



August 18, 2010

**Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173)**

***Bank Holding Companies to Face Increased Regulations and Restrictions***

For the past year, Congress has been working to craft legislation that would address many of the perceived weaknesses in the financial system that many believe contributed to the failure of banks and other financial institutions.

After weeks of negotiations over the most controversial provisions of bills that had passed the House and Senate (H.R. 4173 and S. 3217), the House-Senate Conference committee members reached an agreement in the early hours of June 25. Despite the Conference committee agreement and subsequent House passage of the combined bill, final passage in the Senate remained uncertain until Republican Senators Olympia Snowe (R-ME), Susan Collins (R-ME), and Scott Brown (R-MA) announced their support, supplying the necessary 60 votes needed to overcome a Republican-led filibuster.

The passage of H.R. 4173 on July 15 was lauded by President Obama, who claimed that the bill would “protect consumers and lay the foundation for a stronger and safer financial system” and “bring greater economic security to families and businesses across the country.”

The bill, in general, attempts to expand federal oversight, regulating the financial industry more stringently and providing additional mechanisms to improve consumer protection. Bank holding companies (BHCs), in particular, will be subject to additional regulation and reporting requirements. The bill instructs the Federal Reserve Board (Fed) and other federal banking agencies to enact numerous regulations covering BHCs, but in some cases, provides little detail, giving regulators substantial power to determine their precise configuration.

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**Key Provisions in the Wall Street Reform and Consumer Protection Act Regarding Large, Interconnected Bank Holding Companies (BHCs)**

*Financial Stability Oversight Council (FSOC)*

Section 115 establishes the Financial Stability Oversight Council (FSOC). In order to guard against the potential risks posed by distressed or threatened large, interconnected BHCs or non-bank financial companies (NBFCs), the FSOC is authorized to collect information from these entities and make recommendations to the Fed with regard to the prescription of certain standards, including:

- requiring covered entities to maintain a minimum amount of contingent capital that can be converted to equity in times of stress;
- requiring covered entities to report periodically on their plans for resolution in the event of serious distress or failure; and
- requiring covered entities to make periodic reports on their credit exposure, and the extent to which other significant entities have credit exposure to them.

Finally, the FSOC is authorized to make recommendations to the Fed with regard to the prescription of standards to avoid certain risks, enhanced public disclosures and short term debt limits.

*Treatment of Large, Former BHCs*

Section 117 requires former bank holding companies with assets of \$50 billion or more as of January 1, 2010, that also received financial assistance under the Troubled Asset Recovery Program (TARP) or participated in TARP's Capital Purchase Program to be treated as non-bank financial companies (NBFCs) supervised by the Fed. A former bank holding company may appeal its treatment as a supervised NBFC by requesting a hearing before the FSOC. In order for the FSOC to grant such an appeal, 2/3 of the FSOC members present, including the Chairman, must vote in the affirmative. If the FSOC denies the appeal, its decision must be reviewed and reevaluated annually.

*Acquisition Notice Requirements*

Section 163 requires BHCs with at least \$50 billion in total consolidated assets to give prior notice to the Fed before acquiring direct or indirect ownership or control of a non-banking companies with at least \$10 billion in total consolidated assets.

*Enhanced Fed Authorities Regarding Supervision and Prudential Standards*

Section 165 requires the Fed to establish "more stringent" prudential standards for BHCs with at least \$50 billion in total consolidated assets. Required standards for these BHCs would include risk-based capital requirements and leverage limits, liquidity requirements, overall risk management requirements, resolution plan and credit exposure report requirements, and concentration limits. The Fed would also have the discretion to establish additional standards, including a contingent capital requirement, enhanced public disclosures, short-term debt limits, and other prudential standards it deems appropriate.



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Section 165 would also require the Fed, in coordination with other federal regulators, to conduct annual “stress” tests on the covered BHCs to determine whether they have the capital to absorb losses as a result of adverse economic conditions.

Finally, this provision would require covered BHCs to maintain a debt to equity ratio no greater than 15 to 1, if the FSOC determines that they pose a grave threat to U.S. financial stability and that the requirement is necessary to mitigate that risk.

