Global Credit Crisis: Regulatory Developments Affecting Financial Institutions

March 2010

SULLIVAN & CROMWELL LLP
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FDIC Proposal on Compensation Programs

FDIC Authorizes Publication of Advance Notice of Proposed Rulemaking on Employee Compensation at Banking Organizations

SUMMARY

At the January 12, 2010 meeting, the Board of Directors of the Federal Deposit Insurance Corporation ("FDIC") authorized publication of an Advance Notice of Proposed Rulemaking on Employee Compensation (the "ANPR") by a vote of 3 to 2 (with Comptroller Dugan and OTS Director Bowman dissenting). The ANPR seeks comment on how, and whether, the FDIC's risk-based deposit insurance assessment system applicable to all insured banks should be amended to account for risks imposed by employee compensation programs.

Citing a "broad consensus that some compensation structures misalign incentives and induce imprudent risk taking within financial organizations", the FDIC is considering establishing criteria to determine whether a financial institution's employee compensation programs provide incentives for employees to take excessive risks. The FDIC is concerned that such risk-taking increases the institution's risk of failure and thereby could lead to increased losses to the Deposit Insurance Fund. The ANPR proposal could apply not only to compensation at the insured depository, but also at its parent and nonbank affiliates. Under the approach outlined in the ANPR, whether a financial institution's compensation program either "meets" or "does not meet" the criteria would be used to adjust the institution's risk-based assessment rate, thereby acting as an incentive for institutions that meet the criteria and a disincentive for those that do not. According to the ANPR, the criteria that the FDIC is considering are not aimed at limiting the amount that insured depository institutions can pay their employees, but rather are intended to compensate the Deposit Insurance Fund for risks associated with certain compensation programs.

The FDIC requests comments on the ANPR within 30 days after publication in the Federal Register.
BACKGROUND

Section 7 of the Federal Deposit Insurance Act ("FDIA") requires the FDIC to establish a risk-based system to assess the probability that the Deposit Insurance Fund will incur losses from the failure of insured depository institutions. The ANPR cites a number of articles by academics, consultants and others for the "broad consensus that some compensation structures misalign incentives and induce imprudent risk taking". It concludes that excessive and imprudent risks, including, "to some extent", incentives provided by poorly-designed compensation programs, were contributing factors to financial institution failures and increased losses to the Deposit Insurance Fund. Utilizing the authority under Section 7 of the FDIA, the FDIC is considering whether, and how, risks associated with employee compensation programs should be incorporated into its existing risk-based assessment system to compensate the Deposit Insurance Fund for potential risk associated with employee compensation programs that reward employees based on short-term results without considering whether those short-term results create longer-term risks to the firm and its stakeholders, including shareholders and the FDIC.

The ANPR joins a number of other recent legislative and regulatory agency efforts focused on risk management by financial institutions and the risks associated with compensation programs, including: efforts by Congress to implement regulatory reform, such as under H.R. 4173, sponsored by Representative Barney Frank, which passed the House of Representatives in December; the Federal Reserve Board's recent principles-based proposal on incentive compensation policies for banking organizations, described in our Memorandum of October 25, 2009; and final disclosure rules adopted by the SEC in December requiring expanded disclosure of compensation and corporate governance matters, described in our Memorandum of December 18, 2009 (both memoranda are located on our website at http://www.sullcrom.com/publications).

METHODOLOGY

Purpose

The FDIC's purpose in establishing a methodology to assess the risk of employee compensation programs is to "focus on whether an employee compensation system is likely to be successful in aligning employee performance with the long-term interests of the firm and its stakeholders, including the FDIC".

The FDIC's stated goals under the ANPR include:

- Adjusting the FDIC's risk-based assessment rates to compensate the Deposit Insurance Fund for risks presented by certain compensation programs;
- Using the FDIC's risk-based assessment rates to provide incentives for insured depository institutions to adopt compensation programs to align employees' interests with those of the insured depository institution's other stakeholders, including the FDIC; and

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- Promoting the use of compensation programs that reward employees for focusing on risk management.

According to the ANPR, the purpose of the initiative is not to impose a cap or ceiling in the level of compensation that institutions may pay to their employees. Instead, the ANPR states that the FDIC's initiative is intended to "complement" other supervisory initiatives (such as the Federal Reserve Board's principles-based proposal related to incentive compensation) related to compensation programs. Nonetheless, the ANPR pointedly notes that supervisory standards are set to define "minimum standards" and the FDIC would use the assessment system to "provide incentives for institutions to meet higher standards".

Establishing Standard and Criteria

The methodology that the FDIC is considering would lead to an established standard for employee compensation programs and would include a series of criteria that would allow the FDIC (and the insured depository institution) to determine whether that standard has been met. The ANPR seems to contemplate that the list of potential criteria would create a "safe harbor", so that financial institutions will have greater certainty that their employee compensation programs will satisfy the FDIC's goals and that the insured depository institution will not be subject to an increased risk assessment.

The contemplated criteria that are outlined in the ANPR may include the following:

- A significant portion of compensation for senior management and employees whose work presents significant risk to the institution and who receive a significant portion of compensation based on achieving performance goals should be made in the form of restricted, non-discounted company stock that would vest over a number of years.
- Company stock awards should vest over several years and should be subject to a "clawback" so that gains realized on payment of awards can be recouped in the event earlier risks lead to losses.
- A board committee comprised of independent directors with input from independent compensation advisors should administer the compensation program.

Consequences of Meeting or Not Meeting Standard

The ANPR leaves open for comment what the consequences of meeting or not meeting the established standard would be. As described in the ANPR, the FDIC could determine to levy a reduced risk-based assessment on an institution that meets the foregoing criteria or an increased risk-based assessment on an institution that does not, based on the relative risk that the employment programs represent to the Deposit Insurance Fund.

REQUEST FOR COMMENTS

The ANPR requests comments on all aspects of the proposal, including, but not limited to:

- Whether, and how, to incorporate employee compensation criteria into the FDIC's risk-based assessment system?
Should the risk-based assessment system reward firms whose compensation programs present lower risk or penalize institutions with programs that present higher risks?

How should the FDIC measure and assess whether a board of directors is effectively overseeing the design and implementation of the institution's compensation program?

Whether an adjustment should be made to the risk-based assessment rate of an institution that could or could not attest that its compensation program included the contemplated approach described above?

Should the effort to price the risk posed to the Deposit Insurance Fund by compensation programs be directed only towards larger institutions; institutions that engage in certain types of activities (such as trading); or should it include all insured depository institutions?

How large (how many basis points) would an adjustment to the risk-based assessment rate of an institution need to be for the FDIC to have an effective influence on compensation practices?

Whether, as an alternative to the contemplated approach described above, the FDIC should consider using quantifiable measures of compensation that relate to the institution's health or performance?

How should the risk-based assessment system be adjusted if an employee is paid by both the insured depository institution and its holding company and affiliates?

Which employees should be subject to the compensation criteria and how should those employees be identified?

How should compensation be defined?

Should an adjustment to the risk-based assessment system be made where certain bonus compensation practices are followed, such as guaranteed bonuses, bonuses "greatly disproportionate" to base salary and lump sum bonuses not subject to clawback?

What would be a reasonable period of deferral for payment of variable or bonus compensation?

What vesting period would be appropriate for restricted stock awarded as described in the contemplated approach described above?

Comments on the proposal are due within 30 days after publication of the ANPR in the Federal Register.

IV. CONCLUSION

As evidenced by the FDIC's adoption of this ANPR, issues related to employee compensation and efforts to quantify and control risks related to various types of compensation arrangements continue to evolve and will continue to be a topic of significant discussion in 2010.

One issue highlighted by the ANPR is how difficult it may be for financial institutions to satisfy the different, and often inconsistent, compensation initiatives being proposed by both legislative and administrative bodies. As mentioned above, the ANPR refers to higher standards than the supervisory standards. The proposed compensation model under the ANPR contemplates significant portions of compensation to be paid in restricted, non-discounted company stock, while other initiatives (such as the Federal Reserve Board's proposal) encourage financial institutions to weight compensation more heavily in salary.

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Failed Bank Acquisitions

FDIC Releases Revised Frequently Asked Questions on the Statement of Policy on Qualifications for Failed Bank Acquisitions

SUMMARY

On January 6, 2010, the Federal Deposit Insurance Corporation released Frequently Asked Questions (the “Revised FAQs”) on its August 26, 2009 Statement of Policy on Qualifications for Failed Bank Acquisitions (the “Statement of Policy”). The FAQs replace and supersede the Frequently Asked Questions that were released by the FDIC on December 11, 2009 and subsequently withdrawn (the “Original FAQs”). The Statement of Policy was described in our Memorandum of August 28, 2009 and the Original FAQs were described in our Memorandum of December 14, 2009, both of which are located on our website at http://www.sullcrom.com/publications/.

The Revised FAQs make two significant changes from the guidance in the Original FAQs, both of which are of particular relevance for so-called “blind pool”, “recapitalization” and similar “platform bank” arrangements to purchase failed banks. Foremost, the Revised FAQs provide that structures in which investors each ultimately own 5% or less of the voting equity will result in the investors being presumed to be acting in concert and subject to the Statement of Policy if the investors in the aggregate acquire more than two-thirds of the total voting equity of an acquired depository institution or its holding company (an “investee institution”), although this presumption can be rebutted. The Original FAQs had provided that, if each investor were limited to not more than 5% of the total voting power, the investors and the investee institution would be exempt from the limitations and restrictions of the Statement of Policy, without regard to the level of total voting equity ownership by the investors. In addition, the Revised FAQs provide that “concerted action” among investors will be determined by the FDIC based on a “facts and circumstances” analysis. Under the Original FAQs, the FDIC would generally defer to the determination of the investee institution’s primary federal regulator.
The Revised FAQs appear to discourage “blind pool” or similar arrangements that were structured in response to the Statement of Policy. Under those structures, voting ownership by each investor was limited to 5% so that the special capital and other requirements of the Statement of Policy would not be applicable to the investors and the investee institution. The Revised FAQs introduce structural requirements to those transactions, while appearing to encourage transactions involving a combination of one or more lead investors, which are, and make the investee institution, subject to the Statement of Policy and “blind pool” investors, which are not subject to the Statement of Policy.

More fundamentally, the Revised FAQs suggest an FDIC position that the Statement of Policy should have broad application. Their effect will need to be seen in light of that FDIC policy objective.

**IMPORTANT CHANGES FROM THE ORIGINAL FAQS**

**Application of the Statement of Policy to Certain Structures**

The Statement of Policy established an exclusion for investors with 5% or less of the total voting power of an investee institution, provided there is no “evidence of concerted action” by such investors. Nonetheless, in the Revised FAQs, the FDIC states concerns with ownership structures in which all investors own 5% or less of the voting equity of an investee institution, resulting in neither the investors nor the investee institution itself being subject to the Statement of Policy. Accordingly, in these cases, the FDIC will presume concerted action among such investors if, in the aggregate, they hold more than two-thirds of the total voting equity.

The presumption of concerted action in this instance may be rebutted if the investors or a placement agent provides sufficient evidence to the FDIC that the investors are not participating in concerted action. The Revised FAQs provide a long list of the factors that the FDIC will consider in evaluating whether the presumption of concerted action has been rebutted. The factors are:

- whether each investor was among many potential investors contacted by the bank/thrift or its agent, and each investor reached an independent decision to invest in bank/thrift;
- whether an investor is managed or advised by an investment manager or investment advisor who performs the same services for another investor;
- whether the investors have engaged, or anticipate engaging, as part of a group consisting of substantially the same entities as are shareholders of the bank/thrift, in substantially the same combination of interests, in any additional banking or non-banking activities in the United States;
- whether an investor has any significant ownership interest in any other investor in the bank/thrift;
- whether an investor is entitled to acquire any other investor’s shares;
- whether there are any agreements or understandings between any of the investors for the purpose of controlling the bank/thrift;
- whether the investors (and each director representing each investor) will consult with the other investors concerning the voting of bank/thrift shares; and
- whether the directors representing the investors will represent only the particular investor which nominated him or her, and will not represent any combination of investors.
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The application of each factor and its relative significance are not specified, and it remains to be seen how willing the FDIC will be to allow the presumption to be rebutted.

**Determination of “Concerted Action”**

The Original FAQs noted that the FDIC will generally defer to the determination of an investee institution’s primary federal regulator (for example, the Federal Reserve in the case of a bank holding company or the Office of Thrift Supervision in the case of a savings and loan holding company) as to whether investors are acting as “an association” or participating in a “concerted action” under applicable holding company or change in control laws. The Revised FAQs change this determination to a “facts and circumstances” analysis by the FDIC, in which the FDIC has indicated it will take into account the evaluation of the investee institution’s primary federal regulator.

In the Revised FAQs, the FDIC stated that participation in widespread offerings will not generally be considered to be evidence of concerted action by the resulting investors, but did not indicate what constitutes a “widespread offering” and did not offer further guidance regarding the FDIC’s concerted action analysis. The Revised FAQs do not contain the specific guidance in the Original FAQs that the use of a placement agent to solicit investors in a potential failed bank opportunity (provided that each investor makes its own independent decision regarding the investment) would not be in and of itself determinative of concerted action.

**Implications of the Revised FAQs**

In response to the Statement of Policy, a number of so-called “blind pool” or “recapitalization” arrangements had been structured to acquire failed banks without subjecting either (i) the investee institution to the Statement of Policy’s special capital requirement or (ii) the investors to the Statement of Policy’s holding period and other requirements. The Revised FAQs appear designed to favor a combination of a blind pool and one or more lead investors with the lead investors and the investee institution subject to the Statement of Policy.

These transactions generally have been structured so that no investor owns more than 5% of the voting equity of the investee institution (and many investors own much less). The Revised FAQs, however, subject the investors and investee institution to the Statement of Policy requirements unless such investors either (i) hold no more than two-thirds of the target institution’s voting stock (the “two-thirds exemption”) or (ii) are able to rebut the presumption of acting in concert.

Limiting blind pool investors to two-thirds of the investee institution’s existing voting equity (with one-third of the voting equity being retained by the existing holders) would effectively mean that the investors cannot expand the target’s capital in connection with failed bank acquisitions by more than 200%. Most of the blind pool arrangers and investors anticipate a far greater expansion level. In addition, requiring that one-third of the voting equity be retained by the existing holders presents additional challenges in a recapitalization transaction. Accordingly, usage of the two-thirds exemption will seemingly be infrequent.
unless coupled with investments by one or more lead investors who are willing to be subject to the Statement of Policy as described below.

The rebuttal approach imposes a measure of uncertainty and potential for a prolonged review. If the investors were deemed to be acting in concert, then each would be subject to the Statement of Policy. This may be unacceptable to many investors due to the holding period and disclosure requirements. The difficulty of obtaining information from investors about their management, strategies and structures could well impede the ability of sponsors to structure deals contemplating a rebuttal process. Moreover, particularly in view of the FDIC’s apparent intention to apply the Statement of Policy widely, the outcome of the rebuttal process is uncertain. At a minimum, the potential for a long review may decrease the flexibility of investors. For example, if the target is a failing bank or entity organized to acquire one, a prolonged review process could delay the timing of a bid beyond the stated deadline.

On the other hand, many transactions anticipate an IPO within the three-year holding period. This fact could substantially mitigate concerns of investors over the effect of the Revised FAQs.

Further compounding this uncertainty is the second significant change from the Original FAQs. As mentioned, the Original FAQs provided for the FDIC generally to defer to the determination of the primary regulators. Prior determinations by those regulators offer substantial predictability. In providing that the FDIC will only “take into account” – as opposed to deferring to – the views of the primary regulator, as well as requiring a “facts and circumstances” analysis by the FDIC, the Revised FAQs suggest a substantial lessening of predictability. Thus, transaction structures could be subject to two different standards on the same concept – acting in concert.

The Revised FAQs appear to encourage a combination of a blind pool and one or more lead investors which would own at least one-third of the voting power of the investee institution, thus opening opportunities for private equity and other private capital investors to participate. The investee institution would be subject to the special capital requirement, and the lead investor(s) would be subject to the various requirements applicable to “private investors” under the Statement of Policy. The investors with voting interests of 5% or less, however, would not be subject to the private investor requirements, and the potential of a prolonged and uncertain rebuttal period would be largely eliminated. This structure should work for both a recapitalization of an existing institution or an investment in a new institution created to acquire failed banks.

As the Revised FAQs are written, it would still appear to be possible to structure a transaction that is not subject to the Statement of Policy. The structure would involve an investor not deemed a “private investor” acquiring one-third of the investee institution and blind pool investors acquiring the remainder. The term “private investor”, however, remains undefined and, therefore, it remains unclear if the term is intended to apply to investors beyond traditional “private equity investors” such as pension funds, sovereign wealth funds, insurance companies and possibly wealthy individuals or families. In view of the
FDIC’s overall approach, it would be highly desirable to review such a structure with the FDIC before initiating implementation.

The Revised FAQs also appear to leave in place the Statement of Policy’s exemption for private investments in publicly-held banks and bank holding companies where the existing public shareholders retain a “substantial majority” of the voting stock.

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Bank Capital and Liquidity Requirements

Basel Committee Issues Proposals to Strengthen Bank Capital and Liquidity Regulation

SUMMARY

On December 17, 2009, the Basel Committee issued two consultative documents proposing reforms to bank capital and liquidity regulation, which are intended to address lessons learned from the financial crisis that began in 2007. The document titled “Strengthening the Resilience of the Banking Sector” proposes fundamental, although in many respects anticipated, changes to bank capital requirements. The document titled “International Framework for Liquidity Risk Measurement, Standards and Monitoring” proposes specific liquidity tests that, although similar in many respects to tests historically applied by banks and regulators for management and supervisory purposes, going forward would be required by regulation.

The proposals in the first document, which we refer to as the “capital proposals”, would significantly revise – and, as described by the consultative document, simplify – the definitions of Tier 1 Capital and Tier 2 Capital, with the most significant changes being to Tier 1 Capital. Among other things, the proposals would disqualify innovative capital instruments – including U.S.-style trust preferred securities and other instruments that effectively pay cumulative distributions, and in many cases are debt for tax purposes – from Tier 1 Capital status. They would also re-emphasize that Common Equity is the “predominant” component of Tier 1 Capital by (i) adding a minimum Common Equity to risk-weighted assets ratio, with the ratio itself to be determined based on the outcome of an impact study that the Committee is conducting, and (ii) requiring that goodwill, general intangibles and certain other items that currently must be deducted from Tier 1 Capital instead be deducted from Common Equity as a component of Tier 1 Capital. This approach could have a significant impact on acquisitions in which goodwill arises.
The proposals in the second document, which we refer to as the “liquidity proposals”, impose two measures of liquidity risk exposure, one based on a 30-day time horizon and the other addressing longer-term structural liquidity mismatches over a one-year time period.

Comments on both proposals are due by April 16, 2010, with the expectation that the Committee will release a “fully calibrated, comprehensive set of proposals” by December 31, 2010 and final provisions will be implemented by December 31, 2012. The U.S. bank regulators have urged comment on the proposals. Ultimate implementation in individual countries is subject to the discretion of the bank regulators in those countries, and the regulations or guidelines actually adopted in particular jurisdictions may, of course, differ from the Basel Committee’s proposals.

The proposals in their entirety are quite detailed and specific in some areas (the components of regulatory capital, for example) and merely conceptual in others, with details yet to be developed (the new leverage ratio, for example). They inevitably require close analysis by banking organizations – both banks and bank holding companies – that will be affected, because of their potentially profound effect on the banking industry and individual organizations. We have outlined below only key components of the proposals.

**CAPITAL PROPOSALS**

The capital proposals have four key elements:

- raising the quality, consistency and transparency of the capital base;
- strengthening the risk coverage of the capital framework, particularly with respect to counterparty credit risk exposures arising from derivatives, repos and securities financing activities;
- introducing a leverage ratio requirement as an international standard; and
- measures to promote the build-up of capital buffers in good times that can be drawn upon during periods of stress, introducing a countercyclical component designed to address the concern that existing capital requirements are procyclical – that is, they encourage reducing capital buffers in good times, when capital could more easily be raised, and increasing capital buffers in times of distress, when access to the capital markets may be limited or they may effectively be closed.

**The Capital Base**

When the Basel committee adopted Basel II, it expressly chose not to address or change the components of capital, reserving that task for a later date. The capital proposals now do that. Tier 1 Capital would be defined to have just two components – “Common Equity” and “Tier 1 Additional Going Concern Capital”. For banks that are joint stock companies, common shares (and, except in rare circumstances, only voting common shares) and related capital and surplus will be the sole form of qualifying Common Equity. Common Equity must satisfy each of 14 criteria. These criteria include:

- the instrument is perpetual and, apart from dividends, never repaid outside of liquidation;
- the bank does nothing to create an expectation at issuance that the instrument would be bought back, redeemed or cancelled;

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• distributions are not preferential to any other legal or contractual obligation;
• the instrument takes the first and proportionately greatest share of any losses as they occur; and
• the paid-in amount is recognized as equity capital (and not as a liability) for purposes of determining balance sheet insolvency.

