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financial regulatory reform lawflash

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Financial Regulatory Reform Heads Down the Homestretch

A final compromise on the Volcker Rule headlines a climate change in the regulation of financial institutions.

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On June 25, Congress concluded its conference committee process for a bill that entails sweeping financial reforms. As was the case following the banking crisis of the 1980s, Congress appears poised to enact an assortment of miscellaneous reforms aimed at correcting perceived deficiencies in the existing regulatory structure, and arming regulators with increased authority going forward.

The codification of the "Volcker Rule," the elimination of the Office of Thrift Supervision, and heightened regulatory scrutiny for many financial institutions are just a few of the changes to financial institution regulation contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Changes such as the establishment of the Financial Stability Oversight Council (the Council), a financial services oversight body charged with identifying systemic risks and strengthening the regulation of financial holding companies and certain nonbank companies; the creation of a new Bureau of Consumer Financial Protection, corporate governance changes for public companies; increased enforcement capability for the U.S. Securities and Exchange Commission (SEC); changes to executive compensation; regulatory changes in retail brokerage and private client services; derivative reform; and changes to the Sarbanes-Oxley whistleblower protections have been discussed in previous Morgan Lewis LawFlashes. Additional aspects of this legislation will be discussed in future LawFlashes.[1]

The Volcker Rule

Former Federal Reserve Chairman and White House economic adviser Paul Volcker has been a major proponent of limiting certain capital market activities of banks, including the ownership or sponsorship of hedge funds and private equity funds and proprietary trading. Volcker has described the focus of his concern as those activities that "plac[e] bank capital at risk in the search of speculative profit rather than in response to customer needs." Although derivatives activity conducted by banks has in large

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[1] View the current collection of Morgan Lewis updates and alerts on our Financial Regulatory Reform page, at http://www.morganlewis.com/topics/financialregulatoryreform.

part been focused on customer facilitation and needs, Volcker's recommendations included restrictions on derivatives activities by banks.

The proposal to limit bank capital markets activity concept was introduced relatively late into the financial reform debate in Congress. The proposal was not included in the original House bill but was part of the financial reform bill passed by the Senate. The proposal resonated with the conference committee, which adopted a version of the "Volcker Rule" that roughly tracks the Senate version but includes some limited ability for banks to invest in hedge funds and private equity funds.

The final version of the Volcker Rule adopted by the conference committee applies to proprietary trading activity conducted by a banking entity or nonbank financial company supervised by the Federal Reserve as a systemically important nonbank. "Proprietary trading" activity was defined as involving transactions by the banking entity or nonbank, as principal, to "purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission and the Commodity Futures Trading commission may, by rule . . . determine."

A "banking entity" is defined by the bill as any insured depository institution, any company that controls an insured depository institution, or any company that is treated as a bank holding company for purposes of the International Banking Act of 1978, or any affiliate or subsidiary of any such entity. The definition excepts from its scope any institution that functions solely in a trust or fiduciary capacity, provided that its deposits are in trust funds received in a bona fide fiduciary capacity, its insured funds are not marketed or offered through an affiliate, and the institution does not otherwise take advantage of the federal financial safety net.

The purchase and sale of government obligations are excepted from the definition of proprietary trading, as are purchases of securities and other instruments in connection with underwriting, and market-making-related activities, so long as the activity is designed to not exceed the reasonably expected near-term demands of clients, customers, or counterparties. An additional exception exists for certain risk-mitigating hedging activities and investments in small business investment companies, and certain purchases by a regulated insurance company for the general account of the company.

Securities investments by insured banks are already heavily regulated. For example, the Office of the Comptroller of the Currency (OCC) allows national banks to invest only in "investment securities," which are debt securities that are both marketable and not predominantly speculative.[2] Bank holding companies' trading activities are also subject to capital and prudential limitations. Federal thrifts are typically even more constrained in their securities investments.[3]

The conference committee version of the Volcker Rule permits banking entities and nonbank financial companies supervised by the Federal Reserve Board (Regulated Entities) to continue to organize and offer private equity or hedge funds and to serve as general partner or managing member of such a fund, so long as the activities meet all of the following conditions:

- The Regulated Entity provides bona fide trust, fiduciary, or investment advisory services and the fund in which the Regulated Entity invests is organized and offered only in connection

[2] 12 U.S.C. § 1.2.
[3] 12 U.S.C. § 1464(c).

with the provision of these bona fide services and only to persons that are customers of such services of the Regulated Entity.

