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CLIENT MEMORANDUM

September 7, 2011

Federal Reserve Interim Final Rule Adopts Regulations for Savings and Loan Holding Companies

On August 12, 2011, the Board of Governors of the Federal Reserve System (the "**Board**") issued an interim final rule setting forth the Board's regulations for savings and loan holding companies ("**SLHCs**") and their non-depository subsidiaries (the "**Interim Final Rule**").[1] The Interim Final Rule effects the transition of the SLHC regulations previously issued by the Office of Thrift Supervision (the "**OTS**") in connection with the transfer of supervisory authority over SLHCs from the OTS to the Board.[2] The Interim Final Rule will become effective on the date of its publication in the Federal Register, which is expected soon.

In the Interim Final Rule, the Board has sought to conform regulation of SLHCs as much as possible to the Board's approach to regulation of bank holding companies ("**BHCs**") under the Board's Regulation Y. Notably:

- Subject to the exemptions provided by the Home Owners' Loan Act ("**HOLA**"), SLHC activities and the regulatory process for engaging in such activities will now largely mirror those for BHCs. Gramm-Leach-grandfathered unitary savings and loan holding companies, however, retain their ability to conduct commercial activities consistent with their grandfathered status.
- The standards and procedures applicable to determinations of control of SLHCs are largely conformed (subject to the open issues discussed in this memorandum) to those applied by the Board under Regulation Y, which, among other things, will have the effect of requiring significant investors in SLHCs to file notices with the Board under the Change in Bank Control Act ("**CIBC Act**") and will eliminate the rebuttal of control process previously available under the OTS regulations implementing the Savings and Loan Holding Company Act.
- Existing SLHC ownership structures, however, will not be revisited by the Board, except in the limited circumstances noted in this memorandum.

[1] Pending publication in the Federal Register, the Interim Final Rule is available on the Board's website at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110812b1.pdf. The Board is seeking comment on all aspects of the Interim Final Rule, including whether all regulations relating to the supervision of SLHCs are included in the rulemaking and, alternatively, whether the rulemaking carries over provisions that currently do not apply to SLHCs or their non-depository subsidiaries. Comments must be received by October 27, 2011.

[2] The supervisory responsibility of the OTS over SLHCs and their non-depository subsidiaries was transferred to the Board on July 21, 2011 pursuant to Section 312 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

Structure of the Interim Final Rule: The Interim Final Rule includes: (1) new Regulation LL, setting forth regulations generally governing SLHCs;[3] (2) new Regulation MM, setting forth regulations governing SLHCs in mutual form; and (3) technical amendments to current Board regulations that are necessary to accommodate the transfer of supervisory authority over SLHCs to the Board. This memorandum focuses on Regulation LL, with particular emphasis on the provisions relating to permissible nonbanking activities of SLHCs and change of control.

General Overview of Regulation LL

The structure of the new Regulation LL closely resembles that of the Board's Regulation Y,[4] which regulates the acquisition of control of banks and BHCs, as well as the nonbanking activities of BHCs. In numerous instances, Regulation LL duplicates existing OTS regulations governing SLHCs with only technical modifications to account for the shift in supervisory responsibility from the OTS to the Board. In some cases, however, where the requirements or criteria found in existing OTS rules are substantively the same as those found in the Board's rules, the Board conforms the language and format used in Regulation LL to that of Regulation Y. Regulation LL also incorporates several substantive changes to existing OTS regulations, including those implementing changes mandated by the Dodd-Frank Act.

Permissible Nonbanking Activities of SLHCs

Financial Holding Company Activities

Under Section 4(k) of the Bank Holding Company Act of 1956 (the "**BHC Act**"), a BHC that qualifies for and elects to be treated as a "financial holding company" ("**FHC**") is permitted to engage in any activity that is financial in nature, incidental to a financial activity and, with the Board's prior approval, complementary to a financial activity (the "**4(k) Activities**"). The expanded powers of FHCs are much broader than those of regular BHCs that have not elected, or do not qualify for, FHC status and include activities such as securities underwriting and dealing, insurance underwriting, merchant banking, insurance company portfolio investing and certain commodities trading.