Tier 1 Additional Going Concern Capital is also defined by reference to 14 criteria (albeit different from the criteria for Common Equity). These criteria include:

• the instrument is subordinated to depositors, general creditors and subordinated debt of the bank;
• the instrument is perpetual, with no maturity date and no incentives to redeem;
• the instrument may be redeemable at the option of the issuer only after a minimum of five years, and any optional redemption (i) is subject to prior supervisory approval and (ii) may occur only if the bank either (x) replaces the called instrument with capital of the same or better quality or (y) demonstrates that its capital position is well above the capital requirements after the optional redemption option is exercised;
• the bank must have full discretion at all times to cancel, and not merely defer, distributions/payments (that is, no cumulative dividends). This criterion would prohibit inclusion of (i) cumulative preferred stock, which is currently permitted as a component of Tier 1 Capital for U.S. bank holding companies, subject to limitations, and (ii), along with other criteria, U.S.-style trust preferred securities and other innovative capital elements that are effectively cumulative;
• the instrument cannot have a credit sensitive dividend feature;
• cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders;
• the instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law;
• instruments classified as liabilities must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point;
• the instrument cannot have any features that hinder recapitalization, “such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified timeframe.” This criterion would prohibit so-called “reset” or “down-round” provisions of the type that have been included in the documents for some capital issuances during the recent financial crisis; and
• if the instrument is issued by a special purpose vehicle as opposed to an operating entity of the holding company in the consolidated group, the proceeds must be immediately available without limitation to an operating entity or the holding company in a form which meets or exceeds the other criteria for inclusion in Tier 1 Additional Going Concern Capital. Although not further addressed in the capital proposals, this standard implies that the special purpose vehicle must apply the proceeds of the security it issues to purchase from an operating entity or the holding company a security that is Tier 1 Capital (as opposed to remitting proceeds as a dividend or consideration for a purchase of assets).

The capital proposals define Tier 2 Capital by reference to nine criteria, generally consistent with existing standards for securities included in Tier 2 Capital. These criteria include:

• the instrument must have a minimum original maturity of at least five years, with the capital credit amortizing on a straight-line basis in the five years before maturity, and must include no incentives to redeem. Although the proposals do not comment further on this standard, bank regulators historically have taken the view that a step-up in coupon (or other feature creating an incentive to redeem) combined with a redemption right may effectively be a maturity date;
the instrument must not be redeemable at the option of the issuer for at least five years after initial issuance, with the other conditions to optional redemption similar to those for Tier 1 Additional Going Concern Capital;

the investor may have no acceleration rights, except in bankruptcy and liquidation;

the instrument cannot have a credit sensitive dividend/distribution feature;

if the instrument is not issued by an operating entity or the holding company in the consolidated group, its proceeds must be immediately available without limitation to an operating entity or the holding company in a form which meets or exceeds the other criteria for inclusion in Tier 2 Capital.

As in the case of the similar standard for Tier 1 Additional Going Concern Capital, this standard implies that the special purpose vehicle must apply the proceeds of the security it issues to purchase from an operating entity or the holding company a security that is Tier 2 Capital (as opposed to remitting proceeds as a dividend or consideration for a purchase of assets).

Notably, the capital proposals do not include in Tier 2 Capital any components for items that are not securities. Most importantly, they do not include in Tier 2 Capital any portion of the allowance for loan and lease losses, or ALLL. Nor do they specifically comment on the failure to include any amount of the ALLL. Under existing standards, the ALLL may be included in Tier 2 Capital, subject to a limit of 1.25% of risk-weighted assets. This could have the procyclical impact of discouraging the building of strong ALLLs.

As mentioned, the capital proposals reiterate that the “predominant form” of Tier 1 Capital must be common shares and retained earnings. Although the proposals do not specify a measure of predominance (by percentage or otherwise), they reinforce the predominance standard by (i) adding a minimum Common Equity to risk-weighted assets ratio, with the ratio itself to be determined based on the outcome of an impact study that the Committee is conducting, and (ii) specifying that certain items that existing capital regulations require be deducted from Tier 1 Capital instead must be specifically deducted from the Common Equity component of Tier 1 Capital, implicitly for purposes of the predominance test. Those items include goodwill and deferred tax assets which rely on future profitability of the bank, in each case net of any associated deferred tax liability.

The capital proposals also specify that other intangibles must be deducted from the Common Equity component of Tier 1 Capital, again implicitly for purposes of the predominance test. Basel I as initially adopted in 1987 does not specifically address whether or the extent to which specifically identifiable intangible assets other than goodwill – for example certain servicing rights – may be included in (that is, not deducted as “lesser” assets from) components of capital. The risk-based capital regulations and guidelines adopted by national regulators in many countries do. For example, the U.S. federal bank regulatory agencies permit readily marketable mortgage servicing assets, non-mortgage servicing assets and purchased credit-card relationships to be included (that is not deducted) from Tier 1 Capital, subject to a number of specific limitations.

Minority interests will not be eligible for inclusion in the Common Equity component of Tier 1 Capital but will be eligible for inclusion in Tier 1 Additional Going Concern Capital and Tier 2 Capital.

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The capital proposals leave open the possibility that the Basel Committee will recommend changes to the existing required levels of minimum capital – 4% Tier 1 Capital to risk-weighted assets and 8% Total Capital to risk-weighted assets. The consultative document contemplates that the Basel Committee will initiate a comprehensive impact assessment of the proposed enhancements, including as an “anchor of this analysis” the impact of the changes to the definition of capital, and that analysis will set the foundation for determining whether any adjustment will be required to the overall basic requirements. As noted above, the proposals also include a minimum Common Equity to risk-weighted assets ratio requirement to be determined after such impact assessment.

Other matters of note with respect to the proposed changes in the components of capital include the following:

- The capital proposals do not include specific provisions concerning convertible instruments or “contingent capital” – that is, capital instruments that are issued as fixed income securities but convert to common shares if specific events (which may include a systemic risk determination by a governmental authority or an event specific to the issuer, such as falling out of capital compliance) occur. The proposals simply note that the Basel Committee continues to review the role these instruments should play in a regulatory capital framework.

- As noted above, hybrid securities and other innovative capital instruments of the type that have been issued in large volume since the mid-1990s (many of which are debt for tax purposes) generally will not qualify as Tier 1 Capital. Going forward, the capital proposals specify that they will be “phased out.” However, the proposals do not specify a grandfathering period and instead comment that “the Committee will consider appropriate transitional and grandfathering arrangements.”

- The proposals specify that no adjustment should be applied to remove from the Common Equity component of Tier 1 Capital unrealized gains or losses recognized on the balance sheet. They go on to note the concern that “the existing policy adopted in certain jurisdictions of filtering out certain unrealized losses” has undermined confidence in Tier 1 Capital. This would appear to have the consequence in the United States, for example, that write-downs of available for sale securities recorded in accumulated other comprehensive income or loss, which currently are included as a positive or negative number, as applicable, within shareholders’ equity but disregarded for purposes of regulatory capital measures, would no longer be disregarded in calculating the Common Equity component of capital, at least for purposes of the predominance test.

- Similarly, for banks that adopt mark-to-market accounting for their own liabilities, the capital proposals would preclude filtering out from the Common Equity component of Tier 1 Capital all gains or losses resulting from changes in the fair value of liabilities which are due to changes in the bank’s own credit risk.

- Historically, capital regulations have addressed the components of capital as support for a bank as a going concern. The capital proposals draw a distinction between Tier 1 Capital, which is referred to in parenthetical references as “going-concern capital,” and Tier 2 Capital, which is referred to in parenthetical references as “gone-concern capital” – that is, capital that acts as support for depositors in receivership, bankruptcy or liquidation but has less of a role in preserving the bank as a going concern.

- The capital proposals would eliminate Tier 3 Capital as a component of regulatory capital. The proposals explain the elimination of Tier 3 Capital as a step to ensure that market risks are met with the same quality of capital as credit and operational risks.
Risk Coverage

The capital proposals designed to strengthen risk coverage are focused on the two internal-ratings based approaches in Basel II (and not on Basel I or, with limited exceptions, the standardized approach in Basel II). The recommendations address:

- a determination that the regulatory capital treatment for counterparty credit risk was insufficient in a number of areas, including:
  - failure to incorporate into the capital framework “wrong-way risk” – that is, an exposure to a counterparty that is adversely correlated with the credit quality of that counterparty (for example, in Basel II terminology, a circumstance where the product of exposure at default (EAD) and probability of default (PD) increases as counterparty risk deteriorates);
  - the failure to fully account for market value losses short of default with respect to counterparties;
  - the failure to recognize the degree to which large institutions are interconnected;
  - the fact that the close-out period for replacing trades with a counterparty may extend for a longer period than is captured by the existing capital calculations;
  - the destabilizing effect of margin calls, sometimes precipitating defaults;
  - the failure to use central counterparties to clear trades; and
  - the failure to recognize that securitizations have much more price volatility than corporate exposures; and
- shortcomings in banks’ risk management of counterparty credit exposures, including:
  - insufficient back-testing techniques;
  - insufficient stress testing;
  - failure to recognize exposure to wrong-way risk, particularly with respect to financial guarantors; and
  - use of insufficient multipliers to determine exposure at default.

The Basel Committee’s proposals to address these concerns include:

- implementing an explicit charge for specific wrong-way risk;
- applying a multiplier of 1.25 to the asset value correlation of exposures to large regulated financial firms (with assets of at least $25 billion) and to all exposures to unregulated firms, regardless of size;
- extending the margin period of risk to 20 days for OTC derivatives and securities financing transactions netting sets that are large (that is, over 5,000 trades), have illiquid collateral, or represent hard-to-replace derivatives;
- requiring that the data used to calculate expected exposures to counterparties include a period of stress;
- incorporating a simple capital add-on to better capture credit valuation adjustments that recognizes a clearly defined set of hedges;
- updating the simplified assumptions (referred to as the “shortcut method”) that currently may be used by some banks to model exposures;
- implementing various improvements in the calculation of EAD to promote more robust collateral management practices (for example, failure to address the risk of downgrade triggers and the inability of some banks to model collateral jointly with exposures) and in the operations and risk analysis supporting the collateral management process (for example, re-use of collateral);
creating a separate supervisory haircut category for repo-style transactions using securitization collateral and prohibit resecuritizations as eligible financial collateral for regulatory capital treatment purposes;

- increasing incentives to use central counterparties for OTC derivatives;

- enhancing counterparty credit risk management requirements by (i) addressing general wrong-way risk, (ii) making the qualitative requirements for stress testing more explicit, (iii) revising the model validation standards and (iv) issuing supervisory guidance for sound-back testing of counterparty credit risk exposure; and

- placing additional constraints on banks’ own estimates of multiples used to determine exposure of default.

**Leverage Ratio**

The existing Basel Accords – Basel I and Basel II – do not include a simple leverage ratio (that is, a capital requirement where the denominator is total assets, perhaps subject to adjustments, as opposed to risk-weighted assets). By contrast, the capital regulations and guidelines of the U.S. federal bank regulatory agencies do include such a leverage ratio requirement, calculated as Tier 1 Capital divided by average total consolidated assets for the relevant period, less goodwill and certain other deductions (with a stated minimum for the strongest institutions being 3.0% and for most other institutions and purposes being 4.0%, although regulatory pronouncements and practice indicate that maintenance of a higher ratio – at least 5.0% – is generally expected). Earlier this year the Basel Committee announced its intention to introduce a leverage ratio as a supplemental measure to the risk-based ratio of Basel II. The capital proposals discuss at length considerations that the Basel Committee will address in devising the three principal components of a leverage ratio – that is, (i) the numerator, (ii) the denominator, and (iii) the minimum percentage requirement for the ratio. However, at this point, pending completion of impact studies to be conducted during the first half of 2010, they do not include a specific definitive proposal on any of the three components.

As to the numerator in the leverage ratio (referred to as the “capital measure”), the proposals state that a “high quality measure of capital” will be used, but leave open the possibility that it could be limited to the Common Equity component of Tier 1 Capital or, alternatively, could be either Tier 1 Capital in its entirety (including Tier 1 Additional Going Concern Capital) or Total Capital (that is, Tier 1 Capital plus Tier 2 Capital).

As to the denominator in the calculation, the capital proposals indicate that the starting point will be “the accounting measure of exposure” (that is, the applicable GAAP), but likely with adjustments. Possible adjustments include:

- even in jurisdictions where accounting and regulatory netting is otherwise permitted for mutual exposures, disregarding netting and applying a gross measure of exposures, or alternatively, and in order to accommodate inconsistency in approaches to netting across jurisdictions, applying a common set of regulatory netting rules as currently set out in Basel II;
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- including all on-balance sheet assets, including high quality liquid assets (although the proposals note that the committee will assess the impact of possibly excluding high-quality liquid assets that qualify for the liquidity proposal as described below);
- disallowing netting in repo-style transactions;
- likely following GAAP with respect to securitizations, but collecting data and evaluating the impact of expected accounting changes (for example, in the United States, the changes to FAS No. 140 and FIN 46(R) made by FAS Nos. 166 and 167, which starting January 1, 2010 for most sellers/sponsors will cause many securitizations to be taken onto the financial statements of the related sellers/sponsors), and considering as an alternative approach including a bank’s entire managed portfolio of securitizations;
- when a bank sells credit protection using a credit derivative (for example, a credit default swap) and is effectively providing a guarantee, converting the exposure to an asset equivalent applying a 100% conversion factor, but, consistent with the gross measure of exposure referred to in the first bullet point above, not permitting netting of other credit derivatives with the same counterparty; and
- including in the denominator off balance sheet items that, under the Basel II standards, are treated as asset equivalents, applying a 100% credit conversion factor.

In Basel terminology, “Pillar 3” is the disclosure pillar of the capital regime. The capital proposals note that the Basel Committee will require rigorous Pillar 3 disclosures with respect to the leverage ratio and ultimately will include a disclosure template setting out the components required in the calculation.

As to the minimum required leverage ratio (expressed as a percentage), the capital proposals do not suggest or even discuss a particular percentage. They note that “the ratio will be calibrated to constrain the build-up of leverage in the banking sector, hoping to avoid destabilizing de-leveraging processes which can damage the broader financial system and the economy.”

**Procyclicality**

Bank regulators have noted even prior to the current crisis the tendency of capital levels to decline during good times, partly because of lower estimates of probability of default and, consequently, loss. The Basel Committee notes that it is conducting two specific impact studies on possible measures to reduce procyclicality. It also makes several specific proposals.

The two measures that are the subject of impact studies are:

- a proposal that, in calculating exposures, banks use the highest average probability of default (PD) estimate applied by the bank historically to each of its exposure classes as a proxy for a downturn PD, as opposed to PD estimates based on the long-term data horizons currently provided for in Basel II; and
- a proposal that banks use an average of historic PD estimates for each exposure class.

The specific proposals do not correspond to the impact studies. The first specific proposal is to promote stronger provisioning practices through three related initiatives. The initiatives are:

- advocating a change in accounting standards toward an expected loss approach;
- updating supervisory guidance to be consistent with the move to such an expected loss approach; and
addressing disincentives to provisioning in the regulatory capital framework.

A second specific proposal is to establish a capital “buffer” above the minimum capital requirements and require that, if a bank’s capital level fall within the buffer range, the bank be limited in making dividends and other distributions (including share buybacks and discretionary bonus payments) depending upon where in the buffer range the bank falls. The capital proposals include a table of illustrative numbers, presented with a cautionary note that they “do not represent a view on relative or absolute levels, as the proposal still needs to be calibrated.” As an example, however, if a bank suffers losses such that its capital level falls to a level above the minimum requirement equal to 30% of the size of the capital buffer, then the bank will be required to conserve 80% of its earnings in the subsequent financial year by being required to pay out no more than 20% of its earnings in dividends, share buybacks and discretionary bonus payments. Depending on the circumstances of the individual institutions, this could have a significant effect on compensation structure.

The proposals outline a framework but leave open for development, including through the comment process, key aspects of the proposal, including (i) calibration (that is, percentage requirements), (ii) the type of capital required to comprise the buffer, and (iii) the elements subject to restriction on distributions (perhaps beyond ordinary dividends and share buybacks and discretionary bonus payments).

The Basel Committee notes, in discussing the buffer proposal, that it is in the process of reviewing a regime which would adjust the capital buffer range when there are signs that credit has grown to excessive levels. The notion is to use the buffer concept as a means to restrain excessive credit growth. The capital proposals note that the concept is at an early stage of development and, as a consequence, outline it only conceptually.

LIQUIDITY PROPOSALS

The liquidity proposals have three key elements:

- a “Liquidity Coverage Ratio” designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon under an acute liquidity stress scenario specified by supervisors;
- a “Net Stable Funding Ratio” designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon; and
- a set of common metrics – referred to as “monitoring tools” – that the Basel Committee indicates should be considered as the minimum types of information that banks should report to supervisors, as applicable, and supervisors should use in monitoring the liquidity risk profiles of supervised entities.

The liquidity proposals indicate that compliance with the Liquidity Coverage Ratio, the Net Stable Funding Ratio and the monitoring tools would be mandatory for all internationally active banks. Nevertheless, the proposals note that these ratios and monitoring tools may be used for other banks and for any subset of
subsidiaries of internationally active banks that supervisors may choose. They do not address regulatory sanctions that may be applied for non-compliance.

**Liquidity Coverage Ratio**

The Liquidity Coverage Ratio is defined as the ratio, for a bank, of its “stock of high quality liquid assets” divided by a measure of its “net cash outflows over a 30-day time period”. The standard requires that the ratio be no lower than 100%. Both the numerator and denominator are defined in a way intended to insure that sufficient liquid assets are available to meet any cash flow gaps throughout a 30-day period following an acute liquidity stress scenario that is assumed to involve:

- a three-notch downgrade in the bank’s public rating;
- run-off of a proportion of retail deposits;
- a loss of unsecured wholesale funding capacity and reductions of potential sources of secured funding on a term basis;
- loss of secured, short-term financing transactions for all but high-quality liquid assets;
- increases in market volatilities that impact the quality of collateral or potential future exposures of derivative positions and thus require larger collateral haircuts or additional collateral;
- unscheduled draws on all the bank’s committed but unused credit and liquidity facilities; and
- the need for the bank to fund balance sheet growth arising from non-contractual obligations honored in the interest of mitigating reputational risk.

High quality liquid assets for purposes of the numerator are intended to meet four fundamental characteristics (low credit and market risk, ease and certainty of valuation, low correlation with risky assets, and listed on a developed and recognized exchange market) and four market-related characteristics (active and sizeable market, presence of committed market makers, low market concentration, and flight to quality considerations). The Basel Committee has determined that the only assets that meet these characteristics are:

- cash;
- central bank reserves, to the extent that they can be drawn down in times of stress;
- marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities, the Bank for International Settlements, the International Monetary Fund, the European Commission, and certain multi-lateral development banks that meet specified criteria; and
- government or central bank debt issued in domestic currencies by the country in which the liquidity risk is being taken or the bank’s home country.

The Basel Committee indicated that is also gathering data on corporate bonds and covered bonds and, subject to limitations (likely to include haircuts of 20% to 40% even if other criteria are satisfied) it will consider whether these instruments may be included.

Net cash outflows is defined, for purposes of the denominator in the Liquidity Coverage Ratio, as “cumulative expected cash outflows minus cumulative expected cash inflows arising in the specified stress scenario in the time period under consideration.” The liquidity proposals include very detailed
provisions with respect to cash outflows and inflows. The approach, generally described, is to identify a cash source and then apply a “factor” to the proportion of the cash source that is expected to be paid out (referred to as a “run-off factor”) or received in the relevant period. The run-off factors range from 7.5% to 100%, with, as examples, 7.5% applying to “stable” retail deposits and the “stable” portion of unsecured wholesale funding provided by small business customers; 15% to less stable retail deposits and less stable unsecured wholesale funding provided by small business customers; 25% to unsecured wholesale funding provided by non-financial corporate customers, sovereigns, central banks and public entities where the related deposits are demonstrated to be needed for the entities’ operational purposes; 75% to other unsecured wholesale funding provided by non-financial corporate customers; and 100% to unsecured wholesale funding provided by other legal entity customers, including financial institutions (which are specified to include banks, securities firms, insurance companies and multilateral development banks). The net cash outflow provisions assume 100% loss of any funding to the bank from asset-backed commercial paper conduits, securities investment vehicles and similar facilities. They also assume that committed credit and liquidity facilities extended to clients will be drawn over specified ranges – for example, 10% for retail customers and 100% for non-financial corporate customers.

With respect to cash inflows, the proposals assume that banks will receive 100% of all performing contractual wholesale cash inflows, but that maturing reverse repos or securities lending agreements will be rolled over and will not give rise to any cash inflows where the bank is the “lender” (for example, a true repo) but will not be rolled-over and, accordingly, will involve a cash outflow where the bank is the borrower (that is, a reverse repo).

**Net Stable Funding Ratio**

The Net Stable Funding Ratio is defined as the ratio, for a bank, of its “available amount of stable funding” divided by its “required amount of stable funding”. The standard requires that the ratio be no lower than 100%. The standard is designed to ensure that investment banking inventories, off-balance sheet exposures, securitization pipelines and other assets and activities are funded with at least a minimum amount of stable liabilities in relation to their liquidity risk profiles.

Generally described, the numerator in the ratio – “available stable funding” – is calculated by applying to designated items on the right side of the balance sheet (that is, items that are sources of funding) a factor – called an “ASF factor” – ranging from 100% to 0% depending upon the particular equity or liability component, with the factor reflecting stability of funding. Similarly, the denominator in the ratio – the required amount of stable funding – is calculated by applying to each asset on the left side of the balance sheet and certain off-balance sheet commitments (that is, items requiring funding) a specific required stable funding factor – called an “RSF factor” – reflecting the amount of the particular item that supervisors believe should be supported with stable funding.