- The Regulated Entity acquires or retains only a *de minimis* ownership interest in private funds (no more than 3% of the Tier 1 capital of the banking entity in all private funds).
- The Regulated Entity does not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the private fund or a private fund in which a bank-sponsored fund invests.
- The Regulated Entity does not share with the private fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.
- No director or employee of the Regulated Entity takes or retains any ownership interest in the private fund, unless the director or employee is directly engaged in providing investment advisory or other services to the private fund.
- The Regulated Entity discloses to prospective and current investors, in writing, that any losses in the private fund are borne solely by investors in the fund and not by the Regulated Entity, and otherwise complies with any additional rules of the appropriate federal banking agencies, the SEC, or the CFTC.

Regulated Entities that currently have proprietary investments in private funds exceeding 3% of their Tier 1 capital must seek to reduce their stakes in private funds by no later than one year after the earlier of (i) the date on which the bank's capital commitment ends and (ii) the two year anniversary of the effective date for the Volcker Rule or such later date as the Federal Reserve establishes under its power to extend effectiveness, although the Federal Reserve Board may grant an extension of up to two years.

Regulated Entities are to bring their activities and investments into compliance with the Volcker Rule requirements within two years of the date the requirements become effective or two years after the date the entity or company becomes a nonbank financial company supervised by the Federal Reserve. The Federal Reserve may extend this two-year period for not more than one year at a time, up to an aggregate of three years. An extended transition period for certain "illiquid funds" may be set by the Federal Reserve for a five-year period. It is unclear from the statutory language whether this five-year extended transition period is to run concurrently with other extensions. During the interim period, banks and nonbanks will be subject to additional capital and other requirements established by the regulatory authorities as described below.

The version of the Volcker Rule adopted by the conference committee requires federal banking agencies, the SEC, and the U.S. Commodity Futures Trading Commission (CFTC) to adopt rules to prohibit any permitted activity (private fund sponsorship and proprietary investments as well as proprietary trading activity) if the activity would do any of the following:

(i) Involve or result in a material conflict of interest between the Regulated Entity and its clients, customers, or counterparties

(ii) Result, directly or indirectly, in an unsafe and unsound exposure by the Regulated Entity to high-risk assets or high-risk trading strategies

(iii) Pose a threat to the safety and soundness of the Regulated Entity

(iv) Pose a threat to the financial stability of the United States

Finally, federal banking agencies, the SEC, and the CFTC are directed to adopt rules imposing additional capital requirements and quantitative limitations regarding the operation of private funds, and *de minimis* investments in private funds, if those agencies determine that such requirements and limitations are appropriate to protect the safety and soundness of the Regulated Entities. Federal banking agencies are instructed to perform an 18-month study of the investment activities of banking entities, and to report to the Council and Congress their recommendations as to what additional restrictions, if any, should be placed on these activities.

The Demise of "Functional Regulation"

In a tacit admission that the "functional regulation" regime advanced in the Gramm-Leach-Blilely Act of 1999 (GLBA) was not successful, the final version of financial reform legislation amends the Bank Holding Company Act of 1956 once again. This change empowers the Federal Reserve Board to examine the bank holding company and each subsidiary of a bank holding company, regardless of whether the subsidiary is functionally regulated by the SEC, state insurance regulator, or other regulators. Proponents of this change in regulatory direction cite the failure of any financial regulator to identify the risky activities of AIG Financial Products Corp, a subsidiary of American International Group, Inc. (AIG) during the lead up to the financial crisis that began in 2007. AIG also owned a small federal thrift, and was therefore subject to Office of Thrift Supervision (OTS) oversight. The Acting Director of OTS has testified before the Senate Committee on Banking, Housing, and Urban Affairs that "OTS did not foresee the extent of the risk concentration and the profound systemic impact CDS [credit default swap] products caused within AIG."

