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A legal update from Dechert's Financial Institutions Group

The New Regulatory Regime for Savings and Loan Holding Companies

The Board of Governors of the Federal Reserve System (Federal Reserve) on August 12, 2011 issued an interim final rule (Rule) setting forth regulations governing savings and loan holding companies (SLHCs). The Rule was adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which transferred responsibility for the supervision and regulation of SLHCs from the Office of Thrift Supervision (OTS) to the Federal Reserve effective July 21, 2011.

The Rule has three components: (i) new regulations governing SLHCs organized in stock form, (ii) new regulations governing SLHCs organized in mutual form, and (iii) various technical amendments to current Federal Reserve regulations necessary to accommodate the transfer of supervisory authority over SLHCs to the Federal Reserve.

The Rule will significantly change the regulation of SLHCs in several important ways, particularly with respect to control determinations and the ability of SLHCs to engage in nonbanking activities. As mandated by Dodd-Frank, the Rule preserves the grandfathered status of unitary SLHCs established prior to May 4, 1999, but does not address the intermediate holding company (IHC) structure which may be utilized by the Federal Reserve to exempt grandfathered unitary SLHCs which are significantly engaged in nonfinancial activities from certain reporting and other requirements that will otherwise apply to them as SLHCs.

This update focuses on significant aspects of the Rule that apply to stock-form SLHCs. The Rule became effective on September 13, 2011, the date of its publication in the Federal Register. Comments may be submitted to the Federal Reserve until November 1, 2011.

New Control Rules for SLHCs

The Rule repeals many of the longstanding control rules applicable to SLHCs under Part 574 of the OTS regulations and largely replaces them with the Federal Reserve's control rules and principles applicable to bank holding companies (BHCs). The Rule attempts to equalize, to the maximum extent possible, the rules and processes governing the acquisitions of control of BHCs and SLHCs. However, some distinctions remain based on the fact that BHCs and SLHCs are governed by separate statutory schemes (the Bank Holding Company Act (BHC Act)) and the Home Owners' Loan Act (HOLA), respectively).

Some of the key differences between the prior OTS control rules applicable to SLHCs and the new Federal Reserve rules are described briefly here.

Presumptions of Control

An understanding of the control presumptions employed by bank regulators is often a critical factor for an investor seeking to avoid a control determination in connection with an investment in a BHC or an SLHC. While there are many similarities between the control regimes of the HOLA and

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the BHC Act, e.g., both utilize a 25% voting threshold for determining conclusive control over a bank or savings association, the Federal Reserve employs control presumptions that differ in various respects from those previously utilized by the OTS. Those include: (i) the rebuttable presumption applicable to owning 10% or more of a publicly traded institution's voting stock, whether or not the holder is one of the two largest shareholders; (ii) the rebuttable presumption that the holder of securities that are immediately convertible, at the option of the holder, into voting stock of a savings association or SLHC controls the underlying voting stock, notwithstanding the consideration paid; (iii) the rebuttable presumption that a company that has one or more management officials in common with a savings association or an SLHC controls the institution if the company owns more than 5% of the voting securities of the savings association or SLHC and no other person owns as much as 5% of the institution; and (iv) the presumption that a company that owns less than 5% of the voting securities of a savings association or SLHC does not control the institution.[1] These presumptions are incorporated into the Rule and mirror the presumptions in Regulation Y applicable to banks and BHCs.

Thrift investors will need to adjust to the new presumptions, which replace decades of OTS regulation and precedent.

Change in Bank Control Act Filing

OTS practice was not to require a Change in Bank Control Act (CIBCA) filing if the investor entered into a rebuttal of control agreement with the OTS. However, consistent with the Federal Reserve's rules regarding investments in banks and BHCs, the Rule generally requires an investor seeking to acquire 10% or more of the voting stock of a savings association or SLHC to make a CIBCA filing, notwithstanding that the investor may execute passivity commitments to evidence its intention not to exercise or attempt to exercise control over the institution for purposes of the HOLA. A CIBCA filing requires public notice and comment and generally includes information about the proposed acquisition and background of the investor.

1 This *de minimus* non-control presumption has been relied upon by the Federal Reserve in some cases as the basis for requiring that investors owning more than 5% of a BHC execute passivity commitments in order to avoid a controlling influence determination under the BHC Act. As a general rule, the OTS did not require less than 10% investors to execute rebuttal of control agreements.

The Federal Reserve's Policy Statement on Equity Investments in Banks and BHCs

In the preamble to the Rule, the Federal Reserve states that it will evaluate new investments in and relationships with SLHCs using its current practices and policies applicable to BHCs. These policies and practices are largely reflected in the Federal Reserve's Policy Statement on Equity Investments in Banks and BHCs adopted in 2008 (Policy Statement).[2] The Federal Reserve also states that it does not anticipate revisiting ownership structures previously approved by the OTS. Recent developments suggest to us that these policies are themselves in flux and may be amended given the Federal Reserve's evolving views with regard to investments between 5% and 10% of voting shares.