More specifically, with respect to the numerator in the ratio:
available stable funding is defined as the total amount of a bank’s (i) capital, (ii) preferred stock with a maturity of one year or more, (iii) liabilities with effective maturities of one year or more, and (iv) that portion of “stable” non-maturity deposits and/or term deposits with maturities of less than one year that would be expected to stay with the bank for an extended period in an idiosyncratic stress event; and

the ASF factors range from 100% to 0%, with the more stable funding sources having higher ASF factors (and, accordingly, contributing more to meeting the minimum 100% requirement). For example, Tier 1 Capital and Tier 2 Capital are assigned 100% ASF factors, “stable” retail deposits an 85% ASF factor, “less stable” retail deposits a 70% ASF factor, certain wholesale funding and deposits of non-financial corporate customers a 50% ASF factor, and other liabilities and equity categories a 0% ASF factor.

With respect to the denominator in the ratio:

the required amount of stable funding is calculated as the sum of the value of assets held, after converting certain off-balance sheet exposures to asset equivalents, multiplied by a specified RSF factor;

the RSF factors range from 0% to 100%, with assets requiring a less stable funding source having lower RSF factors (and, accordingly, contributing more to meeting the minimum 100% requirement). For example, cash and money market instruments are assigned a 0% RSF factor, unencumbered marketable securities with maturities of one year or more and representing claims on sovereigns a 5% RSF factor, unencumbered AA corporate bonds with maturities of one year or more a 20% RSF factor, gold a 50% RSF factor, loans to retail clients having a maturity of less than one year an 85% RSF factor, and all other assets a 100% RSF factor.

Monitoring Tools
The liquidity proposals outline four monitoring tools, or "metrics", that are described, together with the ratios described above, as being intended to “provide the cornerstone of information which aid[s] supervisors in assessing the liquidity risk of a bank.” The metrics address:

contractual maturity mismatch;
concentration of funding;
available unencumbered assets; and
market-related monitoring tools.

Contractual Maturity
This metric is defined as “contractual cash and security inflows and outflows from all on- and off-balance sheet items, mapped to defined time bands based on their respective maturities.” The proposal leaves it to national supervisors to define the precise time buckets but recites that possibilities include requesting the cash flow mismatch to be constructed for overnight, 7 day, 14 day, 1, 2, 3 and 6 months, and 1, 3, 5 and beyond 5 year buckets.

Concentration of Funding
This metric requires three items:
• calculation of the ratio of funding liabilities sourced from each significant counterparty to the bank’s “balance sheet total” (which appears to mean total liabilities as opposed to total liabilities plus shareholders’ equity);
• calculation of the ratio of funding liabilities sourced from each significant product/instrument to the bank’s balance sheet total; and
• a list of asset and liability amounts by significant currency.

A “significant counterparty” is defined as a single counterparty or group of affected or affiliated counterparties accounting in aggregate for more than 1% of the bank’s total liabilities. Similarly, a “significant instrument/product” is defined as a single instrument/product or group of similar instruments/products which in aggregate amount to more than 1% of the bank’s total liabilities, and a “significant currency” is defined as liabilities denominated in a single currency, which in aggregate amount to more than 1% of the bank’s total liabilities. The proposal includes a statement that each metric should be reported separately for time horizons of less than one month, 1-to-3 months, 3-to-6 months, 6-to-12 months, and for longer than 12 months. It is not clear how such time buckets apply to what appear to be point-in-time calculations.

Available Unencumbered Assets
Available unencumbered assets are defined as “unencumbered assets that are marketable as collateral in secondary markets and/or eligible for central banks’ standing facilities.” This metric is only informational. The proposals recite that, for an asset to be counted in this metric, the bank must have already put in place operational procedures needed to monetize the asset.

Market-Related Monitoring Tools
This metric, which also appears to be informational, relates to early warning indicators in monitoring potential liquidity difficulties at banks. It includes market-wide information (for example, equity prices and spreads in debt markets generally), information on the financial sector (for example, equity and debt market information for the financial sector broadly and for specific subsets of the financial sector, including indices), and bank-specific information (for example, information on the equity prices of the specific bank or credit default swaps spreads for the bank).
CONCLUDING OBSERVATIONS

In view of the severity of the recent financial crisis, we believe it unlikely that the Basel Committee’s implementation of the proposals will involve the prolonged period of delay and postponement that marked the adoption of Basel II. Regardless of the derivation of the adage that “a crisis is a terrible thing to waste,” it is likely to inform the Committee’s deliberations. Moreover, we believe that national regulators will begin to implement at least certain of the recommendations as a supervisory matter, particularly if there is any slippage in timing by the Committee.

*   *   *

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Bank Capital and Liquidity Requirements
December 28, 2009
The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. The base risk-based capital guidelines initially adopted by bank regulators in the Organization for Economic Co-operation and Development are based upon the Basel Committee's December 1987 consultative paper titled "Proposals for International Convergence of Capital Measurement and Capital Standards", often referred to as "Basel I". In June 2006 the Basel Committee released a comprehensive new accord titled "International Convergence of Capital Measurement and Capital Standards – A Revised Framework", often referred to as "Basel II". Although Basel II has three approaches – a standardized approach and two advanced approaches, the United States regulators have adopted only the most advanced approach, referred to as the internal ratings-based approach, or "IRB", and have applied it only to so-called core banking organizations that have either more than $250 billion in assets or $10 billion in foreign exposures.

Comments should be submitted either by e-mail to baselcommittee@bis.org or in writing to Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland.

Although the consultative document on capital uses the term "bank", it defines the term "bank" consistently with Basel II, to mean any "bank, banking group or other entity (for example, holding company) whose capital is being measured".

The capital guidelines of the United States bank regulatory agencies already include a leverage ratio. Other jurisdictions historically have not, and an explicit leverage ratio is not a component of Basel I or Basel II in their current forms.

The treatment of deferred tax assets historically has varied considerably among jurisdictions. The risk-based capital guidelines applicable to United States banks have, since 1995, required that deferred tax assets that depend upon future taxable income be deducted from Tier 1 Capital to the extent they exceed the lesser of the amount that the bank expects to realize within one year and 10% of Tier 1 Capital.

Tier 3 Capital was added as a permitted component of capital, maintainable against market risk, pursuant to the Basel Committee's 1996 paper titled "Amendment to the Capital Accord to Incorporate Market Risks". Generally described, Tier 3 Capital consists of short-term subordinated debt (minimum maturity of two years) that is not redeemable before maturity without approval by the relevant regulator and is subject to various other limitations on payments depending upon capital compliance. Few, if any, U.S. banks issued Tier 3 Capital, largely because it would not qualify as debt for U.S. federal income tax purposes.

The term "internationally active banks" is not defined. The U.S. federal bank regulatory agencies have defined the term to mean, for purposes of their versions of Basel II, banking organizations with either $250 billion or more of total assets or $10 billion or more of foreign exposures.
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Bank Capital and Liquidity Requirements
December 28, 2009
NY12528:411660.3
Transparency and Compliance for Cross-Border Cover Payment Messages


SUMMARY

On December 17, 2009, the U.S. Federal banking regulators, in consultation with the U.S. Department of the Treasury’s Office of Foreign Assets Control (“OFAC”) and Financial Crimes Enforcement Network, issued interagency guidance to clarify the supervisory perspective on certain key points discussed in the May 2009 paper of the Basel Committee on Banking Supervision (the “Basel Committee”) addressing transparency in cross-border cover payment messages (the “Cover Payments Paper”). The Basel Committee published the Cover Payments Paper in response to the April 2007 statement of the Wolfsberg Group and The Clearing House Association, which offers recommendations to enhance transparency in cover payment messages. In the Cover Payments Paper, the Basel Committee addresses supervisory expectations as to the inclusion of information in cover payment messages and the roles of the various financial institutions—the originator’s bank, the cover intermediary banks, and the beneficiary’s bank—with regard to that information and in implementing the new SWIFT message format, MT 202 COV. MT 202 COV was effective as of November 21, 2009 and contains mandatory fields for information on the originator and beneficiary of a funds transfer, information not provided in the previous message format. The guidance focuses on three aspects of the Cover Payments Paper:

- Mandatory use of the MT 202 COV format for all cover payments originated by U.S. financial institutions.
- Supervisory expectations regarding screening and monitoring of cover payments by intermediary banks.
- The general supervisory approach with respect to cross-border cover payments in the form of instructions for examiners on assessing risk management practices and compliance processes.
The guidance is of particular relevance for financial institutions that act as intermediaries in cover payments, as it notes the role of correspondent banks in encouraging transparency in cover payment messages and indicates that intermediary banks are expected within reasonable time frames to have as part of their electronic monitoring processes for funds transfers a risk-based method to identify cover payments with incomplete fields or fields with meaningless data and should have processes in place to address such situations as part of its overall risk management for correspondent banking services.

BACKGROUND

Banks use cover payments to settle cross-border funds transfers on behalf of customers to beneficiaries or domestic funds transfers in foreign currencies. Typically, they involve payments between banks that do not have a correspondent relationship with each other in the currency of the funds transfer. Settlement is through intermediary banks. The originator's bank may directly instruct the beneficiary's bank to effect the payment to the beneficiary using a SWIFT MT 103 message and send a separate "cover" payment message using a SWIFT MT 202 message to an intermediary bank to satisfy the payment obligation of the originator's bank created by the MT 103. MT 202 cover payment messages have not historically included information on the originators and beneficiaries of funds transfers. This lack of information prevents intermediary banks from effectively assessing risks related to correspondent banking and fulfilling their sanctions screening and suspicious activity monitoring obligations.

On April 19, 2007, the Wolfsberg Group ("Wolfsberg") and The Clearing House Association ("Clearing House") issued a statement endorsing two actions to enhance transparency in cover payment messages. These actions were (1) the creation of a SWIFT message format for cover payments that includes information on the originator and beneficiary of a funds transfer and (2) the adoption of payment message standards within the banking industry (the "Message Standards"). The Message Standards are:

- Financial institutions should not omit, delete or alter information in payment messages or orders for the purpose of avoiding detection of that information by any other financial institution in the payment process.
- Financial institutions should not use any particular payment message for the purpose of avoiding detection of information by any other financial institution in the payment process.
- Subject to all applicable laws, financial institutions should cooperate as fully as practicable with other financial institutions in the payment process when requested to provide information about the parties involved.
- Financial institutions should strongly encourage their correspondent banks to observe these principles.

Following the issuance of the Wolfsberg/Clearing House statement, the Basel Committee encouraged the initiative and indicated that it would explore the development of supervisory policies to support transparency efforts in the industry. In May 2009, the Basel Committee published the Cover Payments Paper, which addressed supervisory issues related to cover payments and the implementation of the new MT 202 COV message format. The Cover Payments Paper is summarized below.

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December 24, 2009
BASEL COMMITTEE’S COVER PAYMENTS PAPER

The Basel Committee’s Cover Payments Paper indicates that it was not intended to create any new obligations on banks, as banks’ obligations are established under national law implementing international and national standards. The Basel Committee notes, however, its support for encouragement of increased transparency for cover payments and common supervisory expectations related to transparency at the international level.

The Cover Payments Paper discusses (i) the inclusion of originator and beneficiary information in cover payments; (ii) the roles of originating, cover intermediary and beneficiary banks in processing cross-border wire transfers; and (iii) the roles of supervisors with respect to assessing their supervised institutions’ risk management practices with respect to cover payments.

I. INCLUSION OF INFORMATION

Special Recommendation (SR) VII of the Financial Action Task Force (“FATF”) and the related FATF Interpretive Note address the inclusion of originator information in international wire transfers. The Cover Payments Paper recognizes that FATF SR VII does not directly deal with the issue of cover payments and seeks to clarify supervisory expectations. The Basel Committee indicates that information on originators and beneficiaries should be included in messages sent to cover intermediary banks processing cross-border wire transfers related to customer transfers. The Basel Committee recognizes that those expectations require prior implementation of suitable technical standards for cover payments (i.e., the MT 202 COV).

II. ROLES OF BANKS

The Cover Payments Paper discusses supervisory expectations with respect to the roles of the originator’s bank, cover intermediary banks and the beneficiary’s bank in processing cross-border cover payments. The Basel Committee asserts that it is the responsibility of the originator’s bank to ensure that complete information is included in each wire transfer. Cover intermediary banks and beneficiaries’ banks also have a role to play in ensuring appropriate flows of information.

A. ORIGINATORS’ BANKS

The Basel Committee notes that originators’ banks have a special role to play in international wire transfers. Those banks are responsible for the customer due diligence on the originator, verifying the accuracy of originator information and maintaining adequate records on the originator. The originator’s bank also must ensure that messages sent to cover intermediary banks contain originator and beneficiary information. Originator information should include information required by FATF SR VII as required by local regulation and, at a minimum, an identifier code and name of the beneficiary. The identifier code...
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must allow the intermediary bank to easily and reliably identify the beneficiary and allow automated screening against lists of names. Originators’ banks also must have policies that address the proper use of SWIFT message formats and monitor the originators’ activity consistent with the banks’ knowledge of the customers, their businesses and risk profiles, including the source of their funds.

B. COVER INTERMEDIARY BANKS

The Cover Payments Paper takes the position that cover intermediary banks are responsible for ensuring that information contained in the cover payment message received by them is passed on to the next bank in the chain. In addition, the Cover Payments Paper indicates that they should (i) have reasonable policies in place to ensure in real time that required fields in cover payment messages are not blank (SWIFT will reject payments where mandatory fields are not populated); and (ii) take appropriate steps with respect to messages with blank fields, such as, rejecting the message, obtaining missing information from the originator's bank or filing a suspicious activity report.

Cover intermediary banks also are expected to screen originator and beneficiary names against sanctions lists. The Cover Payments Paper recognizes that there may be situations in which screening by the cover intermediary bank would be duplicative of screening conducted by the originator's bank, such as where the banks are part of the same corporate group and the group uses a unified list for screening purposes. The paper recognizes that in these situations it may be appropriate to rely on the screening by the originator’s bank where allowed. Cover intermediary banks are cautioned that they remain liable under applicable domestic law even though the screening has been outsourced. Due diligence would be required to determine whether such reliance is appropriate in a particular situation.

Cover intermediary banks are expected to monitor their relationships with correspondent banks. The Cover Payments Paper anticipates that applicable national law will frequently permit banks to use a risk-based approach, under which monitoring may occur after transactions have been processed. Cover intermediary banks are expected to have reasonable policies and procedures in place to monitor cover payment messages for manifestly meaningless or incomplete fields and to respond as appropriate. Appropriate responses include (i) obtaining complete information from the originator's bank or the precedent cover intermediary bank; (ii) considering terminating or restricting the correspondent relationship if the correspondent bank declines to provide required information or has repeatedly sent messages with meaningless or incomplete fields; or (iii) filing a suspicious activity report. The Cover Payments Paper recognizes that cover intermediary banks are not in a position to evaluate whether the transaction between the originator and beneficiary is suspicious. Cover intermediary banks are, however, expected to monitor transactions for patterns of suspicious activity and, where appropriate, to file suspicious activity reports or review correspondent relationships.

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C. BENEFICIARIES' BANKS

The Cover Payments Paper takes the position that beneficiaries’ banks are responsible for verifying the identity of the beneficiary, conducting due diligence on the beneficiary, and monitoring the activities of the beneficiary. Beneficiaries’ banks should (i) have risk-based procedures to identify messages with incomplete information on the originator; and (ii) consider transparency problems in assessing whether transactions are suspicious and must be reported. Beneficiaries’ banks are expected to consider restricting or terminating business relationships with banks that do not adhere to transparency standards.

D. SUPERVISORY EXPECTATIONS FOR ALL BANKS

The Cover Payments Paper also identifies issues of general applicability. Originators’ banks, cover intermediary banks, and beneficiaries’ banks must comply with applicable data protection laws and protect against confidentiality breaches and improper use of information. Where required, due diligence is expected to be covered by banks’ internal audit and compliance procedures and be incorporated into banks’ staff training and systems and controls. Banks are expected to ensure compliance with FATF SR VII transparency standards and only enter into relationships with banks that adhere to them.

III. ROLE OF SUPERVISORS

Supervisors must ensure that originators’ banks, cover intermediary banks, and beneficiaries’ banks fulfill their respective roles in processing cover payments and in maintaining transparency in cover payment messages. The Cover Payments Paper recommends steps for supervisors to take in evaluating risk management practices relating to cover payments.

ORIGINATORS’ BANKS’ USE OF MT 202 COV

The Interagency guidance confirms that the U.S. Federal banking agencies expect the MT 202 COV to be used by U.S. originators’ banks for all cover payments when there is an associated MT 103 message, irrespective of whether there is a cross-border transfer. When the MT 202 COV is required, U.S. banks may comply with other applicable messaging regulations (e.g., the “Travel Rule”) by including the required information on the MT 202 COV. The guidance notes that sending a message in the MT 202 format when the MT 202 COV is required is inconsistent with the Message Standards. For other bank-to-bank transactions, such as bank-to-bank transfers for correspondent accounts, U.S. banks may continue to use the MT 202 format. U.S. banks’ procedures should address the appropriate use of the new message format for transactions where they act as originators’ banks.

INTERMEDIARY BANKS’ MONITORING AND SCREENING OBLIGATIONS

Clarifying the role of intermediary cover banks, the guidance makes clear that they are expected to monitor the transactions of originators’ banks for suspicious activity and review their relationships with...
originators’ banks as appropriate. In monitoring transactions and in reviewing correspondent relationships, banks are to use techniques similar to those applied to payments between originators and beneficiaries. Such monitoring may be risk-based and occur on an automated basis after the transfers have been processed.

The guidance notes that the implementation of the MT 202 COV format does not alter sanctions screening obligations, although more information may be available for screening. As with the MT 202, banks must subject all messages to sanctions screening. The guidance also states that banks must continue to block or reject transfers as required by law, and make required reports to OFAC.

Banks are not expected to gather information relating to incomplete fields or to verify the accuracy of information in cover payment messages. Banks are expected to have a process where a risk-based approach to monitoring identifies MT 202 COV fields that are “manifestly meaningless or incomplete” (i.e., where it is obvious, without further research or investigation, that the message does not identify parties to a transaction). U.S. banks that process cover payments must adapt automated monitoring systems within reasonable time frames to identify fields with meaningless or incomplete data and have policies to address messages with such data in connection with their risk management of correspondent banking services.

Additionally, the guidance provides general points about correspondent banking practices. The guidance emphasizes that correspondent banks play an important role in ensuring transparency in cover messages. Accordingly, they are expected to “strongly encourage” compliance with the Message Standards. With respect to risk management of correspondent accounts, U.S. cover intermediary banks must consider a correspondent bank’s failure to use the MT 202 COV format when available and have appropriate controls in place to respond to such failures. The guidance also notes that banks must continue to monitor correspondent transactions using a risk-based approach and that they remain subject to the due diligence requirements under the USA PATRIOT Act and related regulations.

**GENERAL SUPERVISORY APPROACH**

To assist banks in understanding the general supervisory approach to cover payments, the guidance contains recommendations for examiners to ensure correspondent banking practices comport with supervisory expectations and existing regulatory requirements. When assessing risk management practices, examiners are specifically instructed to:

- Review whether a bank has in place Bank Secrecy Act/Anti-Money Laundering and OFAC risk assessments that address payment operations and account for all relevant factors, including correspondent banking relationships, volume and jurisdictions of funds transfers, and whether the bank is the originator’s bank, intermediary bank or beneficiary’s bank.
- Determine whether a bank has implemented transparency standards for international funds transfers and maintains systems for consistent adherence to those standards.

Transparency and Compliance for Cross-Border Cover Payment Messages
December 24, 2009
CONFIRM THAT ORIGINATORS’ BANKS INCLUDE COMPLETE INFORMATION FOR CROSS-BORDER FUNDS TRANSFERS.
EVALUATE A BANK’S PROCESSES TO CONDUCT DUE DILIGENCE ON FOREIGN CORRESPONDENT BANKS, AS REQUIRED UNDER THE USA PATRIOT ACT AND RELATED REGULATIONS.

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Transparency and Compliance for Cross-Border Cover Payment Messages
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Failed Bank Acquisitions

FDIC Releases Frequently Asked Questions on the Statement of Policy on Qualifications for Failed Bank Acquisitions

SUMMARY

On December 11, 2009, the Federal Deposit Insurance Corporation released Frequently Asked Questions (the “FAQs”) on its August 26, 2009 Statement of Policy on Qualifications for Failed Bank Acquisitions (the “Policy Statement”). The Policy Statement provides certain terms and conditions for both “private investors” interested in acquiring failed banks or thrifts from the FDIC and the institution in which the private investors invest (“Failed Bank Transactions”). The FAQs clarify the Policy Statement’s exclusion for non-control investments in bank or thrift holding companies which acquire failed banks. In addition, the FAQs address how “concerted action” among investors would render unavailable the Policy Statement’s exclusion for investors with 5% or less of the total voting power of an acquired depository institution or its holding company.

The FAQs are of particular relevance for so-called “blind pool” arrangements to purchase failed banks. As a general matter, the FAQs clarify that blind pools can be structured so that they are exempt from the limitations and restrictions of the Policy Statement.

