
THE BANKING REGULATION REVIEW

EDITOR
JAN PUTNIS

LAW BUSINESS RESEARCH

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THE BANKING REGULATION REVIEW

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EDITOR'S PREFACE

Legal and regulatory areas of concern come and go in their perceived importance. It is, however, very difficult to recall any other occasion when a subject regarded by many lawyers as so obscure and arcane as international banking regulation has come to such prominence in such a short period of time.

Before the onset of the financial crisis in western economies in 2007, banking regulation was regarded by many as a discipline practised by technocrats who were, to put it politely, best left to themselves. The subject has risen up the agenda so quickly since then that few lawyers who advise financial institutions have had time to draw breath and assess the position now reached. The reality, of course, is that no final position has been reached and none is ever likely to be reached: banking regulation will continue to evolve, punctuated by bursts of activity every time there is a serious crisis to manage. What has happened is that the importance of this subject, and its rightful place amongst legal disciplines, has finally been recognised. This means that there is now great demand, from the banks themselves, but also from governments and regulators, for accessible and user-friendly explanations of the applicable rules.

The continual evolution of the rules makes any survey of banking regulation very difficult to write without risking almost immediate obsolescence. This book is an attempt to rise to that challenge and it is hoped that future editions will address the many further developments in this area that are expected to take place in the coming months and years. The book is aimed principally at lawyers and others who need access to an overview of the applicable rules in the important areas that the book covers and a commentary on recent developments. It also includes commentary on many of the areas of banking regulation that are of critical importance to the major cross-border transactions in which banks become involved.

The book illustrates the many and differing approaches that governments and banking regulators have taken to addressing what they perceive to be the problems affecting the banks that they regulate. To that extent, the lack of international coordination is a potential source of dismay amongst politicians and others who have spent so much time over the past three years trying to develop common approaches to the international challenges highlighted by the financial crisis.

It is, however, to be hoped that surveys of the kind in this book also inform the continuing debate about how to minimise the risk of a further crisis on anything like the scale that we have just seen. It will, quite literally, pay for governments to appreciate that further significant financial crises are inevitable in the future, and that the principal aim of reform should, therefore, be to minimise their likely impact, both on the lives of the millions of people who rely on banks and on local and regional economies.

It is a tribute both to the contributors and the publishers that so many leading banking and regulatory lawyers have made themselves available to write chapters for this book. I would like to thank them all for the support and encouragement that they have provided at a time when many of them have been almost overwhelmed with work on other projects emerging from the financial crisis. Many of the contributors have also been involved in initiatives designed to stabilise and reform the banking sectors in their countries. I would also like to thank Gideon Robertson and his colleagues at the publishers for their efforts in coordinating the project that this book has become, and in bringing it to fruition.

Jan Putnis

Slaughter and May

London

June 2010

Chapter 35

UNITED STATES

*Luigi L De Ghenghi, Reena Agrawal Sahni and Cristina Fong**

I INTRODUCTION

The US and global financial crisis in 2008 precipitated an avalanche of activity and changes in US banking regulation. In that year, the US Congress, the President, and the regulators exerted their power and influence to help turn back the tide of the financial crisis by using long-dormant tools and promulgating new programmes. Once the crisis was contained, these authorities began to propose changes with the avowed purpose of attempting to prevent a future financial crisis. US banking regulators have stepped up their bank examinations and increased scrutiny in the areas of capital and reserves; the President has proposed, and the US Congress is in the process of implementing, a financial regulatory reform agenda that would increase regulation in certain areas, shift regulatory responsibility in others, and prohibit or limit banking organisations from engaging in certain activities. As the details of that regulatory reform are still to be finalised at the time this article is going to press, we will highlight certain areas where changes are likely to occur in 2010.

The proposed restructuring of the US financial regulatory framework is the most drastic overhaul of US financial regulation since the 1930s. However, we expect that the changes occasioned by any legislation adopted by the US Congress will still take some time to implement.

* Luigi L De Ghenghi is a partner, Reena Agrawal Sahni is counsel and Cristina Fong is an associate at Davis Polk & Wardwell LLP. The authors would like to express their gratitude to William B Hoffman, Jeanine P McGuinness, E Ashley Harris, Priya Bindra and Catherine E Thomas, all of Davis Polk & Wardwell LLP, whose efforts in preparing this chapter were invaluable.

II THE REGULATORY FRAMEWORK APPLICABLE TO BANKS

i Dual banking system

The United States has a dual banking system, whereby banks, or depository institutions, may be chartered by either federal or state authorities. Federal bank regulators with chartering powers include the Office of the Comptroller of the Currency (‘the OCC’), which charters national banks,¹ and the Office of Thrift Supervision (‘the OTS’),² which charters thrifts, or federal savings associations.³ Both the OCC and the OTS are part of the US Treasury Department. Separately, each state also has either a banking department or division of financial institutions that may charter either banks or thrifts. An institution must apply for and obtain a bank or thrift charter from either a federal or state regulator in order to accept deposits.

The Federal Deposit Insurance Corporation (‘the FDIC’) is also a federal bank regulator.⁴ The FDIC does not charter banking institutions, but it (1) administers the federal deposit insurance programme that insures certain bank deposits, including supervising any bank failures, and (2) regulates certain bank activities and operations in order to protect and preserve the federal deposit insurance fund.

ii Bank holding companies

Any legal entity with a controlling ownership interest in a bank is regulated as a bank holding company by the Board of Governors of the Federal Reserve System (‘the Federal Reserve’).⁵ Currently, thrift-holding companies are regulated by the OTS, but the Federal Reserve is expected to regulate all depository institution holding companies under financial reform proposals.

The Federal Reserve also regulates state banks that choose to become Federal Reserve member banks, in addition to the respective state or federal banking regulators that charter the banks. All nationally chartered banks are required to hold stock in one of the Federal Reserve banks, while state-chartered banks may choose to be members and hold stock in a regional Federal Reserve Bank, upon meeting certain standards. Benefits

1 National Bank Act §2, 12 USC §26.

2 Financial Institutions Reform, Recovery, and Enforcement Act §301, 12 USC §1464.

3 This article will largely focus on bank and bank holding company regulation, and will not cover the entire scope of thrift and thrift holding company regulation.

4 Federal Deposit Insurance Act §1, 12 USC §1811(a).

5 The Bank Holding Company Act defines ‘bank holding company’ as any company that has control over any bank or over any company that is or becomes a bank holding company by virtue of the Act. Any company has control over a bank or over any company if: (1) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per cent or more of any class of voting securities of the bank or company; (2) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or (3) the board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company (12 USC §1841(a)).

of Federal Reserve membership include eligibility to serve as a director, which affords member banks the opportunity to participate in monetary policy formulation.⁶

While state banking regulators normally focus their supervisory attention on depository institutions, there are also some state regulations that may apply to bank holding companies.

iii Foreign banks

Foreign bank activities in the United States are supervised by the Federal Reserve, as well as any other regulator implicated by the type of charter or entity that a foreign bank uses to conduct its banking business in the United States. The foreign activities of US banks are also regulated by the Federal Reserve.

III PRUDENTIAL REGULATION

Relationship with the prudential regulator

i Overview

Most banks are first regulated by their chartering entities, or their primary regulators. Primary regulators are generally responsible for conducting bank examinations, initiating supervisory and enforcement actions, and approving branch, change of control, merger and other applications. State-chartered institutions are regulated at the federal level by the Federal Reserve in the case of state member banks or by the FDIC in the case of state non-member banks.

Secondary regulators share oversight responsibilities with primary regulators. The FDIC serves as a secondary regulator for banks that offer insured deposits.

The following chart illustrates these relationships:

Institution type	Chartering agency	Primary federal regulator	Secondary federal regulator
<i>Federal charter</i>			
National bank	OCC	OCC	Federal Reserve, FDIC
Federal savings association	OTS	OTS	FDIC
Federal savings bank	OTS	OTS	–
<i>State charter</i>			
State non-member bank	State agency	FDIC	N/A
State member bank	State agency	Federal Reserve	FDIC
State savings bank	State agency	FDIC	N/A
State savings association	State agency	OTS	FDIC

⁶ See Federal Reserve Bank of Boston, Federal Reserve Membership for a State-chartered Bank 2: www.bos.frb.org/bankinfo/members/member.pdf.

Institution type	Chartering agency	Primary federal regulator	Secondary federal regulator
<i>Foreign banks</i>			
Foreign bank uninsured state branches and agencies	State agency	Federal Reserve	N/A
Foreign bank uninsured federal branches and agencies	OCC	OCC	Federal Reserve
Foreign bank commercial state chartered lending companies	State agency	Federal Reserve	N/A
Foreign bank edge corporations	Federal Reserve	Federal Reserve	N/A
Foreign bank agreement corporations	Federal Reserve	Federal Reserve	N/A
Foreign bank representative offices	State agency	Federal Reserve	N/A

Banks and bank holding companies may also be subject to functional regulation by other regulatory agencies, depending on the types of activities in which they engage. For instance, a bank holding company’s securities underwriting and dealing activities are also regulated by the Securities and Exchange Commission (“the SEC”), the functional regulator of any SEC-registered broker-dealer, and any insurance activities would be supervised by the relevant state insurance regulator.

There are currently a number of proposals being considered by the US Congress that would alter the US bank regulatory regime described *supra*.

ii Regulatory reporting requirements and bank examinations

In order to supervise bank holding companies and banks, regulators have two primary tools – regulatory reporting requirements and on-site banking examinations. Bank holding companies and banks are subject to extensive financial, structure and other periodic reporting requirements. Financial reporting requirements for banks include capital, asset and liability data reported quarterly on call reports, and for bank holding companies include financial statements for the bank holding company and certain nonbank subsidiaries. Bank holding companies are also required to provide annual reports to the Federal Reserve that detail their shareholders and their organisational structure. Banking institutions that are experiencing financial difficulties or are not in compliance with regulatory requirements face more frequent and additional reporting obligations.

Bank regulators also conduct on-site examinations of bank holding companies and banks. Regulators generally conduct three principal types of formal examinations: (1) safety and soundness, or ‘full scope’, examinations that determine the fundamental

financial health of a bank and generally take place every 12 or 18 months;⁷ (2) compliance examinations that cover consumer compliance and fair lending issues; and (3) specialty examinations that cover areas such as trust activities and information technology infrastructure.

In the aftermath of the financial crisis, regulators have come under intense public scrutiny by congressional committees, the Financial Crisis Inquiry Commission, the Government Accountability Office, and several other investigative or oversight bodies that have questioned the quality of regulatory supervision in the years leading up to the financial crisis. While there have not been any formal changes in either bank regulatory reporting requirements or bank examination procedures, since the financial crisis, bank regulators appear to have increased their scrutiny of all regulatory reports, expanded the range of their full scope and specialty examinations, and also sharpened their supervisory focus on such areas as regulatory capital, corporate governance (boards and management) and liquidity and funding risk management.⁸

Aside from transactions such as mergers and acquisitions or other matters that require formal approvals,⁹ bank regulators are also routinely informed or involved on a more informal basis with certain key decisions contemplated by a bank or bank holding company, including capital-raising activities, dividend policies and changes in business plans or strategies.

iii Federal Deposit Insurance Fund

The FDIC, as the regulator in charge of the Deposit Insurance Fund (“DIF”), is also involved in the supervision of depository institutions with insured deposits. The wave of bank failures that began with the 2008 financial crisis intensified in 2009. In 2009, 140 FDIC-insured depository institutions, holding assets of \$169.7 billion, failed, the largest number of bank failures in a year since the savings and loan crisis in 1989–90.¹⁰ To ensure public confidence in the safety of their deposits, Congress extended, until 31 December 2013, the Emergency Economic Stabilisation Act of 2008’s temporary increase in the Standard Maximum Deposit Insurance Amount (“SMDIA”), which represents the maximum amount of deposit insurance available to a single account holder at any insured depository institution, from \$100,000, to \$250,000.¹¹

7 The frequency of full scope examinations generally depends on the type of regulated entity and the scope of its activities. For instance, large bank holding companies are generally subject to more frequent full scope examinations than FDIC-insured state non-member banks.

8 See, e.g., Cheyenne Hopkins, ‘Regulatory Actions Hit a Record Level in ‘09’, *Am. Banker*, 10 March 2009, www.americanbanker.com/issues/175_46/reg-actions-hit-a-record-level-1015700-1.html.

9 For a further discussion, see Section VI, *infra*.

10 FDIC, fourth quarter 2009, *Quarterly Banking Profile*, December 2009, <http://www2.fdic.gov/qbp/2009dec/qbp.pdf>.

11 FDIC, Deposit Insurance Regulations; Temporary Increase in Standard Coverage Amount, 74 Fed. Reg. 47711 (17 September 2009), <http://fdsys.gpo.gov/fdsys/pkg/FR-2009-09-17/pdf/E9-22406.pdf>.

