

MORRISON | FOERSTER

BOOTCAMP 2011

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UPDATE ON BASEL III REQUIREMENTS

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Outline

- Basel III proposals
 - new capital requirements
 - effect of proposals on hybrid capital
 - capital conservation ratio
 - countercyclical buffer
 - leverage ratio
 - liquidity ratios
- Further proposals awaited
- Systemically important financial institutions

Basel III Proposals

- BCBS consultative document – December 2009
- BIS announcement and annex – July 2010
- August 2010 consultation on “gone concern” capital requirements
- BCBS agree calibration of capital standards – September 2010
- BCBS proposals endorsed at G20 meeting in Seoul in November 2010
- Final Basel III rules published on 16 December 2010
- Requirements relating to loss absorbency at point of non viability published on 13 January 2011

New Capital Requirements

- Common equity minimum requirement raised gradually to 4.5% of risk weighted assets, phased in in 2013 and 2014
- Overall tier 1 capital requirement raised gradually to 6%, phased in in 2013 and 2014
- Minimum total capital requirement remains at 8%
- New capital conservation buffer of 2.5%, phased in in 2016, 2017 and 2018
- New countercyclical buffer in the range of 0% to 2.5%

New Capital Requirements (cont.)

- Tier 1 capital:
 - common equity
 - non-common equity instruments meeting specific criteria
- Common Equity Tier 1
 - bank's common shares meeting criteria for such classification (or equivalent for non-joint stock companies)
 - stock surplus/share premium on Common Equity Tier 1 instruments
 - retained earnings and other disclosed reserves
 - common shares issued by bank's consolidated subsidiaries and held by third parties (as minority interests) that meet certain additional criteria for inclusion in Common Equity Tier 1 after regulatory adjustments (deductions)

Classification Criteria for Common Shares

- The most subordinated claim in liquidation of the bank
- Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim)
- Principal is perpetual and never repaid outside of liquidation (other than discretionary repurchases or other allowable discretionary capital reductions under relevant law)
- No expectation created at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation
- Distributions paid out of distributable items and not tied or linked to the amount paid in at issuance and not subject to a contractual cap

Classification Criteria for Common Shares (cont.)

- No circumstances under which the distributions are obligatory (no event of default for non-payment)
- Distributions paid only after all legal/contractual obligations have been met (including payments on more senior capital instruments). Therefore no preferential distributions
- It takes the first and proportionately greatest share of any losses as they occur and absorbs losses on a going concern basis proportionately and *pari passu* with all the other instruments within the 3 highest quality capital
- The paid in amount is recognised as equity capital (ie not as a liability) for determining balance sheet insolvency
- The paid in amount is classified as equity under the relevant accounting standards
- It is directly issued and paid-in and the bank can not directly or indirectly have funded the purchase of the instrument

Regulatory adjustments (deductions)

- Deductions from Common Equity Tier 1 include:
 - goodwill/other intangibles (except mortgage servicing rights) (net of associated deferred tax liability)
 - deferred tax assets whose realisation depends on the bank's future profitability (net of associated deferred tax liabilities)
 - treasury stock (unless already de-recognised)
 - certain specified portions of investments in financial institutions not consolidated for regulatory purposes
 - cash flow hedge reserves relating to hedging of items which are not fair valued on the balance sheet
 - any increase in equity capital resulting from securitisation transactions
 - unrealised gains and losses resulting from changes in bank's own credit risk on fair valued liabilities
 - certain other deductions

Additional/hybrid Tier 1 Capital

- To be classified as tier 1 capital, the criteria for non common equity instruments includes:
 - subordinated to all depositors and all creditors
 - not secured or guaranteed
 - perpetual, with no incentives to redeem and no investor put option
 - fully discretionary non-cumulative dividends/coupons
 - callable by bank only after 5 years
 - any return of capital only with prior supervisory authorisation
 - capable of principal loss absorption on a going concern basis

Tier 2 Requirements

- Tier 2 capital to be simplified:
 - elimination of distinction between upper and lower tier 2 (tier 3 to be abolished)
- Minimum Tier 2 criteria:
 - original maturity of at least 5 years, with no incentive to redeem
 - callable only by the issuer and only after 5 years, with prior supervisory approval
 - dividends/coupons – may not have a credit-sensitive dividend feature
 - in a liquidation, subordinated to all non-subordinated creditors