Prior to the Dodd-Frank Act, the OTS interpreted HOLA as providing an affirmative grant of authority to all SLHCs that were not exempt from HOLA's restrictions on activities ("**Covered SLHCs**")[5] to engage in 4(k) Activities. The OTS permitted Covered SLHCs to engage in 4(k) Activities without requiring them to satisfy any FHC-related standards in the BHC Act or to file any prior or after-the-fact notices.[6]

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[3] Regulation LL's definition of SLHC follows HOLA, as amended by the Dodd-Frank Act, and excludes, among other entities, "a bank holding company that is registered under, and subject to, the Bank Holding Company Act of 1956, or any company directly or indirectly controlled by such company (other than a savings association); a company that controls a savings association that functions solely in a trust or fiduciary capacity as provided in section 2(c)(2)(D) of the Bank Holding Company Act [of 1956]; [and] a company described in section 10(c)(9)(C) of HOLA solely by virtue of such company's control of an intermediate holding company established under section 10A of the Home Owners' Loan Act." 12 C.F.R. § 238.2(m) (to be effective upon publication of the Interim Final Rule in the Federal Register). We note that all citations in this memorandum to sections of Regulation LL are to those sections that will become effective upon publication of the Interim Final Rule in the Federal Register.

[4] 12 C.F.R. Part 225.

[5] HOLA provides an exemption from its activities restrictions for certain SLHCs that only controlled, or were in the process of acquiring, a single savings association at the time the Gramm-Leach-Bliley Act of 1999 was passed and that meet certain other criteria. *See* 12 U.S.C. §§ 1467a(c)(3), (9)(C). The Board indicated in the Supplementary Information Release accompanying the Interim Final Rule (the "**Release**") that, because the Dodd-Frank Act did not modify the operative provisions of HOLA establishing the exemption, the Board does not consider the exemption to have been modified. *See* Release at 6-7 n.13.

[6] *See* Release at 7.

Section 606(b) of the Dodd-Frank Act amended HOLA to require Covered SLHCs that wish to engage in 4(k) Activities, effective July 21, 2011, to meet all of the criteria a BHC is required to meet in order to qualify for FHC status[7] and to comply with all of the requirements applicable to an FHC under Sections 4(l) and 4(m) of the BHC Act, as well as the FHC requirements under Section 804(c) of the CRA, as if the Covered SLHC were an FHC. Moreover, a 4(k) Activity must be conducted by an SLHC in accordance with the same requirements that apply to the conduct of such activity by an FHC.

Notwithstanding the statutory mandate that Covered SLHCs comply with FHC requirements in order to engage in 4(k) Activities, the "well capitalized" and "well managed" standards for SLHCs actually differ from those applicable to BHCs. The definition of "well managed" applicable to SLHCs under Regulation LL adopts the Regulation Y definition – which generally provides that a company or a depository institution is deemed to be well managed if it received at its most recent examination at least a satisfactory composite rating and, if such rating is given, at least a satisfactory rating for management – but clarifies that "a satisfactory rating for management" means a management rating or a risk-management rating, as applicable.[8] In addition, the definition of "well capitalized" applicable to SLHCs under Regulation LL differs from the Regulation Y definition applicable to BHCs because SLHCs are not currently subject to formal regulatory capital requirements. Instead, an SLHC is considered well capitalized if:

- all of its subsidiary savings associations and other subsidiary depository institutions are well capitalized (within the meaning of Regulation Y) and
- the SLHC is not subject to any outstanding formal administrative order or enforcement action by the Board relating to its capital position.[9]

In the Release, the Board noted that the federal banking agencies are reviewing consolidated capital requirements for all depository institutions and their holding companies pursuant to the Collins Amendment and Basel III, and it is expected that the agencies' Basel III notice of proposed rulemaking would address any proposed application of Basel III-based requirements to SLHCs. The Board expects that when the rulemaking process is complete, the definitions of "well capitalized" for SLHCs and BHCs will be more closely aligned.[10]

In light of Section 606(b) of the Dodd-Frank Act, the Board has determined that Covered SLHCs that wish to engage in 4(k) Activities after July 21, 2011 must affirmatively elect to be treated as FHCs. In particular, Regulation LL requires a Covered SLHC seeking to engage in 4(k) Activities to:

- file a declaration with the Board to elect to be treated as an FHC and have that election be deemed effective by the Board (an "**effective election**")[11] and

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[7] To qualify for FHC status, a BHC must satisfy the following conditions: (1) all depository institution subsidiaries and the BHC itself must be well capitalized and well managed; (2) the BHC must file an election to engage in activities available only to FHCs and certify that it meets the above requirements; and (3) all of its depository institution subsidiaries must have received a rating of at least "satisfactory" under the Community Reinvestment Act ("**CRA**") in their most recent examinations. *See* 12 U.S.C. § 1843(*l*).