The high number of bank failures has continued to put strain on the DIF. At the end of the fourth quarter of 2009, the DIF had a negative balance of \$20.9 billion, primarily because of an additional \$17.8 billion in provisions for bank failures. Over the course of 2009, the fund balance decreased by \$38.1 billion.¹²

As a result, the FDIC took various steps in 2009 to restore the reserve ratio (a ratio of reserve funds against deposits insured) to the 1.15 per cent mandated by statute, while also attempting to acknowledge the fact that the payees into the system (i.e., the surviving depository institutions), nevertheless remained under significant strain.

On 29 September 2009, the FDIC adopted an amended restoration plan (amending an October 2008 restoration plan), imposing a revised rate schedule in order to allow the DIF to return to the reserve ratio of 1.15 per cent within eight years, instead of the five required in October 2008. The extended horizon was an acknowledgement of the strains currently faced by banks.¹³

Despite these strains, however, on 22 May 2009, the FDIC imposed an emergency special assessment of five basis points on each insured institution's total assets minus tier 1 capital as of 30 June 2009, payable on 30 September.¹⁴ On 29 September 2009, the FDIC increased annual assessment rates uniformly by three basis points beginning in 2011.¹⁵ On 17 November 2009, the FDIC amended its regulations, requiring insured institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter 2009, and for all of 2010, 2011 and 2012.¹⁶ The FDIC will exercise its supervisory discretion to exempt an institution from the prepayment requirement if the FDIC determines that the prepayment would affect the institution's safety and soundness. Institutions may also apply for such an exemption. The FDIC noted that prepayment is required in order to allow the FDIC to address its upcoming liquidity needs, specifically its need to have cash on hand to pay for projected failures.

The deposit insurance assessment system remains in a state of flux, with the FDIC recently issuing a proposal to revise the assessment system for large depository institutions with assets of over \$10 billion, using a scorecard of financial measures that are intended to be more forward-looking, including a calculation of the potential

12 FDIC, fourth quarter 2009, *Quarterly Banking Profile*, December 2009, <http://www2.fdic.gov/qbp/2009dec/qbp.pdf>.

13 FDIC, Amendment of Federal Deposit Insurance Corporation Restoration Plan, 74 Fed. Reg. 51062 (29 September 2009), www.fdic.gov/regulations/laws/federal/2009/09notice102.pdf; 12 USC §1817(b)(3)(E), as amended by the Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, §204(b), 123 Stat. 1649.

14 FDIC, Final Rule: Special Assessment, 75 Fed. Reg. 25639 (29 May 2009), www.fdic.gov/regulations/laws/federal/2009/09final529.pdf.

15 FDIC, Notice of Proposed Rulemaking and Request for Comment: Prepaid Assessments, 74 Fed. Reg. 51063 (proposed 2 October 2009), <http://edocket.access.gpo.gov/2009/pdf/E9-23803.pdf>.

16 FDIC, Final Rule Regarding Prepaid Assessments, 12 CFR §327, 74 Fed. Reg. 59056 (17 November 2009), www.fdic.gov/regulations/laws/federal/2009/09finalAD51Nov17.pdf.

losses the institution would impose on the DIF should it fail, with the view that such institutions pose unique and concentrated risks to the DIF.¹⁷

Finally, in order for a foreign bank to establish or operate a state branch without federal deposit insurance, the branch, in addition to meeting other requirements, may now only accept initial deposits in an amount equal to the SMDIA or greater.¹⁸

Management of banks

The two traditional areas of regulatory focus on the management of banks have been the responsibilities and duties of bank holding company and bank boards, directors and senior management and the regulation of insider loans.

Bank and bank holding company boards of directors are different from corporate boards in that they normally have more competing interests to balance, such as shareholder, depositor, parent holding company (in the case of a bank), creditor and regulatory interests. Bank and bank holding company boards are generally responsible for overseeing management plans and ensuring that there are adequate controls and systems in place to identify and manage risk, while management is responsible for the implementation, integrity and maintenance of risk management systems. Bank examiners normally review bank and bank holding company board performance and make recommendations for improvement if they find weaknesses.¹⁹

During the financial crisis, regulators actively used their authority to review board performance and, in some cases, they encouraged banks to include directors with more banking experience and less ties to management on their boards.

The Federal Reserve Act and implementing regulations also govern extensions of credit by a bank to an executive officer, director or principal shareholder of that bank, of a bank holding company of which the member bank is a subsidiary, or of any other subsidiary of that bank holding company. In general, a bank may not extend credit to any such 'insider' unless the extension of credit (1) is made on substantially all the same terms, and subject to no less stringent credit underwriting procedures, as those for comparable transactions by the bank with persons who are not insiders and not employed by the bank, and (2) does not involve more than the normal risk of repayment or present other unfavourable features. Regulatory reform proposals would strengthen insider loan restrictions, including credit exposures on derivative transactions

17 FDIC, Notice of Proposed Rulemaking and Request for Comment: Assessments, 75 Fed. Reg. 23516 (3 May 2010), <http://edocket.access.gpo.gov/2010/pdf/2010-10161.pdf>.

18 12 CFR §347.213, <http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&rgn=div5&view=text&node=12:4.0.1.2.35&idno=12#12:4.0.1.2.35.1.3.13>; FDIC, Final Rule: Deposit Insurance Regulations; International Banking, Foreign Banks, 74 Fed. Reg. 47711, (17 September 2009) <http://fdsys.gpo.gov/fdsys/pkg/FR-2009-09-17/pdf/E9-22406.pdf>.

19 OCC, Directing Red Flags in Board Reports – a Guide for Directors (2004), http://www.occ.treas.gov/RF_Book.pdf; OCC, Internal Controls – a Guide for Directors (2000), <http://www.occ.treas.gov/director.pdf>; OCC, The Director's Handbook – the Role of National Bank Director (1997), <http://www.occ.treas.gov/director.pdf>.

with insiders, and impose limitations on asset purchases from insiders.²⁰ It is likely that these proposals will be a part of the financial regulatory bill.

i New areas of regulatory focus – executive compensation

Since 2008, bank and bank holding company management compensation has become an area that has received widespread media, political and regulatory attention. Prior to the financial crisis, although there was regulatory guidance in place with respect to bank management compensation,²¹ there was little regulatory guidance with respect to bank holding company management compensation. After government assistance to banks and bank holding companies resulted in increased public scrutiny of compensation, Congress and regulators have both formally and informally become more involved in reviewing compensation packages and providing input on the appropriateness of compensation.

On 22 October 2009, the Federal Reserve announced a proposed regulatory framework intended to address risky incentive compensation practices at financial institutions and align shareholder and employee incentives.²² The Federal Reserve expects all banking organisations to evaluate their incentive compensation arrangements and related risk management, control, and corporate governance processes. In addition, the Federal Reserve commenced two supervisory initiatives: a special horizontal review of incentive compensation practices at 28 large complex banking organisations, whereby supervisory findings will be incorporated into each organisation's supervisory ratings, and a review of incentive compensation practices at regional, community and other banking organisations not classified as large complex banking organisations as part of the risk-focused examination process for these organisations.

The Federal Reserve's proposed guidance is notable and different from other executive compensation proposals in that it:

- a* avoids prescriptive formulas, pay caps and automatic deferrals – instead, it imposes the responsibility on management to craft compensation programmes that are appropriate for their organisations; and
- b* focuses on those employees, whether executive or non-executive, who individually or as a part of a group, have the ability to expose the banking organisation to material amounts of risk; it will challenge the banking organisations to characterise the risk profiles of different positions and organisations and to implement compensation programmes that contribute to risk management.²³

20 Wall Street Reform and Consumer Protection Act of 2009, HR 4173, 111th Cong. §1310 (2009); Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §614 (2010).

21 OCC, Charters, *Comptroller's Licensing Manual* 13–15 (2009), <http://www.occ.treas.gov/corpbook/group4/public/pdf/charters.pdf>.

22 Federal Reserve System, Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55227 (27 October 2009), <http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf>.

23 Davis Polk client memorandum, Federal Reserve Proposed Guidance: Aligning Incentive Compensation with Safety and Soundness Concerns (27 October 2009), www.davispolk.com/files/Publication/ddd7e00e-96dc-4bc1-a241-54f8859f76d1/Presentation/PublicationAttachment/66fe94b0-6c4d-43a3-bc4f-5722c2d485b0/102709_fed_comp%20_guidance.pdf.

Despite the fact that this is only proposed guidance, it has been reported that Federal Reserve supervisors have already met with at least 25 of the largest US banks and have required that they submit plans for repairing deficiencies in how they monitor pay. On 6 May 2010, Chairman Bernanke said that the Federal Reserve is moving ahead with issuing final compensation guidance.²⁴ As of 26 May 2010, it has yet to be issued.

On 12 January 2010, the FDIC issued an advance notice of proposed rule-making, requesting comment on whether compensation policies should be incorporated as a factor in the risk-based insurance premiums charged to insured depository institutions.²⁵ The premise of this rulemaking is that compensation systems that encourage excessively risky behaviour pose a threat to the depository institution and its stakeholders, including the DIF.²⁶

The FDIC plans to hold a meeting in June 2010 to issue a formal proposal based on the advance notice of a proposal. FDIC Chairman Bair has said that the formal proposal will focus on 'variable pay', including bonuses and other incentive compensation. It will also focus on the strength of corporate governance over pay, and may include quantitative measures, such as compensation as a percentage of net operating income, unlike the Federal Reserve's proposal.²⁷

Regulatory capital

Regulatory capital has emerged from the financial crisis as one of bank regulators' primary areas of supervisory focus. This section will cover existing capital requirements and how US regulators have addressed the perceived failures of such capital requirements to provide US bank holding companies and banks with enough capital to withstand the financial crisis. This section will also cover proposals for reforming international bank capital requirements and their implications, including the development of new bank capital instruments.

24 Vicki Needham, Bernanke Backs Financial Reform, Says Fed Is Moving Forward, *The Hill*, 6 May 2010, <http://thehill.com/blogs/on-the-money/domestic-taxes/96459-bernanke-backs-financial-reform-says-fed-is-moving-forward->.

25 FDIC, Advance Notice of Proposed Rulemaking, Incorporating Employee Compensation Criteria into the Risk Assessment System, 75 Fed. Reg. 2823 (proposed 19 January 2010), <http://frwebgate3.access.gpo.gov/cgi-bin/PDFgate.cgi?WAISdocID=29610323686+3+2+0&WAISaction=retrieve>.

26 FDIC, Advance Notice of Proposed Rulemaking, Incorporating Employee Compensation Criteria into the Risk Assessment System, 75 Fed. Reg. 2823 (proposed 19 January 2010), <http://frwebgate3.access.gpo.gov/cgi-bin/PDFgate.cgi?WAISdocID=29610323686+3+2+0&WAISaction=retrieve>.

27 Karey Wutkowski, 'Pay Czar Says FDIC Has Vital Role in Policing Pay', *Reuters*, 29 April 2010, <http://uk.reuters.com/article/idUK'TRE63S4RP20100429>.

i Capital rules applied to US banks

Basel II implementation

In 2004, the Basel Committee on Banking Supervision (‘the Basel Committee’) published capital guidelines, known as Basel II, governing the capital adequacy of large, internationally active banking organisations or ‘core’ banking organisations with at least \$250 billion in consolidated total assets or at least \$10 billion of on-balance sheet foreign exposures. Unlike many international jurisdictions that have already implemented Basel II, implementation is still ongoing in the United States. The bank regulators’ final rule to implement the advanced approaches of Basel II for core banking organisations became effective on 1 April 2008, and it is expected that core banks will have completed Basel II implementation by mid-2011.²⁸ Core banks consist of approximately eleven²⁹ banks that account for over half of the total US banking system’s assets. ‘Non-core’ or ‘general’ banking institutions were permitted to continue to use Basel I or the Basel II standardised approach, known as Basel I-A.³⁰

Current capital requirements

In order to be considered ‘adequately capitalised,’ a bank holding company must have a tier 1 capital ratio of at least 4 per cent, a total capital ratio of at least 8 per cent and a leverage ratio (tier 1 capital to average total assets) of at least 4 per cent. To be ‘well capitalised’ a bank holding company must have a tier 1 capital ratio of at least 6 per cent, a total capital ratio of at least 10 per cent and a leverage ratio of at least 5 per cent. Most bank holding companies in the US are required to be well capitalised as a result of electing to be financial holding companies as discussed in more detail in Section IV, *infra*. Banks are also subject to their own capital standards. Although the Federal Reserve,

28 *Walter W Eubanks, Cong. Research Service, RL 34485, Basel II in the United States: Progress Toward A Workable Framework* (2008); Mark Sobel, Deputy Assistant Secretary, US Dep’t of the Treasury, Transatlantic Cooperation on Financial Regulatory Reform, Remarks at the Centre for European Policy Studies Brussels (28 April 2010), www.treas.gov/press/releases/tg663.htm.

