rather a subsidiary of a bank holding company.

Any such company that ceases to be a bank holding company, and any successor company, will be treated as a Board-supervised nonbank financial company. The company may appeal its treatment as such with the Financial

Stability Oversight Council. If the Council denies the appeal, the Council is required to review its determination annually, suggesting that Congress did not intend the restriction to be perpetual.

H. Moratorium on Nonbank Banks

The Dodd-Frank Act imposes a 3-year moratorium on new applications for FDIC insurance and Change in Bank Control Act notices for industrial banks, credit card banks, and trust banks that are exempt from the definition of "bank" under the BHC Act and owned by a commercial firm.

A company is a "commercial firm" if the annual gross revenues derived by the company and all of its affiliates from activities that are financial in nature represent less than 15 percent of the consolidated annual gross revenues of the company.

The Government Accountability Office is required to conduct a study to determine whether it is necessary, in order to strengthen the safety and soundness of institutions or the stability of the financial system, to eliminate the exemptions for nonbank banks—including savings associations—under the BHC Act. With respect to savings associations, the GAO is required to determine the adequacy of the federal bank regulatory framework applicable to such institutions and evaluate the potential consequences of subjecting such institutions to the requirements of the BHC Act, including with respect to the availability and allocation of credit, the stability of the financial system and the economy, the safe and sound operation of such institutions, and the impact on the types of activities in which such institutions and their holding companies may engage.

VI. CAPITAL REQUIREMENTS

A. Countercyclical Capital Rules

The Dodd-Frank Act amends the BHC Act to specifically authorize the Board to issue orders and regulations relating to bank holding company capital requirements. The Board previously did not have such explicit authority. In adopting such rules, the Board is required to make the capital requirements countercyclical so that the amount of required capital increases in times of economic expansion and decreases in times of economic contraction, consistent with the company's safety and soundness.

B. Risk-Based Capital and Leverage Limits

The Board is required to establish risk-based capital requirements and leverage limits for mega bank holding companies and Board-supervised nonbank financial companies unless the Board determines that such requirements are "not appropriate" for a company because of the structure or activities of such company "such as investment company activities or assets under management." If the Board determines not to impose such requirements, the Board nevertheless must apply "other" standards that result in "similarly stringent risk controls." The Act does not elaborate on what "other" standards the Board is required to apply that would result in similarly stringent risk controls.

C. Minimum Leverage and Activity Risk Capital

The Act also requires the Board and other federal banking agencies (FDIC and OCC) to establish minimum leverage capital requirements and risk-based capital requirements applicable on a consolidated basis to depository institutions, depository institution holding companies, and Board-supervised nonbank financial companies. The minimum requirements may not be less than the pre-existing leverage and risk-based capital requirements generally applicable to banks. Trust preferred and cumulative preferred securities are excluded from Tier 1 capital.

In addition, the banking agencies are required to develop capital requirements for depository institutions, depository institution holding companies, and Board-supervised nonbank financial companies that address "the risks that the activities of such institutions pose, not only to the institution engaging in the activity, but to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity." The rules must address at a minimum risks arising from significant derivatives activities, securitized products purchased and sold, securities borrowing and lending, and repurchase agreements and reverse repurchase agreements; concentrations in assets for which the values presented in financial reports are based on models rather than historical cost or prices deriving from deep and liquid two-way markets; and concentrations in market share for any activity that would substantially disrupt financial markets if the institution is forced to unexpectedly case the activity.

It is unclear how these capital requirements will be reconciled with the other mandated capital requirements. It also is unclear how they will apply to Board supervised nonbank financial companies. The literal language of the Act appears to require the agencies to act jointly in establishing the capital rules

without differentiating among depository institutions, bank holding companies, and nonbank financial companies.

It also is unclear how the capital mandates of the Dodd-Frank Act will relate to the proposed changes in the Basel capital framework currently under consideration.

D. Contingent Capital

The Financial Stability Oversight Council is required to conduct a study of the feasibility, benefits, costs, and structure of a contingent capital requirement for Board-supervised nonbank financial companies and large bank holding companies. The study must include:

- An evaluation of the degree to which such requirement would enhance the safety and soundness of companies subject to the requirement, promote financial stability, and reduce risks to U.S. taxpayers;

- An evaluation of the characteristics and amount of contingent capital that should be required;

- An analysis of potential prudential standards that should be used to determine whether the contingent capital of a company would be converted to equity in times of financial stress;

- an evaluation of the costs to companies, the effects on the structure and operation of credit and other financial markets, and other economic effects of requiring contingent capital;

- an evaluation of the effects of such requirement on the international competitiveness of companies subject to the requirement and the prospects for international coordination in establishing such requirement; and

- recommendations for implementing regulations.