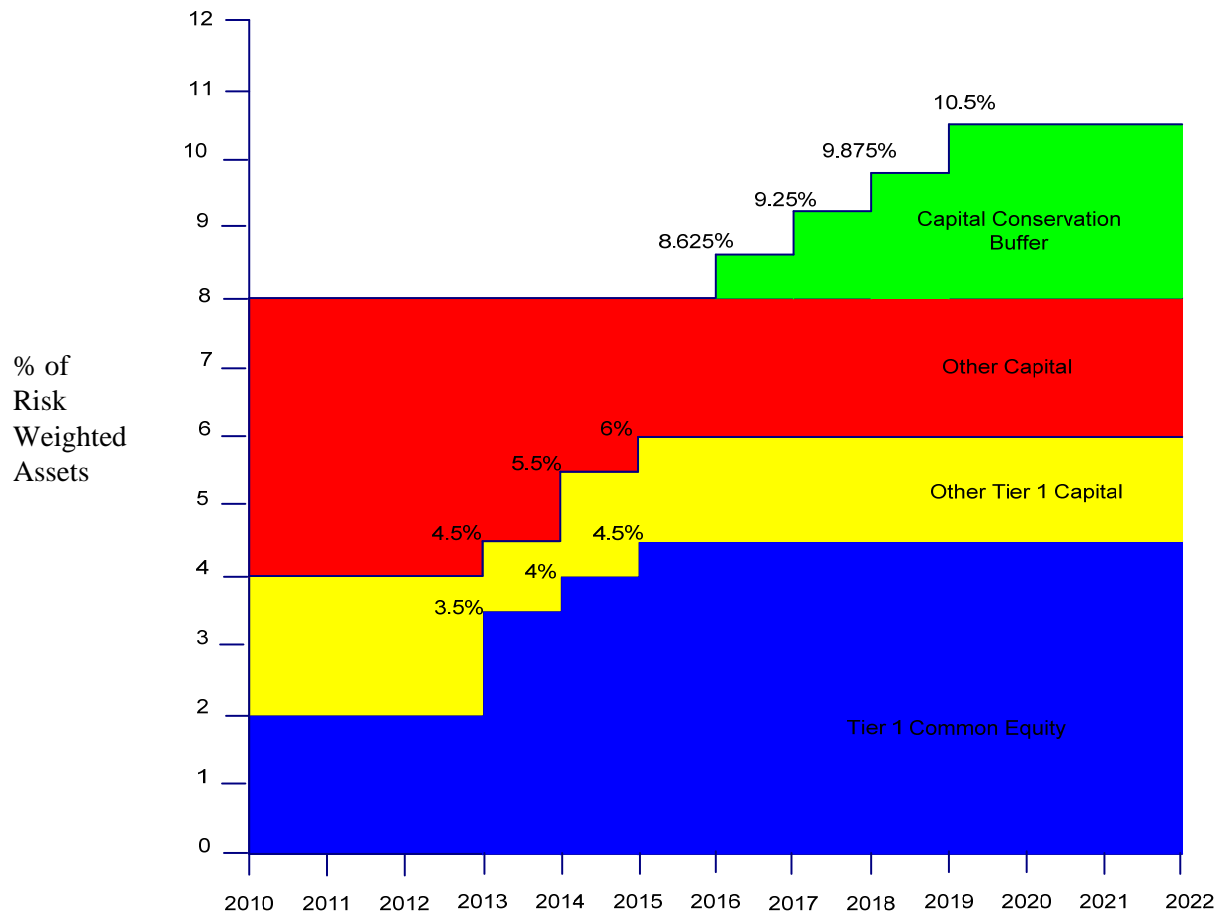
Write-off/conversion

- BCBS consultative document August 2010 – “gone concern” proposal
- Applies to all tier 1 and tier 2 instruments that are not common stock
- Contractual terms providing for write-off/conversion into common stock upon trigger event occurring
- Trigger event is earlier of:
 - the decision to make a public sector injection of capital without which the bank would have become non viable
 - the decision that a write-off / conversion is necessary, without which the bank would become non-viable
- Additional rules for banking groups
- “Going concern” proposals for contingent capital awaited