29 Fed. Reserve, Basel II Capital Accord, Preamble, Notice of Proposed Rulemaking and Supporting Board Documents (30 March 2006), www.federalreserve.gov/generalinfo/Basel2/DraftNPR/npr/section_2.htm (noting that as of the date of the notice, eleven top-tier banking organisations met the core bank criteria).

30 In June 2008, the federal banking agencies issued a proposed rule that would give all non-core banking institutions the option to adopt a new risk-based framework. This framework would adopt the standardised approach of Basel II for credit risk and the basic indicator approach of Basel II for operational risks. The proposed rule, if adopted, will replace the Basel I-A option. Joint notice of proposed rulemaking implementing the Basel II standardised risk-based capital framework in the United States, 73 Fed. Reg. 43982 (proposed 29 June 2008), <http://edocket.access.gpo.gov/2008/pdf/E8-16262.pdf>.

OCC and FDIC all require that the banks that they supervise have a minimum risk-based capital ratio of 8 per cent, some of the capital components may differ.³¹

Capital elements

There are two types of capital components that banking regulators use in monitoring the financial health of banks: ‘core capital elements’ (‘tier 1’ capital elements) and ‘supplementary capital elements’ (‘tier 2’ capital elements).

In the case of bank holding companies, tier 1 capital is composed of common stock, non-cumulative perpetual preferred stock, certain restricted core capital elements,³² disclosed reserves and minority interests in the equity accounts of consolidated subsidiaries. In the case of banks, trust preferred securities and hybrid securities are not considered tier 1 capital elements and may be included only in tier 2 capital.

Tier 2 capital is composed of capital items that are considered to be important parts of a bank’s capital base, but may not have the same loss-absorbing properties as tier 1 capital. Tier 2 capital, for bank holding companies, includes hybrid capital instruments (e.g, mandatory convertible debt, cumulative perpetual preferred stock), term subordinated debt, intermediate-term preferred stock and certain types of reserves.³³

On a case-by-case basis, the Federal Reserve, or other federal bank regulator, may determine whether, and to what extent any instrument that does not fit wholly within the terms of a regulatory capital element will qualify as an element of tier 1 or tier 2 capital.

Capital instruments can ‘qualify’ as an element of tier 1 or tier 2 capital by meeting certain conditions and restrictions, specifically, the element must:

- a* be fully paid up and effectively unsecured;³⁴
- b* be subordinated to all senior indebtedness of the organisation, and, if issued by a bank, must also be subordinated to claims of depositors;
- c* not contain or be covered by any covenants, terms or restrictions that are inconsistent with safe and sound banking practices (i.e., provisions that adversely affect liquidity, limit management’s flexibility to run the business or limit regulators’ ability to resolve problem bank situations); and
- d* meet certain additional qualifications.

31 For a summary of bank capital requirements, see *Mark Jickling & Edward V Murphy, Cong. Research Service, R40249, Who Regulates Whom? An Overview Of US Financial Supervision* 9 (2009), http://assets.opencrs.com/rpts/R40249_20091214.pdf.

32 Restricted core capital elements include: qualifying cumulative perpetual preferred stock and qualifying trust preferred securities (must be issued by a trust or similar entity sponsored, but generally not consolidated, by a banking organisation that is the sole common equity holder of the trust).

33 See, e.g., undisclosed reserves, asset revaluation reserves, general provisions or general loan-loss reserves.

34 If a banking organisation has purchased or has directly or indirectly funded the purchase of its own capital instrument, that instrument generally is disqualified from inclusion in regulatory capital.

ii *Adequacy of capital standards challenged by the financial crisis*

The collapse, and near collapse, of several financial institutions challenged the notion that the Basel rules, as applied, were accurate indicators of the appropriate amount of capital that institutions needed in order to remain solvent during unexpected and severe market shocks, such as the severe downturn in the US housing market, the first domino to fall during the financial crisis.

Unable to change capital requirements quickly in response to the crisis, bank regulators instead used their existing regulatory authority to informally encourage or formally require bank holding companies and their subsidiary banks to increase their capital. Federal Reserve Board policy requires a bank holding company to act as a source of financial and managerial strength to each of its subsidiary banks and to commit resources to their support. Similarly, under the cross-guarantee provisions of the Federal Deposit Insurance Act, the FDIC can hold any FDIC-insured depository institution liable for any loss suffered or anticipated by the FDIC in connection with ‘the default’ of a commonly controlled FDIC-insured depository institution or any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution ‘in danger of default’. The result of the bank regulators’ efforts was the beginning of a sustained period of increased bank capital offerings and minority investments in banks.³⁵

In the case of bank holding companies or banks that were dangerously close to becoming or that were not adequately capitalised regulators used more formal mechanisms, such as enforcement actions, pursuant to the statutory authority provided in the Federal Deposit Insurance Corporation Improvement Act of 1991³⁶ to compel such institutions to increase their capital. In 2009, the number of formal supervisory enforcement actions against financial institutions and institution affiliated parties reached unprecedented levels. Bank regulators issued 1,143 formal enforcement actions against

35 Alejandro Lazo, ‘Washington Mutual Gets \$7 Billion Boost’; ‘Bank to Close Home-Loan Offices, Eliminate 3,000 Jobs’, *Washington Post*, 9 April 2008, www.washingtonpost.com/wp-dyn/content/article/2008/04/08/AR2008040803339.html; Morgan Stanley press release, ‘Morgan Stanley Announces Plan to Pursue Global Strategic Alliance with Mitsubishi UFJ Financial Group’ (22 September 2008), www.morganstanley.com/about/press/articles/6934.html; Goldman Sachs press release, ‘Berkshire Hathaway to Invest \$5 Billion in Goldman Sachs’ (23 September 2008); David Enrich & Damian Paletta, ‘Regulators Push the Banks – Seek Outside Capital, Market Officials Urge, and WaMu Is Doing So’, *Wall St Journal*, 7 March 2008, <http://online.wsj.com/article/SB120486529923119143.html>; Tomoeh Murakami Tse, ‘After Losses, Banks Do Damage Control’; ‘Citigroup, Others Shoring Up Capital’, *Washington Post*, 30 April 2008, www.washingtonpost.com/wp-dyn/content/article/2008/04/29/AR2008042902700.html.

36 The Federal Deposit Insurance Corporation Improvement Act of 1991 requires the relevant federal banking regulator to take ‘prompt corrective action’ with respect to a depository institution if that institution does not meet certain capital adequacy standards. Federal Deposit Insurance Corporation Improvement Act §131(a), 105 Stat. 2253 (codified at 12 USC §1831o).

banks and bank holding companies, more than double the number issued in 2008.³⁷ While informal actions are not made public, some data indicates that the number of these actions in 2009 also doubled from 2008 levels, reaching 1,099.³⁸ The majority of these enforcement actions appear to have related to regulatory requirements to increase capital levels.³⁹

When it was clear that market confidence in bank holding companies' ability to remain solvent was not restored as a result of this initial capital raising activity and other government efforts discussed in Section V, *infra*, the government took further action by implementing the Supervisory Capital Adequacy Program ('the SCAP'). The Federal Reserve, supervisors, economists and analysts led and conducted the SCAP and assessed the amount of capital needed by the 19 largest US bank holding companies to withstand greater than expected losses and still remain sufficiently capitalised through 2010 to be able to meet the needs of their creditworthy borrowers. The SCAP consisted of a series of stress tests under a baseline economic scenario and a variety of more adverse scenarios.⁴⁰

A critical capital measure in the SCAP was tangible common equity, which is among the most conservative measures of a banking organisation's health since it only includes common equity and excludes preferred stock and intangible assets. This measure, as opposed to traditional tier 1 capital, has gained increasing favour among bank regulators as a benchmark for a banking organisation's capital adequacy. Measurements of the stress-tested bank holding companies' tangible common equity revealed severe weaknesses, as many of the banks failed to satisfy the 3 per cent target for the tangible common equity ratio.

Ten bank holding companies that were examined in the SCAP took various remediating actions to increase their regulatory capital, including new issuances of common equity or other eligible securities of \$39 billion, conversions of existing preferred equity to common equity in the amount of \$23 billion, and sales of businesses or portfolios of assets that increased common equity by \$9 billion. Some firms also increased capital through reduced dividend payments and issuance of common shares to employee stock ownership plans.⁴¹

The SCAP was seen as largely successful in helping to restore the marketplace's confidence in US financial institutions' solvency because the methodology and results

37 Cheyenne Hopkins, 'Regulatory Actions Hit a Record Level in '09', *Am. Banker*, 10 March 2010, www.americanbanker.com/issues/175_46/reg-actions-hit-a-record-level-1015700-1.html.

38 *Id.* The referenced data was provided to the *American Banker*.

39 See, e.g., 'Supervision, Regulation and Credit Dep't., Federal Reserve Bank of Philadelphia, Formal Enforcement Actions Issued Against Institutions – What Do Today's Numbers Say?', 14 *SRC Insights* 2, www.philadelphiafed.org/bank-resources/publications/src-insights/2009/fourth-quarter/Insights4_09.pdf.

40 *Fed. Reserve, The Supervisory Capital Assessment Program: Overview of Results* (2009), www.federalreserve.gov/bankinforeg/bcreg20090507a1.pdf.

41 Fed. Reserve press release, 'Federal Reserve Board Makes Announcement Regarding the Supervisory Capital Assessment Program (SCAP)' (9 November 2009), www.federalreserve.gov/newsevents/press/bcreg/20091109a.htm.

of the tests were made public and because financial institutions were indeed able to raise the necessary capital in the markets after the tests. As a result, some bank regulators have suggested that stress testing should become a part of routine bank examinations, while others have remained reluctant. For instance, Federal Reserve Governor Daniel Tarullo has said that bank regulators should consider conducting routine, publicly disclosed stress tests,⁴² while Comptroller of the Currency John Dugan has said that stress tests are unlikely to become a standard tool for regulators that will be released publicly, particularly because some of the *ad hoc* decisions made by regulators in designing the original tests make the process too imprecise.⁴³ Some Congresspersons have also taken the view that stress testing should become routine and have introduced proposed legislation on the subject.⁴⁴

iii The future of regulatory capital and practical implications

An international consensus has emerged that bank holding companies and banks must be required to hold more capital. Analysts have already begun estimating the financial impact that such increased capital requirements may have on the financial industry. JP Morgan analysts have estimated that the capital needs of US banks would be \$44 billion higher and all banks would be \$221 billion higher, in the event that all capital reforms are implemented.⁴⁵ Accordingly, capital reform can be viewed as one of the most important aspects of the regulatory reform movement currently under way. Aside from the impact on business models and pricing, the proposed changes may require new capital instruments to meet banks' new regulatory capital needs.

US and Basel capital proposals

On 3 September 2009, the US Treasury issued a policy statement entitled 'Principles for Reforming the US and International Regulatory Capital Framework for Banking Firms'.⁴⁶ The policy statement was developed in consultation with bank regulators and contemplates significant revisions to, and perhaps the replacement of, major parts of the

42 Karey Wutkowski, 'Fed's Hoenig: Banks Should Reveal Stress Tests', *Reuters*, 26 April 2010, www.reuters.com/article/idUSTRE63P65I20100426.

43 Michael R Crittenden, 'OCC's Dugan: Bank Stress Tests Worked But May Not Be Repeated', *Wall St Journal*, 15 April 2010, <http://online.wsj.com/article/BT-CO-20100415-715020.html>.

44 Wall Street Reform and Consumer Protection Act of 2009, HR 4173, 111th Cong §1115 (2009).

45 They also estimate that banks could end up passing the cost on to customers through higher prices. 'In order to return to similar levels of profitability as per current forecasts, we estimate that pricing on all products (retail banking, commercial banking and investment banking) would have to go up by 33 per cent', Nick O'Donohue, head of research at JP Morgan, said. See Steve Slater, 'Bank Reform May Have \$220 Bln Capital Hit', *Reuters*, 17 February 2010, <http://uk.reuters.com/article/idUKTRE61G27M20100217>.

46 US Dep't of the Treasury, 'Principles for Reforming the US and International Regulatory Capital Framework for Banking Firms' (3 September 2009), www.treas.gov/press/releases/docs/capital-statement_090309.pdf.