[8] *Compare* 12 C.F.R. § 238.2(t) *with* 12 C.F.R. § 225.2(s).

[9] *Compare* 12 C.F.R. § 238.2(s)(1) *with* 12 C.F.R. § 225.2(r)(1).

[10] *See* Release at 15-16.

[11] The declaration must include, among other things, a certification that the SLHC and each depository institution controlled by it is well capitalized and well managed as of the date the declaration is submitted. An election will not be effective if, during the review period, the Board finds that: (1) any insured depository institution controlled by the SLHC (other than certain recently acquired savings associations) has not achieved a CRA rating of "satisfactory" or better or (2) any depository institution controlled by the SLHC is not both well capitalized and well managed. *See* 12 C.F.R. § 238.65.

- comply with a number of ongoing FHC requirements, including the obligation to promptly notify the Board when the Covered SLHC or any depository institution controlled by it has ceased to be well capitalized or well managed.

These requirements, including the process for making an effective election, are similar to the provisions in Regulation Y for BHCs.

As noted above, the OTS previously permitted Covered SLHCs to engage in 4(k) Activities without having to satisfy any of the FHC-related criteria in the BHC Act. Regulation LL establishes a special process under which Covered SLHCs that engaged in 4(k) Activities as of July 21, 2011 may come into conformance with the new FHC requirements. Under this special process, a Covered SLHC wishing to continue its 4(k) Activities must provide to the Board, by December 31, 2011, the above-mentioned declaration along with a description of its 4(k) Activities. If a Covered SLHC is unable to make an effective election, it must submit to the Board by December 31, 2011 an alternate declaration that includes:

- a list of its 4(k) Activities;
- a description of why it cannot file an effective election; and
- a description of how it will achieve compliance prior to June 30, 2012.

Covered SLHCs that are not able to make an effective election are subject to the same notice, remediation agreement, divestiture and other provisions that apply to BHCs that fail to meet the FHC requirements.

Activities Not Requiring an FHC Election

Section 4(c)(8) Activities. The BHC Act generally permits BHCs to conduct activities that the Board has determined by rule or order to be "closely related to banking" ("**Section 4(c)(8) Activities**"). Such activities are also permitted for SLHCs under HOLA.[12] Under prior OTS practice, SLHCs were permitted to engage in Section 4(c)(8) Activities without making any filings with the OTS. Under Regulation LL, however, an SLHC seeking to commence a new Section 4(c)(8) Activity will be required to make an application to the Board, unless the SLHC:

- received a rating in its most recent examination of satisfactory or above (if prior to January 1, 2008) or a composite rating of "1" or "2" (if thereafter);
- is not in a troubled condition as defined in Regulation LL; and
- does not propose to commence the activity by an acquisition (in whole or in part) of a going concern.[13]

In evaluating an SLHC's application to engage in a Section 4(c)(8) Activity, the Board will consider whether the conduct of the activity by the SLHC can reasonably be expected to produce public benefits that outweigh possible adverse effects.

Insurance Agency and Escrow Activities. HOLA expressly permits SLHCs to engage in insurance agency and escrow activities.[14] As a result, although these activities fall within the scope of 4(k) Activities,

[12] *See* 12 U.S.C. § 1467a(c)(2)(F)(i).

[13] *See* 12 C.F.R. § 238.54(a)(1).

[14] *See* 12 U.S.C. § 1467a(c)(2)(B).

Covered SLHCs do not need to make an FHC election or comply with FHC requirements in order to engage in them.

1987 List Activities. HOLA also permits SLHCs to engage in activities that SLHCs were authorized, by regulation, to directly engage in on March 5, 1987 (the "**1987 List Activities**").[15] The 1987 List Activities were listed in the OTS regulations, and the list has been incorporated into Regulation LL.[16] Notably, the 1987 List Activities include real estate development, an activity that is not permissible for BHCs or even FHCs. Noting that the Dodd-Frank Act does not modify or condition the ability of SLHCs to engage in 1987 List Activities, the Board confirmed in the Release that the 1987 List Activities remain permissible for Covered SLHCs, subject to the notice requirements contained in Regulation LL.[17]

