



FINANCIAL INSTITUTIONS REGULATORY UPDATE

The Financial Institutions Regulatory Practice Group of Sidley Austin LLP

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FDIC Releases Final Guidance on Private Equity Investments in Failed Banks

On August 26, 2009, the Federal Deposit Insurance Corporation (“FDIC”) adopted its final Statement of Policy on the Acquisition of Failed Bank Depository Institutions (the “SOP”). The SOP establishes a framework of guidance for “private capital” investments in acquirers of deposit liabilities and the operations of failed depository institutions. While the FDIC has relaxed some of the originally proposed restrictions, the SOP still stands as a significant impediment to private equity financing of the resolution of failed institutions. The FDIC intends to review the operation of the SOP and make adjustments as it deems necessary within six months of its adoption. Additionally, the FDIC may waive one or more provisions of the SOP if it determines that such waiver is appropriate.

Applicability

The SOP applies prospectively to private investors in a company, including a company acquired to facilitate bidding on failed banks or thrifts, that proposes to assume deposit liabilities (or a combination of deposits and assets) from the resolution of a failed depository institution. Such assumption can be direct or indirect, including through a shelf charter. Additionally, the SOP applies to applicants for deposit insurance with respect to *de novo* charters issued in connection with the resolution of failed depository institutions. The SOP does not expressly address investments in healthy or *de novo* institutions that may be used for roll-up acquisitions outside the resolution process. Notwithstanding a number of requests to define what “private investors” are subject to the SOP, the FDIC demurred, taking the position that there is too much diversity and fluidity in the types of structures being proposed for failed bank acquisitions to further define the term.

The FDIC has stressed that the SOP is prospective only, and does not apply to acquisitions of failed depository institutions that occurred prior to August 26, 2009, although the impact on future acquisitions by the same entities is less clear. In addition, the SOP does not apply to investors in partnerships or other ventures with bank holding companies (“BHCs”) or thrift holding companies (“THCs”) (excluding

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shell holding companies) where the BHC or THC has a “strong” majority interest in the applicable bank or thrift and has an “established” record in successfully operating banks or thrifts. The FDIC indicates that it “strongly encourages” such partnerships. However, the specific requirements for the BHC/THC’s supermajority interest and track record remain undefined. Finally, in response to several requests for a *de minimis* exemption, the SOP excludes investors with five percent or less of the total voting power of an acquired bank or thrift or its BHC or THC, provided that there is no evidence of concerted action by the investors.

If an investor in a bank, thrift, BHC or THC can demonstrate by application to the FDIC that the relevant bank or thrift has maintained a composite CAMEL rating of 1 or 2 continuously for a period of seven years, the FDIC may release that investor from the requirements of the SOP.

Capital Commitment

In response to numerous comments, the FDIC reduced the capital requirements for acquired depository institutions in the final SOP, and eliminated entirely the unworkable proposal to require private equity investors to act as a “source of strength” for the institutions in which they invest. An acquired depository institution must now have an initial capitalization sufficient to establish and maintain a ratio of Tier 1 common equity¹ to total assets of at least ten percent for the first three years following the acquisition, and a capital adequacy level of “well capitalized” thereafter for the period of ownership by private investors.² The depository institution would have to take immediate steps to restore its ten percent ratio or its well-

¹ The reference to Tier 1 “common equity” is tighter than the original proposal to measure all Tier 1 capital, which would also include, for example, certain non-cumulative perpetual preferred stock.

² “Well capitalized” has the same definition as that found in 12 C.F.R. § 325.103(b)(1). While the ten percent capital standard is less than the requirement in the proposal, it still represents an additional capital burden on these investors. The FDIC generally requires *de novo* banks to maintain a ratio of Tier 1 capital to total assets of at least eight percent for the first three years of operation. In order to be considered “well capitalized,” existing banks must maintain a ratio of Tier 1 capital to total assets of at least five percent.

capitalized status, as appropriate, in the event that it failed to meet these standards. The SOP notes that failure to maintain either requisite capital level will result in the depository institution being treated as “undercapitalized” for purposes of a Prompt Corrective Action, triggering all of the measures that would be available to the depository institution’s regulator.

Cross Support

The SOP provides that if one or more investors own eighty percent or more of two or more depository institutions, the stock of the depository institutions commonly owned by the investors shall be pledged to the FDIC. If any one of these depository institutions fail, the FDIC may exercise such pledges to the extent necessary to recoup losses incurred by the FDIC as a result of the depository institution failure. As noted above, the FDIC may waive this requirement if it determines that exercise of pledges would not result in a decrease to the FDIC’s losses in the event of depository institution failure. While this scales back from the original proposal the circumstances in which cross support may be exercised, the SOP still fails to address fundamental concerns regarding the structural ability of private equity funds to provide such protection and questions about how interests may be aggregated across multiple investors when the investor groups are overlapping but not identical from transaction to transaction.