Basel I and Basel II capital frameworks. Aside from calling for higher capital requirements, the policy statement also called for better-quality capital stating that, ‘voting common equity [should] represent a large majority of a banking firm’s tier 1 capital [...] and tier 1 capital should constitute a large majority of a banking firm’s total regulatory capital’. The policy statement also calls for a non-risk-based leverage constraint, an explicit liquidity standard and the introduction of countercyclical elements to the regulatory capital regime that would require banking firms to increase the size of their capital buffers in expanding economic cycles that would serve as a source of capital during contracting economic cycles. Treasury has said that it seeks to reach a comprehensive international agreement on capital by 31 December 2010, with implementation of reforms by 31 December 2012.⁴⁷

On 17 December, 2009, the Basel Committee also issued a set of capital proposals entitled ‘Strengthening the Resilience of the Banking Sector’,⁴⁸ which would revise the definitions of tier 1 capital and tier 2 capital. Among other things, the proposals would not permit innovative capital instruments such as trust-preferred securities and other instruments that pay cumulative distributions to be included in tier 1 capital. The Basel Committee’s proposals would also require that common equity be the predominant component of tier 1 capital by adding a minimum common equity to risk-weighted assets ratio, the impact of which will be amplified by the proposed requirement that regulatory adjustments, including deductions for goodwill and deferred tax assets, be made from tier 1 common equity. The Basel Committee has yet to determine the exact ratio. It will be determined based on the outcome of a quantitative impact study conducted by the Basel Committee earlier this year.⁴⁹ The Basel Committee also introduced a series of liquidity proposals entitled ‘International Framework for Liquidity Risk Measurement, Standards and Monitoring’,⁵⁰ which proposes two measures of liquidity risk exposure: a liquidity coverage ratio, requiring ‘high-quality liquid assets’ to equal or exceed 100 per cent of estimated ‘net cash flows’ over a 30-day period of stress; and a net stable funding ratio, addressing mismatches of funding sources and liabilities over a one-year period under stressed conditions. Comments were due on these proposals by 16 April 2010, and the Basel Committee anticipates finalising a complete set of standards by 31 December 2010, with final implementation by 31 December 2012.

The implementation of the Basel Committee’s proposals in the United States will depend in part on whether the proposed financial regulatory reform legislation, when finally enacted, will require the US banking regulators to adopt regulatory standards

47 US Dep’t of the Treasury press release, ‘Stronger Capital and Liquidity Standards for Banking Firms’ (3 September 2009), www.ustreas.gov/press/releases/tg274.htm.

48 Basel Comm. on Banking Supervision, consultative document, ‘Strengthening the Resilience of the Banking Sector’ (2009), <http://www.bis.org/publ/bcbs164.pdf>.

49 Basel Comm. on Banking Supervision, Instructions for the Comprehensive Quantitative Impact Study (2010), www.bis.org/bcbs/qis/qiscompinstr.pdf.

50 Basel Comm. on Banking Supervision, consultative document, International Framework for Liquidity Risk Measurement, Standards and Monitoring (2009), www.bis.org/publ/bcbs165.pdf?noframes=1.

that in substance will be consistent with the Basel Committee proposals. As of 26 May 2010, the Senate financial regulatory reform bill contains a requirement that the federal banking regulators must establish minimum leverage and risk-based capital requirements, ‘not less than’ those currently applicable to banks rather than bank holding companies, to all insured depository institutions and their holding companies as well as systemically important non-bank financial companies (such as insurance companies). In addition, the federal bank regulators’ capital requirements would be required to address risks deemed to be systemic, including risks arising from (1) significant volumes of activity in derivatives, securitised products, financial guarantees, securities borrowing and lending, and repo transactions; (2) concentrations in assets for which reported values are based on models; and (3) concentration in market share for any activity that would substantially disrupt financial markets if an institution were forced to unexpectedly cease the activity.⁵¹

New bank capital instruments

One likely result of these capital reform proposals is that a new set of bank capital instruments will need to be developed and negotiated with regulators. The capital instruments that have attracted the most interest thus far are contingent convertible bonds, or bonds that convert into loss-absorbing equity once a certain trigger is breached, such as a bank’s tier 1 ratio falling below a certain level.

Treasury Secretary Geithner and Federal Reserve Chairman Bernanke have both said that requiring banks to hold contingent capital would help in easing the impact of future crises. Chairman Bernanke noted that the central bank is looking at this option ‘very carefully’.⁵² As of 26 May 2010, the Senate financial regulatory reform bill would permit the Federal Reserve Board to require contingent capital in its regulatory capital standards, but only after an interagency council known as the Financial Stability Oversight Council completes a study on contingent capital and reports on the results to Congress.

Contingent capital has already been issued in the UK, first by Lloyds Banking Group, with Lord Turner, the chairman of the FSA, urging banks, ‘to create a role for contingent capital’.⁵³ Proponents of contingent capital say that benefits include allowing financial firms to raise capital when they most need it. They also argue that, by exposing bondholders to more risk, it could improve incentives for bank management not to take on excessive risk.⁵⁴

Despite regulatory support for contingent capital, Standard & Poor’s (‘S&P’) issued a report on 10 November 2009 stating that they did not see them as a form of common equity and would generally view them as hybrid equity. S&P noted that contingent capital may not convert into ‘equity early enough to help the issuer since, “[p]ublished capital

51 Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §171 (2010).

52 Brai Odion-Esene & Ian McKendry, ‘Geithner, Bernanke in Favor of Banks Holding Contingent Capital’, *iMarketNews*, 20 April 2010, <http://imarketnews.com/node/12105>.

53 Anousha Sakoui & Patrick Jenkins, ‘Stability Concerns over CoCo Bonds’, *Financial Times*, 5 November 2009, www.ft.com/cms/s/0/833b6f8e-ca34-11de-a3a3-00144feabdc0.html.

54 Steven K Beckner, ‘Fed Board Staffers Mull “Contingent Capital” for Banks’, *iMarketNews*, 4 January 2010, <http://imarketnews.com/node/6647>.

ratios can be lagging indicators of financial strength'.⁵⁵ Some investors have also voiced concerns that by design, convertible capital would convert into equity at a time when a bank's share price is likely to already be under pressure and accordingly it might do more harm than good because the expectation of large amounts of debt converting into equity may exacerbate share price declines and create investor panic.

IV CONDUCT OF BUSINESS

Bank holding company and bank activities are subject to a number of overlapping legal requirements. Some of the most important are summarised below.

Banking v. non-banking activities

The Bank Holding Company Act ('the BHC Act') generally prohibits a bank holding company from owning or controlling any company other than a US bank or from engaging in, or directly or indirectly owning or controlling any company engaged in, any activities that are not 'so closely related to banking as to be a proper incident thereto'.⁵⁶ These restrictions on the non-banking activities and investments of a bank holding company reflect the traditional US policy of maintaining an appropriate separation between banking and commerce.⁵⁷

The BHC Act was amended by the Gramm-Leach-Bliley Act of 1999 ('the GLB Act') to permit bank holding companies to exercise certain expanded powers if they

55 John Glover, 'CoCos Are No Cure-All for Banks' Capital Requirements, S&P Says', *Bloomberg*, 10 November 2009, www.bloomberg.com/apps/news?pid=20601009&sid=aJn9_iFJ4nBg (quoting Lloyds securities analysts).

56 See 12 USC §1843(a), (c)(8). The BHC Act also contains various narrow exemptions from this general prohibition, including exemptions that allow a bank holding company (1) to make non-controlling investments for its own account or an investment fund controlled by it in up to 4.9 per cent of any class of voting securities and up to 24.9 per cent of the total equity (including voting, non-voting securities and subordinated debt) of any non-banking company; (2) to invest in a subsidiary that does not have any office or direct or indirect subsidiary or otherwise engage in any activities directly or indirectly in the United States, other than those that are incidental to its foreign or international business; (3) to hold investments as a fiduciary; or (4) to furnish services to its subsidiaries (12 USC §§1843(c)(1)(C); (c)(4), (c)(6), (c)(7), (c)(13)).

57 This traditional policy is justified mainly on the grounds that the mixing of banking and commerce would lead to (1) conflicts of interest in the allocation of credit, (2) potential increased risks to insured depository institutions and expansion of the federal deposit insurance safety net, (3) undue concentration of economic power and therefore anti-competitive behaviour, and (4) the creation of conglomerates that would be too complex to manage or supervise because it is not possible to have the skills needed to manage or supervise both financial and commercial businesses in the same group. See, e.g., Leach, 'The Mixing of Commerce and Banking', in *Proceedings of the 43rd Annual Conference on Banking Structure and Competition, Federal Reserve Bank of Chicago*, 13 (May 2007).

qualify for and elect to be treated as financial holding companies, or FHCs.⁵⁸ In contrast to ordinary bank holding companies, FHCs are not limited to owning and controlling banks and engaging in, or owning or controlling companies engaged in, activities that are ‘closely related to banking’. FHCs may also engage in, or own or control any companies engaged in, any activity that is financial in nature, incidental to a financial activity or complementary to a financial activity.⁵⁹ This category of financial and financial-related activities includes everything deemed to be ‘closely related to banking’ and much more.⁶⁰ In particular, FHCs are permitted to make controlling and non-controlling investments in companies engaged exclusively in financial activities or activities that are incidental or complementary to financial activities, including securities underwriting and dealing, insurance underwriting, merchant banking, insurance company portfolio investments and certain commodities trading.⁶¹ They are also permitted to make controlling and non-controlling investments in non-financial and mixed financial/non-financial companies, including companies engaged in owning and managing real estate, subject to certain conditions, under the merchant banking power.⁶²

i Proposed changes in permitted activities

The Volcker Rule

By early 2010, the expanded financial activities for FHCs that was permitted by the GLB Act were called into question by the President and lawmakers alike. Proprietary trading activity by banks and bank holding companies, in particular, has been a subject of much scrutiny and criticism, and has become an area of focus of politicians who perceive it to have contributed to the financial crisis. In response, the President put forth a proposal, advocated by former Federal Reserve Chairman Paul Volcker, to prohibit banks and bank holding companies from investing in or sponsoring hedge funds and private equity funds and to prohibit proprietary trading for the institution’s own profit.⁶³ This proposal has been referred to as ‘the Volcker Rule’.

58 Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 106th Cong., 1st Sess. (12 November 1999), 113 Stat. 1338–1481 (1999). The GLB Act continues to reflect the US policy of maintaining an appropriate separation between banking and commerce, but it reduced the degree of that separation.

59 12 USC §1843(k)(1).

60 12 USC §1843(k)(4), especially (k)(4)(F).

61 12 USC §§1843(k)(4)(B) (insurance underwriting); (k)(4)(E) (securities underwriting and dealing); (k)(4)(H) (merchant banking); (k)(4)(I) (insurance company portfolio investments). See, e.g., The Royal Bank of Scotland, 94 *Federal Reserve Bulletin* C60 (2008) (certain energy commodities trading as a complement to energy derivatives trading).

62 12 USC §(k)(4)(H) (merchant banking).

63 The White House press release, ‘President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers’ (21 January 2010), www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e.

As of 26 May 2010, the Senate financial regulatory reform bill prohibits insured depository institutions, their holding companies, any company treated as a bank holding company for purposes of the BHC Act (such as a non-US bank with a commercial banking presence) and any of their subsidiaries (including broker-dealers and fund managers) from engaging in proprietary trading or investing in or sponsoring hedge funds or private equity funds. Exceptions to the ban on proprietary trading include trading on behalf of a customer, as part of market making activities, or otherwise in connection with or facilitation of customer relationships (including related risk-mitigating hedging activities), but the precise definition of these exceptions is currently unknown and likely will not be clarified until the US bank regulators draft the necessary implementing regulations.⁶⁴

Derivatives

There have been a number of proposals to reform the regulation of the derivatives market. The most significant proposals for bank holding companies and banks are proposals that would (1) require most derivative contracts to be cleared through central clearinghouses and traded on exchanges and require information concerning all other derivatives contracts to be reported to trade repositories or regulators, (2) provide regulatory agencies significant new authorities to ensure that all swaps dealers and major swap participants are subject to strong capital, margin and collateral requirements with respect to their swap activities and (3) effectively prohibit all insured depository institutions from acting as a swap dealer or a major swap participant. As of 26 May 2010, all of these proposals have been incorporated into the Senate financial regulatory reform bill.⁶⁵

While most regulators and analysts have agreed with some form of increased transparency in the derivatives trading market, and have disagreed on the implementation details, the proposal to effectively prohibit any insured depository institutions from acting as a swap dealer or major swap participant has garnered not only industry opposition, but also opposition from the Federal Reserve, the Obama Administration and even former Federal Reserve Chairman Paul Volcker. Opponents of this prohibition generally argue that, by pushing swaps activities out of highly regulated banks and into less regulated financial entities, including non-US financial firms, systemic risk will actually increase. Opponents have also argued that, since it is unlikely for these prohibitions to be implemented internationally, non-US financial firms would be more competitive in the derivatives market than US financial firms.⁶⁶ As of 26 May 2010, there is speculation

64 Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §619 (2010).