Phase-In of New Capital Requirements

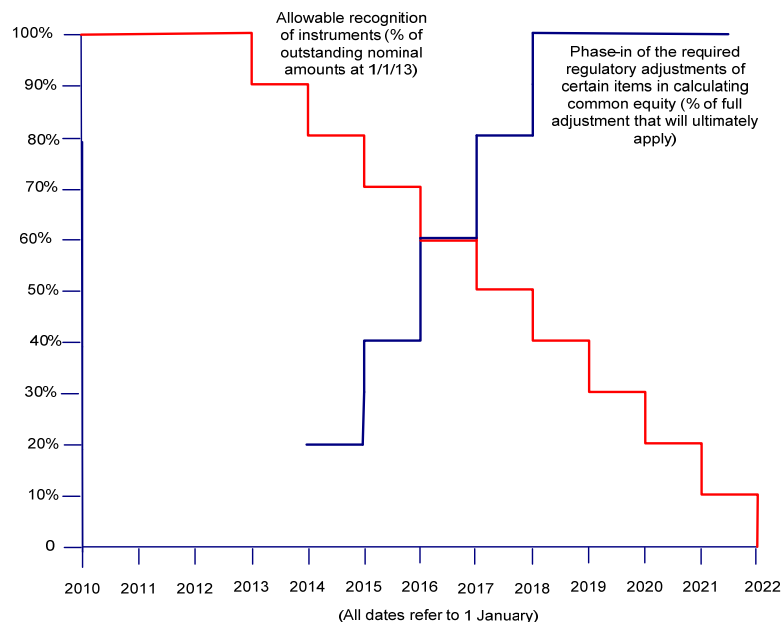
- Minimum common equity and tier 1 requirements to be phased in between 1 January 2013 and 1 January 2015:
 - common equity tier 1 minimum raised to 3.5% in 2013, 4% in 2014 and 4.5% in 2015
 - total Tier 1 capital to be raised to 4.5% in 2013, 5.5% in 2014 and 6% in 2015
- Regulatory adjustments to be phased in from 1 January 2014:
 - initially to be 20% of deduction increasing to 100% by 2018
- Grandfathering of existing instruments:
 - existing capital instruments that no longer qualify as tier 1 or tier 2 capital will be gradually derecognised from 1 January 2013 over 10 years
 - capital no longer qualifying as common equity will be excluded from 1 January 2013 with gradual de-recognition in limited circumstances

Basel III Minimum Capital Requirements



Recognition of (a) Non-common equity instruments (issued before 13 September 2010), that no longer qualify as Tier 1 or Tier 2 capital and (b) Certain non-joint stock company instruments no longer qualifying as Common Equity Tier 1 capital

Capital instruments issued after 12 September 2010 cannot benefit from the phase-out arrangements



Generally, capital instruments no longer meeting the requirements for inclusion in common equity Tier 1 capital will be excluded from common equity Tier 1 from 1 January 2013

Leverage Ratio	Supervisory Monitoring	Parallel Run	Pillar 1
		Disclosure	
Liquidity Coverage Ratio	Observation Period	Minimum Standard In Force	
Net Stable Funding Ratio	Observation Period	Minimum Standard In Force	

Effect of Proposals on Hybrid Capital

- CRD 2 provisions
- Dodd-Frank provisions
- Tier 1 v tier 2
- Current activity:
 - contingent convertibles
 - principal write downs
 - step down, step-up structures

Capital Conservation Ratio

- To comprise common equity
- Restraints on dividends and discretionary bonuses if buffer falls below 2.5%
- Capital conservation ratio to commence in 2016 at 0.625% and increase to 1.25% in 2017, 1.875% in 2018 and 2.5% in 2019

Countercyclical Buffer

- Primary aim is to protect banking sector from periods of excess credit growth
- Aim is to temper build-up phase of economic cycle
- Each jurisdiction to be given discretion to set countercyclical buffer:
 - will be add-on to minimum buffer range under conservation buffer
 - decisions should be pre-announced by 12 months
- Special rules for internationally active banks
- Banks should calculate the buffer with at least the same frequency as their minimum capital requirements

Countercyclical Buffer (cont.)

- EU Consultation Paper – September 2010
- ESB and ESRB to develop principles and technical standards in relation to calculation of buffer add-ons
- Competent authorities to set buffer add-ons
- Add-ons subject to 2.5% ceiling

Leverage Ratio

- Tier 1 leverage ratio to be set at 3% during parallel run period between 2013 and 2017
- Bank level disclosure of leverage ratio and components to start in January 2015
- Supervisory monitoring period to commence on 1 January 2011
- Leverage ratio not to become binding until early 2018
- Current proposals is to base leverage ratio on banks' capital (the numerator) compared to their Exposure (the denominator) on new definition of tier 1 capital.
- Exposure should follow accounting standards.

Leverage Ratio (cont.)

- High quality liquid assets include cash and cash-like instruments in the measure of Exposure
- Securitisation exposures will be counted in a manner generally consistent with accounting treatment
- Derivatives exposures will either follow the applicable accounting treatment or use the current exposure method
- Other off balance sheets are included:
 - commitments
 - unconditionally cancellable commitments
 - direct credit substitutes
- 10% credit conversion factor for any commitments that are unconditionally cancellable at any time by the bank.

Counterparty Credit Risk (“CCR”) Framework

- Basel III makes significant changes to CCR framework with effect from 2013.
- Measures designed to strengthen risk coverage include:
 - expected positive exposure with stressed parameters to address wrong-way risk
 - requirement that banks determine capital charges for CCR using stressed inputs.
 - capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty (credit valuation adjustment)
 - higher capital charges for bilateral OTC exposures to financial institutions

Counterparty Credit Risk (“CCR”) Framework (cont.)