THE FREQUENTLY ASKED QUESTIONS

Additional Clarity on Exclusions

The Policy Statement established an exclusion for “investors in partnerships or similar ventures with bank or thrift holding companies or in such holding companies (excluding shell holding companies) where the holding company has a strong majority interest in the resulting bank or thrift and an established record for successful operation of insured banks or thrifts.” The FAQs clarify that, in the case of investments through a partnership or venture with an established bank or thrift holding company, the definition of “strong majority interest” for purposes of this exclusion means that at least two-thirds of both the total
equity and the voting equity of the partnership or joint venture post-acquisition must be held by the bank holding company. This exclusion is also intended to exempt non-controlling investments in stable holding companies which subsequently and contemporaneously acquire failed banks. In the case of such investments, this exclusion would appear to apply if new private investors investing for purposes of or in connection with the Failed Bank Transaction have no more than one-third of the total equity post-acquisition.

The FDIC also noted that it will take into account any “special rights” the private investors receive through “covenants, agreements, special voting rights, or other such mechanisms” when determining the application of this exclusion in either case. Although not defined here, it seems likely that these “special voting rights” are the same “special voting rights” described below.

What still remains unclear is the FDIC’s position if private investors acquire more than one-third of the total equity in a banking institution and some time thereafter the banking institution seeks to acquire a failed bank. The FDIC may prefer to deal with such situations on a case-by-case basis rather than provide firm guidelines.

The Policy Statement also established an exclusion for investors with 5% or less of the total voting power of an investee institution irrespective of their aggregate ownership, provided there is no “evidence of concerted action” by such investors (the “5% exclusion”). The FDIC noted that it will generally defer to the determination of an investee institution’s primary federal regulator (for example, the Federal Reserve in the case of a bank holding company or the Office of Thrift Supervision in the case of a savings and loan holding company) as to whether investors are acting as “an association” or participating in a “concerted action” under applicable holding company or change in control laws. The FDIC may determine, however, not to defer to the primary federal regulator where there are specific facts evidencing a lack of independent action that were not available to the primary federal regulator in making its determination.

Any separate analysis by the FDIC of the concerted action issue will be “fact-based.” The FDIC clarified that it did not consider the use of a placement agent to solicit investors in a potential failed bank opportunity (provided that each investor makes its own independent decision regarding the investment) to be in and of itself determinative of concerted action. In addition, the FDIC said that concerted action would not “be presumed in and of itself” because investors conducted a due diligence review of the individuals proposed to serve on the board and as executive officers of the resulting institution.

The FDIC also clarified that concerted action would be assumed if investors obtained special voting rights permitting those investors to “directly or indirectly select a majority of the board of directors, to designate key management, or to control routine operating decisions of the institution, or if agreements or understandings exist among those investors that provide such rights.”

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December 14, 2009
In addition, the FDIC clarified that the 5% exclusion would apply to an investor that owned less than 5% of the voting power but more than 5% of the equity of the resulting investee institution provided that any non-voting equity owned by the investor (1) is not convertible into voting equity “at any time or under any circumstances” or (2) is convertible into voting equity but satisfies the following criteria:

- the shares of non-voting equity may not be converted into voting shares in the hands of or at the election of the investor or any affiliate of the investor; and
- the shares may only be transferred by the investor (i) to an affiliate of the investor or to the investee banking organization; (ii) in a widespread public distribution; (iii) in transfers in which no transferee (or group of associated transferees) would receive 2% or more of any class of voting securities of the banking organization; or (iv) to a transferee that would control more than 50% of the voting securities of the banking organization without any transfer from the investor.

The features required for ownership of non-voting shares without being deemed to own the underlying voting shares are identical to the requirements of the Federal Reserve’s noncontrol investment rules and consistent with the approach taken by the Office of Thrift Supervision.

Finally, the Policy Statement excluded any investor (in the absence of concerted action) owning less than 5% of the voting equity of the investee institution. The FDIC has now explicitly stated that the converse is also true: if any investor owns 5% or more of the voting equity of a depository institution or its holding company, then (presumably assuming that no other exclusion is available) the Policy Statement would apply to that investor and the investee depository institution. The exclusion from the continuity of ownership provisions of the Policy Statement for mutual funds (defined as open-ended investment companies registered under the Investment Company Act of 1940 that issue redeemable securities allowing investors to redeem on demand) would presumably still apply where they own more than 5% of an investee institution’s voting equity.

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ENDNOTE

¹ The Policy Statement is described in our Memorandum of August 28, 2009.
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House Financial Services Committee Draft
Financial Regulatory Reform Legislation

House Financial Services Committee Chairman Barney Frank
Releases Discussion Draft of the Financial Stability Improvement Act
of 2009

SUMMARY
On October 27, U.S. House Financial Services Committee Chairman Barney Frank released a discussion
draft of the Financial Stability Improvement Act of 2009 (the “Discussion Draft”), a legislative proposal for
reform of the regulation of the financial services industry.¹ The proposed legislation would, among other
things, create a framework for regulation of systemically important financial firms and activities; provide an
alternative resolution regime for systemically important financial firms; merge the Office of Thrift
Supervision into the Office of the Comptroller of the Currency, retaining the federal thrift charter; reform in
several significant respects the regulation of insured depository institutions and their holding companies;
and impose certain asset retention requirements on originators and securitizers of asset-backed
securities.

BACKGROUND
The Discussion Draft was developed in close collaboration with the Treasury Department and addresses
many of the same topics set forth in the legislative proposals released by Treasury last August.² Chairman Frank convened a Committee Hearing on the Discussion Draft on October 29 to receive
testimony from Treasury Secretary Geithner, federal bank regulators and others. Chairman Frank intends
to begin the committee’s legislative markup of the proposed legislation this week.
FRAMEWORK OF LEGISLATION

According to the Financial Services Committee, the Discussion Draft is designed to “address the issue of systemic risk and ‘too big to fail’ financial institutions.” If enacted in its current form, it would implement the following regulatory reforms in the financial services sector:

- Create a Financial Services Oversight Council to monitor systemic risk and identify financial companies and activities (including payment, clearing and settlement activities) that may pose a threat to financial stability or the economy
- Subject such identified companies and activities to heightened oversight, standards and prudential regulation
- Abolish the Office of Thrift Supervision (“OTS”) and transfer supervision of federal savings associations to the Office of the Comptroller of the Currency (“OCC”) and state savings associations to the FDIC. Thrift holding companies would become bank holding companies subject to regulation by the Federal Reserve
- Remove the exemption under the Bank Holding Company Act of 1956 (the “BHC Act”) for companies owning industrial loan companies, credit card banks and other so-called “non-bank banks” and require such companies to establish an intermediate holding company through which these companies would be required to conduct all of their financial activities, with significant restrictions on transactions with non-financial affiliates
- Expand transactional restrictions between insured depository institutions and their affiliates and insiders and strengthen and apply the national bank loan to one borrower rule to all such institutions
- Require originators of loans and asset-backed securities to retain a percentage of the credit risk associated with the assets
- Create an alternative resolution mechanism for systemically important financial companies identified by the Financial Services Oversight Council
- Restrict the Federal Reserve’s emergency lending authority under Section 13(3) of the Federal Reserve Act and provide the FDIC with authority to lend to solvent financial companies during times of severe economic distress

FINANCIAL SERVICES OVERSIGHT COUNCIL

The Discussion Draft establishes a Financial Services Oversight Council ("FSOC"), the membership of which would consist of the heads of the federal financial regulatory agencies as voting members, and a designated state insurance commissioner and state banking supervisor as non-voting members. The FSOC would be chaired by the Secretary of the Treasury and act by majority vote. The FSOC would not be an “agency” for purposes of any state or federal law and would not therefore be subject to statutes such as the Administrative Procedure Act and the Freedom of Information Act.

The FSOC would have a number of duties relating to the monitoring and oversight of systemic risk in the financial system. It would monitor the financial services marketplace to identify potential threats to financial stability, advise Congress on financial regulation and market stability, and provide a forum for discussion, analysis and information-sharing among its members. In addition, the FSOC would be charged with identifying financial companies and financial activities (including financial market utilities or payment, clearing or settlement systems) that should be subject to heightened prudential standards in order to promote financial stability and mitigate systemic risk. Finally, the FSOC would serve as a forum
to resolve disputes among federal financial regulatory agencies regarding jurisdiction over a particular financial company or activity.

PRUDENTIAL REGULATION OF IDENTIFIED FINANCIAL COMPANIES AND ACTIVITIES

The FSOC could designate any financial company to be subject to heightened prudential regulatory standards if it determines that material financial distress at the company or the nature, scope or mix of the company’s activities could pose a threat to financial stability or the U.S. economy. The Discussion Draft refers to such financial companies as “identified financial holding companies” (“IFHCs”). The U.S. financial operations of a foreign company could also be designated as an IFHC, and the Federal Reserve would have authority to prescribe regulations regarding the application of heightened prudential standards to such entities, giving due regard to the principle of national treatment and competitive equality. An IFHC that is not already a bank holding company would either be treated as such if it engages exclusively in financial activities permissible under Section 4(k) of the BHC Act or, if it does not engage exclusively in such activities, it would be required to establish a new intermediate holding company (a so-called “section 6 holding company”) supervised by the Federal Reserve in or through which it would have to conduct all its financial activities. As discussed below, these intermediate holding companies would be subject to a number of restrictions and conditions, including significant restrictions on transactions with affiliates. The Discussion Draft would prohibit the FSOC and the Federal Reserve from publicly releasing a list of IFHCs. However, publicly-traded companies designated as IFHCs could be subject to certain related disclosure obligations arising under the federal securities laws.

Under the terms of the Discussion Draft, the Federal Reserve would be required to impose such heightened prudential standards as it deems advisable on an IFHC, including enhanced risk-based capital requirements, leverage limits and liquidity requirements. Additionally, an IFHC would be subject to a substantially enhanced prompt corrective action regime (which, among other things, would provide that the Federal Reserve must require an IFHC to file for bankruptcy within 90 days of becoming critically undercapitalized) and must periodically submit plans to the Federal Reserve for its rapid and orderly resolution in the event of severe financial distress. The Federal Reserve could also recommend that functional regulators impose heightened prudential standards on any functionally regulated subsidiary or depository institution subsidiary of an IFHC. Although the functional regulator would retain authority to enforce these heightened standards, the standards would be those recommended by the Federal Reserve, and the Federal Reserve would retain backup authority to enforce the standards if the functional regulator fails to act. In addition, the Discussion Draft gives the Federal Reserve the authority to break up or restrict the activities of any IFHC the size of which or the scope or nature of the activities of which were deemed by the Federal Reserve to pose a threat to the safety and soundness of the IFHC or to the financial stability of the United States. The Federal Reserve would also be given broad authority to establish risk limits for IFHCs on exposure to other companies.
The FSOC could also mandate that any financial activity or practice be subject to heightened prudential standards and safeguards if it determines that the activity or practice poses a systemic threat to the stability of the financial system. The functional regulators would be charged with enforcing those heightened standards and safeguards, which again would be those recommended by the Federal Reserve. As in the case of functionally regulated subsidiaries of IFHCs, the Federal Reserve would retain backup enforcement authority in this area. Finally, with respect to financial market utilities and payment, clearing or settlement activities determined to be subject to heightened prudential standards, the Federal Reserve, in consultation with the FSOC and any relevant supervisory agency, would be required to develop risk management standards to promote broader financial stability. These standards would be primarily enforced by the appropriate federal regulator, but the Federal Reserve would coordinate the examination process and have backup enforcement authority. The Federal Reserve would have direct authority if the entity did not have a primary federal regulator.

REGULATION OF THRIFTS AND OTHER DEPOSITORY INSTITUTIONS AND THEIR HOLDING COMPANIES

The Discussion Draft would preserve the federal thrift charter but abolish the OTS and instead create a separate division within the OCC to supervise and regulate federal savings associations. Responsibility for regulation of state savings associations would be transferred to the FDIC. The proposed legislation would also eliminate the exemption for thrifts from the definition of “bank” in the BHC Act, thereby subjecting thrift holding companies to regulation by the Federal Reserve as bank holding companies under the BHC Act. The grandfather rights of unitary thrift holding companies under the Gramm-Leach-Bliley Act would be retained for those that engage in non-financial activities, but such companies would have to form an intermediate section six holding company as described below to conduct all banking and financial activities. In addition, following the merger of the OTS into the OCC, the OTS representative on the FDIC Board of Directors would be replaced with the Chairman of the Federal Reserve Board or another Governor designated by the Chairman.

The Discussion Draft also eliminates the exemption for industrial loan companies, credit card banks and other so-called “non-bank banks” from the definition of “bank” in the BHC Act, thereby subjecting companies that control these institutions to the requirements of the BHC Act. Unlike the Department of Treasury’s original proposal, the Discussion Draft does not go so far as to require the parent companies of these depository institutions to divest commercial or other activities not permissible for a financial holding company. Parent companies (as well as savings and loan holding companies that engage in non-financial activities), however, must create an intermediate section six holding company to hold all banking and other financial activities separate from the parent company’s non-financial activities.

Any intermediate section six holding company must have a separate board of directors, 25 percent of the members of which must be independent; no executive officer of the intermediate section six holding company or its subsidiaries may serve as a director, officer or employee of a non-financial affiliate.
intermediate section six holding company and its subsidiaries would be subject to consolidated regulation by the Federal Reserve as a bank holding company and, in addition, to onerous restrictions with respect to transactions with its affiliates, including anti-tying and cross-marketing restrictions. In particular, the section six holding company and its subsidiaries would be treated as a member bank for purposes of Sections 23A and 23B of the Federal Reserve Act in connection with covered transactions (as defined in Section 23A) between them and a non-financial affiliate, and the subsidiary bank would be prohibited from entering into any covered transaction with a non-financial affiliate. Covered transactions with third parties, to the extent the proceeds of the transaction are transferred to or used for the benefit of a non-financial affiliate, would also be prohibited. Although the Federal Reserve would not supervise the non-financial activities or subsidiaries, the ultimate parent company would be required to serve as a source of financial strength to the intermediate holding company.

The Discussion Draft would expand significantly several prudential lending restrictions imposed currently by federal law. Any potential credit exposure of a depository institution to its affiliates under derivative contracts would be treated as a covered transaction under Section 23A of the Federal Reserve Act. Credit exposure under a derivative contract would also be included in the national bank lending limit, which would be applied to all insured depository institutions. In addition, asset sales and purchases by an insured depository institution involving an officer, director or principal shareholder (or entities that they control) would be subject to FDIC regulation to ensure that they are on market terms. Any such transaction in an amount exceeding 10 percent of an insured depository institution’s capital and surplus would have to be approved by the institution’s board of directors.

The Discussion Draft would also impose a number of reforms in the area of supervision of banking organizations. The Discussion Draft would remove the so-called “Fed lite” provisions of the Gramm-Leach-Bliley Act that restrict the ability of the Federal Reserve to examine, take enforcement action against, obtain information from, or establish prudential standards for functionally regulated subsidiaries of bank holding companies. The Federal Reserve would also be required to levy fees on bank holding companies with total consolidated assets of $10 billion or more sufficient to defray the cost of examining such bank holding companies.

CREDIT RISK RETENTION IN ASSET-BACKED SECURITIZATIONS
The Discussion Draft requires the federal banking regulators and the SEC jointly to write rules requiring originators or securitizers of loans and asset-backed securities to retain a material portion (generally at least 10 percent) of the credit risk associated with the loans or assets transferred to the pool.

ALTERNATIVE RESOLUTION AUTHORITY
The Discussion Draft establishes an alternative mechanism for the resolution of failing IFHCs. A troubled IFHC would be subject to this resolution mechanism only if, at the time of failure, (i) the Federal Reserve
Board and the Board of Directors of the FDIC (or the SEC, if the largest subsidiary of the IFHC is a broker-dealer) recommend resolution by at least a two-thirds vote of the then-serving members of each body and (ii) the Secretary of the Treasury, in consultation with the President, determines that resolution is necessary to avoid or mitigate serious adverse effects on the financial system or economic conditions.

Once this determination is made, the Secretary of the Treasury must appoint the FDIC as receiver or qualified receiver (under which the FDIC would have the same authority that it has today as conservator, subject to a two-year deadline for restoring the institution to a sound and solvent condition, with the possibility of three one-year extensions). In its capacity as receiver of an IFHC, the FDIC would have many of the same tools available to it that it currently has as receiver of a depository institution, as well as the authority, if the Treasury and the FDIC determine that such action is “necessary for the purpose of financial stability and not for the purpose of preserving the covered financial company”, to take certain stabilization actions to prevent market disruption associated with the IFHC’s failure. If the FDIC takes such actions, it is required to ensure that the IFHC’s unsecured creditors bear some loss, that shareholders are not paid until all other claims are paid in full, and that management “responsible for the failed condition of the financial company” is removed.

Costs incurred by the FDIC under this enhanced resolution authority would be covered initially by selling assets of the IFHC that is being resolved. If the proceeds of the resolution are not sufficient, any remaining costs would be covered by a new “Systemic Resolution Fund” capitalized first with FDIC obligations issued to the Treasury and then with new after-the-fact industry assessments imposed on all financial companies with more than $10 billion in assets on a graduated basis.

The Discussion Draft gives the FDIC backup examination authority over IFHCs for resolution purposes and, while the statute is unclear, may give the FDIC backup enforcement authority over any depository institution holding company and its non-bank subsidiaries to control risks to the Deposit Insurance Fund.

**EMERGENCY ASSISTANCE**

The Discussion Draft would significantly restrict the Federal Reserve’s ability under Section 13(3) of the Federal Reserve Act to provide temporary liquidity assistance in “unusual and exigent circumstances”. Under these restrictions, the Federal Reserve could no longer provide such assistance to a “single and specific” entity but only as part of a “broadly available credit or other facility”. The Federal Reserve could only provide assistance under this authority with the prior written approval of the Secretary of the Treasury.

The Discussion Draft also provides the FDIC with new authority to provide liquidity to solvent depository institutions or financial companies by extending credit or guaranteeing obligations (but not providing equity), if necessary to prevent financial instability during times of severe economic distress. This authority may only be exercised upon the written approval of the Secretary of the Treasury and at least a two-thirds vote of the then-serving members of the Federal Reserve Board and the Board of Directors of
the FDIC. Funding for this FDIC assistance would come from general Treasury funds, and losses would be recouped, as with the resolution framework described above, through assessments on all financial companies with more than $10 billion in assets on a graduated basis.

* * *

ENDNOTES


2 The Treasury Department’s legislative proposal is available at: http://www.financialstability.gov/roadtostability/RRread.html.

3 These members would be the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Director of the OTS (until the OTS is merged into the OCC), the Chairman of the SEC, the Chairman of the CFTC, the Chairperson of the FDIC, the Director of the Federal Housing Finance Agency and the Chairman of the National Credit Union Administration.
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Federal Reserve Proposal on Incentive Compensation Policies for Banking Organizations

Federal Reserve Issues Proposal to Ensure that Incentive Compensation Policies Do Not Undermine the Safety and Soundness of Banking Organizations by Encouraging Excessive Risk-Taking

SUMMARY

On October 22, 2009, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) issued a comprehensive proposal (the “Proposal”) on incentive compensation policies that is intended to ensure that these policies do not undermine the safety and soundness of banking organizations by encouraging excessive risk-taking. The Proposal applies to all banking organizations supervised by the Federal Reserve (U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations (including securities subsidiaries) of foreign banks with a branch, agency, or “commercial lending company” subsidiary in the United States (each a “banking organization”)). It covers executive and non-executive employees who receive any current or potential compensation that is tied to achievement of one or more performance metrics, as well as “golden parachute” and “golden handshake” arrangements.

The Proposal is based on three key principles that are designed to govern incentive compensation arrangements. There are no prescriptive requirements, such as “caps” or “claw backs”, but there is extensive guidance as to the development, implementation and relevant considerations for these arrangements.

The Proposal imposes immediate obligations on banking organizations to review their incentive compensation arrangements. In addition, the Proposal includes two supervisory initiatives. The first
applies to 28 large, complex banking organizations (“LCBOs”), and the second applies to all other banking organizations. In each case, the Federal Reserve will review the banking organization’s policies and practices to determine their consistency with the principles established by the Federal Reserve for risk-appropriate incentive compensation. Deficiencies will be factored into the organization’s supervisory ratings. Compliance with the Proposal is likely to require a significant dedication of resources to develop and implement the requisite internal reviews, policies, reports, systems and controls.

The Federal Reserve requests comments on the Proposal within 30 days after publication in the Federal Register.

I. BACKGROUND

The Proposal represents, as described by Federal Reserve Governor Daniel Tarullo, “one part of a broad program by the Federal Reserve to strengthen the supervision of banks and bank holding companies in the wake of the financial crisis”. It reflects the Federal Reserve’s view that “[f]laws in incentive compensation practices were one of many factors contributing to the financial crisis”. In the words of Federal Reserve Chairman Bernanke, “[c]ompensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability”.

The Proposal explains that supervisory action is also necessary to address the “first mover” problem. The Federal Reserve is concerned that individual firms will be reluctant to act alone to deal with misaligned incentive programs due to concern about losing valuable employees.

The Proposal is designed to be consistent with the Financial Stability Board’s (“FSB”) Principles for Sound Compensation Practices issued in April 2009 and the FSB’s Implementation Standards issued in September 2009. The Proposal notes the Federal Reserve’s intention to work with other nations to achieve a “level playing field”.