Proxy Solicitation Exemption

The Rule exempts from the prior approval process under the CIBCA—but not the HOLA—voting shares acquired through the receipt of revocable proxies in connection with a proxy solicitation for the purpose of conducting business at an annual or special meeting. As a practical matter, this will impact investors in a savings association or an SLHC and how they may conduct a proxy contest.

In contrast, OTS regulations included a proxy solicitation exemption that applied to the control rules under both the CIBCA and the HOLA. In addition, the Federal Reserve's Regulation Y includes proxy solicitation exemptions that apply under both the CIBCA and the BHC Act, which traditionally have enabled investors to conduct proxy contests involving banks and BHCs.

There would not seem to be any policy reason to treat banks and thrifts differently for purposes of the proxy solicitation exemption. We would expect the Federal Reserve to clarify this discrepancy in the final rule or in guidance.

2 The Policy Statement generally describes the circumstances under which a minority investor in a BHC would not be deemed to control the BHC for purposes of the BHC Act, including permissible levels of equity investment and board representation and the types of relationships and interaction the investor may have with management and the company. A minority investor may own up to 33% of the total equity of a BHC without being deemed to control the BHC, as long as it owns less than 15% of the BHC's voting securities. However, minority investors in an SLHC seeking to avoid control presumably will not be able to take advantage of the 33% of total equity rule in the Policy Statement since, unlike the BHC Act, the HOLA provides that an investor will be deemed to conclusively control an SLHC if it owns more than 25% of its total equity.

New Requirements Relating to SLHC Nonbanking Activities

Prerequisites to Engage in Financial Activities

As mandated by Dodd Frank, the Rule provides that SLHCs may engage in "financial activities" permissible for a financial holding company (FHC) under section 4(k) of the BHCA ***only if*** the SLHC and its depository institution subsidiaries are deemed "well capitalized" and "well managed" and if all depository institution subsidiaries have a CRA rating of "satisfactory" or better. Section 4(k) financial activities include securities underwriting, insurance underwriting and merchant banking activities. Grandfathered unitary SLHCs are exempt from these requirements and may continue to engage in financial and other activities without restriction.

Substantially similar rules apply to BHCs seeking to qualify for FHC status and engage in Section 4(k) financial activities. Under prior OTS rules, however, SLHCs were automatically eligible to engage in Section 4(k) financial activities without having to satisfy any of the FHC-related criteria applicable to BHCs.

Under the Rule, in order to engage in Section 4(k) financial activities, SLHCs must file an election with the Federal Reserve to be treated as an FHC and certify that it and each of its depository institution subsidiaries are "well capitalized"[3] and "well managed."[4]

Timing Considerations

SLHCs that are currently engaged in Section 4(k) financial activities must file an election to be treated as an FHC with the Federal Reserve by December 31, 2011, including a description of the FHC activities engaged in by the SLHC. If an SLHC is currently engaged in section 4(k) financial activities but does not meet the "well capitalized" and "well managed" standards, it must file a declaration with the Federal Reserve by December 31, 2011, including a description of how it will achieve compliance with the relevant requirements prior to June 30, 2012.

Additional Activities Permissible for SLHCs

The Rule permits SLHCs to engage in certain activities that are not permissible for BHCs or FHCs. These activities are authorized by the HOLA and include real estate development and real estate management activities. SLHCs also may engage in insurance agency activities, whether or not they qualify to be treated as an FHC, whereas a BHC may engage in insurance agency activities (subject to certain exceptions) only if it becomes an FHC.

New Exemptions from SLHC Status

Companies that Own ''Trust-Only'' Thrifts

As mandated by Dodd-Frank, the Rule excludes from the definition of "savings and loan holding company," a company that controls a savings association that functions solely in a trust or fiduciary capacity. Previously, such companies were regulated as SLHCs by the OTS. Companies that own "trust-only" banks have long been exempt from BHC status.

On July 21, 2011, the Federal Reserve issued guidance outlining the deregistration process for companies that are SLHCs solely because they own a "trust-only" thrift. In requesting deregistration, a company must affirm that its trust-only thrift meets the requirements for the exclusion, including that all or substantially all of the deposits of the thrift are in trust funds and are received in a bona fide fiduciary capacity.

While companies that deregister from SLHC status will eliminate the Federal Reserve as a holding company regulator, they nonetheless may find themselves subject to other regulatory obligations. For example, companies that own trust-only national banks—and are not regulated as BHCs—are generally required by the Office of the Comptroller of the Currency (OCC) to enter into capital support and maintenance agreements with their trust-only bank subsidiary and the OCC. Such agreements effectively impose a source of strength obligation on the parent company that would otherwise apply by statute and regulation if the company were regulated as a BHC.

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[3] To be "well capitalized," a depository institution subsidiary of an SLHC must have capital sufficient to be deemed "well capitalized" under the prompt corrective action standards of its principal federal regulator. However, the SLHC itself will not have to satisfy "well capitalized" standards at the holding company level until after capital requirements are adopted for SLHCs pursuant to Dodd-Frank and the Basel accords.