- Banks to determine capital charges for CCR using stressed inputs.
- 1.25 asset value correlation multiplier to large regulated financial institutions whose total assets are at least U.S.\$100bn
- Central counterparties:
 - ongoing IOSCO work
 - standards to be finalised during 2011
 - BCBS consultative document relating to capitalisation of exposures to CCPs

External Credit Ratings

- BCBS believe aspects of existing capital framework encouraged investors to place too much reliance on external credit ratings
- Proposals include:
 - issue specific rating assessment may only be applied to unrated issues by the same issuer that ranks pari passu or senior to rated issue
 - banks to develop methodologies to assess credit risk of securitisation exposures even if rated
 - amendments to eligibility criteria for entities providing credit protection
 - banks should use ratings of CRAs consistently for both risk weighting and risk management purposes

Liquidity Ratios

- Two proposed liquidity ratios:
 - short term liquidity cover ratio (“LCR”)
 - longer-term net stable funding ratio (“NSFR”)
- Liquidity cover ratio:
 - high quality liquid assets to cover net cash outflows over 30 day period
 - builds on traditional internal methodologies used by banks to assess exposure to contingent liability events
 - defined as stock of high quality liquid assets divided by total net cash outflows for next 30 days

Liquidity Ratios (cont.)

- Certain high quality liquid assets (“level 1 assets”) to be included on asset side on an unlimited undiscounted basis
- Level 2 assets must comprise no more than 40% of the overall stock and must have a minimum 15% haircut
- Observation period for liquidity cover ratio commences in 2011 and ratio to be introduced at start of 2015

Liquidity Ratios (cont.)

- Net stable funding ratio:
 - designed to promote resilience over a period of one year
 - builds on net liquid asset and cash capital methodologies used by internationally active banks
 - available stable funding (“ASF”) must be at least equal to required stable funding (“RSF”)
- NSFR should be reported at least quarterly
- NSFR will be a minimum standard by 1 January 2018

BCBS Proposals Still Awaited

- Going-concern proposals
- Systemically important banks
- Trading book review
- Credit ratings and securitisations
- Cross-border bank resolution

G-20 – Systemically Important Financial Institutions

- G-20 meeting in Seoul endorsed FSB’s proposals to reduce “moral hazard risks” posed by SIFIs and address the “too big to fail” issue
- SIFIs should have loss absorbency capital commensurate with system-wide losses that would be occasioned by their failure
- Initial focus on global SIFIs (GSIFIs):
 - FSB and national authorities to draw up list of GSIFIs by mid 2011
- GSIFIs to be required to have greater capacity to absorb losses than under proposed Basel III minimum standards
- More intensive and effective supervisory oversight

G-20 – Systemically Important Financial Institutions (cont.)

- Resolution Frameworks:
 - all jurisdictions should have a resolution framework in place to facilitate rapid resolution of a failing institution
 - depositors should be able to continue to access their deposits
 - authorities must have power to transfer and sell viable parts of the entity
- Internationally active institutions:
 - sharing and co-operation agreements
 - elimination of laws protecting domestic creditors at expense of foreign creditors
 - for GSIFIs, co-operation agreement between home and host authorities
- FSB to draw up criteria for assessing resolvability of SIFIs by March 2011

Any Questions?

There now follows a coffee break.

Session 2 begins at 3.45pm.

Comparison of Dodd Frank Act and EU Regulatory Reform

Peter Green
Jeremy Jennings-Mares

Outline

- OTC derivatives
- Volcker rule and swaps push out rule
- Systemically important institutions
- EU AIFM Directive and U.S. Private Fund Advisers Registration Act
- Other issues

Derivatives - Overview

- Following the financial crisis, the regulation of OTC derivatives has been in sharp focus:
 - initial impetus was in relation to CDS
 - the OTC market generally now faces much greater regulation
- There have been recent detailed regulatory proposals in the U.S. and the EU and other jurisdictions (e.g. Japan)

Derivatives - Overview (cont.)