II. PROPOSAL

A. INCENTIVE COMPENSATION PRINCIPLES

The Proposal sets forth three key principles for incentive compensation arrangements that are designed to help ensure that incentive compensation policies do not encourage excessive risk-taking and are consistent with the safety and soundness of banking organizations. The three principles provide that a banking organization’s incentive compensation arrangements should:

- Provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks.
- Be compatible with effective internal controls and risk management.
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- Be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.

The Proposal indicates that the Federal Reserve expects all banking organizations to evaluate their incentive compensation arrangements based on these three principles. Where there are deficiencies in the incentive compensation arrangements, they must be immediately addressed.

The Proposal explicitly rejects a “one size fits all” approach, and specific limits or requirements, such as pay caps, “claw backs” or allocation between cash and equity, are not included. The Proposal distinguishes supervisory guidance from a formal rule, but the practical effect in individual cases is likely to be similar.

B. COVERED EMPLOYEES

The Proposal covers all employees “who have the ability to materially affect the risk profile of an organization, either individually, or as part of a group”. It explicitly notes that “problematic compensation practices were not limited to the most senior executives”. Covered employees are divided into three segments:

- Senior executives and other employees who are responsible for the oversight of a banking organization's firm-wide activities or material business lines.
- Individual employees, including non-executive employees, whose activities may expose the banking organization to significant amounts of risk. (An example cited in the Proposal is traders with large positions relative to the banking organization’s overall risk tolerance.)
- Groups of employees who are subject to similar incentive compensation arrangements and who, in the aggregate, may expose the banking organization to significant amounts of risk, even if no individual employee is likely to expose the banking organization to a significant amount of risk. (An example cited in the Proposal is loan officers who, as a group, originate loans that account for a material amount of the organization’s credit risk.)

C. BALANCED RISK-TAKING INCENTIVE COMPENSATION ARRANGEMENTS

The Proposal provides that incentive compensation arrangements should “balance risk and financial results in a manner that does not provide employees incentives to take excessive risks”. A balanced incentive compensation arrangement is described as an arrangement that takes into account the risks and financial benefits from the employee’s activities and the impact of those activities on the banking organization’s safety and soundness. As an example, the Proposal states that two employees who generated the same amount of short-term revenue should not receive the same amount of incentive compensation if the risks taken to generate that revenue differ materially.

To determine whether incentives encourage risk-taking beyond a banking organization’s ability to identify and manage the risk and to implement balanced risk-taking incentives, the Proposal provides a number of guidelines:

Federal Reserve Proposal on Incentive Compensation Policies for Banking Organizations
October 25, 2009
Banking organizations should consider the full range of risks (including, credit, market, liquidity, operational, compliance and reputational) associated with an employee’s activities, as well as the time period over which the risks may be realized.

The relevant time horizon for a risk outcome may extend beyond the stated maturity of an exposure, and special concern should be directed to “bad-tail” risks, i.e., those that have a low probability of being realized but have highly adverse effects if they are.

There is an important distinction between “reliable” quantitative measures that are available for some risks and “informed judgment” that is used for other risks. In the latter case, there is a “need for strong internal controls and ex post facto monitoring”.

Banking organizations, particularly LCBOs, should consider using “scenario analysis”.

Unbalanced incentive arrangements may be moved toward balance by a variety of methods: risk-adjusting the payments, deferring payment so as to adjust actual payments based on actual outcomes, lengthening performance periods, and reducing sensitivity to short-term performance, including reducing the rate at which awards increase as higher levels of performance are achieved. The Proposal cautions against over-reliance on judgment in determining deferrals, as compared to determining deferrals formulaically, because “extensive use of judgment might make it more difficult to execute deferral arrangements in a sufficiently predictable fashion to influence employee behavior”.

Incentive arrangements should take into account differences among employees, particularly the difference between senior executives and other employees. In this regard, the Proposal notes that equity compensation may not be expected to be as effective in restraining risk incentives for lower level employees as for senior executives; that for senior executives at LCBOs incentive compensation arrangements are likely to be better balanced if they involve deferral of a “substantial portion” of incentive compensation over a multi-year period and payment of a “significant portion” in equity-based instruments vesting over multiple years; and that a single formulaic approach is likely to encourage at least some employees to take excessive risk.

Careful consideration should be given to how “golden parachutes” and the vesting of deferred compensation may affect risk-taking behavior. For senior executives, the Proposal notes that forfeiture provisions may be counterproductive, especially in a competitive marketplace where sign-on bonuses are prevalent.

Banking organizations should effectively communicate to employees the ways that incentives will be reduced as risks increase.

D. COMPATIBILITY WITH EFFECTIVE CONTROLS AND RISK MANAGEMENT

The Proposal states that a banking organization’s internal risk-management processes and controls should reinforce and support the development and continuation of balanced incentive compensation arrangements. The Proposal suggests:

- Appropriate controls should be in place, such as regular internal audits (or other review), to ensure that the processes for achieving balanced incentives are followed and to protect against evasion by maintaining the integrity of the risk management function. A banking organization should create and maintain sufficient documentation to permit an audit of the banking organization’s processes for establishing, modifying and monitoring incentive compensation arrangements.
Risk management employees and other appropriate personnel should have input into the organization’s processes for designing incentive compensation arrangements and assessing effectiveness in limiting excessive risk-taking.

Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified employees and should avoid conflicts of interest (including by not having their incentives based predominantly on the financial performance of the units that they review).

Incentive arrangements should be monitored and modified to the extent necessary to provide balanced incentives.

The Proposal explains that the design and implementation of effective incentive compensation arrangements “is a complex task” and requires the “commitment of adequate resources”.

E. EFFECTIVE CORPORATE GOVERNANCE

The Proposal states that banking organizations should have strong and effective corporate governance to help ensure sound compensation practices. This requirement primarily relates to a banking organization’s board of directors and board committees but also includes guidance related to processes for designing incentive compensation and disclosure to shareholders of pay practices. The Proposal states that directors should:

- Actively oversee incentive compensation arrangements. The Proposal provides that the board is “ultimately responsible” for ensuring that a banking organization’s incentive compensation arrangements do not jeopardize its safety and soundness. Among the board’s responsibilities are “review and approv[al] of the overall goals and purposes” of the incentive compensation arrangements, “clear direction” to management, “ensur[ing] that the compensation system” will “achieve balance”, direct approval of incentive compensation arrangements for senior executives, and approval and documentation of material exceptions.

- Monitor the performance, and regularly review the design and function, of incentive compensation, including on both a backward and forward-looking scenario basis. In this connection, the board should receive, at least annually, assessments by management.

- Have the organization, composition and resources in order to achieve effective oversight of incentive compensation. At least one member of the compensation committee should have a level of experience and expertise in risk management and compensation practices in financial services that is appropriate for the organization’s activities. The board should also have the authority to select and compensate outside counsel and executive compensation and risk management consultants as needed, and, in that connection, the board should be sensitive to independence issues.

LCBOs should use a systematic approach to developing a compensation system supported by formal internal policies and procedures.

Disclosure to shareholders of incentive compensation arrangements should appropriately describe such arrangements and related risk management, control and governance processes to allow them to “monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take excessive risks”. The last statement may be an implicit endorsement of
“say-on-pay”. The Proposal notes that the Federal Reserve will work with the Securities and Exchange Commission to improve disclosure regarding incentive compensation arrangements.

F. IMPLEMENTATION INITIATIVES AND CONSEQUENCES

Although the Proposal is subject to comment for 30 days, banking organizations are instructed to begin an immediate review of their incentive compensation policies to ensure that they do not encourage excessive risk-taking and implement corrective programs as needed. This review should be based on the Proposal’s three key principles. It is intended to help prepare banking organizations for the Federal Reserve’s two supervisory initiatives, which are intended to spur and monitor the financial industry’s progress toward implementing the Proposal.

The first initiative is a special, coordinated “horizontal” review of the incentive compensation policies and practices of the 28 LCBOs, which will “commence promptly”. In the Federal Reserve’s view, these organizations are significant users of incentive compensation arrangements and flawed arrangements at these organizations are more likely to have a more serious effect on the broader financial system. The horizontal review, which appears to be similar in form to the recently conducted “stress test” at 19 large bank holding companies, will be led by Federal Reserve staff, who will work with relevant Reserve Bank supervisors. As part of this initiative, LCBOs will be expected to provide the Federal Reserve with information and documentation that describes (i) the structure of the banking organization’s current incentive compensation arrangements, (ii) the current processes used by the organization to oversee the arrangements and help ensure that they do not encourage excessive risk and (iii) the organization’s plans, including timetables, for improving risk sensitivity and related risk management, controls and corporate governance practices. The policies and implementing practices of each LCBO will become part of supervisory expectations for it and will be monitored to ensure “full implement[ation] in a timely manner”. The objectives of the horizontal review are to:

- Enhance supervisory understanding of the details of current practices, as well as the steps taken or proposed to be taken by organizations to improve the balance of incentive compensation arrangements.
- Assess the strength of controls and whether actual payouts under incentive compensation arrangements are effectively monitored relative to actual risk outcomes.
- Understand the role played by boards of directors, compensation committees, and risk-management functions in designing, approving, and monitoring incentive compensation systems.
- Identify emerging best practices through comparison of practices across organizations and business lines.

Second, the Federal Reserve will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations that are not LCBOs. These reviews will
be tailored to each organization based on the scope and complexity of the organization’s activities and the prevalence of incentive compensation arrangements.

The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization’s supervisory ratings, “which can affect the organization’s ability to make acquisitions”. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization’s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

Both supervisory initiatives will aid the Federal Reserve in identifying best practices for incentive compensation for banking organizations.

G. FOREIGN BANKS

In the case of the U.S. operations of foreign banks, the U.S. incentive compensation policies are to be (i) coordinated with the bank’s group-wide policies, (ii) developed in accordance with the rules of the bank’s home country supervisor, and (iii) consistent with the bank’s overall corporate and risk management structure and controls.

H. COMMENT

The Proposal invites comment on all its aspects, including the guiding three principles, legal and regulatory issues, burden, exceptions (such as for firm-wide profit sharing plans) and formulaic limits (referring to suggestions that at least 60% of all incentive compensation be deferred and at least 50% be equity-linked). The Proposal also inquires as to what statutory, regulatory or private sector actions might mitigate market forces.

III. CONCLUSION AND OBSERVATIONS

The general approach of the Proposal does not depart materially from previous broad statements of policy by the Administration and Federal Reserve. It does, however, provide considerable detail regarding the types of internal processes that are expected to be implemented by banking organizations to monitor risk associated with incentive compensation arrangements throughout the organization. Substantial resources will be needed for banking organizations to align their incentive compensation policies with the Proposal and demonstrate such alignment to Federal Reserve examiners. The Proposal and the Federal Reserve’s oversight are likely to result in greater uniformity of incentive compensation arrangements across organizations with similar risk profiles.

One fundamental question raised by the Proposal is whether banking organizations are being encouraged to weight compensation more heavily to fixed salaries. Although the Proposal acknowledges
that incentive compensation has numerous benefits, the attendant risks identified by the Federal Reserve may prove determinative. Such a change, however, would be inconsistent with other compensation initiatives that promote greater focus on performance.

Finally, the Proposal stresses that the development of incentive compensation arrangements will be an evolving process extending over many years. The Federal Reserve will prepare a report after 2010 on trends and developments.

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Bank Capital Reform

Treasury Department Proposes Bank Capital Reforms

SUMMARY
Late yesterday, the U.S. Treasury Department issued a policy statement entitled “Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms” (the “Policy Statement”). The Policy Statement, which was developed in consultation with the U.S. bank regulatory agencies, sets forth eight “core principles that should shape a new international capital accord”. Six of the principles relate directly to bank capital requirements. The seventh of these principles relates to liquidity and the eighth to non-banking organizations.

The Policy Statement expands substantially upon the preliminary indications of Treasury’s thinking regarding regulatory capital reform as reflected in its June 17 white paper on financial regulatory reform, “A New Foundation: Rebuilding Financial Supervision and Regulation”, and makes clear that Treasury is contemplating a fundamental revamping of capital standards, both internationally through the Basel Committee process and in the United States. It would involve substantial revisions to, if not replacement of, major parts of the Basel I and Basel II capital frameworks and affect all regulated banking organizations, large and small, as well as institutions of systemic importance that are not currently regulated as banking organizations.

The Policy Statement:

• Proposes higher capital requirements “across the board” for all banking firms — and even higher capital requirements for systemically-important financial firms — and that these requirements be designed to protect the stability of the financial system as a whole as well as the solvency of individual firms.
• Emphasizes the importance of the quality of capital, stressing the need for common voting equity to constitute a “large majority” of tier 1 capital and for tier 1 capital to constitute a “large majority” of total regulatory capital.
• Addresses the so-called “procyclicality” of current capital standards.
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- Expresses skepticism as to the reliability of credit ratings and internal models as tools for measuring capital requirements.
- States that risk-weightings of some assets and exposures — including credit derivatives, structured asset-backed and mortgage-backed securities, off-balance-sheet vehicles, trading positions, and equity investments — should be a function of not only their own risk characteristics but “also should reflect the systemic importance of the various exposure types”.
- Acknowledges that the existing capital standards “too often are a lagging indicator of financial distress” and suggests the consideration of “supplemental triggers” for prompt corrective action based, for example, on non-performing loans or liquidity.
- States that capital requirements “should reflect more forward-looking, through-the-cycle considerations” and rely less on value-at-risk models and point-in-time rating systems.
- States that a leverage ratio, although “a blunt instrument”, must be utilized.
- Calls for a new “conservative, explicit liquidity standard”.
- Proposes a number of actions to prevent the “re-emergence of an under-regulated non-bank financial sector that poses a threat to financial stability”.

THE POLICY STATEMENT

Although the Policy Statement contains only “high-level principles” and not numerical recommendations, it explicitly and repeatedly calls for higher and stronger capital requirements for all institutions and “substantially heightened” capital requirements for bank and non-bank financial firms deemed to pose a risk to financial stability due to their “combination of size, leverage, interconnectedness, and liquidity risk” (Tier 1 Financial Holding Companies or “Tier 1 FHCs”). What is not clear, however, is the base against which these higher standards would be measured. Most major U.S. banks today have capital ratios that are substantially above even well capitalized standards, and common equity has become an increasing element of Tier 1 capital. Accordingly, the impact of new capital standards could be less significant if the “higher” comparison is to current regulatory capital requirements rather than to current actual capital levels. Even in the case of the former, however, changes in the calculation of both the numerator (capital) and the denominator (assets and certain liabilities) of capital ratios could raise capital requirements substantially above current levels.

The new capital regime would have a number of objectives that reinforce the goal of higher and stronger capital. It should be “as simple as possible”, be “able to respond to unanticipated changes”, and incorporate a “macro-prudential” focus. The Policy Statement explicitly recognizes that “[s]tricter capital requirements . . . may limit credit availability,” but this is apparently acceptable if credit availability is not “unduly curtail[ed]”.

The Policy Statement suggests that these changes be phased in over a period of several years. The recommended schedule provides for a “comprehensive international agreement by December 31, 2010, with implementation of the reforms effective December 31, 2012”. Although the Policy Statement stresses that the capital rules “should be as consistent as possible internationally”, it remains possible that the U.S. bank regulatory agencies could officially adopt, or informally implement, some of these new capital standards at an earlier date.

Bank Capital Reform
September 4, 2009
The following is a summary of the Policy Statement’s eight “Core Principles”.

**Core Principle #1:** Capital requirements should be designed to protect the stability of the financial system (as well as the solvency of individual banking firms).

In a major conceptual departure from the existing regulatory capital regime, the new capital framework would have a “macro-prudential focus” designed to promote the stability of the financial system as a whole. The implicit suggestion is that individual banks could be required to maintain capital above that required “for the solvency of individual firms”. This new focus is described as a “macro-prudential approach to the regulation of banking firms [which] requires a broad shift in the way capital and related regulations are conceived and analyzed”. This macro-prudential approach is designed to mitigate the procyclical effect of capital and accounting rules by reducing the extent to which they both “permit risk to accumulate in boom times, exacerbating the volatility of credit cycles”, and discourage the accumulation of “larger capital cushions in good times”. The Policy Statement expresses a particular concern with system-wide “liquidity shocks” resulting from a rapid deleveraging of one or more financial firms.

**Core Principle #2:** Capital requirements for all banking firms should be higher, and capital requirements for Tier 1 FHCs should be higher than capital requirements for other banking firms.

This clear principle is supplemented with one specific policy recommendation. The Gramm-Leach-Bliley Act requirements for financial holding company (“FHC”) status, which enables bank holding companies to engage in a broader range of financial activities, are currently imposed only at the bank level. Under the Policy Statement, the “well capitalized” and “well managed” requirements would also be applied to the parent FHC on a consolidated basis.

The “substantially heightened” capital requirements to be imposed on Tier 1 FHCs are explicitly designed “to force them to internalize the costs of . . . potential spillover effects”. They are to be designed for effectiveness “under extremely stressful economic and financial conditions”.

**Core Principle #3:** The regulatory capital framework should put greater emphasis on higher quality forms of capital.

The Policy Statement distinguishes between “going concern loss absorption capacity of capital” and “merely the capacity of capital to serve as a buffer against taxpayer losses in the event of firm liquidation”. The former is regarded as considerably more valuable and is described as “particularly important for Tier 1 FHCs”.

This principle sets forth three standards for achieving its objectives. The first is consistent with existing published capital standards, but the last two may represent somewhat of a departure (or at least make more formal previously informal policies):

- A large majority of a banking firm’s tier 1 capital should consist of common equity.
- Tier 1 capital should constitute a large majority of a banking firm’s total regulatory capital.
- Voting common equity should also represent a large majority of a banking firm’s tier 1 capital.
In addition, this principle calls for “strict, internationally consistent qualitative and quantitative limits” on deferred tax assets and non-equity hybrid and other innovative securities as elements of capital.

**Core Principle #4: Risk-based capital requirements should be a function of the relative risk of a banking firm’s exposures, and risk-based capital ratios should better reflect a banking firm’s current financial condition.**

This principle reflects the concern that the “capital inadequacy of some of our largest banking firms during the recent crisis stemmed in significant part from the inadequate capture of risk exposures in our capital rules”. The Policy Statement singles out for particular criticism “excessive regulatory reliance on internal banking firm models or ratings from credit rating agencies”, both of which are key components in determining capital requirements under existing standards for securitizations and trading portfolios and are even more central to capital calculations under Basel II in its current form.

Under the macro-prudential approach, higher risk-based capital charges would apply to exposures deemed to exhibit “a high correlation with the economic cycle, or whose prevalence is likely to contribute disproportionately to financial instability in times of economic stress”. The Policy Statement identifies as a “key example” of the latter, the structured finance credit protection purchased by many banking firms from AIG, the monoline insurance companies and other thinly capitalized special purpose derivatives products companies.

The Policy Statement identifies five types of “systemically important exposure types” that could attract higher capital charges:

- Implicit and explicit exposures to off-balance-sheet vehicles sponsored by the banking firm.
- Proprietary and other trading positions.
- Equity investments.
- Structured asset-backed securities and mortgage-backed securities.
- Counterparty credit risk exposures to financial firms, including non-centrally cleared derivatives and securities financing transactions (repurchase and reverse repurchase agreements, securities lending and borrowing transactions, and margin loans).

This principle also focuses on the need for “regulatory capital ratios more transparently [to] reflect the current condition of the firm”. As one element of this transparency, the Policy Statement appears to suggest that unrealized gains or losses on available-for-sale securities should be included in capital calculations. A reference to the recently completed stress tests for U.S. banks could be read to suggest that capital ratios should incorporate stress beyond current conditions.

A significant element of the Policy Statement is its proposal to revise substantially the U.S. prompt corrective action (“PCA”) framework, which is designed to enable supervisors to intervene early in troubled firms. Noting that “far too many banking firms [have gone] from well-capitalized status directly to failure”, the Policy Statement suggests the addition of supplemental triggers based on non-performing loans or liquidity.
Core Principle #5: The procyclicality of the regulatory capital and accounting regimes should be reduced and consideration should be given to introducing countercyclical elements into the regulatory capital regime.

This principle calls for modification of regulatory capital and accounting frameworks to reduce their procyclicality. The key element of this approach would be a requirement that banking firms hold a buffer over their minimum capital requirements during good economic times, which would be available for draw-down in bad economic times. Both the minimum capital requirement and the buffer would be substantial. The former “must remain credible in the eyes of the financial markets even under severe economic downturn conditions”. The latter “must be sufficient to address likely capital impairment through the credit cycle with minimal credit contraction or deleveraging behavior by banking firms”. The Policy Statement lists two principal options for implementing the supplemental buffer requirement, both of which are described as having advantages and disadvantages:

- Fixed, time-invariant target capital ratio(s) above the minimums, with capital distribution restrictions as the penalty for falling below the target ratios.
- Time-varying minimum capital ratio(s), where the applicable minimum capital ratio for banking firms at a particular time is a function of one or more contemporaneous macroeconomic indicators.

This principle also calls for “more forward-looking, through-the-cycle considerations” intended to result in higher capital requirements during the early phases of the credit cycle. These would supplement or replace procyclical measures, such as value-at-risk models and point-in-time internal rating systems.

This principle takes a similar approach for loan loss reserves, which should be more forward-looking and extend beyond recent historical experience. The objective is recognition of higher provisions earlier in the credit cycle.