While the Federal Reserve was designated as the "umbrella" supervisor of financial holding companies by GLBA, GLBA limited the Federal Reserve's examination authority to the holding company and any subsidiary that could have a materially adverse effect on the safety and soundness of a depository institution subsidiary. The Federal Reserve was also to defer to the "functional regulator" of insurance and securities subsidiaries of a financial holding company. The Federal Reserve lacked any regulatory authority over thrift holding companies, and therefore had no jurisdiction over AIG.

The Abolishment of the Office of Thrift Supervision

Consolidation of bank regulators has been on the "to do" list of financial reform proponents for decades. As a result of the failures of Washington Mutual Bank, FSB and IndyMac Bank F.S.B., and OTS's involvement as a tangential regulator of troubled AIG, the future of the OTS was put at risk. The Dodd-Frank Act will abolish the OTS as an agency, parceling out most of its responsibilities to the OCC, to which its employees will be detailed. The conference committee has decided to retain the thrift charter under OCC supervision, and thrift holding companies will be eligible to qualify to conduct the activities of a financial holding company if they meet the qualifications already applicable to bank holding companies.

Going forward, the OCC, as regulator of national banks, will serve as the primary supervisor of federal savings associations, with the Federal Deposit Insurance Corporation (FDIC) supervising state-chartered thrifts, and the Federal Reserve will serve as the regulator of thrift holding companies and any nondepository subsidiary of a thrift holding company. The Comptroller of the Currency has been instructed to designate a Deputy Comptroller who shall be responsible for the supervision and examination of federal thrifts.

Too Big to Grow

While not meeting the "too big to fail" issue head on, the new legislation does address the issue in part. The Bank Holding Company Act will be amended by the bill to prohibit the Federal Reserve from approving an interstate acquisition if the applicant controls or would control more than 10% of the total amount of deposits in the United States, unless the acquisition relates to an insured bank or thrift in danger of failing or to an FDIC-assisted transaction. The Bank Merger Act provisions of the Federal Deposit Insurance Act would also be amended to prohibit the reviewing bank agency from approving an interstate merger if the resulting bank would control more than 10% of the total amount of deposits of insured banks in the United States, unless the bank were failing or involved in an assisted transaction under the Federal Deposit Insurance Act.

The legislation would prohibit a merger or other transaction that resulted in the total consolidated liabilities of the acquiring financial company being in excess of 10% of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the proposed transaction. This concentration limit would not be applied to an acquisition of a bank in danger of failing, an assisted transaction, or if the increase in liabilities is *de minimus*.

Tightening Up

Recognizing that derivatives and securities lending and borrowing transactions can pose as much risk to insured banks as loans, the Dodd-Frank Act amends the Federal Reserve Act Section 23A to add these activities. The amended provision subjects these activities to the same quantitative and qualitative restrictions of 23A as currently apply to loans and similar covered transactions. Exceptions for transactions with financial subsidiaries are eliminated.

Similarly, the national banks' legal lending limits definitions found in the National Bank Act would be expanded from "loans and expansions of credit" to include credit exposure arising from derivatives, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions. Insured state-chartered banks will be able to engage in a derivative transaction only if the lending limits set by the state in which the bank is chartered take into consideration credit exposure stemming from derivatives. The legislation does not distinguish between credit exposure from a central clearing house (which will be applicable to most derivatives as a result of the derivatives reform portions of the bill) and exposure to other derivatives counterparties, such as customers and other swap dealers.

Addressing the issue of "regulatory arbitrage," the Dodd-Frank Act would prohibit charter conversions during any period in which the converting institution is subject to a formal enforcement action or a memorandum of understanding brought by its primary regulator with respect to a significant supervisory matter, unless both the existing and future regulator approved of the conversion. A final enforcement action by a state attorney general as to a state-chartered institution would have similar effect. Regulatory arbitrage emerged as an issue during the financial crisis as a result of the conversion by Countrywide Bank, N.A. (Countrywide) from a national bank to an OTS-regulated federal thrift in March 2007, many thought, to escape a tightening regulatory environment. Countrywide encountered severe problems in August 2007 and eventually was acquired by Bank of America in July 2008.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact authors and Morgan Lewis attorneys **Kathleen W. Collins**, **Monica L. Parry**, and **Georgia Bullitt**, listed below:

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In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

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