- September 2009: G-20 Agreement
- Regulatory proposals are focused on four key areas:
 - reducing counterparty risk including strengthening clearing requirements
 - reducing operational risk including greater standardisation and electronic processing
 - increasing transparency including through trade repositories
 - improving market integrity

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act

- Scope:
 - both include very wide definitions including most derivatives
 - in the U.S., FX swaps and forwards may be exempted by regulation
- Regulatory responsibility:
 - in the EU derivative trading continues to be regulated by relevant national regulators
 - CCPs in the EU will also be regulated by national regulators
 - ESMA will have an important role including development of technical standards and overseeing non-EU CCPs
 - Dodd-Frank establishes a bifurcated approach between the CFTC (swaps) and the SEC (security based swaps)

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Non-financial entities:
 - under Dodd-Frank, exemption for non-financial entities which use a swap to hedge or mitigate commercial risk subject to certain conditions
 - EU rules permit non-financials to exclude derivatives which can be objectively viewed as reducing risks directly linked to their commercial activities
 - EU also provides a clearing threshold for non-financials in respect of derivatives not excluded from the clearing obligation

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Clearing requirements:
 - both EU and U.S. require impetus from clearing entities and regulators on which derivatives will be subject to clearing obligation
 - non-discriminatory acceptance for clearing from approved class in both cases
 - EU regulation does not currently require exchange trading for cleared derivatives
- Reporting requirements:
 - reporting requirements to trade repositories are similar
 - in U.S., non-financials must report all swap transactions to repository even if exempt from clearing
 - in EU, non-financials are only required to report to repository if reporting threshold is exceeded
 - EU rules do not currently provide for real time public reporting of derivative transactions but MiFID review envisages post trade reporting requirements for OTC derivatives eligible for central clearing or reported to trade repositories under EMIR

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Trade repositories:
 - similar registration system in U.S. and EU
 - U.S. provisions do not specifically provide for recognition of non-U.S. repositories
 - EU rules do envisage recognition of foreign repositories subject to conditions
 - similar provisions re risk control, disclosure, governance, etc.
- Regulation of CCPs:
 - more detailed cob, organisational and prudential rules in EU. U.S. regulators to produce standards
 - grandfathering of existing CCPs in EU and U.S.
 - both EU and U.S. provide for recognition of foreign clearing systems subject to conditions
 - both provide for minimum capital requirements – currently U.S. proposals are less detailed
 - U.S. regulators may impose shareholding limits
 - no ownership cap in the EU but disclosure of shareholdings and changes in shareholdings required at specified thresholds

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Segregation of collateral requirements:
 - both U.S. and EU contain rules requiring segregation of margin
 - EU rules enable clients of clearing members to require their collateral to be segregated from that of other clients within the CCP
 - in the U.S., in relation to non cleared swaps, counterparties can require segregation of initial margin
 - in relation to cleared swaps, the CFTC is consulting on four alternative approaches to collateral

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Timing:
 - EU regulation intended to be in force by 2012
 - EU technical standards due to be completed by ESMA by end June 2012
 - most provisions of Dodd-Frank and relevant rules to be effective by July 2011
- Other provisions:
 - Dodd-Frank rules enable CFTC to impose position limits
 - EU rules contain no specific rules on position limits – CCPs may however impose these under their risk management obligations
 - no specific provisions relating to interoperability of CCPs under Dodd-Frank
 - under Dodd-Frank non eligible contract participants (ECPs) must execute trades on an exchange

Derivatives - Issues for Cross-border Institutions

- Dodd-Frank will not apply to activities outside the U.S. unless:
 - they have a direct and significant connection with activities in, or effect on, commerce of the U.S. or
 - they contravene such rules or regulations as may be prescribed under the Act necessary or appropriate to prevent the evasion of the relevant provisions of the Act
- Dodd-Frank envisages that swaps may be cleared through foreign clearing houses
- EU draft Regulation:
 - applies to entities with an establishment in the EU
 - envisages CCPs outside the EU subject to specified criteria
- Major cross-border financial institutions are, however, likely to have to consider both sets of rules

Volcker Rule

- Implemented as part of the Dodd-Frank legislation
- Except for certain permitted activities, a “banking entity” cannot engage in proprietary trading or acquire/retain any equity or ownership interest in a hedge fund or private equity fund
- A “non-bank financial company supervised by the Board” that engages in proprietary trading or fund activities will be subject to additional capital requirements and quantitative limits, to be established by rule

Important terms

- “Banking entities” are:
 - bank holding companies (BHCs)
 - non-U.S. entities treated as BHCs
 - insured depository institutions
 - affiliates or subsidiaries of the foregoing
- “Nonbank financial companies supervised by the Board” may engage in proprietary trading but will be subject to rules adopted by the Federal banking agencies, the CFTC, and the SEC relating to:
 - Additional capital requirements
 - Quantitative limits

Important terms (cont.)

- A nonbank financial company is:
 - any company (not including BHCs, exchanges, clearinghouses, swap data repositories) that is “predominantly engaged in financial activities”
 - annual gross revenues derived by the company and all of its subsidiaries from activities that are “financial in nature” and, if applicable, from the ownership or control of one or more insured depository institutions, represent 85% or more of consolidated annual gross revenues of the company
 - consolidated assets of the company and all of its subsidiaries related to activities that are “financial in nature” and, if applicable, from the ownership or control of one or more insured depository institutions, represent 85% or more of the consolidated assets of the company

Important terms (cont.)