Control Determinations

Regulation LL discontinues the approach adopted by the OTS in its regulations, which integrated regulations implementing the provisions of both Section 10 of HOLA[18] and the CIBC Act[19] relating to acquisitions of savings associations and SLHCs into a single set of "Control Regulations" in Part 574, even while reflecting the different standards and definitions established by the two Acts.[20] Instead, Regulation LL follows the format of the Board's Regulation Y and outlines separately the requirements for control determinations under HOLA and the CIBC Act. In the Release, the Board noted that it has proposed to use its established rules and processes with respect to control determinations under HOLA and the CIBC Act "in light of the similarity between the statues governing BHCs and SLHCs" and in order to "ensure consistency between equivalent statutes administered by the same agency."[21] The Board clarified, however, that it does not anticipate revisiting ownership structures previously approved by the OTS. Rather, the Board "would apply its rules only to new investments and would only reconsider the particular structures of past investments approved by the OTS if the company proposes a material transaction, such as an additional expansionary investment, significant recapitalization, or significant modification of business plan."[22]

Control Determinations Under HOLA

Section 10 of HOLA, as amended by the Dodd-Frank Act, requires prior approval of the Board for any SLHC to acquire direct or indirect control of 5% or more of any class of voting securities of a savings association or SLHC and for any other company (other than a BHC) to acquire direct or indirect control of a savings association or SLHC. Structurally, Subpart B of Regulation LL, which implements Section 10 of HOLA, closely resembles the provisions in Subpart B of Regulation Y, which implement Section 3 of the BHC Act, and, just like Regulation Y, contains separate sections specifying transactions requiring Board approval,[23] transactions not requiring Board approval,[24] procedural and notice requirements[25] and factors considered by the Board in acting on applications.[26]

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[15] *See* 12 U.S.C. § 1467a(c)(2)(F)(ii).

[16] *See* 12 C.F.R. § 238.53(b).

[17] *See* Release at 9.

[18] Section 10 of HOLA codifies the Savings and Loan Holding Company Act. *See* 12 U.S.C. § 1467a.

[19] *See* 12 U.S.C. § 1817(j).

[20] *See* 12 C.F.R. Part 574.

[21] Release at 4.

[22] *Id*. at 6.

[23] *See* 12 C.F.R. § 238.11.

The definition of "control" adopted by the Board for purposes of Regulation LL mirrors the definition in Section 10 of HOLA.[27] Reflecting its view that HOLA and the BHC Act include "virtually identical" definitions of control, the Board explains in the Release that "because of this similarity, Regulation LL includes provisions interpreting the definition of control under HOLA in the same manner as that term is interpreted under the BHC Act, adopts procedures for reviewing control determinations that are identical for SLHCs and BHCs, and conforms the filing requirements under the [CIBC Act] for SLHCs to those for BHCs."[28] As a result, existing OTS regulations relating to control determinations and rebuttals under HOLA, including the rebuttable control factors and procedures for rebuttal and the rebuttal of control agreement, are not included in Regulation LL.

Although the definitions of "control" in HOLA and the BHC Act are quite similar, they are not identical. For example, HOLA's definition of "control" applies to persons "acting in concert with one or more other persons," whereas the BHC Act's definition applies only to companies and does not incorporate the concept of "acting in concert."[29] As a practical matter, however, since the CIBC Act and the related provisions of Regulation Y apply to persons and incorporate the concept of acting in concert, and since the BHC Act and Regulation Y apply to companies acting through persons, this difference would be unlikely to prevent the Board from treating individuals acting in concert differently under Regulation LL than under Regulation Y.

Another difference is that under HOLA's control definition, a person is deemed to control an SLHC if the person has contributed more than 25% of the SLHC's capital. It is likely, however, that the Board will not apply this test for control determination purposes and will instead follow its 2008 Policy Statement on Equity Investments in Banks and Bank Holding Companies, which provides that an investor in a banking organization holding up to a 14.9% voting and 33% total equity interest would not, in the absence of other control factors, control or have a controlling influence over a banking organization.[30]

The Release specifically states that, to the extent possible, the Board intends to review investments and relationships with SLHCs by companies using its current practices and policies applicable to BHCs.[31] While noting that the overall indicia of control used by the Board under the BHC Act for purposes of determining whether a company exercises a controlling influence over the management or policies of a banking organization are similar to the control factors found in existing OTS regulations, the Board recognized that the OTS rules weigh these factors differently. The Board also recognized that its approach to control determinations differs in certain respects from that of the OTS. Unlike the OTS, the Board considers potential control relationships for all investors, rather than only the largest two investors, based on all of the facts and circumstances to determine if there is a controlling influence.[32] In addition, while the OTS permitted investors that triggered a control factor under the OTS regulations to submit for approval a rebuttal of control agreement, the Board does not use a separate application process for

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[24] *See* 12 C.F.R. § 238.12.