65 *Id.* §§723, 731, 736, *et seq.* (2010).

66 See Letter from Fed. Chairman Benjamin Bernanke to Lawmakers (13 May 2010), <http://blogs.wsj.com/economics/2010/05/13/bernanke-letter-to-lawmakers-on-swaps-spin-off/>; Letter from Former Fed. Chairman Paul Volcker to Senators Dodd and Shelby (6 May 2010), www.scribd.com/doc/31049970/Volcker-s-Letter-on-Derivatives-Proposal.

that this effective prohibition may be eliminated from the final version of the financial regulatory reform bill.⁶⁷

Transactions with affiliates

Sections 23A and 23B of the Federal Reserve Act and the Federal Reserve Board's Regulation W restrict transactions between a bank and an affiliated company. Subsidiary banks are subject to certain restrictions on loans to affiliated companies. Generally, each subsidiary bank is limited in its extensions of credit to any affiliate to 10 per cent of the its capital and its extension of credit to all affiliates to 20 per cent of its capital. These limits are designed to protect a depository institution from suffering losses in its transactions with affiliates. The Federal Reserve implements these statutory provisions for all depository institutions and has the power to provide exemptions from these provisions.

As of 26 May 2010, the Senate financial regulatory reform bill calls for further constraints on the ability of banks to engage in over-the-counter derivatives and securities financing transactions with affiliates. Existing federal restrictions on transactions between banks and affiliates would be also be applied to transactions between a bank and private investment vehicles sponsored or advised by the bank. The Federal Reserve's discretion to provide exemptions from these rules would also be limited.⁶⁸

Consumer protection regulation

Traditional bank activities such as lending and deposit-taking are subject to a broad range of consumer protection statutes at both the federal and state level. Consumer protection statutes can generally be grouped into three categories: disclosure laws, civil rights laws and privacy laws.

i Overview

Disclosure laws include the Truth in Lending Act,⁶⁹ which establishes standard disclosures for consumer creditors nationwide. Important loan terms must be disclosed in uniform terminology, with rules for each type of credit. The Truth in Savings Act⁷⁰ requires that consumers receive written information about the terms of their deposit accounts and it also governs the advertising of deposits and interest computations.

67 Fawn Johnson, 'Sen. Reed Signals Support for "Volcker Rule" Over Swaps Ban', Dow Jones, 25 May 2010, www.americanbanker.com/syndication/reed-volcker-1019780-1.html; and Damian Paletta and Victoria McGrane, 'Frank: Provision to Force Banks to Spin Off Derivatives "Goes Too Far"', Dow Jones, 25 May 2010, www.americanbanker.com/syndication/derivatives-1019770-1.html.

68 Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §723 (2010).

69 Truth in Lending Act of 1968, Pub. L. No. 90-321, 90th Cong., 2nd Sess., (29 May 1968) 82 Stat. 146 (1968).

70 Truth in Savings Act of 1991, Pub. L. No. 102-242, 102nd Cong., 1st Sess., (19 December 1991) 105 Stat. 2236 (1991).

Civil rights laws include the Equal Credit Opportunity Act,⁷¹ which prohibits certain types of discrimination in personal and commercial transactions⁷² and the Community Reinvestment Act ('the CRA'),⁷³ intended to encourage depository institutions to help meet the credit and development needs of their communities, especially the needs of low-and moderate-income neighbourhoods. If a depository institution does not receive at least a satisfactory rating for its CRA compliance, it could prevent such an institution or its holding company from engaging in certain permissible activities for financial holding companies and acquisitions of other financial institutions.

Banks are also subject to certain consumer privacy laws. Title V of the GLB Act⁷⁴ governs the protection and disclosure of consumer financial information by institutions. The GLB Act and its regulations apply to individuals who acquire financial products or services primarily for personal, family or household purposes.

The GLB Act contains three basic requirements. A financial institution must provide:

- a* an initial notice to consumers that describes the institution's privacy policies and its practices regarding the disclosure of non-public personal information to affiliates and non-affiliated third parties;
- b* an annual notice of its privacy policies to any consumer with whom the institution continues to maintain a customer relationship; and
- c* an opportunity for customers to 'opt out' of having non-public personal information about them disclosed to non-affiliated third parties.

Bank regulatory guidelines require each financial institution to create, implement and maintain a comprehensive written information security programme designed to ensure the security and confidentiality of customer information, and protect against unauthorised access to or use of such information that could result in substantial harm or inconvenience to any customer.⁷⁵

A bank's primary regulator is responsible for ensuring the bank's compliance with federal consumer protection laws. Examinations and investigations of consumer

71 Equal Credit Opportunity Act of 1974, Pub. L. No. 93-495, 93rd Cong., 1st Sess., (28 October 1974) 88 Stat. 1521 (1974).

72 Creditors may not discriminate against an applicant, or discourage a potential applicant, on the basis of race, colour, religion, national origin, sex, marital status, age receipt of income from public assistance programmes, or good faith exercise of rights under the Consumer Credit Protection Act.

73 Community Reinvestment Act of 1977, Pub. L. No. 95-128, 95th Cong., 1st Sess. (12 October 1977), 91 Stat. 1111 (1977).

74 Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 106th Cong., 1st Sess. (12 November 1999), 113 Stat. 1338–1481 (1999).

75 Interagency Guidelines Establishing Standards for Safeguarding Customer Information and Rescission of Year 2000 Standards for Safety and Soundness; Final Rule, 66 Fed. Reg. 8616, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2001_register&docid=01-1114-filed.pdf.

complaints are used by regulators to check for compliance. For non-depository lenders, the Federal Trade Commission is responsible for enforcing consumer laws.

Depository institutions normally correct consumer protection law violations voluntarily during the course of regulators' examinations. However, if institutions do not voluntarily comply or the violations are particularly severe, civil money penalties may be applied by bank regulators. Most of the federal consumer credit laws can also be enforced by consumers through civil lawsuits, which may entitle consumers to an award of actual damages as well as punitive damages in some cases.

ii New developments

As part of the review into the causes of the financial crisis, the US Congress castigated federal bank regulators for not enforcing existing consumer protection statutes and for not implementing regulations that would have addressed some of the problems that were later discovered in the mortgage market.

Regulatory and legislative developments

In response, federal banking agencies have greatly increased their rule-making in the consumer protection area. Since September 2008, federal bank regulators have enacted almost twenty final rules regarding consumer protection matters, including amendments to the Truth in Lending Act that have included the addition of a new and restricted class of 'higher-priced mortgages,' new changes to mortgage disclosures and mortgage lending practices, and overdraft fee disclosures.

Congress has also seized on public anger over consumer protection matters and has passed the Credit CARD Act of 2009, which went into effect in February 2010 and limits when credit card interest rates can be increased on existing balances and allows consumers whose interest rates have been increased to reduce their rates to previous levels if they have paid their bills on time for six months.⁷⁶ Banking industry representatives have said that the new law will mean higher interest rates for all customers, including those that have good credit, and lowered credit limits or no credit cards at all for high-risk customers with bad credit. There is also pending legislation in Congress that seeks to limit bank overdraft fees.

Comprehensive consumer protection reform

Although Congress and bank regulators have tried to improve consumer protection regulation through use of existing statutory and regulatory tools, many have argued that a complete overhaul of the framework for consumer protection laws is required.

A key aspect of the proposed financial regulatory reform plan is a proposal for a Consumer Protection Financial Agency that would be responsible for issuing and enforcing consumer protection regulations. The House bill would create an autonomous federal agency that would be self-funded by industry assessments and would regulate

76 Connie Prater, 'Obama Signs Credit Card Reforms into Law', *Credit Card News*, 22 May 2009, www.creditcards.com/credit-card-news/obama-signs-credit-card-law-1282.php.

both banks and non-banks with respect to consumer financial products and services.⁷⁷ The Senate bill would create a bureau within, and funded by, the Federal Reserve.⁷⁸ Many in the financial industry have noted that either of these proposals would lead to an agency that would have ‘unprecedented authority to regulate in detail all bank consumer products and services’.⁷⁹

BSA/AML

The Bank Secrecy Act (‘BSA’),⁸⁰ as amended by the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (‘the PATRIOT Act’)⁸¹ requires all financial institutions, including banks, to, among other things, establish a risk-based system of internal controls reasonably designed to prevent money laundering and the financing of terrorism. The BSA includes a variety of recordkeeping and reporting requirements (such as cash and suspicious activity reporting), as well as due diligence/know-your-customer documentation requirements. Bank regulators and the Financial Crimes Enforcement Network or FinCEN, a division of the United States Treasury, issue and enforce BSA implementing regulations. Criminal anti-money laundering violations may also be prosecuted by the Department of Justice (‘the DoJ’).

*i New developments of interest to banks*⁸²

2010 Federal Financial Institutions Examination Council (‘FFIEC’) Bank Secrecy Act/ Anti-Money Laundering (BSA/ AML) Examination Manual

The FFIEC BSA/AML Examination Manual, released on 29 April 2010, is an important source of guidance for banks on the types of policies, procedures and processes that bank regulators expect them to implement in order to comply with BSA regulations. The 2010 manual updates guidance that had been in place since 2007 and includes reworked sections on enterprise-wide BSA/AML compliance programmes and suspicious activity reporting. The manual also provides more current guidance to bank examiners about

77 Wall Street Reform and Consumer Protection Act of 2009, HR 4173, 111th Cong. §§4001-4951 (2009).

78 Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §§1011, 1017 (2010).

79 Creating a Consumer Financial Protection Agency: A Cornerstone of America’s New Economic Foundation: Hearing before the S. Comm. on Banking, Housing and Urban Affairs, 111th Cong. (2009) (statement of Edward L Yingling, President and CEO, American Bankers Association).

80 Currency and Foreign Transactions Reporting Act, Pub. L. No. 91-508, Title II (1970).

81 The United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Publ. L. No. 107-56, 115 Stat. 272 (2001).

82 This discussion is limited to recent FinCEN regulatory actions of interest to banks. There have been a number of other actions taken by FinCEN relating to money services businesses, mutual funds and hedge funds that are beyond the scope of this article.

how to determine whether violations are systemic or recurring, as opposed to technical or isolated violations.⁸³

Beneficial ownership

FinCEN is devoting increasing attention to enhancing access to beneficial ownership information in order to combat the abuse of legal entities by those engaging in financial crimes.⁸⁴ As James Freis, Director of FinCEN, testified before the US Senate Committee on Homeland Security and Government Affairs in February 2010, ‘Heightened risks can arise with respect to beneficial owners of accounts because nominal accountholders can enable individuals and business entities to conceal the identity of the true owner of assets or property derived from or associated with criminal activity.’⁸⁵

On 5 March 2010, FinCEN, the SEC and the bank regulators, in consultation with staff of the Commodity Futures Trading Commission, issued intra-agency guidance on obtaining and retaining beneficial ownership information. The guidance, which is intended to clarify and consolidate existing US regulatory expectations relating to beneficial ownership information, reiterates that financial institutions are required to establish and maintain customer due diligence procedures that are reasonably designed to identify and verify the identity of beneficial owners of an account based on the institution’s evaluation of risk pertaining to that account. The guidance notes that certain trusts, corporate entities, shell entities and private investment companies are examples of customers that may pose heightened risk.⁸⁶

FinCEN has also noted that in addition to issuing this guidance it is also currently working with bank regulators and Congress to draft legislation that requires the submission of beneficial ownership information at the time of company formation, the obligation to keep that information updated throughout the entity’s existence and significant penalties for failure to abide by these requirements.⁸⁷ Considering the long

83 US Dep’t of the Treasury Press Release, Financial Crimes Enforcement Network, the 2010 Version of the Bank Secrecy Act/Anti-Money Laundering Examination Manual (29 April 2010), www.fincen.gov/news_room/nr/html/20100429.html; Fed. Fin. Inst. Examination Council, *Bank Secrecy Act/Anti-money Laundering Examination Manual* (2010), www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2010.pdf.

84 Keeping Foreign Corruption Out of the United States: Hearing before the S. Comm. on Homeland Security and Governmental Affairs, Subcomm. on Investigations, 111th Cong. (2010) (statement of James Freis, Director, FinCEN).

85 *Id.* FinCEN’s recently issued guidance regarding beneficial ownership, discussed below, repeats this statement.

86 FinCEN, Fed. Reserve, FDIC, OCC, OTS, SEC and NCUA joint release, Guidance on Obtaining and Retaining Beneficial Ownership Information (5 March 2010), www.FinCEN.gov/statutes_regs/guidance/pdf/fin-2010-g001.pdf.

87 Keeping Foreign Corruption Out of the United States: Hearing before the S. Comm. on Homeland Security and Governmental Affairs, Subcomm. on Investigations, 111th Cong. (2010) (statement of James Freis, Director, FinCEN).

list of Congressional priorities at the moment, it is unclear whether and when such legislation will be submitted and considered by Congress.