- “Supervised by the Board” if systemically significant:
 - test: material financial distress at the company or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company could pose a threat to the financial stability of the U.S.
 - determination based on 2/3 vote of Financial Stability Oversight Council
 - for foreign nonbank financial companies, consideration not limited to U.S. activities and subsidiaries
 - any BHC with total consolidated assets \geq \$50 billion as of January 1, 2010 that participated in the Capital Purchase Program under TARP and ceased to be a BHC will be treated as a NFC supervised by the Board

Important terms (cont.)

- company may establish (or Board may require establishment of) an intermediate holding company for “financial activities” for purposes of Board supervision
- financial activities
 - activities that are financial in nature
 - includes ownership or control of one or more insured depository institutions
 - does not include internal financial activities conducted for the company or any affiliate, including internal treasury, investment, and employee benefit functions
- nonfinancial activities not subject to Board supervision or prudential standards

Important terms (cont.)

- “proprietary trading” defined as engaging as principal for the trading account of the entity in any transaction to acquire or dispose of a security, derivative, contract of sale of a commodity for future delivery, any option on such a security, derivative or contract, or any other security or financial instrument specified by the appropriate federal agencies
- “trading account” means any account used for acquiring or taking positions principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short term price movements, and any other account specified by rule

Important terms (cont.)

- hedge funds or private equity funds includes entities that would be subject to registration under the Investment Company Act but for Section 3(c)(1) (fewer than 100 owners) or for Section 3(c)(7) (those offered only to “qualified purchasers”)
- sponsoring a hedge fund or a private equity fund includes controlling the fund (by virtue of being a general partner or a managing member, or through board control), or sharing a name with the fund

De Minimis Investments

- A banking entity may make and retain an investment in a fund that the banking entity organises and offers; provided, that:
 - it seeks unaffiliated investors for the fund
 - within one year of a fund's start date, the banking entity's investments shall not exceed more than 3% of the total ownership interests in such fund
 - the aggregate of investments in all such funds does not exceed 3% of the banking entity's Tier 1 capital
- The one year period can be extended by up to 2 more years upon application to the Board

Permitted Activities

- Transactions in U.S. government securities (including securities of the GSEs)
- Transactions in connection with underwriting or market-making activities, to the extent designed not to “exceed the reasonably expected near term demands of clients, customers or counterparties”
- Risk-mitigating hedging activities in connection with a banking entity’s individual or aggregate positions, contracts or holdings
- Customer transactions
- The purchase or sale of securities and derivatives by a regulated insurance company engaged in the insurance business, subject to state insurance regulation and federal safety and soundness review

Permitted Activities (cont.)

- Certain proprietary trading that occurs solely outside of the U.S. by a banking entity that is not directly or indirectly controlled by a banking entity organised under the laws of the U.S.
- The acquisition or retention of an ownership interest or the sponsorship of a fund by a banking entity solely outside of the U.S. if interests in the fund are not offered or sold to a U.S. resident and the banking entity is not directly or indirectly controlled by a banking entity organised in the U.S.
- All other activities deemed appropriate by the applicable oversight agencies that would promote the safety and soundness of the banking entity

Permitted Activities (cont.)

- Organising and offering a private equity or hedge fund, if the banking entity (*the “fiduciary” exception*):
 - provides bona fide trust, fiduciary, or investment advisory services
 - provides trust or related services and offers interests in the fund only in connection with providing such services and only to bank customers
 - does not acquire or retain an interest in the funds except for de minimis investments (see above)
 - observes certain limitations on transactions between it and the fund
 - does not guarantee the obligations or performance of the fund

Limitations on Permitted Activities

- No transaction, class of transactions, or activity may be deemed a permitted activity if it would:
 - involve a “material conflict of interest” (to be defined by rule) between the banking entity and its clients, customers, or counterparties
 - result, directly or indirectly, in a material exposure by the banking entity to “high-risk assets” or “high-risk trading strategies” (to be defined by rule)
 - pose a threat to the safety and soundness of the banking entity
 - pose a threat to the financial stability of the U.S.