[4] To be "well managed," an SLHC and its depository institution subsidiaries must have received at least a "satisfactory" composite rating at their most recent examination and at least a "satisfactory" rating for management, if such a rating is given, or otherwise a "satisfactory" rating for risk management.

As a supervisory matter, we understand that the OCC is considering whether, and under what circumstances, it may be appropriate for companies that own trust-only federal thrifts and deregister as an SLHC, to enter into capital maintenance and support agreements similar to those entered into by their counterparts that own trust-only national banks and are exempt from regulation as a BHC.

Companies that Own Intermediate Holding Companies

The Rule also excludes from the definition of an SLHC, a company that controls an IHC. Under Dodd-Frank, the Federal Reserve may authorize a grandfathered unitary SLHC to establish an IHC through which it would conduct all or a portion of its financial activities. Under this structure, the IHC would be an SLHC, but its ultimate parent company would not, thereby exempting the parent from various reporting and other requirements applicable to SLHCs (but not the requirement to serve as a source of strength to its subsidiary thrift).

The Rule does not provide any guidance regarding the circumstances under which a grandfathered unitary SLHC will be permitted or required to utilize the IHC structure. Thus, grandfathered unitary SLHCs currently remain subject to the various requirements and obligations attendant to SLHC status, including reporting obligations (subject to certain exemptions proposed by the Federal Reserve and discussed below), management interlocks restrictions, the limitation on acquiring more than 5% of the voting stock of an unaffiliated thrift and the examination authority of the Federal Reserve.

Presumably, the Federal Reserve will address issues pertaining to the availability of the IHC structure in a future rulemaking or guidance.

Reporting Requirements

The Rule requires SLHCs to file reports with the Federal Reserve in such form and with such information as the Federal Reserve may prescribe.

On August 25, 2011, the Federal Reserve issued a proposal regarding the reporting obligations of SLHCs. The proposal generally requires SLHCs to submit the same reports as BHCs beginning March 31, 2012, subject to certain exemptions and a two year phase-in period. Comments on this proposal may be submitted on or before November 1, 2011.

Non-exempt SLHCs

Under the proposal, during 2012 (but no sooner than March 31, 2012), an SLHC, unless it qualifies for an exemption, would be required to submit the FR Y-9 series of reports (consolidated and parent only financial statements) and a year-end annual report (FR Y-6 or FR Y-7). During 2013 and beyond, non-exempt SLHCs would be required to file all applicable BHC regulatory reports. Non-exempt SLHCs must also continue to file OTS Form H-(b)11 with the Federal Reserve until further notice.

Exempt SLHCs

The proposal initially exempts a limited number of SLHCs from filing most BHC reports. These institutions are:

- Unitary grandfathered SLHCs whose savings association subsidiaries' consolidated assets constitute less than 5% of the total consolidated assets of the SLHC; and
- SLHCs where the top-tier holding company is an insurance company that only prepares financial statements using statutory accounting principles.

Exempt SLHCs would not be required to file any BHC reports, except for a year-end annual report (FR Y-6 or FR Y-7) beginning with fiscal year end December 31, 2012. Exempt SLHCs also must continue to file with the Federal Reserve existing Schedule HC from the OTS' Thrift Financial Report and OTS Form H-(b)11, until further notice.

The proposal states that the Federal Reserve will reevaluate the reporting requirements for exempt SLHCs as it gains more experience in supervising these companies and following adoption of consolidated regulatory capital rules for SLHCs.

Dividends by Subsidiary Savings Associations of SLHCs

The Rule requires subsidiary savings associations of SLHCs to provide the Federal Reserve with 30 days' prior notice of a proposed declaration of a dividend. The Rule implements a statutory requirement of the HOLA. Under certain circumstances, federal savings associations must also provide the OCC with 30 days' notice before the proposed declaration of a dividend. Prior to the effectiveness of Dodd-Frank, a federal savings

association subsidiary of an SLHC filed a single notice with the OTS.

In guidance issued on July 25, 2011, the Federal Reserve stated that, upon receiving a dividend notice, it would provide a copy to the thrift's principal regulator(s) and work closely with such regulator(s) in evaluating the notice. A determination with respect to the proposed dividend must be made before the end of the 30-day review period.

This new regulatory regime will result in two regulators—rather than one—evaluating the permissibility of a proposed dividend declaration by a subsidiary savings association of an SLHC, including whether the proposed dividend would raise safety and soundness concerns.

Source of Strength Requirement

As mandated by Dodd-Frank, the Rule requires SLHCs to serve as a source of financial and managerial strength to its subsidiary savings associations. The Federal Reserve has long applied such a requirement to BHCs, but SLHCs have not previously been subject to a formal source of strength obligation.

The Federal Reserve is required to adopt regulations by July 21, 2012, implementing the statutory source of strength requirements applicable to BHCs and SLHCs by Dodd-Frank.

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