In addition, FinCEN reports that it is working with its counterparts in the Financial Action Task Force (‘FATF’) to ensure that FATF’s standards on beneficial ownership evolve in a way in which compliance is both achievable and effective.⁸⁸

SAR confidentiality

On 9 March 2009, FinCEN issued proposed rules that clarify the circumstances under which suspicious activity reports (or ‘SARs’) filings would be confidential.⁸⁹ The proposed rules would prohibit, with certain exceptions, financial institutions from disclosing SARs to any person, not only the persons involved in the transaction to which the SAR relates, as the current regulation provides. The proposed rules would also clarify that SARs and any information that would reveal the existence of a SAR are confidential;⁹⁰ however, the underlying facts, transactions and documents upon which a SAR is based would not be confidential and could be disclosed in civil litigation or any other proceedings.

FinCEN also issued proposed guidance on the sharing of SARs by depository institutions with certain affiliates.⁹¹ Current FinCEN guidance permits sharing of SARs upward in an organisational structure to entities that are deemed to control the financial institution.⁹² For example, depository institutions can share SARs with their US or non-US head offices or controlling companies. The proposed guidance clarifies that the proposed regulations discussed above would permit financial institutions to share SARs more broadly, with all affiliates that have SAR filing requirements, subject to written confidentiality agreements.

88 Keeping Foreign Corruption Out of the United States: Hearing before the S. Comm. on Homeland Security and Governmental Affairs, Subcomm. on Investigations, 111th Cong. (2010) (statement of James Freis, Director, FinCEN).

89 FinCEN, Notice of Proposed Rulemaking: Confidentiality of Suspicious Activity Reports, 74 Fed. Reg. 10148 (proposed 9 March 2010), www.fincen.gov/statutes_regs/frn/pdf/frnSAR_Confidentiality.pdf.

90 Current regulations have confused financial institutions because they contain less precise language that protects the confidentiality of SARs and any information that would disclose that a SAR has been prepared or filed.

91 FinCEN, Proposed Guidance: Sharing Suspicious Activity Reports by Depository Institutions, 74 Fed. Reg. 10158 (9 March 2010), www.fincen.gov/statutes_regs/frn/pdf/frnDI_SAR_Sharing.pdf.

92 US Dep’t of the Treasury, Interpretive Guidance – Sharing Suspicious Activity Reports by Depository Institutions With Certain US Affiliates, 74 Fed. Reg. 10158, 10159 (9 March 2009), <http://edocket.access.gpo.gov/2009/pdf/E9-4693.pdf>.

Information sharing

FinCEN has identified information sharing among governmental agencies and among financial institutions regarding potential money-laundering and terrorist activities as an important tool in combating financial crimes and a strategic focus area for the agency.⁹³

FinCEN regulations require financial institutions, upon FinCEN's request, to search their records to determine whether they have maintained accounts or conducted transactions with a person that a federal law enforcement agency has certified is suspected based on credible evidence of engaging in terrorist activity or money laundering.⁹⁴ On 10 February 2010, FinCEN adopted a final rule that expands this requirement to allow certain foreign,⁹⁵ state and local law enforcement agencies to initiate 314(a) inquiries as well, generally following the same procedures currently applicable to federal agencies.⁹⁶

The PATRIOT Act also allows two or more financial institutions to 'share information with one another regarding individuals, entities, organisations, and countries suspected of possible terrorist or money-laundering activities'.⁹⁷ Section 314(b) establishes a safe harbour from liability for a financial institution or a group of financial institutions that voluntarily chooses to share information with other financial institutions for the purpose of identifying and reporting possible money laundering or terrorist activities. Financial institutions had been hesitant to share information pursuant to this authority particularly in cases of fraud, since it is often unclear at the outset of a fraud investigation whether money laundering or terrorist activities are implicated.

In order to encourage more information sharing, on 16 June 2009, FinCEN issued guidance that included several types of suspected fraud as permissible information sharing categories covered by the Section 314(b) safe harbour.⁹⁸ FinCEN's Director James

93 Keeping Foreign Corruption Out of the United States: Hearing before the S. Comm. on Homeland Security and Governmental Affairs, Subcomm. on Investigations, 111th Cong. (2010) (statement of James Freis, Director, FinCEN).

94 31 CFR §103.100 (known as the '314(a) Rule' after Section 314(a) of the PATRIOT Act, which directs the Secretary of the Treasury to adopt such regulations). In the case of money laundering, FinCEN also requires the requesting agency to certify that the matter is significant, and that the requesting agency has been unable to locate the information sought through traditional methods of investigation before attempting to use this authority. FinCEN, Final Rule: Expansion of Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activity, 75 Fed. Reg. 6560 (10 February 2010), www.fincen.gov/statutes_regs/frn/pdf/20100204.pdf.

95 Members of the European Union that have signed the Agreement on Mutual Legal Assistance between the US and the European Union will be able to initiate 314(a) inquiries.

96 Agencies from foreign jurisdictions will be required to first contact a federal law enforcement officer that will be appointed as a 314(a) liaison between foreign jurisdictions and FinCEN. This federal law enforcement officer will confirm that the inquiry relates to a significant matter before referring the inquiry to a financial institution.

97 Pub. L. No. 107-56, §314(b). See also the implementing regulation at 31 CFR §103.110.

98 FinCEN, Guidance on the Scope of Permissible Information Sharing Covered by Section 314(b) Safe Harbor of the US PATRIOT Act (16 June 2009), www.fincen.gov/statutes_regs/guidance/pdf/fin-2009-g002.pdf.

Freis noted that FinCEN has, ‘already begun to see SARs being filed which indicate fraud-related information sharing involving suspected check fraud, wire transfer fraud, insurance fraud, mortgage fraud, new account fraud, and consumer loan fraud’.⁹⁹

BSA/AML enforcement activity

BSA/AML compliance was one of the top enforcement priorities for FinCEN and bank regulators from 2005 to 2007. BSA/AML enforcement increased dramatically during these years. There were six BSA/AML enforcement actions brought against financial institutions in 2005, while there were 32 in 2007.¹⁰⁰ By 2009, BSA/AML enforcement actions had decreased to 11, evidencing shifting priorities as regulators turned their focus to bank capital, liquidity and funding and managing bank failures. By 2010, many analysts had begun speculating that BSA/AML compliance would return to the forefront, with the financial crisis abating. In fact, several significant enforcement actions have already been brought and settled before the end of the second quarter.¹⁰¹

In May 2010, the former ABN AMRO Bank, NV (now named the Royal Bank of Scotland NV) (‘ABN AMRO’), agreed to forfeit \$500 million to the US in connection with a deferred prosecution agreement (‘DPA’). The bank was charged with a single count of violating the Bank Secrecy Act and one count of conspiring to defraud the US and to violate the International Emergency Economic Powers Act (‘IEEPA’) and the Trading with the Enemy Act (‘TWEA’).¹⁰² The BSA violations involved the failure of ABN AMRO’s New York branch to maintain adequate anti-money-laundering procedures and processes. According to court documents, ABN AMRO’s New York branch office lacked adequate staffing, training and oversight, which permitted multiple high-risk shell companies and foreign financial institutions to use the bank to launder money through the United States. In addition, ABN AMRO admitted that it failed to maintain proper documentation about its customers.¹⁰³ The OFAC violations in this case are described below.

In March 2010, Wachovia Bank (‘Wachovia’) entered into a DPA with the DoJ and the US Attorney’s Office in the Southern District of Florida. It agreed to forfeit \$110 million to the US and to pay an additional civil money penalty of \$50 million to the US pursuant to the terms of the DPA and a separate OCC order. Wachovia allegedly

99 James H Freis Jr, Director, FinCEN, Remarks at the Florida International Bankers Association 2010 AML Conference (18 February 2010).

100 See Bankers Online, ‘BSA/AML Penalties List’, www.bankersonline.com/security/bsapenaltylist.html#sanderson.

101 Cheyenne Hopkins, ‘As Crisis Wanes, AML Issues Returning to the Forefront’, *Am. Banker*, 11 March 2010, www.americanbanker.com/issues/175_47/anti-money-laundering-1015748-1.html.

102 International Emergency Economic Powers Act, 50 USC §§1701-1706; Trading with the Enemy Act, 50 USC App §§5(b) & 16. IEEPA and TWEA are two of several laws underlying the sanctions administered by the US Treasury’s Office of Foreign Assets Control.

103 Dep’t of Justice press release, ‘Former ABN AMRO Bank NV Agrees to Forfeit \$500 Million in Connection with Conspiracy to Defraud the United States and with Violation of the Bank Secrecy Act’ (10 May 2010), www.justice.gov/opa/pr/2010/May/10-crm-548.html.

wilfully failed to implement adequate BSA/AML policies, procedures, or monitoring controls and failed to effectively monitor for potential money-laundering activity more than \$420 billion in transactions with Mexican *casas de cambio*, resulting in the laundering of at least \$110 million in drug proceeds.¹⁰⁴

OFAC

The US Department of the Treasury's Office of Foreign Assets Control ("OFAC") administers US economic sanctions against foreign countries, entities and individuals to counter threats to the US national security, foreign policy or economy. The goal of these programmes is to deny, wholly or partly, the benefits of the US economy to targets of sanctions, by denying access to the financial system, capital markets, and import and export markets for goods, services and technology. There are more than twenty separately-imposed OFAC sanctions programmes. While OFAC is responsible for promulgating and administering the sanctions, all of the bank regulatory agencies cooperate in ensuring that financial institutions comply with the sanctions. OFAC sanctions may also carry criminal penalties and may be enforced by the DoJ.

One of the most important recent changes in OFAC regulations and enforcement has been the implementation of increased civil penalties for the violation of most OFAC sanctions. Pursuant to the International Emergency Economic Powers Enhancement Act passed in 2007, civil penalties for the violation of most OFAC sanctions increased from \$50,000 to the greater of twice the transaction value or \$250,000 per violation.¹⁰⁵ The severity of the potential penalties for violations, prompted OFAC to issue new final enforcement guidelines on 9 November 2009, in order to make its enforcement approach to apparent OFAC violations more transparent.¹⁰⁶

OFAC's enforcement guidelines note that OFAC will consider certain 'general factors' in determining the appropriate enforcement response to an apparent violation and, if a civil monetary penalty is warranted, in establishing the amount of that penalty. If it is determined that a civil penalty is appropriate, OFAC will generally mitigate the penalty based on certain factors such as voluntary self disclosure, cooperation with OFAC, and whether the case involved is a first time violation.

From 2006 to 2008, OFAC enforcement activity against financial institutions steadily increased. In 2006, there were 21 OFAC enforcement actions brought against financial institutions, while in 2008 there were 61.¹⁰⁷ While the total number of OFAC

104 Dep't of Justice press release, Wachovia Enters Into Deferred Prosecution Agreement (17 March 2010), www.occ.gov/ftp/release/2010-30a.pdf.

105 International Emergency Economic Powers Enhancement Act of 2007, Pub. L. No. 110-96, 110th Cong., 1st Sess., (16 October 2007), 50 USC §1701 note, 121 Stat. 1011-1012 (2007).

106 Office of Foreign Assets Control, Economic Sanctions Enforcement Guidelines, 74 Fed. Reg. 57593 (9 November 2009), <http://edocket.access.gpo.gov/2009/pdf/E9-26754.pdf>.

107 See OFAC, Civil Penalties and Enforcement Information, www.treas.gov/offices/enforcement/ofac/civpen/index.shtml (provides a year-by-year listing of all enforcement actions, including enforcement actions brought against financial institutions).

enforcement actions brought in 2009 decreased, very significant OFAC cases have been brought and settled recently.

For instance, Lloyds TSB Bank plc ('Lloyds') entered into a DPA with the DoJ on 9 January 2009.¹⁰⁸ According to the DPA, Lloyds, in the United Kingdom and through other non-US branches, removed or omitted identifying information, such as client names and addresses, from US-dollar payment instructions that it received from Iranian and Sudanese clients and forwarded them to non-affiliated US banks for processing. According to the DPA, this resulted in transactions being processed through US banks on behalf of sanctioned clients that OFAC would otherwise have required US banks to block or reject.

This prosecution marks the first time in recent history that US law enforcement authorities have asserted jurisdiction over a non-US person whose conduct occurred outside the United States, but which caused OFAC violations by a non-affiliated US person. Pursuant to the DPA, Lloyds agreed to forfeit \$350 million to federal enforcement authorities and New York State. ABN AMRO¹⁰⁹ and Credit Suisse AG¹¹⁰ settled similar charges for \$500 million and \$536 million, respectively, and other non-US banks have been reported to be under investigation for similar matters.