Permitted Fund Services

- A banking entity may provide prime brokerage services to a sponsored fund if :
 - the provision of such services complies with other applicable restrictions of the regulations
 - the CEO (or equivalent officer) of the banking entity certifies annually to such compliance
 - the Board determines that the transaction is consistent with the safe operation and sound condition of the banking entity

Limitations on Relationships with Funds

- A banking entity that serves as an investment manager, investment adviser or sponsor to a fund or that organises and offers interests in a fund may not enter into “covered transactions”, nor may its affiliates
- Covered transactions – transactions such as extension of credit, issuance of a guarantee, purchase of an asset, etc., which could be used to effectively transfer to the fund the benefit of the bank’s access to the federal “safety net” i.e. lower cost insured deposits and access to the discount window
- For non-bank financial companies supervised by the Board, who carry out such notes in relation to funds, additional capital requirements or other restrictions will be specified by rule

Phase-In Period

- Generally, these provisions shall take effect on the earlier of:
 - 12 months after the date of the issuance of the final rules
 - two years after the date of enactment of the Act
- Bank entities and nonbank financial companies will have two years after the effective date (or two years after the date on which the entity becomes subject to Federal Reserve supervision as a bank entity or a nonbank financial company) to bring their activities into compliance
- This phase-in period may be extended by the Federal Reserve for one year at a time, with extensions not to exceed an aggregate of three years
- However, the Federal Reserve may extend the period in order to permit compliance with a contractual obligation that was in effect on May 1, 2010, in connection with illiquid funds

Milestones



Anticipated Effects

- Generally, for market:
 - proprietary trading limitations (including derivatives activities)
 - will remove certain participants from the market
 - will that impact liquidity? will hedge funds replace banks?
 - how will banks distinguish between market making and risk mitigating trades and proprietary trades?
 - passive investments in funds
 - impacts banks that are sponsors or LPs
 - impacts the private equity market as a whole
 - activities involving funds will be subject to Section 23A/B Federal Reserve Act
 - banks and non-banks also may be subject to additional capital requirements

European Equivalents of Volcker Rule

- In UK, Independent Commission on Banking Call for Evidence in September 2010
- In UK, various legislative developments regarding activities/soundness of financial institutions

UK Financial Sector Stability Developments

- Special Resolution Regime – created powers for UK authorities to transfer all or part of a failing bank’s business to a private sector purchaser or to a publicly-controlled “bridge” bank or to take the bank into temporary public ownership
- Bank insolvency regime and bank administration regime
- Bank recovery and resolution plans (“living wills”)
- Investment banks – special administration regime

European Equivalents of Volcker Rule

- Currently no European-level equivalent to Volcker Rule
- European Commission communication in October 2010 relating to crisis management in the financial sectors and describing certain measures under consideration, such as equivalents of the UK's SRR and living wills
- Possible European legislative proposals spring 2011

Lincoln Provision - Swaps Push-out Rule

- No “Federal assistance” may be provided to any “swaps entity” with respect to any swap, security-based swap, or other activity of the swaps entity
- Clarifies that insured depository institutions may have affiliates that are swaps entities, so long as the institution is supervised by the Federal Reserve and complies with certain provisions applicable to dealings between affiliates under sections 23A/23B of FRA

Key Terms

- Federal assistance:
 - the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility
 - FDIC insurance
 - guarantees
 - in any case, for the purpose of
 - making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity
 - purchasing the assets of any swaps entity
 - guaranteeing any loan or debt issuance of any swaps entity
 - entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity

Key Terms (cont.)

- Swaps entity:
 - only swap dealers and major swap participants registered under the Commodity Exchange Act or Securities Exchange Act (excludes exchanges and clearing houses)
 - excludes insured depository institutions that are major swap participants

Exceptions to Prohibition

- Prohibition on Federal assistance does not apply to insured depository institutions that limit their swap activities to:
 - hedging and other similar risk mitigating activities directly related to the insured depository institution's activities
 - acting as a swaps entity for swaps involving rates or reference assets that are permissible for investment by national banks
 - CDS is permissible only if centrally cleared
- Insured depository institutions still must comply with proprietary trading ban under the Volcker Rule

Effective Date and Transition Period

- Prohibition takes effect 2 years after effective date of the Act
- To the extent an insured depository institution would be subject to the prohibition, the applicable Federal banking agency (in consultation with the CFTC and SEC) shall permit the institution up to 24 months to divest the swaps entity or cease the prohibited activities
 - may extend transition period up to 1 year
- Prohibition only applies to swaps entered into after the end of the transition period

Implications for Foreign Financial Institutions

- On its face, the exceptions for insured depository institutions do not apply to noninsured U.S. branches and agencies of foreign banks
- Colloquy related to § 716 between Senator Lincoln and Senator Dodd may explain Congressional intent regarding the treatment of uninsured U.S. branches and agencies of foreign banks
- Colloquy states that:
 - there was a significant and clearly unintended oversight with regard to the treatment of uninsured U.S. branches and agencies of foreign banks
 - under the U.S. policy of national treatment, uninsured U.S. branches and agencies of foreign banks are authorised to engage in the same activities as insured depository institutions
 - it was not intended to force U.S. branches and agencies of foreign banks to push-out all their swap activities
 - U.S. branches and agencies of foreign banks should be treated the same as insured depository institutions under § 716, including the safe harbour language