Affiliate Transactions

The FDIC has determined that the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act, together with those found in the Board of Governors of Federal Reserve’s (“Federal Reserve”) Regulation W and Regulation O, are not sufficient to prevent private capital investors from engaging in inappropriate affiliate transactions. Accordingly, the SOP flatly prohibits extensions of credit to investors, their investment funds if any, and any affiliates of either by insured depository institutions acquired by said investors. “Existing” extensions of credit are exempted, presumably meaning extensions of credit that exist at the time of the acquisition of an insured institution, rather than those in existence on August 26, 2009, although the language is somewhat ambiguous in this regard.

The SOP states that “extension of credit” has the same definition as that found in Regulation W, but “affiliate” is defined more broadly as any company in which an investor owns, directly or indirectly, at least ten percent of the equity of such company and has maintained such ownership for at least thirty days. Investors must provide regular reports to applicable depository institutions identifying all such affiliates.

Secrecy Law Jurisdictions

Investors that employ ownership structures which utilize entities that are domiciled in secrecy law jurisdictions are not eligible to own direct or indirect interests in a depository institution unless the investors: (1) are subsidiaries of companies that are subject to comprehensive consolidated supervision, as recognized by the Federal Reserve; (2) execute agreements on providing information to the depository institution’s primary federal regulator regarding the non-domestic investors’ operations and activities; (3) maintain their books and records (or duplicates thereof) in the U.S.; (4) consent to the disclosure of otherwise-confidential information and agree to cooperate with the FDIC, if necessary, in obtaining information obtained by foreign governmental entities; (5) consent to jurisdiction and agent designation for service of process; and (6) consent to be bound by statutes and regulations administered by the appropriate U.S. federal bank regulatory agency.

The SOP defines “secrecy law jurisdiction” as a country that: (1) applies a bank secrecy law limiting U.S. bank regulators from determining compliance with U.S. laws or preventing them from obtaining information on the competence, experience and financial condition of applicants and related parties; (2) lacks authorization for exchange of information with U.S. agencies; (3) does not provide for minimum standards of transparency for financial activities; or (4) permits offshore companies to operate shell companies without substantial activities within the host country. This last category would seem to sweep in many jurisdictions that may be used as vehicles for parallel investment by non-U.S. investors, regardless of whether there are actual issues with the availability of information from those jurisdictions.

Continuity of Ownership

Investors subject to the SOP are prohibited from selling or transferring their securities in depository institutions for a three year period following the acquisition of a depository institution without the FDIC’s prior approval. The FDIC will not unreasonably withhold such approval in the event that an investor wishes to transfer its securities to an affiliate, provided that the affiliate agrees to be subject to the requirements of the SOP that applied to the investor. The SOP excludes from this requirement mutual funds defined as open-ended investment companies under the Investment Company Act of 1940 that issue redeemable securities allowing investors to redeem on demand.

Prohibited Structures/“Silos”

The SOP reiterates that the FDIC will no longer approve ownership structures that typically involve a private equity firm (or its sponsor) creating multiple investment vehicles funded and apparently controlled by said private equity firm (or its sponsor) to acquire ownership of a depository institution. This will complicate transaction structuring to address holding company regulation issues.

Special Owner Bid Limitation

As originally proposed, investors holding, directly or indirectly, ten percent or more of the equity of a depository institution in receivership will not be considered eligible to be bidders to become investors in the deposit liabilities, or a combination of deposit liabilities and assets, of such failed depository institution.

Disclosure

The SOP states that investors should expect to submit to the FDIC information about themselves and all entities in the ownership chain, including information on the size of the capital fund or funds, diversification, the return profile, marketing documents, the management team, the business model and all other information necessary to assure compliance with the SOP. However, the methods for such submissions are not yet clear. To the extent that any such information constitutes confidential business information, the FDIC will not disclose such information except in accordance with law.

Limitations

The FDIC emphasizes that none of the SOP requirements are intended to replace any determination required by a primary federal banking regulator or federal BHC or THC regulator under applicable statutes or regulations. Similarly, the SOP's requirements are not intended to replace: (1) determinations made and requirements imposed with respect to the general character, fitness and expertise of the management being proposed by investors; (2) the need for a thorough and reasonable business plan that addresses business lines and strategic initiatives and includes appropriate contingency planning elements, satisfactory corporate governance structures and representations; and (3) any other supervisory matters.

If you have any questions about the information in this update, please contact the Sidley lawyer with whom you regularly work.

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