V FUNDING

Traditional funding sources

Bank holding companies and banks have a number of different funding sources, including (1) consumer-driven bank products and services such as demand deposit accounts, certificates of deposit and deposit sweeps; (2) interbank borrowing through agreements such as repurchase agreements; and (3) capital markets activities including commercial paper, subordinated debt, preferred securities and equity issuances and offerings.

Bank holding companies and banks also have access to additional funding and liquidity sources during strained credit markets when traditional funding sources may either be prohibitively expensive or unavailable. The Federal Reserve's discount window, available only to member banks and other depository institutions, which has existed since the Federal Reserve System was created in 1913, has long served the banking industry 'as a safety valve in relieving pressures in reserve markets'.¹¹¹ Its typical overnight extensions of

108 Dep't of Justice Press Release, 'Lloyds TSB Bank Plc Agrees to Forfeit \$350 Million in Connection with Violations of the International Emergency Economic Powers Act' (9 January 2009), www.justice.gov/opa/pr/2009/January/09-crm-023.html.

109 Dep't of Justice press release, 'Former ABN AMRO Bank NV Agrees to Forfeit \$500 Million in Connection with Conspiracy to Defraud the United States and with Violation of the Bank Secrecy Act' (10 May 2010), www.justice.gov/opa/pr/2010/May/10-crm-548.html. The \$500 million ABN AMRO settlement included the AML charges discussed *supra*.

110 Dep't of Justice press release, 'Credit Suisse Agrees to Forfeit \$536 Million in Connection with Violations of the International Emergency Economic Powers Act and New York State Law' (16 December 2009), <http://www.justice.gov/opa/pr/2009/December/09-ag-1358.html>.

111 Fed. Reserve, *The Federal Reserve Discount Window 1* (2008), www.frbdiscountwindow.org/discountwindow_pf.doc.

credit to depository institutions can ‘relieve liquidity strains in a depository institution and in the banking system as a whole’,¹¹² as well as ensuring ‘the basic stability of the payment system more generally by supplying liquidity during times of systemic stress’.¹¹³ Almost all discount window credit has been extended as secured advances for many years.¹¹⁴

Funding sources and the financial crisis of 2008

In the first quarter of 2008, the credit markets had become frozen for certain highly leveraged, largely unregulated market participants. As the value of their securities portfolios decreased, they were increasingly viewed by the credit markets as higher credit risks. As rumours swirled that some large financial institutions might collapse, interest spreads widened dramatically for all market participants and creditors refused to lend to certain borrowers. The problems reverberated throughout the global credit markets as market participants were unaware which of their counterparties might have significant exposure to troubled financial institutions, inhibiting lending even to financially strong borrowers.

i Federal Reserve response

By the time credit markets had practically frozen in March of 2008, it became clear that neither traditional funding sources nor the Federal Reserve’s discount window would be enough to restore credit, funding and liquidity to the markets. In response to these unprecedented credit needs, the Federal Reserve created several additional funding programmes, including the Primary Dealer Credit Facility, an overnight facility that provided secured loans to some of the United States’ largest investment banks and the Commercial Paper Funding Facility, which created a Federal Reserve special-purpose vehicle to purchase commercial paper directly from issuers, including non-depository institutions and even non-financial institutions. At the height of the financial crisis, just these two programmes alone had approximately \$365 billion in outstanding loans or advances, while all funding programmes totalled approximately \$2 trillion, providing much needed credit, funding and liquidity to the markets.¹¹⁵ These, and most similar Federal Reserve programmes, were terminated on 1 February 2010 once credit and funding markets had significantly improved.¹¹⁶

112 *Ibid.*

113 *Ibid.*

114 See James Clouse, Recent Developments in Discount Window Policy, 80 Fed. Reserve Bull. 966 (November 1994).

115 See Fed. Reserve, Periodic Report Pursuant To Section 129(B) of the Emergency Economic Stabilization Act of 2008: Update On Outstanding Lending Facilities Authorized by the Board Under Section 13(3) of the Federal Reserve Act 4-6 (29 December 2008).

116 Fed. Reserve Press Release, Federal Reserve Announces Extensions of and Modifications to a Number of its Liquidity Programs (25 June 2009), www.federalreserve.gov/newsevents/press/monetary/20090625a.htm; Federal Reserve funding programmes also included the Term Auction Facility, the Term Securities Lending Facility, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility and the Term Asset-Backed Securities

ii US government response

Although the Federal Reserve's programmes provided critical immediate funding for financial institutions, it was clear that the magnitude of the financial crisis required a more comprehensive solution. Congress passed the Emergency Economic Stabilisation Act ('EESA'), which authorised the Treasury to spend up to \$700 billion to purchase troubled assets and make capital injections, to provide financial institutions, and certain other entities, with much needed funding. EESA was signed into law on 3 October 2008.

One of the US Treasury's most important capital injection programmes was the Capital Purchase Program, which provided capital to financial institutions determined to be viable through the purchase of up to \$250 billion of senior preferred shares in such financial institutions, which included warrants for future Treasury purchases of common stock.¹¹⁷ As of 31 December 2009, the date on which the programme ended, Treasury had invested \$204.9 billion in 707 financial institutions and \$135.8 billion has been repaid as of 31 March 2010.¹¹⁸

Also in October 2008, the FDIC Board approved the Temporary Liquidity Guaranty Program ('TLGP') as part of the broader effort by the Treasury and the Federal Reserve to stabilise the nation's financial system. The purpose of TLGP was to provide funding and liquidity to the interbank lending market. The Debt Guarantee Program, a part of TLGP, allowed participating entities to issue FDIC-guaranteed senior unsecured debt. The Debt Guarantee Program was highly attractive to participating entities, particularly the larger bank holding companies, because it provided access to funding at a relatively low cost and accordingly, the programme was largely considered a success.

Loan Facility. These programmes, except for the Term Asset-Backed Securities Loan Facility that terminates on 30 June 2010, terminated on 1 February 2010. In addition to these funding programmes the Federal Reserve also provided certain institutions with individually tailored funding programmes including American International Group, Inc. These individual extensions of credit are beyond the scope of this article.

These new programmes were notable because they represented a departure from traditional Federal Reserve discount window lending practice and policy. The new programmes were open to unregulated non-depository institutions that normally did not have access to the Federal Reserve's discount window. This allowed investment banks to borrow directly from the Federal Reserve, increasing overall funding in the markets. Prior to 2008, the Federal Reserve had not used its legal authority to lend to non-depository institutions since the Great Depression.

An analysis of the legal basis for the Federal Reserve's establishment of such funding programmes and expanding the parameters of its lending are beyond the scope of this article; however, it has been the subject of much legal, academic and political analysis. For more information, see Davis Polk, *Financial Crisis Manual* 18-40 (2009).

117 US Dep't of the Treasury Press Release, Treasury Announces TARP Capital Purchase Program Description (14 October 2008), www.treas.gov/press/releases/hp1207.htm.

118 Office of the Special Inspector Gen. for the Troubled Asset Relief Program, Quarterly Report to Congress (20 April 2010), www.sig tarp.gov/reports/congress/2010/April2010_Quarterly_Report_to_Congress.pdf.

As of 31 August 2009, 92 participating entities had \$306.989 billion in guaranteed debt outstanding.¹¹⁹ For most institutions, the programme concluded on 31 October 2009, with the FDIC's guarantee expiring no later than 31 December 2012.¹²⁰

Aside from the Federal Reserve and US government funding programmes set forth above, there were a number of other government funding programmes instituted during the financial crisis, including programmes to provide funding to certain systemically important entities, including the American International Group and Citigroup, which served to stabilise funding markets broadly.¹²¹

Post-financial crisis funding developments

In 2010, bank regulators issued two significant policy statements on their expectations regarding how bank holding companies and banks manage their funding and liquidity risks.

On 22 March 2010, federal bank regulators issued an interagency policy statement on funding and liquidity risk management.¹²² In the preamble to the guidance, regulators noted that they have observed deficiencies in liquidity risk management including, 'funding risky or illiquid asset portfolios with potentially volatile short-term liabilities and a lack of meaningful [...] liquidity contingency plans'. The guidance clarifies the processes that institutions should implement to identify, measure, monitor and control their funding and liquidity risk, such as having cashflow projections, diversified funding sources, stress testing, a cushion of liquid assets and a formal well-developed contingency funding plan. Aside from overall funding needs, the guidance was specific in highlighting the importance of monitoring and managing intraday liquidity positions.

On 30 April 2010, the federal regulatory agencies issued final guidance addressing the risks associated with funding and credit concentrations arising from correspondent interbank relationships.¹²³ The guidance highlights the need for institutions to identify, monitor, and manage correspondent concentration risk on a standalone and organisation-wide basis. Notably, the guidance states that a financial institution should consider credit

119 FDIC, Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program (31 August 2009), www.fdic.gov/regulations/resources/TLGP/total_issuance8-09.html.

120 FDIC, Amendment of the Temporary Liquidity Guarantee Program to Extend the Debt Guarantee Program and to Impose Surcharges on Assessments for Certain Debt Issued on or After 1 April 2009, 74 Fed. Reg. 26521 (3 June 2009), www.fdic.gov/regulations/laws/federal/2009/09FinalAD37.pdf.

121 For a more detailed discussion of these programmes, see Davis Polk, *Financial Crisis Manual* (2009).

122 Fed. Reserve, FDIC, US Dep't of the Treasury, OCC, OTS, Final Guidance on Correspondent Concentration Risks, 75 Fed. Reg. 23764 (4 May 2010), www.fdic.gov/regulations/laws/federal/2010/10noticeMay4.pdf.

123 Fed. Reserve press release, Interagency Guidance on Correspondent Concentration Risk (30 April 2010), www.federalreserve.gov/boarddocs/srletters/2010/sr1010.pdf.

exposures¹²⁴ of over 25 per cent of total capital and funding exposures as low as 5 per cent of total liabilities indicative of correspondent concentration risk.

Pursuant to the guidance, financial institutions are to establish written policies and procedures to monitor and prevent such correspondent concentration risk. The guidance also highlights regulators' concern with financial institutions conducting proper due diligence on all credit and funding relationships, including confirmation that terms for all credit and funding transactions are on an arm's-length basis and that they avoid potential conflicts of interest.¹²⁵

VI CONTROL OF BANKS AND TRANSFER OF BANKING BUSINESSES

In the United States, investing in banks or bank holding companies has long been a strictly regulated process. There are three federal statutes that may potentially govern the acquisition of a bank or bank holding company, depending on the structure of the acquisition and the type of bank or holding company to be acquired.¹²⁶

a The BHC Act: Section 3(a) of the BHC Act requires the prior approval of the Federal Reserve Board for transactions that result in the formation of a bank holding company or cause a bank to become a subsidiary of a bank holding company; acquisitions by a bank holding company of more than 5 per cent of any class of voting shares of a bank or another bank holding company; acquisitions of all or substantially all of a bank's assets (except by merger into another bank); and mergers of bank holding companies.¹²⁷ Under the BHC Act, a controlling investment in a bank or bank holding company will cause the investor (and any controlling person of that investor) to become a bank holding company and subject it to Federal Reserve regulation.¹²⁸ Control is presumed if a person or entity, acting alone or in concert with others, controls or has the power to vote, 25 per cent or more of the outstanding shares of any class of voting stock, has

124 Credit exposures include, due from bank accounts, federal funds sold on a principal basis, the over-collateralised amount on repurchase agreements, the under-collateralised portion of reverse repurchase agreements, net current credit exposure on derivatives contracts, unrealised gains on unsettled securities transactions, direct or indirect loans to or for the benefit of the correspondent, and investments, such as trust preferred securities, subordinated debt and stock purchases in the correspondent.

125 The guidance does not elaborate on exactly what 'conflicts of interests' means within this context.

126 This article does not address the requirements for the acquisition of thrifts or thrift holding companies. Depending on the outcome of the pending financial regulatory reform bills, separate thrift charters may be abolished.

127 12 USC §1842(a).