The Council may recommend that the Board require any Board-supervised nonbank financial company or large bank holding company to maintain a minimum amount of contingent capital that is convertible to equity in times of

financial stress. In adopting any contingent capital requirement, the Board is required to consider the results of the Council's study and other factors.

In addition, the Comptroller General, in consultation with the banking agencies, is required to study the use of hybrid capital instruments as a component of Tier 1 capital for banks and bank holding companies.

VII. LIMITS ON PROPRIETARY TRADING AND HEDGE FUNDS

The Dodd-Frank Act adds a new section to the BHC Act to prohibit certain proprietary trading activities by bank holding companies, insured depository institutions and their affiliates (referred to as "banking entities"). This provision has been called the "Volcker Rule" after the former Federal Reserve Board chairman who urged its adoption.

"Proprietary trading" is defined to mean "engaging as a principal for the trading account" of the banking entity or financial company "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 regulators may by rule determine. The term "trading account" is defined as "any account used for acquiring or taking positions in securities and instruments . . . principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)" and any other account determined by the regulators.

The Board and the other federal agencies, along with the SEC and CFTC, are required to adopt regulations to implement the prohibition with respect to institutions for which they are the primary regulators. An extended period of time is allowed for compliance.

The agency regulations must take into consideration the results of a study and recommendations by the Financial Stability Oversight Council. The Council is required to make recommendations for implementation so as to: promote and enhance the safety and soundness of banking entities, protect taxpayers and consumers and enhance financial stability, limit the inappropriate transfer of federal subsidies from insured institutions to unregulated entities, reduce conflicts of interest, limit activities that create undue risk or loss, and accommodate the business of insurance within an insurance company.

Certain activities are exempted from the proprietary trading prohibition, including: the purchase and sale of obligations of the United States or any

agency thereof or instruments issued by specified Government sponsored-entities, certain securities in connection with underwriting or market-making related activities, risk-mitigating hedging activities, certain customer-driven transactions, investments in small business investment companies, and certain investment activities of insurance companies.

The Dodd-Frank Act also generally prohibits bank holding companies, depository institutions, and their affiliates from sponsoring or retaining any equity, partnership, or other ownership interest in a hedge fund or a private equity fund, with certain exceptions. Such activities are permissible only if the banking entity provides bona fide fiduciary or investment advisory services, the fund is organized and offered only in connection with such services and only to persons who are customers of such services of the banking entity, the entity does not retain an interest in the fund except for a *de minimis* investment and complies with certain restrictions, the banking entity does not directly or indirectly guarantee or assume the obligations or performance of the hedge fund or private equity fund, the banking entity does not share the same name, no director of the banking entity retains an interest in the fund, and certain disclosure requirements are met.

In no case may a banking entity's investment exceed 3 percent of the total ownership interests of the fund (after one year after the fund is established) and a banking entity's aggregate interests in all such funds may not exceed 3 percent of its Tier 1 capital. For capital purposes, the banking entity must deduct the aggregate amount of its outstanding investments in hedge funds and private equity funds from its assets and tangible equity, and the amount of the deduction shall increase commensurate with the leverage of the hedge fund or private equity fund.

The Volcker Rule does not impose prohibitions on Board-supervised nonbank financial companies but does require that they be subject to additional capital requirements with respect to proprietary trading and hedge fund and private equity fund activities.

VIII. SAVINGS AND LOAN HOLDING COMPANIES

The bill transfers supervisory responsibility for savings and loan holding companies to the Federal Reserve from the Office of Thrift Supervision (which is abolished). In addition, the bill significantly enhances the Board's supervisory authority over such companies.