[25] *See* 12 C.F.R. § 238.14.

[26] *See* 12 C.F.R. § 238.15.

[27] *See* 12 C.F.R. § 238.2(e).

[28] Release at 4-5.

[29] *Compare* 12 U.S.C. § 1467a(a)(2) *with* 12 U.S.C. § 1841(a)(2).

[30] *See* 12 C.F.R. § 225.144.

[31] Release at 5.

[32] *See id*.

rebutting control under the BHC Act, nor is such a process included in Regulation LL.[33] Overall, we believe that it is unlikely that the Board's interpretation of control under HOLA will differ from its interpretation of control for purposes of the BHC Act.

Control Determinations Under the CIBC Act

The CIBC Act regulates the acquisition of control of savings associations and SLHCs by nonbanking companies and individuals or groups of individuals acting in concert. A significant difference between the existing OTS and Board regulations under the CIBC Act was the ability of investors under the OTS's control regulations to use passivity commitments or rebuttal agreements to avoid filing a CIBC Act notice. This difference is eliminated in Regulation LL, which conforms OTS control and rebuttal regulations under the CIBC Act to those of the Board, found in Subpart E of Regulation Y.

Other Matters Addressed in Regulation LL

In addition to the permissible nonbanking activities and control regulations discussed above, Regulation LL covers a number of other issues, in which it generally conforms existing OTS regulations and procedures to those of the Board or, in the absence of existing Board counterparts, adopts those of the OTS, including:

- **Application Processing**. The Board has generally replaced, to the extent possible, existing OTS procedures applicable to the filing and processing of applications. These changes are intended to promote uniformity and consistency in the Board's processing of applications across the range of institutions under its supervision. Among other changes, adoption of the Board's application processing procedures for SLHCs results in the elimination of previous OTS requirements for pre-filing meetings and submission of draft business plans, as well as formal procedures for determining an application to be complete. For the time being, subject to some technical changes, the Board will utilize existing OTS application forms, which are available on the Board's website.
- **Notice of Change of Director or Senior Executive Officer**. The Regulation LL provisions governing the filing of notices with respect to changes of directors or senior executive officers of SLHCs in troubled condition are substantively similar to existing OTS regulations. Consistent with the overall approach taken in the Interim Final Rule, however, the Board has substituted its procedures for those of the OTS with respect to the filing and informational requirements. Regulation LL also provides for appeals and informal hearings to be requested in the event a notice is disapproved, which were not available under the OTS regulations.
- **Prohibited Service at SLHCs**. Regulation LL contains provisions that are substantively similar to existing OTS regulations prohibiting persons who have been convicted of certain criminal offenses or who have agreed to enter into a pre-trial diversion or similar program in connection with a prosecution for such offenses from holding various positions with an SLHC.
- **Management Official Interlocks**. Regulation LL contains provisions that are substantively similar to existing OTS regulations implementing the Depository Institution Management Interlocks Act, subject to appropriate adjustments to reflect the transfer of supervisory authority for SLHCs from the OTS to the Board.

[33] *See id*. Regulation LL does adopt provisions governing control proceedings before the Board that are equivalent to those set forth in Subpart D of Regulation Y.

- **Investigative and Formal Examination Proceedings**. Regulation LL incorporates existing OTS regulations relating to investigative and formal examination proceedings with respect to SLHCs and their affiliates. Although the Board does not have similar rules for BHCs, it has followed similar practices for some time and has indicated in the Release that it will consider extending such rules to BHCs and other entities supervised by the Board.
- **Dividends by Subsidiary Savings Associations**. Under Section 10(f) of HOLA, every subsidiary savings association of an SLHC is required to file a notice at least 30 days prior to declaring a dividend. Such notices, which were previously filed with the OTS, are now required to be filed with the Board. Regulation LL implements this filing requirement through provisions that are substantively similar to portions of the OTS capital distribution regulation.
- **Qualified Stock Issuances**. Regulation LL contains provisions that are substantively similar to the existing OTS control regulations pertaining to certain issuances of new voting shares to an unaffiliated SLHC by an undercapitalized savings association or its parent SLHC. Regulation LL incorporates appropriate adjustments to reflect the transfer of supervisory authority for SLHCs from the OTS to the Board and the use of the Board's applications processing procedures instead of those of the OTS.

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