**Key Provisions Regarding the Regulation of BHCs and Their Subsidiaries**

*Enhanced Reporting and Examination Requirements*

Section 604(a) amends the Bank Holding Company Act of 1956 (BHCA) to require BHCs and their subsidiaries to provide the Fed, upon request, with existing reports and any other supervisory information that they would be required to provide other Federal or State regulators.

Section 604(b) allows the Fed to conduct examinations of BHCs and their subsidiaries in order to assess their financial condition, identify financial, operational, and other risks that may pose a threat to the stability of the BHC or to the U.S. financial system.

*Enhanced Fed Regulatory Authority Over Functionally Regulated Subsidiaries*

Section 604(c) eliminates section 10A of the BHCA, which generally prevents the Fed from regulating functionally regulated subsidiaries.

*Nonbank Acquisition Notice Requirement*

Section 604(e) adds an additional notice requirement for transactions involving BHC acquisitions of nonbanks. The provision would require the Fed, upon receiving notice, to consider whether the transaction would pose a risk to the stability or the U.S. banking or financial system.

*Examinations of Non-Depository Subsidiaries of Depository BHCs*

Section 605 requires the Fed, in coordination with other federal and state regulators, to determine the safety and soundness of these subsidiaries. In the event that the Fed does not undertake such an examination, then another appropriate federal banking agency would be granted back-up authority to perform the examination.

*Capitalization and Management Requirements*

Section 606 of the bill would amend section 4(l)(1) of the BHCA, which sets the conditions for BHCs to engage in expanded financial activities, such as securities or insurance underwriting. Currently, only the depository institution subsidiaries of BHCs engaging in expanded financial activities must be well capitalized and well managed, meaning they must meet the required capital levels established by the Fed and receive satisfactory management ratings. Section 606 would require BHCs, as well as their depository



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subsidiaries, to meet the well capitalized and well managed requirement in order to engage in any of the expanded financial activities described in section 4(k) of the BHCA.

### *Regulations Regarding BHC Capital Levels*

Section 616 requires the Fed to make “countercyclical” capital requirements for BHCs, so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the company.

### *Limits on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds*

Section 619, the so-called “Volcker Rule,” adds a new provision to the BHC Act to restrict “banking entities” from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund. The Volcker Rule places limitations on investments in hedge funds or private equity funds, not investments in individual entities. However, 619(e) is a strong anti-evasion provision which should prevent end-runs around the limitations, such as investing in firms that are owned by private equity funds.

Named for former Federal Reserve Chairman Paul Volcker, this provision invokes Volcker’s core concept of separating commercial banking from more speculative risk activities. The prohibitions laid out in this section extend not only to insured depository institutions but also to any company that “controls” an insured depository institution, foreign firms treated as BHCs under the International Banking Act, and any of their affiliates or subsidiaries.

Although supervised NBFCs that do not control insured depository institutions would be permitted to engage in proprietary trading, or sponsoring or investing in hedge funds or private equity funds, they would be subject to additional Fed-imposed quantitative limits and capital requirements under the Volcker Rule.

The prohibition affecting hedge funds and private equity funds would exempt certain “permitted activities,” so long as they do not involve or result in a material conflict of interest, a material exposure by the banking entity to high-risk assets or trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

“Permitted activities” under the bill include investments in obligations of the United States and various government sponsored entities, investments in small business investment companies, and the sponsorship of a hedge or private equity fund for sale to customers that entails a *de minimis* investment by the organizing banking entity.

For *de minimis* investments, the banking entity must: 1) actively seek unaffiliated investors to reduce or dilute its investment; 2) its investment in a hedge fund or private equity fund must not exceed a 3% ownership stake in the fund, and 3) its investment must be immaterial to the banking entity, and in no event may the aggregate of all the banking entity’s interests in a hedge fund or private equity fund exceed 3% of its Tier 1 capital.

The FSOC is required to conduct a study and make recommendations on implementing the Volcker Rule within 6 months of enactment, but would not have clear authority to overrule any of the Rule’s statutory provisions. The Rule takes effect twelve months after the date the final rules are issued, or two years after the date of enactment, whichever is earlier.

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