Of particular importance, the Policy Statement urges that regulatory capital disincentives to robust provisioning be reduced or eliminated. The Policy Statement cites, as one such disincentive, existing U.S. risk-based capital rules under which reserves are included in regulatory capital only up to a specified percentage of risk-weighted assets. A number of banks and their trade organizations have been urging the federal banking agencies to remove the current limit, and the Policy Statement may reinvigorate this effort.

The Policy Statement also suggests examining the merits of providing favorable regulatory capital treatment for, or even requiring some banking firms, such as Tier 1 FHCs, to issue, “appropriately designed contingent capital instruments”. These could include:

- Long-term debt instruments that convert to equity capital in stressed conditions.
- Fully secured insurance arrangements that pay out to banking firms in stressed conditions.
Core Principle #6: Banking firms should be subject to a simple, non-risk-based leverage constraint.  
This principle provides that, in addition to risk-based capital rules, banking firms should also be subject to “a simple leverage ratio” which would “make the regulatory system more robust by limiting the degree to which gaps and weak spots in the risk-based capital framework can be exploited”. The Policy Statement also suggests that this leverage requirement would provide macro-prudential benefits. The Policy Statement acknowledges, however, that the leverage ratio “is a blunt instrument that, viewed in isolation, can create its own set of regulatory arbitrage opportunities and perverse incentive structures”. To mitigate against these, the Policy Statement recommends that the leverage ratio “should at a minimum incorporate off-balance sheet items”.

Core Principle #7: Banking firms should be subject to a conservative, explicit liquidity standard.  
This principle differs from the others in that it relates to liquidity rather than capital, and it represents a major departure from current practice, although liquidity has always been monitored during the examination process.

The Policy Statement proposes the creation of a liquidity regulation regime independent from the regulatory capital regime. The liquidity regulations would be designed to accomplish two goals:

- Enhancing the short-term resiliency of banking firms by requiring them to hold a pool of unencumbered liquid assets sufficient to cover likely funding shortfalls in the event of an acute liquidity stress scenario.
- Reducing longer-term structural asset-liability maturity mismatches at banking firms.

The “core attributes” of the regulations should include: simplicity; comparability; conservative assumptions about the liquidity of assets during times of financial stress; and conservative stress-case assumptions about runoff rates for all types of liabilities, as well as collateral calls by derivative counterparties, draws by borrowers on committed credit facilities, and implicit support that would be provided to vehicles sponsored and advised by the banking firm. These regulations would also be adopted as part of a strong macro-prudential liquidity framework aimed at reducing system-wide liquidity risk.

The principle also suggests consideration of the merits of making regulatory capital requirements a function of the liquidity risk of banking firms.

Core Principle #8: Stricter capital requirements for the banking system should not result in the re-emergence of an under-regulated non-bank financial sector that poses a threat to financial stability.

In order to achieve this objective, the Policy Statement suggests a number of actions:

- Tier 1 FHC regulation.
- Banking firms will be required to consolidate sponsored and advised vehicles for financial statement purposes.
Money market mutual funds will be subject to tighter regulation, including tighter regulation of their credit and liquidity risks.

Derivative transactions will be subject to reporting requirements and higher margin and capital requirements, and standardized derivative transactions will be subject to central clearing and central trading requirements.

Securitization markets will be subject to greater transparency standards and requirements to align the incentives of loan originators and securitization sponsors with those of investors.

The terms on which financing is extended from banking firms to non-bank financial firms will be carefully monitored in order to limit the build-up of leverage in the non-bank financial sector.

* * *
SULLIVAN & CROMWELL LLP

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Bank Capital Reform
September 4, 2009
Failed Bank Acquisitions

FDIC Releases Final Policy Statement on Private Investments in Failed Insured Depository Institutions

SUMMARY

On August 26, 2009, the Federal Deposit Insurance Corporation (“FDIC”) released its Final Statement of Policy on the Acquisition of Failed Insured Depository Institutions (the “Final Statement”), which provides terms and conditions for both “private investors” interested in acquiring failed banks or thrifts, or their deposit liabilities, from the FDIC (“Failed Bank Transactions”) and the institution in which the private investors invest (the “investee institution”). A private investor subject to the Final Statement will, among other things, be (i) prohibited from utilizing “complex and functionally opaque ownership structures” and from selling securities of the investee institution for three years and (ii) required to disclose information relating to the private investor’s chain of ownership and affiliates. An investee depository institution that is subject to the Final Statement will be required to maintain a ratio of “Tier 1 common equity” to total assets of at least 10% throughout the first three years and be prohibited from engaging in certain transactions with affiliates of the private investor. “Affiliate” for these purposes is based on a 10% of equity ownership test.

In some respects, the terms and conditions embodied in the Final Statement are less onerous than those contained in the FDIC’s original proposal (the “Proposed Statement”), but some may still prove problematic for prospective investors and investee institutions. In addition, although the Final Statement provides some clarity with respect to certain of these requirements, significant questions remain with respect to its scope and the manner in which some of the requirements will be applied. The FDIC noted in the preamble to the Final Statement that “the policy statement is just that – a policy statement and not a statutory provision,” and the Final Statement itself provides that the FDIC may waive one or more of its requirements if such an exemption is in the best interests of the Deposit Insurance Fund and the goals and objectives of the Final Statement can be achieved otherwise. Accordingly, the precise scope and
meaning of the Final Statement may not be fully ascertained until it is applied by the FDIC to specific Failed Bank Transactions. We recommend that potential private investors and investee institutions seek the FDIC’s guidance as to the applicability of the Final Statement to their specific circumstances. The inquiry may need to be made before investing in a healthy bank, thrift or holding company.

This memorandum summarizes the Final Statement and includes a chart outlining the principal differences between the Final and Proposed Statements.

THE FINAL STATEMENT
Scope – Covered Investors and Institutions
The Final Statement will apply prospectively to (i) private investors in a company, including any company acquired to facilitate bidding on failed banks or thrifts, proposing to assume, directly or indirectly (including through a shelf charter), deposit liabilities from the resolution of a failed insured depository institution, as well as the investee institution itself, and (ii) applicants for deposit insurance in the case of de novo charters issued in connection with a Failed Bank Transaction.

There appear to be two significant open issues relating to the scope of the Final Statement. First, the term “private investor” is not defined. The FDIC explicitly decided not to provide more precision in the definition of “private investor” and thus in the scope of coverage of the Final Statement. It cited the difficulty of providing a precise definition in light of the “relatively new phenomenon of private capital funds joining together” to participate in the acquisition of failed depository institutions. It is, therefore, not clear whether the Final Statement is intended to apply to investors beyond “traditional” private equity investors to include, for example, pension funds, insurance companies, sovereign wealth funds and even wealthy individuals.

Second, as in the Proposed Statement, there appears to be no requirement under the Final Statement that private investors have a controlling or significant interest in a depository institution acquiring failed bank deposits in order for the investors – and that investee institution – to be subject to the new standards. The Final Statement indicates that, subject to certain possible exceptions, the terms and conditions of the Final Statement will not apply to any depository institution that engages in a Failed Bank Transaction if no private investor owns over 5% of that depository institution or its holding company. This suggests, however, that the Final Statement will apply in cases where one or more private investors has a stake as little as 5%. If this literal approach is taken, it could discourage private non-controlling investments even in healthy depository institutions, because of the potential impediments to future Failed Bank Transactions by the investee institution. In addition, it may be problematic for institutions that have already raised capital privately to engage in Failed Bank Transactions.
Exclusions and Duration of Requirements

The Proposed Statement would have excluded private capital investors in a bank or thrift holding company that had come into existence or been acquired by such investors at least three years prior to the effective date of the Statement. This exclusion has been deleted in the Final Statement.

The Final Statement establishes an exclusion for “investors in partnerships or similar ventures with bank or thrift holding companies or in such holding companies (excluding shell holding companies) where the holding company has a strong majority interest in the resulting bank or thrift and an established track record for successful operation of insured banks or thrifts.” The precise scope and meaning of this exclusion are unclear, although the Final Statement indicates that “such partnerships are strongly encouraged,” which suggests that the FDIC favors these transactions over silo structures or club deals. We believe the intended result is to exempt non-controlling investments by private investors in an existing depository institution holding company that has a successful record of managing depository institutions and seeks, contemporaneously or subsequently, to participate in a Failed Bank Transaction. For example, it may exclude a non-controlling investment by a private investor in up to 24.9% of the equity of an existing bank holding company that seeks to acquire a failed depository institution from the FDIC. The provision could also be read, however, only to exclude the situation in which both an existing bank holding company, with a track record of successful operation of insured depository institutions, and private investors invest in a separate joint venture company that acquires a failed depository institution, and the existing bank holding company has a strong majority interest in the newly-acquired depository institution. Such a transaction is likely to be very unusual, in large part because it would be difficult to realize synergies from this latter type of structure.

Investors with 5% or less of the total voting power of an investee institution are excluded, provided there is no “evidence of concerted action” by such investors.2

The Final Statement applies prospectively; however, it specifically excludes only acquisitions of “failed depository institutions completed prior to” the Final Statement’s approval date. This exclusion is not, therefore, a general grandfather provision for investments made before the approval date of the Final Statement by private investors in depository institutions that wish to engage in a Failed Bank Transaction. Several commenters suggested that the FDIC should specify a date after which the requirements of the Final Statement would no longer apply to an investor. When the language of the Final Statement is read in conjunction with the preamble, it would appear to provide that, upon application and approval by the FDIC, the provisions of the Final Statement will eventually cease to apply to private investors in an investee institution that were covered by the Final Statement if such investee institution has maintained a composite CAMELS 1 or 2 rating continuously for seven years. It is unclear from the Final Statement, however, precisely when this seven-year period begins. The provision could be read to start the seven-year period on the date of the transaction with the FDIC or, if earlier, the date the private investors...
originally made their investments in the acquiring institution. The provision also could be read to exempt upon application and approval any existing acquiring institution (and its investors) that has the requisite seven-year period of CAMELS 1 or 2 ratings. For example, if an institution had received a CAMELS 1 or 2 rating for five years prior to receiving an investment from private investors, the institution and investors may be able to obtain an exemption after two more years of high CAMELS ratings. In the case of a de novo charter issued in connection with an acquisition, it is unclear whether the period begins to run on the date of the acquisition or on the date the acquiring institution receives its first CAMELS rating.

As described below, the capital requirement would expire three years after the date of acquisition.

Effective Date and 6-Month Review
The Final Statement is effective as of August 26, 2009, and, as noted, does not apply to acquisitions of failed depository institutions completed prior to that date. The Board of the FDIC has committed to review the operation and impact of the Final Statement within six months and “shall make adjustments, as it deems necessary.”

Standards for Private Capital Investments
The Proposed Statement set forth eight standards that the FDIC would apply to proposals by private investors (or depository institutions in which such private investors hold stakes) participating in Failed Bank Transactions, which the FDIC would impose as a condition to accepting a bid for such a transaction. These standards were modified by the Final Statement as described below:

- **Capital Commitment:** Under the Final Statement, the resulting depository institution must maintain a ratio of Tier 1 common equity^3^ to total assets of at least 10% for a period of three years from the time of acquisition, after which it must remain “well capitalized” under the existing bank capital framework. Under the Proposed Statement, the capital requirement would have been a minimum 15% Tier 1 leverage capital ratio for a period of three years, subject to extension by the FDIC. Consistent with the Proposed Statement, failure to maintain the required capital level will result in the institution being treated as “undercapitalized” for purposes of the Prompt Corrective Action rules.

- **Source of Strength:** The Proposed Statement would have required covered “Investor organizational structures” to commit to serving as a “source of strength” for their subsidiary depository institutions. This requirement has been deleted in its entirety in the Final Statement.

- **Cross Guarantees:** The Proposed Statement would have required covered investors with majority control of multiple depository institutions to pledge their proportionate interests in each of their controlled institutions to the FDIC to cover any losses to the FDIC’s deposit insurance fund resulting from the failure of, or any assistance provided to, any of their controlled institutions. In the Final Statement, this has been re-cast as a “cross support” requirement and would apply only if one or more covered investors owned 80% or more of two or more banks or thrifts. The FDIC could waive this requirement “where the exercise of the pledge would not result in a decrease in the cost of the bank or thrift failure to the Deposit Insurance Fund.” The Final Statement does not address the mechanics of how investors will pledge their interests or indicate how the 80% concurrent ownership requirement would be calculated.

- **Transactions with Affiliates:** Like the Proposed Statement, the Final Statement would prohibit all extensions of credit to covered investors, their investment funds, and any “affiliates” of either, by an insured depository institution in which an investment is made by such investors. Existing extensions of credit are exempted under the Final Statement. The term “affiliate” would include any company in

Failed Bank Acquisitions
August 28, 2009
which a private capital investor owns, directly or indirectly, 10% or more of the company’s equity and has maintained such ownership for at least 30 days. It is not clear whether “affiliate” would include a situation where a private investor owns a 10% or more, but non-controlling, interest in a company and that company, in turn, owns a 10% or more interest in a second company. The Final Statement also provides that investors must submit regular reports to the insured depository institution identifying all such affiliates in order to facilitate the depository institution’s compliance with this requirement. Compliance with this element of the Final Statement may prove challenging for large institutional investors that may not be able to identify indirect ownership interests in companies through, for example, holdings of third-party managed investment funds or funds of funds.

- **Bank Secrecy**: The Final Statement provides, as did the Proposed Statement, that the FDIC will not approve an ownership structure that utilizes entities domiciled in “secrecy law jurisdictions” unless the investors are subsidiaries of companies that are subject to comprehensive consolidated home country supervision (as recognized by the Federal Reserve Board) and those investors consent to U.S. jurisdiction and agree, among other things, to provide information to and cooperate with the relevant depository institution’s primary federal regulator and the FDIC. This cooperation would include an agreement to “consent to the disclosure of information that might be covered by confidentiality or privacy laws,” which is likely to be a significant concern for foreign bank supervisors where disclosure of bank information covered by secrecy laws to U.S. authorities can be illegal.

The Final Statement defines the term “secrecy law jurisdiction” to mean any country that (i) applies a bank secrecy law that limits U.S. bank regulators from determining compliance with U.S. laws or prevents them from obtaining information on the competence, experience and financial condition of applicants and related parties, (ii) lacks authorization for exchange of information with U.S. regulatory authorities, (iii) does not provide for a minimum standard of transparency for financial activities, or (iv) permits offshore companies to operate shell companies without substantial activities within the host country. Because it is common for non-U.S. investors in private equity funds to invest through non-U.S. vehicles, which frequently are located in jurisdictions that may be viewed as secrecy jurisdictions, this requirement could pose an obstacle to a number of private equity investor groups.

In the preamble, the FDIC notes that “the Final Statement’s provisions requiring transparent ownership and full disclosure are reasonable and prudent” and that “investors can organize efficient and functional ownership structures in the U.S.”

- **Continuity of Ownership**: Covered investments by private capital investors must be held for at least three years, absent prior FDIC approval. This requirement is largely unchanged from the Proposed Statement, although the Final Statement does provide that FDIC approval “shall not be unreasonably withheld” for transfers to an affiliate if the affiliate agrees to be subject to the same conditions as those applicable to the transferring investor. In addition, the Final Statement provides that this restriction shall not apply to investments by mutual funds that issue redeemable securities that allow investors to redeem on demand.

- **Investors in Failed Institutions**: The FDIC “will not under any circumstances” accept bids for the deposits of a depository institution in receivership from any private investor that holds directly or indirectly 10% or more of the equity of the failed institution. This is unchanged from the Proposed Statement.

- **Disclosure**: Private capital investors would have to disclose to the FDIC information on all entities in the proposed ownership chain of the institution acquiring deposits, including detailed information on the management and investments of any funds, as well as any other information requested by the FDIC. The Final Statement clarifies that “confidential business information” submitted pursuant to this requirement “shall be treated as confidential business information and shall not be disclosed except in accordance with law.” We believe that this means that the FDIC will protect the information from public disclosure under Exemption 4 of the Freedom of Information Act.

**Prohibited Structures**

In the Proposed Statement, the FDIC expressed reservations with respect to some structures that private capital investors might use to facilitate an investment in a failed bank. Specifically, the Proposed
Statement cited “so-called ‘silo’ organizational arrangements” as being “substantially inconsistent” with the basic principles of depository institution ownership (experience, willingness to operate a bank in a prudent manner, provide financial and other support to the bank, etc.) and therefore “not to be considered as appropriate for approval for ownership of insured depository institutions.”

The Final Statement refrains from referring to “silo structures” by name but still provides that “complex and functionally opaque ownership structures” will not be approved and notes that structures of this type “have been typified by organizational arrangements involving a single private equity fund that seeks to acquire ownership of a depository institution through the creation of multiple investment vehicles, funded and apparently controlled by the parent fund.” The FDIC’s stated concerns with such structures are that they make it difficult to ascertain the beneficial ownership of the institution, do not clearly identify the parties responsible for making decisions, and can separate ownership of an institution from its control. The FDIC also opposes these structures on the grounds that they “artificially separate the non-financial activities of the firm from its banking activities so that the private equity firm is not required to become a bank or savings and loan holding company.”

The scope of this restriction remains unclear. It would presumably not apply to investments by private investors utilizing such ownership structures if they are non-control investments. It is uncertain, however, whether the FDIC’s concerns would be alleviated if a private equity fund were to make its investment in a bank or thrift using a single “investment vehicle” instead of multiple ones, and, therefore, did not also engage in non-financial activities through that investment vehicle. It is also not clear whether two different funds advised and/or controlled by the same private equity firm would be aggregated. Of particular concern is the FDIC’s statement in the release accompanying the Final Statement that these types of structures (investments “through creation of multiple investment vehicles”) raise “serious concerns about the sufficiency of the financial and managerial support to the acquired institution, even in those instances where the investing fund(s) agrees to be regulated as a bank or savings and loan holding company.” (Emphasis added.) This may represent a more restrictive position than that articulated in the Proposed Statement, which seemed to suggest that the FDIC was comfortable with investor entities that are regulated as a bank or thrift holding companies.

Depending on the scope of this prohibition, it could significantly limit private capital investment.
## Summary Comparison of Key Provisions in the Proposed and Final Statements

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<th>Provision</th>
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<th>Final Statement</th>
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<tr>
<td><strong>Covered Investors</strong></td>
<td>• Covered investors included: (a) private capital investors in a company “(other than a bank or thrift holding company that has come into existence or has been acquired by [a private capital investor] at least 3 years prior to the date of this policy statement;” and (b) applicants for FDIC deposit insurance for de novo bank or thrift charters issued in connection with the resolution of a failed depository institution.</td>
<td>• Applies prospectively only. Acquisitions of failed depository institutions completed prior to the effective date of the Final Statement are excluded. • Will not apply to: (a) investors who partner with bank or thrift holding companies with established track records where the holding company has a strong majority interest in the bank or thrift; or (b) investors with 5% or less of the voting power of the acquired bank or thrift (or its holding company), absent any evidence of concerted action by the investors. • Expiration of applicability: upon application to and approval by the FDIC, the Final Statement will no longer apply to an investor in a bank, thrift or holding company where the bank or thrift has maintained a composite CAMELS 1 or 2 rating for seven consecutive years.</td>
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<td><strong>Capital Requirement</strong></td>
<td>• Tier 1 leverage ratio (including common equity and other forms of Tier 1 capital) of 15% throughout the first 3 years, subject to further extensions by the FDIC. • Thereafter, the depository institution must remain well capitalized; any failure to maintain the required capital levels would result in the depository institution to be considered undercapitalized for the purposes of Prompt Corrective Action (PCA).</td>
<td>• Ratio of Tier 1 common equity(^3) to total assets of at least 10% throughout the first 3 years, but allows the FDIC to increase the capital requirements if warranted. • PCA provisions same as in Proposed Statement.</td>
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<td><strong>Source of Strength</strong></td>
<td>• Required covered investors to agree to serve as a source of strength for the subsidiary depository institution, and required the holding company to agree to raise equity or debt capital if necessary.</td>
<td>• Deletes this provision.</td>
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<td><strong>Cross Guarantees / Cross Support</strong></td>
<td>• Required private capital investors that have majority control of multiple depository institutions to pledge their proportionate interests in each of their controlled institutions to the FDIC to cover any relevant losses to the Deposit Insurance Fund.</td>
<td>• Requires cross support only if two or more depository institutions are at least 80%-owned by one or more common investors.</td>
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<td>• Permits the FDIC to waive the cross support requirement if enforcement would not decrease the cost to the Deposit Insurance Fund.</td>
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<td><strong>Transactions with Affiliates</strong></td>
<td>• Prohibited extensions of credit by a depository institution acquired by private capital investors to those investors, to funds or portfolio companies controlled by them, or affiliates of either.</td>
<td>• Substantially retains this provision.</td>
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<td>• “Affiliate” would include any entity of which a private capital investor owns 10% or more of the equity.</td>
<td>• Modifies the definition of “affiliate” to mean “any company in which the Investor owns, directly or indirectly, at least 10 percent of the equity of such company and has maintained such ownership for at least 30 days.”</td>
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<td>• Adds an expectation that private capital investors will regularly report to the depository institution the identity of all affiliates.</td>
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<td>• Exempts existing extensions of credit.</td>
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<td><strong>Bank Secrecy</strong></td>
<td>• Provided that the FDIC would not approve an ownership structure involving entities domiciled in bank secrecy jurisdictions unless such entities are subsidiaries of companies that are subject to comprehensive consolidated home country supervision and those parent companies consent to U.S. jurisdiction and agree to, among other things, provide information to and cooperate with the relevant depository institution’s primary federal regulator and the FDIC.</td>
<td>• Substantially retains this provision.</td>
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<td>• Defines “bank secrecy jurisdiction” to mean “a country that applies a bank secrecy law that limits U.S. bank regulators from determining compliance with U.S. laws or prevents them from obtaining information on the competence, experience and financial condition of applicants and related parties, lacks authorization for exchange of information with U.S. regulatory authorities, does not provide for a minimum standard of transparency for financial activities, or permits offshore companies to operate shell companies without substantial activities within the host country.”</td>
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<td>Final Statement</td>
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<tr>
<td>Minimum Term of Ownership</td>
<td>• Three years, absent FDIC approval.</td>
<td>• Retains the three-year requirement, absent FDIC approval.</td>
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<td>• FDIC approval would not be granted unless the transferee agrees to be subject to the same requirements as the selling private capital investor.</td>
<td>• States that FDIC approval will not be unreasonably withheld for a transfer to an affiliate if the affiliate agrees to be subject to the same requirements as the selling private capital investor.</td>
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<td>• Exempts registered mutual funds from this provision.</td>
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<tr>
<td>Investors in Failed Institutions</td>
<td>• Bids for the deposits of a depository institution in receivership would not be accepted from private capital investors who own directly or indirectly 10% or more of the equity of the failed institution.</td>
<td>• Retains this provision.</td>
</tr>
<tr>
<td>Disclosure</td>
<td>• Private capital investors would have to disclose to the FDIC information on all entities in the proposed ownership chain of the institution acquiring deposits, including detailed information on the management and investments of any funds, as well as any other information requested.</td>
<td>• Substantially retains this provision.</td>
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<td>• Specifically includes protection for “confidential business information” submitted pursuant to this requirement.</td>
</tr>
<tr>
<td>Silo Structures</td>
<td>• The Proposed Statement expressed reservations about “silo” structures, citing them as being “substantially inconsistent” with the basic principles of depository institution ownership and therefore not appropriate for ownership of insured depository institutions.</td>
<td>• Does not refer to “silo” structures by name, but provides that “complex and functionally opaque ownership structures” will not be approved.</td>
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<td>• Expresses concerns even about funds that elect to register as bank or thrift holding companies.</td>
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ENDNOTES

1 The FDIC released the Proposed Statement for public comment earlier this summer. The Proposed Statement is described in our Memorandum of July 2, 2009.