Anti-Avoidance

- Council may prohibit Federal assistance to swaps entities on an institution-by-institution basis upon a 2/3 vote
- Basis for determination – When other provisions established by Dodd-Frank Act are insufficient to effectively mitigate systemic risk and protect taxpayers

G-20 – Systemically Important Financial Institutions

- G-20 meeting in Seoul endorsed FSB's proposals to reduce "moral hazard risks" posed by SIFIs and address the "too big to fail" issue
- SIFIs should have loss absorbency capital commensurate with system-wide losses that would be occasioned by their failure
- Initial focus on global SIFIs (GSIFIs):
 - FSB and national authorities to draw up list of GSIFIs by mid 2011
- GSIFIs to be required to have greater capacity to absorb losses than under proposed Basel III minimum standards
- More intensive and effective supervisory oversight
- BCBS to produce report on additional loss absorption capacity of GSIFIs by mid 2011

G-20 – Systemically Important Financial Institutions (cont.)

- Resolution Frameworks:
 - all jurisdictions should have a resolution framework in place to facilitate rapid resolution of a failing institution
 - depositors should be able to continue to access their deposits
 - authorities must have power to transfer and sell viable parts of the entity
- Internationally active institutions:
 - sharing and co-operation agreements
 - elimination of laws protecting domestic creditors at expense of foreign creditors
 - for GSIFIs, co-operation agreement between home and host authorities
- FSB to draw up criteria for assessing resolvability of SIFIs by March 2011

Dodd-Frank – Systemically Important Institutions

- Federal Reserve will have oversight of systemically important non-bank institutions
- Bank holding companies with total consolidated assets equal to or greater than U.S.\$50bn are automatically considered systemically important
 - could include non-U.S. institutions
- Financial Stability Oversight Council can also designate institutions that are systemically important
 - could include non-U.S. institutions
- Systemically significant entities will be subject to increased requirements in certain areas including:
 - capital requirements
 - credit exposure limits
 - recovery and resolution plans / living wills
 - limitation on acquisitions

EU AIFM Directive

- Approved by EU Parliament on 11 November 2010
- Likely to be implemented by all EEA member states by early 2013
- Many implementing measures yet to be drafted
- Will apply to:
 - all EU alternative investment fund managers (AIFMs) managing any AIF
 - all non-EU AIFMs managing an EU AIF or marketing any AIF in the EU
- A fund manager regulated by its home member state is exempt if its assets under management do not exceed €100m
- AIFMs must be authorised before they can provide management services to EU or non-EU AIFs unless an exemption applies

EU AIFM Directive (cont.)

- Additional capital and operational requirements
- Transparency and disclosure requirements
- EU AIFMs will be able to market EU AIFs to professional investors across the EU under a marketing passport
- Subject to notification and certain conditions, from 2015 the passport is extended to EU AIFMs marketing non-EU AIFs across the EU
- From 2015, a non-EU AIFM can obtain a marketing passport and obtain the same market access as an EU AIFM:
 - must be prior authorisation from competent authority of 'member state of reference'
 - other conditions must be satisfied

Dodd-Frank – Private Fund Advisers Registration Act 2010

- Dodd-Frank Act eliminated private advisor exemption from registration under Investment Advisers Act 1940
- New exemptions for:
 - foreign private advisers
 - advisers to venture capital funds
 - advisers to private funds with less than U.S.\$150m in assets under management in the U.S.
 - family offices
- SEC to define the exemptions
- SEC published draft rules in November 2010

Dodd-Frank – Private Fund Advisers Registration Act 2010 (cont.)

- Adviser with principal office and place of business outside the U.S. will qualify for private fund adviser exemption if:
 - it has no U.S. person(s) as a client except for one or more qualifying private funds and
 - all assets managed from a place of business in the U.S. are solely attributable to private fund assets the total value of which is less than U.S.\$150m

Dodd-Frank – Private Fund Advisers Registration Act 2010 (cont.)

- Foreign private adviser exemption applies to any foreign private adviser that:
 - has no place of business in the U.S.
 - has fewer than 15 clients and investors in the U.S. in private funds advised by it
 - has aggregate assets under management attributable to clients in the U.S. (and investors in private funds advised by it) of less than U.S.\$25m
 - does not hold itself out generally to the public in the U.S. as an investment adviser or act as an adviser to a registered investment company or business development company

Other Issues

- Regulation of credit rating agencies
- Reliance on credit ratings (including in capital framework)
- Regulatory capital
- Corporate governance / executive compensation
- Bank levies

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