128 12 USC §1841(a)(1).

the power to control the election of a majority of the board of directors; or has the power to exercise a controlling influence over its management or policies.¹²⁹

- b* Bank Merger Act: The Bank Merger Act requires the approval of the appropriate federal bank regulator for any merger involving two or more insured depository institutions, transfers of assets by an insured depository institution to an uninsured bank (or uninsured branch of a non-US bank) in consideration for the assumption of deposits, an insured bank's acquisition of assets of another insured bank, and assumptions of liabilities of any depository institution (insured or uninsured) by an insured depository institution.¹³⁰ The appropriate federal bank regulator is that of the surviving entity in a merger.¹³¹
- c* Change in Bank Control Act: The Change in Bank Control Act ('CIBC Act') applies primarily to the acquisition of control of a US bank or bank holding company and requires prior written notice be given to the bank regulator of the target bank or bank holding company.¹³² Control is defined as the power, directly or indirectly, to direct the management or policies of an insured bank or to vote 25 per cent or more of any class of voting securities of an insured depository institution.¹³³ Control is presumed, but may be rebutted, and a filing under the CIBC Act is required, if a person (including a bank or company) owns or controls 10 per cent or more of any class of voting securities of a US bank and either (1) no other person owns or controls a greater percentage of the same class of voting securities or (2) the shares of the bank or its holding company are registered with the SEC.¹³⁴ The CIBC Act does not apply to transactions requiring approval under the BHC Act or the Bank Merger Act.¹³⁵

On 22 September 2008, the Federal Reserve Board issued a 'Policy Statement on Equity Investments in Banks and Bank Holding Companies',¹³⁶ the purpose of which was to clarify the Federal Reserve Board's position on how a minority equity investment could be structured to prevent an investor from exercising a controlling influence over a bank or bank holding company for purposes of the BHC Act, including with respect to the following issues:

- a* Director representation: A minority investor may generally have one representative on the board of directors, provided the representative is not the chairman of the board or any committee of the board, and does not represent more than 25 per cent of the seats on any board committee. A minority investor may have up to two representatives on the board if (1) its aggregate director representation is

129 12 USC §1841(a)(2).

130 12 USC §1828(c)(1).

131 12 USC §1828(c)(2).

132 12 USC §1817(j).

133 12 USC §1817(j)(8)(B).

134 See, e.g., 12 CFR §225.41(c)(2).

135 12 USC §1817(j)(17).

136 12 CFR §225.144.

proportionate to its total equity interest in the bank or bank holding company but does not exceed 25 per cent of the membership of the board and (2) another shareholder is a bank holding company that controls the bank or bank holding company under the BHC Act.

- b* Total equity interest: A minority investor may generally own up to 24.9 per cent of any class of voting securities of a bank or bank holding company, or a combination of voting and non-voting securities that, in the aggregate, represents less than one-third of the total equity and less than 15 per cent of any class of voting securities of the bank or bank holding company.
- c* Consultations with management: Although a minority investor may generally communicate with management of a bank or bank holding company about the organisation's policies and operations, just like any other shareholder, the decision whether or not to adopt a particular position or take a particular action must remain with the organisation's shareholders as a group, board of directors or management, as applicable. A minority investor may not accompany its communications with explicit or implicit threats to dispose of its shares or to sponsor a proxy solicitation if the organisation or its management does not follow the minority investor's recommendations. This and other limitations on a minority investor's actions are generally reflected in written 'passivity commitments' the Federal Reserve Board requires the minority investor to make as a condition for determining that the investor does not control the bank or bank holding company.
- d* Business relationships: A minority investor is generally required to limit its business relationships with the bank or bank holding company in which it holds its investment, particularly when its voting stake is above 10 per cent, and to ensure that those relationships are on market terms, non-exclusive and terminable without penalty by the banking organisation. A minority investor's written 'passivity commitments' will frequently contain a quantitative limit to business relationships (whether a fixed dollar amount or a percentage of revenues), above which prior approval of the Federal Reserve Board would be required for any transaction.
- e* Covenants: A minority investor is generally not able to impose covenants or contractual terms on a bank or bank holding company that substantially limit management's discretion over major policies and decisions, such as: (1) hiring, firing and compensating executive officers; (2) engaging in new business lines or making substantial changes to a bank's or bank holding company's operations; (3) raising additional debt or equity capital; (4) merging or consolidating; (5) selling, leasing, transferring or disposing of material subsidiaries or major assets; or (6) acquiring significant assets or control of another firm.

The wave of bank failures in 2008 and 2009, together with a rapid rise in the number of banks included on the FDIC's 'troubled bank' list (as of 31 December 2009, the list contained 700 banks representing nearly \$403 billion in assets), has led to renewed interest in private investments in both troubled and failing banks. In the case of failed banks, the FDIC acts as their receiver and coordinates their sale to banks and private investors or their liquidation.

In addition to the requirements discussed above for acquiring banks or bank holding companies, on 26 August 2009, the FDIC released a ‘Statement of Policy on the Acquisition of Failed Depository Institutions’ (‘the Policy Statement’).¹³⁷ Together with two sets of FDIC questions and answers (‘the Q&As’) intended to help explain the requirements,¹³⁸ the Policy Statement imposes additional standards and requirements on potential private investors in failed banks.¹³⁹

The Policy Statement reflects the FDIC’s desire that private investors serve as ‘responsible custodians’ for a failed institution and try to ensure that the institution does not fail again. If a private investor covered by the Policy Statement makes an investment in a failed bank, the post-acquisition financial institution must maintain at least a 10 per cent tier 1 common equity ratio throughout the first three years, generally remain well-capitalised thereafter and be subject to firewalls with respect to any investment funds controlled by the private investor. In addition, the private investor will be subject to a three-year lock-up on the shares it acquires in the absence of FDIC approval, whether in the bank itself or a holding company formed for the purposes of making failed bank investments.

The Policy Statement exempts two types of investors from its requirements:

First, an investor with less than 5 per cent of the total voting power when there is no evidence of ‘concerted action.’ The FDIC presumes ‘concerted action’ among less-than-5 per cent investors where, in the aggregate, such investors have over two-thirds of total voting power. Therefore, other private investors who have an ownership percentage of one-third or more, together with the depository institution itself, must be bound by the Policy Statement in order for the less-than-5 per cent investors outside this anchor group to be exempted. The April Q&As both clarify that the less-than-5 per cent investors not subject to the Policy Statement may, however, elect to be part of the anchor group subject to the Policy Statement in order to meet the one-third test, and note that the one-third test may be satisfied through both voting and non-voting shares.

Second, an investor that enters into a partnership with or invests directly in an existing bank holding company, where the holding company has a ‘strong majority interest’ in the failed bank and an established record for successful operation of insured banks or thrifts, is also exempt. The FDIC presumes that such an established bank holding company does not have a ‘strong majority interest’ if new private investors own more than

137 FDIC, Final Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45440 (2 September 2009), <http://edocket.access.gpo.gov/2009/pdf/E9-21146.pdf>.

138 FDIC, Q&As: Statement of Policy on Qualifications for Failed Bank Acquisitions, issued on 6 January 2010 and updated on 23 April 2010, www.fdic.gov/regulations/laws/faqfbqual.html.

139 Davis Polk client memorandum, ‘A Nice Step Forward: New Q&As on the FDIC’s Policy Statement for Failed Bank Acquisitions’ (29 April 2010), www.davispolk.com/files/Publication/d5fbbeddd-77da-4e82-ac8a-f1968d8e8447/Presentation/PublicationAttachment/abb2f530-d1d0-4e44-950d-32ecb5120f14/042910_fdic_failed_banks.pdf; Davis Polk client memorandum, ‘Structuring Private Equity Investments in FDIC “Problem” Institutions’ (29 March 2009), www.davispolk.com/files/Publication/c816ca5d-f74b-450e-bde1-b1528a80135e/Presentation/PublicationAttachment/ab42637d-8c08-4c5f-803c-02fbb56c1292/032910_PE_NL.pdf.

one-third of the voting or total equity of the company on a pro forma basis. However, the April Q&As clarify that there is no minimum holding period applicable to shares held by investors that were shareholders in the existing holding company prior to the injection of new private capital, and create an exemption from the Policy Statement for ‘recapitalisations’ of existing institutions subject to a limit on the amount of total assets the recapitalised institution may acquire from failed insured depository institutions.

VII SYSTEMIC RISK REGULATION, RESOLUTION AUTHORITY AND THE PROBLEM OF ‘TOO BIG TOO FAIL’

Post-financial crisis, there has been a movement to expand the principles and application of bank holding company and bank regulation to other parts of the financial system. The administration has argued that this is necessary because, ‘over time there has been a gradual but pronounced decline in the share of financial assets originated and held by banks, and a corresponding increase in the share of financial assets held across a variety of non-bank financial institutions, funds and complex financial structures’.¹⁴⁰

One aspect of this movement has been a call for the consolidated supervision of systemically important institutions across functional regulators, which is intended to prevent gaps in regulatory knowledge and supervision of the financial markets.

As of 26 May 2010, both the Senate and House financial regulatory reform bills include a proposal for a systemic risk regulator, to be comprised of the heads of various government agencies that will be tasked with oversight over-systemic risk in the US financial system. The Council will be able to designate non-bank financial companies as ‘systemically important,’ thereby subjecting them to regulation by the Federal Reserve.¹⁴¹

Existing bank and bank holding companies will also have enhanced reporting and other requirements. Specifically, large interconnected bank holding companies, with at least \$50 billion in assets, will face increased capital, liquidity and prudential standards.¹⁴²

In addition to enhanced regulation, the existing bank regulatory agencies will also shift responsibilities and compress. In both the House and Senate bills, the Office of Thrift Supervision is eliminated. Responsibility for thrifts will shift to the remaining bank regulatory agencies.¹⁴³

140 Financial Market Regulatory Restructuring: Hearing before the House Committee on Financial Services, 110th Cong. (2008) (statement of Treasury Secretary Timothy F Geithner).

141 Wall Street Reform and Consumer Protection Act of 2009, HR 4173, 111th Cong. §§1001-1008 (2009); Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §§111, 113 (2010).

142 The House bill has similar provisions. Wall Street Reform and Consumer Protection Act of 2009, HR 4173, 111th Cong. §§1103-1104 (2009); Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §115 (2010).

143 Wall Street Reform and Consumer Protection Act of 2009, HR 4173, 111th Cong. §§1202-1257 (2009); Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §341 (2010).

Another important post-financial crisis regulatory and political movement has been the desire to eliminate ‘the too big to fail’ problem. One element of that movement has been the proposal for enactment of a resolution or orderly liquidation authority for systemically important financial companies that as of 26 May 2010 is included in both the Senate and House financial regulatory reform bills. The resolution authority, modelled on the US bank resolution authority in the Federal Deposit Insurance Act, will give the government the authority to resolve a large, systemically important financial institution without having to place it into bankruptcy. This is thought to retain the discipline that the possibility of liquidation imposes, while providing the government the flexibility to curtail the potential domino effect of the failure of a systemically important financial institution during a period of severe economic and financial stress.¹⁴⁴

Specifically, provided a determination to place a financial company under the resolution regime has been made, the FDIC would step in as receiver of the company, with the authority to sell all or any assets and liabilities to a third party, or, if a third party cannot be found, to establish one or more bridge financial companies to hold the part of the business worth preserving until it can be sold or liquidated in an orderly fashion. One of the main outstanding differences between the Senate bill and the House bill is whether financial companies would pre-fund an orderly liquidation fund to cover the costs of such resolutions, or whether assessments would be made on a post-event basis.¹⁴⁵

In anticipation of an eventual resolution authority, some regulators have already begun to issue notices of proposed rulemaking with respect to living will requirements. Living wills are documents that would be drafted by financial institutions that would set forth how to orderly dismantle the institution in the event that the institution failed and needed to be liquidated. On 11 May 2010, the FDIC issued a notice of proposed rulemaking that would require insured depository institutions with greater than \$10 billion in total assets that are owned or controlled by parent companies with more than \$100 billion in total assets to prepare a living will or a ‘contingent resolution plan’ that would describe the means by which the insured depository institution could be effectively separated from the rest of the banking organisation in the event that either the insured depository institution or the parent failed.¹⁴⁶

144 Wall Street Reform and Consumer Protection Act of 2009, HR 4173, 111th Cong. §§1601-1617 (2009); Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §204 (2010).

145 Wall Street Reform and Consumer Protection Act of 2009, HR 4173, 111th Cong. §1613 (2009); Restoring American Financial Stability Act of 2010, S3217, 111th Cong. §210 (2010).

146 FDIC, Notice of Proposal Rulemaking, Special Reporting, Analysis and Contingent Resolution Plans at Certain Large Insured Depository Institutions, 75 Fed. Reg. 27464 (proposed 11 May 2010).

VIII OUTLOOK AND CONCLUSIONS

The significance of the proposed restructuring of the US financial regulatory framework cannot be understated. It is the most extensive overhaul of the US financial regulatory system since the 1930s. Notably, the proposed financial regulatory system will extend the principles of bank holding company and bank regulation to many other players in the financial markets, including investment banks, non-depository lenders, hedge funds, insurance companies and any others deemed to be systemically important. Although final legislation is likely to be signed by the President in mid-2010, implementation will be a much longer process, as a result of both the implementation deadlines set in the legislation and the regulatory implementation phase that will follow. While the final outcome of the implementation phase remains unknown, the new financial regulatory rules will structure, constrain and channel the behaviour of institutions, markets and individuals, and inspire creative behavioural responses, for the foreseeable future.

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