2 The phrase "evidence of concerted action" is not defined in the Final Statement.

3 Tier 1 capital minus non-common equity elements such as qualifying perpetual preferred stock, and minority interests and restricted core capital elements not already included.

* * *
ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance and corporate transactions, significant litigation and corporate investigations, and complex regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 700 lawyers on four continents, with four offices in the U.S., including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

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Failed Bank Acquisitions
August 28, 2009
Financial Services Regulation

Obama Administration Releases Sweeping Financial Reform Proposals: Types of Firms Regulated, Capital Requirements and Activities Restrictions Would Be Substantially Expanded

SUMMARY

The Administration’s “White Paper” proposals on financial reform, released earlier today by the Treasury Department, would, if enacted, significantly alter not only how financial services firms are regulated but also how they conduct their businesses. All financial services firms, particularly the largest, will need to analyze the potential impact of these proposals.

KEY RECOMMENDATIONS

Following are initial observations on certain key aspects of the Administration’s financial regulatory reform plan.1 If enacted, it would represent the most sweeping reform of financial regulation and financial services companies since the 1930s. Implementation of many, although not all, of these recommendations would require new legislation.

Financial Services Oversight Council

This new interagency body, chaired by Treasury, would replace the President’s Working Group on Financial Markets and generally exercise an advisory and coordination function. The hands-on prudential supervision of systemically-significant firms would be carried out by the Federal Reserve. Each member regulatory agency would retain “exclusive jurisdiction to issue and enforce rules to achieve its mission.” The Council would be located within, and staffed by, Treasury. The Council would have the authority to gather information from any financial firm, refer emerging risks to the attention of regulators, and make recommendations regarding firms that should be regulated as “Tier 1 Financial Holding Companies” (Tier 1 FHCs).
Tier 1 FHCs

The Federal Reserve Board would become the consolidated supervisor, with a "macroprudential focus" of Tier 1 FHCs — i.e., any financial firm "whose combination of size, leverage, and interconnectedness could pose a threat to financial stability." Moreover, every Tier 1 FHC would become subject to the non-financial activity restrictions of the Bank Holding Company Act (BHCA) within five years of being designated as a Tier 1 FHC, including entities that do not own an insured depository institution.

The identification of a firm as a Tier 1 FHC would be made pursuant to rules developed by the Federal Reserve, in consultation with Treasury. The Federal Reserve would also develop, in consultation with Treasury, rules to guide the identification of foreign financial firms as Tier 1 FHCs based on whether their U.S. operations are deemed to pose a threat to financial stability, giving due regard to the principle of national treatment and potential implications under international agreements.

Tier 1 FHCs would be subject to "stricter and more conservative" capital, liquidity, and risk management standards, a new "prompt corrective action" regime similar to that which already exists for insured depository institutions, "enhanced public disclosures," and a requirement that they have in place a "credible plan for the rapid resolution of the firm in the event of severe financial distress." As a continuation of the recent Supervisory Capital Assessment Program, there would be a focus on the sufficiency of high-quality capital in stressed economic scenarios.

Tier 1 FHC subsidiaries — whether regulated or unregulated, domestic or foreign — would be subject to consolidated supervision by the Federal Reserve, although functionally-regulated subsidiaries (e.g., broker-dealers and banks) would continue to be supervised by their primary federal regulators. The White Paper proposes amending the Gramm-Leach-Bliley Act (GLBA) to eliminate the existing limits on the Federal Reserve’s supervisory authority to gather information regarding functionally-regulated bank holding company (BHC) subsidiaries. Moreover, the Federal Reserve would have explicit authority, after consulting with the relevant primary (federal or state) supervisor, to "impose and enforce more stringent prudential requirements" on functionally-regulated subsidiaries "to address systemic risk concerns."

Strengthening Capital and Other Prudential Requirements for All Banks and BHCs

A working group, led by Treasury, will conduct a “fundamental reassessment” of existing capital requirements, with a report to be issued by December 31, 2009. Areas of focus will include implicit exposure to off-balance-sheet vehicles, trading assets, structured credit products, over-the-counter (OTC) derivatives (if not centrally cleared), equity investments, and Tier 1 capital instruments. The review will also address changes to the existing capital framework to reduce "procyclicality" and focus on the importance of developing a "simpler, more transparent measure of leverage for banks and BHCs to supplement risk-based capital measures."

Minimum capital requirements would likely increase. According to the White Paper, the “capital rules in place at the inception of the financial crisis … simply did not require banking firms to hold enough capital
in light of the risks the firms faced.” Moreover, the composition of the instruments that qualify as Tier 1 and Tier 2 capital will be examined. The White Paper notes that “many of the capital instruments that comprised the capital base of banks and BHCs did not have the loss-absorption capacity expected of them.”

The White Paper also recommends that the Basel Committee on Banking Supervision continue to modify the Basel II capital framework to refine the risk-weighting of trading book and securitized products and potentially introduce a supplemental leverage capital ratio.

**Industrial Loan Company (ILC) Exception, Thrift Charter, and Other Grandfathered and Exempt Institutions**

The federal thrift charter and the ILC “bank” exception under the BHCA would be eliminated and, like Tier 1 FHCs, their owners would become subject to the BHCA non-financial activity restrictions within five years. The plan would also eliminate the existing BHCA exemptions and grandfather rights enjoyed by credit card banks, trust companies, and so-called “non-bank banks,” and require their holding companies to become BHCs regulated by the Federal Reserve.

**National Bank Supervisor**

A new “National Bank Supervisor” (in essence a merged OCC-OTS) would regulate all federally-chartered banks. The new federal charter would include the current interstate branching authority enjoyed by thrifts — *i.e.*, states would not be allowed to prevent *de novo* branching into their states or to impose a minimum age requirement on in-state banks that can be acquired by out-of-state banks.

**Regulation of Financial Holding Companies**

The current eligibility criteria for financial holding company (FHC) status would be amended to apply on a consolidated basis such that the FHC as a whole (and not merely its depository institution subsidiaries) would be required to achieve and maintain well-capitalized and well-managed status.

**Consumer Protection Regulation**

A powerful new Consumer Financial Protection Agency (CFPA) would become the primary federal consumer protection supervisor. It would exercise broad examination, supervision, and enforcement authority with respect to certain “credit, savings, payment, and other consumer financial products and services” (with the exception of “investment products and services already regulated by the SEC or CFTC”) and the firms (whether federally- or state-chartered) that provide such products and services.

The CFPA would become the sole agency authorized to write and interpret regulations under existing consumer financial services and fair lending statutes, including the Federal Trade Commission Act, the Truth in Lending Act, the Home Ownership and Equity Protection Act, the Real Estate Settlement and Procedures Act, the Community Reinvestment Act, the Equal Credit Opportunity Act, and the Home Mortgage Disclosure Act, among others.
Moreover, the CFPA would have “broad authority to adopt tailored protections — such as disclosures or restrictions on contract terms or sales practices — against unfairness, abuse, or deception,” including the authority to restrict or ban mandatory arbitration clauses. The CFPA would also be authorized to impose “appropriate duties of care on financial intermediaries.”

The CFPA would also be authorized to define standards for “plain vanilla” financial products (like 30-year-fixed-rate mortgages) and to require “all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer.”

Importantly, the rules issued by the CFPA would not preempt state laws. Instead, states would be authorized to adopt “stricter laws” and to enforce those laws against federally-chartered institutions.

Although the Federal Trade Commission’s primary authority for financial product and services protections would be transferred to the CFPA, it would retain backup authority with the CFPA for the statutes currently within its jurisdiction.

**Federal Resolution Regime**

A new resolution regime would be established for failing bank holding companies, including Tier 1 FHCs, modeled on the resolution provisions of the Federal Deposit Insurance Act. This proposal would permit Treasury, when “financial stability is at risk,” to establish a conservator or receiver for a failing firm, provide financial support to the firm in various ways, take control of the firm’s operations, and sell or transfer all or part of the firm to a bridge institution or other entity — importantly, without triggering termination of the firm’s derivatives contracts. The proposal is similar to a more detailed legislative proposal previously issued by Treasury. Treasury would select the resolution agency, which would “generally” be the FDIC with respect to conservatorships and receiverships, but could be the SEC in the case of failing entities, the largest subsidiary of which is a broker-dealer or securities firm. In light of its proposed role in this regime, the FDIC would be given back-up examination authority over BHCs.

**Regulation of “Systemically Important Payment, Clearing and Settlement Systems”**

The Administration will propose legislation giving the Federal Reserve authority to (i) conduct oversight of certain “systemically important payment, clearing and settlement systems,” (ii) carry out “rigorous on-site safety and soundness examinations” of such systems, and (iii) conduct “prior reviews of changes to [their] rules and operations.” Where such a system is already subject to comprehensive regulation by a federal market regulator (e.g., the SEC), that market regulator would take the lead with respect to examinations and reviews and would retain “primary authority for enforcement.” However, the Federal Reserve would be authorized to participate in the examinations and to “compel corrective actions” in certain cases.

The Federal Reserve would also be authorized generally to collect information from any payment, clearing, or settlement system for purposes of determining whether it is systemically important. The Administration will recommend that Congress grant the Federal Reserve new authority to provide

Financial Services Regulation
June 17, 2009
systemically important systems “direct access to Reserve Bank accounts and financial services and to the discount window.”

**Federal Reserve Act Sections 23A/23B**
The White Paper recommends that regulators limit the ability of banks to engage in OTC derivatives and securities financing transactions with their affiliates and that “existing federal restrictions on transactions between banks and affiliates should be applied to transactions between a bank and all private investment vehicles sponsored or advised by the bank.” Moreover, covered transactions “should be required to be fully collateralized throughout the life of the transactions.” Finally, the White Paper recommends that the Federal Reserve’s authority to grant exemptive relief under Sections 23A/23B should be limited.

**Hedge Funds and “Other Private Pools of Capital”**
The White Paper recommends that advisers to hedge funds and other private pools of capital (including private equity funds and venture capital funds) whose assets under management exceed some undefined “modest threshold” would be required to register with the SEC as investment advisers under the Investment Advisers Act of 1940, and to report such information as “is sufficient to assess whether any fund poses a threat to financial stability.”

In addition, funds advised by these advisers would be subject to new record-keeping and reporting requirements, and would be required to provide new disclosures to investors, creditors, and counterparties. Funds or fund families deemed by the Federal Reserve to meet the Tier 1 FHC criteria described above would be supervised by the Federal Reserve as Tier 1 FHCs and therefore, presumably, become subject to the non-financial activity restrictions of the BHCA.

Finally, the White Paper suggests that “the Federal Reserve and the federal banking agencies should tighten the supervision and regulation of potential conflicts of interest generated by the affiliation of banks and other financial firms, such as proprietary trading units and hedge funds.”

**SEC/CFTC**
As expected, the Administration does not propose merging the SEC and CFTC, but recommends that these agencies should submit, by September 30, 2009, a report to the Congress regarding “changes to statutes and regulations that would harmonize regulation of futures and securities.”

**Comprehensive Regulation of All OTC Derivatives, Including Credit Default Swaps (CDS)**
All OTC derivatives markets, including CDS markets, would be subject to “comprehensive regulation” designed to achieve four broad policy objectives: (i) mitigation of systemic risk posed by activities in these markets; (ii) promotion of efficiency and transparency; (iii) prevention of “market manipulation, fraud, and other market abuses;” and (iv) ensuring that OTC derivatives are not marketed inappropriately to “unsophisticated parties.”
Insurance
The Administration proposes the creation of a new “Office of National Insurance” (ONI) within Treasury to “gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector.” Regulation of insurance companies, however, would remain with the states. Although the ONI would not be a member of the Financial Services Oversight Council, it could recommend to the Federal Reserve that a particular insurance company be supervised as a Tier 1 FHC.

Securitization and “Skin in the Game”
The White Paper suggests that federal bank regulators should “promulgate regulations that require loan originators or sponsors to retain five percent of the credit risk of securitized exposures.” It is unclear under what statutory authority the regulators could currently promulgate such regulations. “Skin-in-the-game” legislation is currently pending in the U.S. House of Representatives.

Investment Adviser/Broker-Dealer Regulation
The SEC would be given new authority to, among other things, require that “broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers” and to “prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers.” The White Paper suggests, however, that the SEC’s authority regarding mandatory arbitration clauses could only be exercised after the SEC conducted a study of the use of such clauses, whether investors are harmed, and whether any action is appropriate.

Other
The White Paper also recommends that:

- recognizing that the proposals would “effect the biggest changes to the Federal Reserve’s authority in decades,” the Federal Reserve should lead a “comprehensive review of the ways in which the structure and governance of the Federal Reserve System affect its ability to accomplish its existing and proposed functions,” including the structure of the Federal Reserve Banks and the role of their boards in bank supervision and regulation.
- Treasury should “support federal regulators, including the Federal Reserve, the SEC and the federal banking regulators in laying out standards on compensation for financial firms that will be fully integrated into the supervisory process.”
- the SEC should require credit rating agencies to implement “robust policies and procedures” to “manage and disclose conflicts of interest” that “differentiate between structured and other products, and otherwise promote the integrity of the ratings process.”
- the Fed’s emergency lending authority under Federal Reserve Act Section 13(3) should be amended to require Treasury’s “prior written approval ... for any extensions of credit by the Federal Reserve to individuals, partnerships, or corporations.”
- the Financial Accounting Standards Board and the International Accounting Standards Board, together with the SEC, should review existing accounting standards with an eye toward reducing “procyclical tendencies and requiring the use of “more forward-looking loan loss provisioning.” Accounting standard setters should also review fair value accounting rules to address procyclicality and to identify “changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments.”
the SEC should enhance the regulation of the money market mutual fund (MMF) industry with the goal of reducing credit and liquidity risk and susceptibility to runs. The White Paper also suggests that the President’s Working Group on Financial Markets should prepare a report “assessing whether more fundamental changes are necessary to further reduce the MMF industry’s susceptibility to runs.”

U.S. regulators and their foreign counterparts should improve international cooperation by, among other things, promoting standardization and better oversight of OTC derivatives markets, strengthening arrangements for the supervision and cross-border resolution of global financial firms, enhancing liquidity and risk management standards, and determining the appropriate Tier 1 FHC definition and application of requirements for foreign financial firms.”

ENDNOTES

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Public-Private Investment Programs

Treasury Department Explains Public-Private Investment Programs to Purchase Legacy Real Estate-Related Loans and Securities

SUMMARY

Earlier this week, Treasury Secretary Timothy Geithner provided important details of Public-Private Investment Programs (the “Programs”) first announced on February 10, 2009 as part of the comprehensive Financial Stability Plan of the U.S. Department of the Treasury (“Treasury”). Under the Programs, $75 billion to $100 billion in TARP capital will be combined with additional capital from private investors, and leveraged with government-provided and government-guaranteed financing, “to generate $500 billion in purchasing power to buy legacy assets – with the potential to expand to $1 trillion over time”. Eligible “legacy assets” include real estate loans held directly on the books of any insured U.S. bank or U.S. savings association (excluding those owned or controlled by a foreign bank or non-U.S. holding company), and securities backed by certain residential and commercial real estate loan portfolios held by any “financial institution”. In both cases, the legacy assets must be situated “predominantly in the United States”. The Programs will be funded out of the second $350 billion of TARP funds authorized under the Emergency Economic Stability Act of 2008.

The Programs are:

- A Legacy Loans Program, pursuant to which public-private investment funds (“PPIFs”), subject to oversight by the Federal Deposit Insurance Corporation (the “FDIC”), will compete to purchase troubled loans from insured banks and savings associations through an auction process. The PPIFs will be capitalized by equity capital from the private sector and Treasury, and will have debt financing guaranteed by the FDIC.
- A Legacy Securities Program consisting of two related parts, under which (1) the previously announced Term Asset-Backed Securities Loan Facility (the “TALF”) of the Board of Governors of the Federal Reserve (the “Federal Reserve”) will be expanded to provide non-recourse loans to private investors to fund purchases of certain legacy non-agency residential mortgage-backed securities (“RMBS”) and commercial mortgage-backed securities (“CMBS”), as well as other asset-backed securities (“ABS”), and (2) Treasury will make co-investment and leverage available to a small number of PPIFs (approximately five) to fund, initially, purchases of certain RMBS and CMBS.
The Programs have been designed with the intent of aligning public and private investor interests so as to maximize the long-term value for U.S. taxpayers. Accordingly, in addition to the co-investment element of the Programs, additional procedural safeguards and mechanisms have been built into the Programs with the intent of reducing the likelihood that taxpayers will overpay for these legacy assets. The government also will have an opportunity to participate in any potential upside if the value of these loans and securities appreciates over time.

Although Treasury's announcement earlier this week set forth important details of the Programs, additional detail will need to be developed over time, including through notice and comment rulemaking (which Treasury specifically indicated will be used to set forth the exact requirements and structure of the Legacy Loans Program) and development of specific governance and other procedures. Treasury, however, has already taken one step in furtherance of implementation of the Programs by soliciting applications from private entities to become pre-qualified managers of a fund under the Legacy Securities Program. Applications from prospective fund managers are due by April 10, 2009.

THE PUBLIC-PRIVATE INVESTMENT PROGRAMS

The Public-Private Investment Programs detailed this week are key initiatives of the Financial Stability Plan announced on February 10, 2009.1 As outlined in February, private sector participation in the effort is a primary policy goal of the United States. In this regard, the core of the approach outlined by Secretary Geithner is the formation of PPIFs, in which the government and private sector investors will invest side-by-side in order to purchase legacy real estate-related loans and securities. One reason private sector participation has been deemed essential is the market discipline that private investors are expected to bring in aid of price discovery efforts. In explaining the Programs, Treasury reiterated its belief that the liquidity discounts currently embedded in some of these legacy assets are placing a “significant strain on the economic capital of U.S. financial institutions and have reduced their ability to engage in new credit formation”. Accordingly, by providing government equity co-investment and attractive public financing, the Programs are intended to draw new private capital into the market and, through bidding and purchasing activity, facilitate price discovery. Over time, the Programs are expected to reduce excessive liquidity discounts embedded in current legacy asset prices. This, in turn, should free up capital and allow U.S. financial institutions to engage in new credit formation. Treasury believes that the “enhanced clarity about the value of legacy assets should increase investor confidence and enhance the ability of financial institutions to raise new capital from private investors”.

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1 The Financial Stability Plan was described in our publication, dated February 10, 2009, entitled “Comprehensive Financial Stability Plan”.

Public-Private Investment Programs
The Programs initially are targeted primarily at legacy assets in the residential and commercial mortgage sectors, including whole loans and securitizations backed by loan portfolios held by “financial institutions”, but Treasury has indicated that the class of eligible assets may evolve over time to include other asset classes.