Among other things, the Board may examine a savings and loan holding company and each subsidiary of such a company in order to inform the Board of the nature of the operations and financial condition of the company and its subsidiaries. Board examiners may assess the financial, operational, and other risks within the savings and loan holding company system that may pose a threat to the safety and soundness of the company or of any depository institution subsidiary of the company or the stability of the U.S. financial system. Board examiners may evaluate the company's systems for monitoring and controlling risks and may monitor the company's compliance with the BHC Act and other laws (other than in the case of a depository institution or functionally regulated subsidiary).

A unitary S&L holding company operating under existing law with grandfather rights as to its nonfinancial activities may be required to conducts its financial activities in an intermediate holding company if the Board determines that an intermediate holding company is necessary for the appropriate supervision of its financial activities or to ensure that supervision by the Board does not extend to the activities of such company that are not financial activities. Such an intermediate holding company will be supervised as a savings and loan holding company. A grandfathered unitary S&L holding company that controls an intermediate holding company must serve as a source of strength to the intermediate company.

The Government Accountability Office is required to complete a study of whether it is necessary in the interests of safety and soundness and financial stability to eliminate the exemption for savings associations from the definition of "bank" in the Bank Holding Company Act. If savings associations lose their exempt status under the BHC Act, their parent companies would become subject to the Act, presumably making obsolete the S&L holding company regulatory regime.

The GAO study is required to evaluate the adequacy of the federal bank regulatory framework applicable to such institutions, including any restrictions that apply to transactions between an institution, the holding company of the institution, and any other affiliate of the institution (including limitations on affiliate transactions or cross-marketing). The GAO must evaluate the potential consequences of subjecting the institutions to the requirements of the BHC Act, including the impact on the availability and allocation of credit, the stability of the financial system and the economy, the safe and sound operation of such institutions, and the impact on the types of activities in which such institutions, and the holding companies of such institutions, may engage.

IX. SECURITIES HOLDING COMPANIES

The Dodd-Frank Act creates a new entity called a "securities holding company" that may elect to be supervised by the Federal Reserve Board. A "securities holding company" is defined to mean a company that owns or controls one or more brokers or dealers registered with the SEC and the associated persons of such a company. The term does not include an insured bank or its affiliates, a Board-supervised nonbank financial company, or certain other institutions.

The purpose of this provision is to provide a means for U.S. securities firms to satisfy requirements in the European Union and elsewhere that financial firms be subject to consolidated supervision as a condition to operating there. Previously, the SEC was recognized as a consolidated supervisor for U.S. securities firms but the SEC ended its so-called "consolidated supervised entity" program in 2008 after the collapse or near-collapse of all of the major nonbank-affiliated Wall Street broker-dealers. The Dodd-Frank Act specifically repealed the provision in the Gramm-Leach-Bliley Act that had authorized so-called "investment bank holding companies" to operate under consolidated supervision of the SEC.

Under the Dodd-Frank Act, a securities holding company may elect to be supervised by the Board if it is required by a foreign regulator or by foreign law to be subject to comprehensive consolidated supervision as a condition to operating in a foreign country. Such a company may register with the Board and will become subject to comprehensive consolidated supervision by the Board. The Board is required to collect information and reports from such companies and to impose capital requirements and risk management standards. The Board may examine such a company and take enforcement actions as appropriate.

Except as the Board may provide, a supervised securities holding company will be subject to the BHC Act in the same manner and to the same extent as a bank holding company, except that such a company will not be deemed to be a bank holding company for purposes of the Act's section 4 restrictions on nonbanking activities.

X. RESOLUTION PROCESS FOR FINANCIAL COMPANIES

The Dodd-Frank Act establishes a new resolution system for failing bank holding companies, Board-supervised nonbank financial companies, and other companies engaged in financial activities, including broker-dealers.

An orderly liquidation authority process will be administered by the FDIC as receiver after a determination by the Treasury Secretary, upon the recommendation of the Federal Reserve Board and FDIC or SEC, that a covered financial company is in default or in danger of default and that the default presents a systemic risk to U.S. financial stability. A financial company could be considered to be in default or in danger of default if a bankruptcy case has been or is likely to be filed, the financial company has incurred or is likely to incur losses that will deplete all or substantially all of its capital, the company's assets are or are likely to be less than its liabilities, or the company is unable to pay its obligations in the normal course of business.

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The foregoing has summarized key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that will affect bank holding companies and other companies engaged in financial activities. These and other provisions of the Act will be analyzed in greater detail in a forthcoming new edition of ***Federal Bank Holding Company Law***.