**Legacy Loans Program**

Under the Legacy Loans Program, insured U.S. banks and savings associations (each, a “Participant Bank”) will be eligible to sell pools of legacy loans to PPIFs under criteria established by the FDIC. Banks and savings associations owned or controlled by a foreign bank or non-U.S. holding company are not eligible to participate as legacy asset sellers. A Participant Bank will begin the process of participating in the Legacy Loans Program by identifying to the FDIC, after consultation with the Participant Bank’s primary bank regulators, a pool of legacy assets that it wishes to sell. The eligibility of such assets must be demonstrated to the satisfaction of the FDIC and Treasury. Upon determination of eligibility, the FDIC will oversee initial due diligence of such assets and a third-party valuation firm selected by the FDIC will provide independent valuation advice for each eligible asset pool. After such review, the FDIC will determine the level of debt to be issued by the PPIF for the purchase of the pool of assets that the FDIC is willing to guarantee. It is anticipated that the debt-to-equity ratio will not exceed 6-to-1 for each PPIF. The FDIC’s guarantee will be collateralized by the purchased assets and the FDIC will assess an annual debt guarantee fee on the PPIF, a portion of which will be allocated to the Deposit Insurance Fund. The PPIF will be required to maintain a “Debt Service Coverage Account” to ensure that working capital for each PPIF is sufficient to meet anticipated debt servicing obligations, interest expenses and operating expenses. A portion of cash proceeds from the sale of asset pools will be retained until cash flow from the asset pools has fully funded the Debt Service Coverage Account, at which point the escrowed cash will be released to the Participant Bank. Assets to be purchased, and any collateral supporting those assets, must be situated “predominantly in the United States”.

Eligible pools of legacy loans will be sold in an auction process conducted by the FDIC. The auction will be structured as a competitive bid for the opportunity of private investors to contribute 50% of the equity for the PPIF, with Treasury contributing the remaining 50%, along with guaranteed debt financing. Private investors, however, may elect to take less than a 50% equity investment from Treasury (subject to a minimum to be determined). Private investors eligible to participate in the auction may include, among others, financial institutions, individuals, insurance companies, mutual funds, publicly-managed investment funds, pension funds, hedge funds, private equity funds and “foreign investors with a headquarters in the United States”. Treasury noted specifically that “participation of mutual funds, pension plans, insurance companies, and other long term investors is particularly encouraged”. Private investor groups must be approved by the FDIC, and cooperation between approved investor groups will be prohibited once the auction process begins. Private investors may not participate in any PPIF that purchases assets from affiliated sellers or sellers who represent 10% or more of the aggregate private
capital in the PPIF. The price offered to the selling Participant Bank will be the sum of the winning bid for an equity stake, plus the government equity, together with the PPIF debt that the FDIC is willing to guarantee based on the pre-determined debt-to-equity ratio. The Participant Bank will have the option to accept the offer or reject the bid within a pre-established period of time, although any institution, in deciding whether to accept or reject a bid, will have to consider a number of factors, including whether such action would have accounting consequences. If the institution accepts a bid, consideration will be paid partially in cash and partially in the debt issued by the PPIF and guaranteed by the FDIC.

Treasury has indicated that the PPIFs will be controlled by private investors, but they will be subject to “strict oversight” by the FDIC. In addition, the FDIC and Treasury will establish governance procedures regarding the management, servicing agreement, financial and operating reporting requirements, exit timing and alternatives for each of the eligible asset pools, and the PPIFs will have to be managed within these parameters. Treasury has indicated that it will not, as an equity investor, have control rights. Instead, it appears that the United States Government largely will rely on the established management parameters and procedures, as well as the oversight role of the FDIC, to protect the interests of Treasury as an equity investor. Treasury and private investors will share profits and losses in proportion to equity invested in the PPIF.

Although the governance and management requirements will be developed over time, Treasury indicated that, among other things, each PPIF will have to agree to waste, fraud and abuse protections designed to protect taxpayers, as well as make representations, warranties and covenants regarding conduct of business and compliance with applicable law. In addition, the PPIF will have to agree to provide access, as needed, to information required by the Government Accountability Office and the Special Inspector General of the TARP. Treasury indicated that “the executive compensation restrictions” will not apply to “passive” private investors, but its statement did not clarify exactly what it meant by “the executive compensation restrictions” or the “passivity” requirement.

Legacy Securities Program
The Legacy Securities Program consists of two related parts designed to draw private capital into the markets for certain legacy securities by providing equity capital and debt financing from Treasury and debt financing from the Federal Reserve under the TALF.

First, the TALF will be expanded such that non-recourse loans will be made available to investors to fund purchases of legacy securitization assets (the “Legacy TALF”).2 Treasury expects the assets to be eligible for purchase under the Legacy TALF initially to include (1) **outstanding** non-agency RMBS that

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2 The TALF, which became operational on March 17, 2009, was designed to provide financing for newly issued asset-backed securities backed by certain types of consumer and small business loans.
were originally rated AAA and (2) outstanding non-agency CMBS and other ABS that are rated AAA.\(^3\) Borrowers will need to meet certain eligibility criteria. The terms of the Legacy TALF, including with respect to the size of haircuts or borrowing against asset value tied to riskiness of the assets provided as collateral, lending rates, minimum loan sizes and loan durations, have not yet been determined. Treasury indicated that these decisions will be informed by discussions with market participants.

Second, Treasury will make co-investment and leverage available to a small number of PPIFs managed by institutions that have been pre-qualified by Treasury (each, a “Fund Manager”) and with sufficient private capital commitments with the purpose of funding purchases of certain residential mortgage-backed securities and certain commercial mortgage-backed securities. Treasury expects the PPIFs will initially target non-agency RMBS and CMBS originated prior to 2009 with a rating of AAA at the time of their origination or an equivalent rating by two or more nationally recognized statistical rating organizations without ratings enhancement, and that are secured directly by the actual mortgage loans, leases or other assets and not other securities (other than certain swap positions, as determined by Treasury). Private investors will invest indirectly in the PPIF through a private vehicle (each, a “Private Vehicle”). Treasury indicates that the Private Vehicle will be “controlled by the applicable Fund Manager”, which will also manage the PPIF. The Private Vehicle and Treasury will be the only two investors in the PPIF.

As with the Legacy Loans Program, the loans and other assets underlying any eligible asset for purchase by a PPIF under the Legacy Securities Program must be situated “predominantly in the United States”. Treasury specifically indicated that the meaning of this limitation is subject to further clarification by Treasury. In addition, the PPIF may only purchase eligible assets from financial institutions from which the Secretary of the Treasury is authorized to purchase assets pursuant to Section 101(a)(1) of the Emergency Economic Stability Act of 2008.\(^4\)

Private parties have been invited by Treasury to apply to become pre-qualified as a Fund Manager based on certain criteria expected to include: (i) demonstrated capacity to raise at least $500 million of private capital, (ii) demonstrated experience investing in the targeted asset classes, including through performance track records, (iii) a minimum of $10 billion (market value) of targeted asset classes under

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\(^3\) Treasury did not specify what other categories of issues ABS would become eligible under TARP. It may be that the plan is simply to extend existing TARP eligibility for newly issued ABS backed by certain types of consumer and small business loans to outstanding loans in those classes.

\(^4\) Such institutions include, but are not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any State, territory or possession of the United States, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Mariana Islands, Guam, American Samoa, or the United States Virgin Islands, and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government.
management, (iv) demonstrated operational capacity to manage the PPIF in a manner consistent with Treasury’s stated investment objective while also protecting taxpayers and (v) a headquarters location in the United States. Although Treasury expects to pre-qualify “approximately five” Fund Managers, it may add more based on the quality of the applications it receives. The applications for pre-qualification as a Fund Manager are due on April 10, 2009, and Treasury expects to notify applicants of its preliminary approval on or prior to May 1, 2009. Once preliminarily approved, Fund Managers will have a limited period of time in which to raise at least $500 million of private capital to target the designated asset classes and must demonstrate committed capital before receiving final approval from Treasury.

Elaborating on the “investment objective” criteria that will be used to select Fund Managers, Treasury has indicated that it expects PPIFs to follow predominantly a long-term buy and hold strategy, although it will consider other strategies involving limited trading. Accordingly, institutions seeking to qualify as Fund Managers are to propose a term for the PPIF, but the term is not to exceed 10 years, subject to extension with Treasury’s consent. If a prospective Fund Manager believes that the PPIF should deviate from a long-term buy and hold strategy, its rationale is to be explained in the application. Fund Managers also are asked to describe the proposed PPIF structure, material terms of the PPIF, including covenants relating to allocation of investment opportunities, competing funds and investments away from the PPIF, proposals for efficient tax structuring and proposed risk management strategies.

Upon final approval, Treasury will provide a commitment to provide equity capital along with the Private Vehicle on a matching basis. Treasury equity capital will be funded in tranches to provide for anticipated investments (subject to agreed limitations). Equity capital from Treasury may only be drawn at the same time and in the same proportion as private capital, and Treasury will retain the right to cease funding of committed but undrawn Treasury equity capital, in its sole discretion.

Fund Managers will have the option to obtain for each PPIF senior secured, non-recourse loans from Treasury, in an aggregate amount of up to 50% of the PPIF’s total equity capital. The loans will not be made available, however, if the private investors have voluntary withdrawal rights from the Private Vehicle. In the pre-qualification application, prospective Fund Managers are invited to request additional debt financing of up to 100% of a PPIF’s total equity capital (subject to restrictions on asset level leverage, withdrawal rights, disposition priorities and other factors that Treasury may identify). Any request for additional debt financing is to be accompanied by a description of the amount of leverage requested along with proposed terms. In addition to this debt financing provided by Treasury, PPIFs may finance the purchase of legacy securities through the Legacy TALF, any other available Treasury

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5 Private investors may be given voluntary withdrawal rights at the level of a Private Vehicle, subject to limitations to be agreed with Treasury, including that no private investor may have the right to voluntarily withdraw from a Private Vehicle prior to the third anniversary of the first investment by such Private Vehicle.
program or debt financing raised from private sources, as long as the equity capital contributed by Treasury and private investors is leveraged proportionately from the additional debt financing sources.

Any loans extended by Treasury under this program will be secured by the legacy securities held by the PPIF, and will have a term to match the term of the PPIF, as proposed by the Manager in its application. Treasury indicated that the PPIF will be required to repay the loans on a pro rata basis as “principal repayments or disposition proceeds are realized” by the PPIF. Although Treasury loans to a PPIF will be senior, Treasury has indicated that financing extended to the PPIF by the Federal Reserve through the Legacy TALF will have priority.

The Fund Manager will control the process of asset selection and pricing, trading, disposition and liquidation, and the Fund Manager, not Treasury, will manage the PPIF. However, as with the Legacy Loans Program, a number of governance and management safeguards will be established. Treasury expects to define the final terms and conditions for the PPIF prior to fundraising, but announced that, among other things, the Fund Manager will have to comply with reporting, valuation, custodial and accounting obligations, and will have to agree to waste, fraud and abuse protections designed to protect taxpayers. In addition, the PPIF may only purchase legacy securities “from sellers that are not affiliates of [the] Fund Manager, any other Fund Manager [under the Legacy Securities Program] or their respective affiliates or any private investor that has committed at least 10% of the aggregate private capital” of the PPIF. Finally, the Fund Manager will be required to provide access to books and records to Treasury, the Government Accountability Office and the Special Inspector General of the TARP and their respective advisors and representatives.

As with the Legacy Loans program, Treasury indicated that “the executive compensation restrictions” will not apply to “passive” private investors, but its statement did not clarify exactly what it meant by “the executive compensation restrictions” or the “passivity” requirement, and also did not specifically address whether Fund Managers would be exempt from such restrictions. Regarding fees of the Fund Manager, Treasury has indicated that a Fund Manager may charge fees to private investors in its discretion, although Treasury will consider the fee proposal when evaluating pre-qualification applications. In addition, Fund Managers may submit proposals to Treasury for fixed management fees in respect of Treasury’s equity capital (“Treasury Fees”) to apply as a percentage of equity capital contributions for invested equity capital. Treasury Fees and Treasury’s share of PPIF expenses will be paid solely out of distributions with respect to Treasury equity capital. Any fees paid to a Fund Manager or an affiliate in connection with a PPIF (other than Treasury Fees and management or incentive fees charged to private investors) should accrue to the benefit of Treasury and private investors on a pari passu basis based on capital commitments. Proceeds received by a PPIF in respect of legacy assets will be divided between Treasury and the Private Vehicle based on equity contributions.

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Public-Private Investment Programs
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**Public-Private Investment Programs**

March 25, 2009

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Noncontrolling Investments in Banking Organizations

Federal Reserve Liberalizes Policy on Certain Aspects of Permissible Noncontrolling Equity Investments; Does Not Address Certain Structural Issues for Private Equity Investors

SUMMARY
On September 22, 2008, the Board of Governors of the Federal Reserve System (the “Board”) issued a new policy statement (the “Policy Statement”) on equity investments in banks and bank holding companies. The Policy Statement liberalizes Board policy on investments that are deemed “noncontrolling” and, therefore, do not subject investors to the Bank Holding Company Act of 1956 (the “BHC Act”). The areas of liberalization include ownership of voting shares, director representation, total equity investment and convertible securities. The Policy Statement does not, however, deal with two other key, and arguably more important, issues: “club” investments and “silo” funds. Consequently, it remains to be seen whether the Policy Statement will facilitate substantial additional private equity investments in banks. In addition, the Policy Statement may facilitate shareholder activism.

BACKGROUND
The BHC Act provides that a company has “control” over a bank or bank holding company, and thereby becomes subject to the BHC Act, if:

- the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25% or more of any class of voting securities of the bank or company;
- the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or
- the company directly or indirectly exercises a “controlling influence” over the management or policies of the bank or company.
The first two prongs of this control test are relatively straightforward. The third, “controlling influence”, is subjective and has been the subject of numerous Board interpretations and guidance.

Investors in banking organizations seek to avoid a control determination for two principal reasons. First, the BHC Act mandates a separation of banking and commerce, and a company engaged in commercial activities, directly or through other controlled investments, cannot control a banking organization and thereby become a bank holding company. Second, companies deemed to control banking organizations are subject to a so-called “source of strength” doctrine, under which they must provide resources to meet the capital shortfalls of a banking organization that they control. In addition, companies deemed to control banking organizations are subject to capital requirements and to supervision and examination by the Board.

In 1982, the Board issued a policy statement on nonvoting equity investments. Because this policy statement was designed to prevent “end runs” around the then-existing limitations on interstate banking, it applied by its terms to investments “by”, rather than “in”, bank holding companies. This policy statement was, however, extended to investments by other organizations in bank holding companies.

The 1982 policy statement was regarded by some as applying a broader definition of controlling influence than had previously been the case. Moreover, the concern about interstate banking was subsequently eliminated by legislation. Nonetheless, the Board has continued to follow that policy statement, and subsequently imposed other limitations on investments in banking organizations that must be satisfied if the investment is not to be deemed to be controlling.

Policy Statement

1. Facts and Circumstances

The Policy Statement emphasizes that a control determination remains an “all the facts and circumstances” test. Accordingly, all aspects of the investor/investee relationship need to be taken into consideration. Consultation with Board staff will continue to be important.

2. Ownership of Voting Shares

The Policy Statement does not deal directly with one of the key issues under the “controlling influence” test: what percentage of voting stock can be owned without constituting control. The prior limit appears to have been 10%, or perhaps 15% under favorable circumstances. There is, however, a suggestion in the Policy Statement that the new limit is at least 15%, and based on conversations with Board staff,

1 Neither the Policy Statement nor the 1982 policy statement refers to the legislative history of the “controlling influence” prong of the BHC Act definition. This legislative history can be read to suggest that the test was to be limited to situations of actual control.
24.9%, absent other “indicia” of control, although some form of limited passivity commitment will likely be required at 10% or above.

The Policy Statement applies only to the BHC Act and not to the Change in Bank Control Act (“CIBCA”). Accordingly, an investor seeking to acquire more than 10% of the voting stock of most banking organizations would typically need to obtain prior clearance under the CIBCA even if the investment were deemed noncontrolling for BHC Act purposes.

3. Number of Directors
As the Policy Statement notes, the Board has generally held that an investor owning 10% or more of the voting stock of a banking organization cannot have any representation on the organization’s board of directors without creating control. This limitation has been liberalized in the Policy Statement in two respects.

First, an investor should be able to have a single director on the board, assuming that the board has at least nine members. It appears that a board representative would be available to an investor holding up to 15%, and quite possibly 24.9%, of the voting stock of a banking organization, provided that the investor has no other “indicia” of control.

Second, if there is a larger shareholder that controls the banking organization and is a bank holding company, an investor can have two representatives on the board, provided that the director representation (i) is proportionate to the investor’s economic interest in the banking organization and (ii) does not exceed 25% of the directors.

In addition, the Policy Statement appears to sanction two board representatives for an investor with up to a 10% voting interest and a 20% total equity interest, provided that the investor’s board representation does not exceed 20% of the board seats.

4. Role of Director Representatives
The Policy Statement provides that the investor’s representative(s) on the board should not serve as chairman of the board or chairman of any committee of the board. The investor’s representative(s) may serve on a committee, provided that the representative(s) do not represent more than 25% of the committee or have the practical ability to make or block policy. The Policy Statement does not address whether the investor’s representative can serve as “lead” director, although such service may be inconsistent with the Policy Statement.

5. Observer
The Policy Statement confirms that an investor can have a nonvoting observer attend board meetings without raising a control issue. It is not totally clear whether the Board would permit an observer in addition to a director, or more than one observer.
6. Total Equity
The Board had previously held that, with few exceptions, control would exist if an investor had 25% or more of the total equity of a banking organization, irrespective of its voting status. The Policy Statement increases that limit to 33⅓%, provided that the investor does not own 15% or more of any class of voting stock. We believe that the Policy Statement could be read to permit such an investor to also have a board representative, although this is not totally clear.

7. Subordinated Debt
The Board has previously held that the total equity test should include subordinated debt held by the investor. The Policy Statement can be read, by implication, to eliminate this approach, but that is not clear.

8. Convertible Securities
One of the most important liberalizations in the Policy Statement relates to convertible securities. The Board had previously held that securities convertible into voting shares at the option of the holder, or mandatorily convertible, represent ownership of the underlying voting shares. The Board had, however, permitted investors to own convertible securities if they were not exercisable for more than 19.9% of a class of voting shares, could not be voted in the hands of the investor and could only be transferred in a widespread public offering, in a transaction where the transferee would receive no more than 2% of the underlying voting securities, or to a transferee that would control more than 50% of the target organization regardless of any transfer from the investor.

The Policy Statement appears to increase that 19.9% interest to 33⅓%, as long as the investor would not be able to exercise the securities to acquire more than 14.9% of the voting shares.

9. “Consultation with Management” – Shareholder Activism
The Policy Statement provides that a noncontrolling minority investor “generally may communicate with banking organization management about, and advocate with banking organization management for changes in, any of the banking organization’s policies and operations”. These communications can include an attempt to convince banking organization management to merge the banking organization with another firm or sell the banking organization to a potential acquirer, as well as recommendations for new or alternative management. These statements appear to enable large shareholders to pursue an activist agenda without being deemed to be in control. At the same time, however, the Policy Statement limits the effectiveness of the activism in three respects.

- First, it indicates that the role of the investor in these decisions must be “limited to voting its shares in its discretion at a meeting of the shareholders of the banking organization (directly or by proxy, including in connection with a proxy solicitation launched by another shareholder), and by exercising voting privileges as a member of the board of the banking organization”.

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Second, the Policy Statement provides that “communications by minority investors should not be accompanied by explicit or implicit threats” to sell their shares or sponsor a proxy solicitation.

Third, and perhaps most importantly, the Policy Statement explicitly states that “the Board has and will continue to monitor carefully minority investments in banking organizations to ensure that investors do not, in fact, exercise a controlling influence over the management or policies of the banking organizations in which they invest.”

10. Business Relationships
The Board has previously held that a large minority investor in a banking organization could not obtain a determination of noncontrol if the investor engaged in material business relationships with the banking organization. The Policy Statement suggests a somewhat more liberal approach if the business relationship is with an investor whose voting securities ownership is “closer to 10 percent than 25 percent” and if it is “on market terms, non-exclusive, and terminable without penalty by the banking organization.”

11. Passivity Commitments
The Board has historically required so-called “passivity commitments” as a condition to concluding that certain investors are noncontrolling. Although these commitments are noted in the Policy Statement, it does not make clear under what circumstances they will be required in the future or whether (and to what extent, other than with respect to director representation) they will be less restrictive than before.

12. Issues Not Addressed
Particularly under current conditions, the need of banking organizations for capital will often exceed the 25% or even 33 1/3% of total equity threshold. Moreover, investors are often unwilling to invest in troubled institutions unless they can exercise some degree of control. In an attempt to meet both banking organizations’ needs for capital and investor concerns, two general structures have been developed for investments by private equity in banking organizations. The first is a “club” arrangement involving several large minority investors, with none being deemed to be in control. The second is a separate, or “siloh”, fund that is created by a private equity group, ownership of which is not attributed to other funds managed by the group.

As has always been the case, noncontrolling investors may not have a contractual right to determine or veto any major policies or operations of the banking organization or its management team. Non-controlling investors, however, may continue to have covenants that prohibit the issuance of senior securities, modification of the terms of the investor’s security or liquidation of the banking organization.
The Policy Statement does not address either of these structures (and explicitly disclaims addressing the former). Although there have been several Board rulings on these structures, Board staff had indicated that they are not necessarily precedential. Accordingly, private equity investment in banking organizations may continue to be limited until there is clearer resolution on these structures.

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