ALLEN & OVERY

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2012: A challenging year for European asset managers

EDITORIAL

European asset managers face significant regulatory challenges in 2012. The impact of new regulation will be substantial and will cause upheaval and change in the sector. As 2012 begins Allen & Overy's Investment Funds Group has summarised regulations that will impact European asset managers, looking at the policy behind each area of regulation, timelines for its implementation, business models in scope and, most importantly, the potential impact on your business. Links to more detail are included in each section.

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For further information on regulatory change affecting the asset management industry please see **GlobalView**, Allen & Overy's new regulatory tracker: www.aoglobalview.com. The site provides forward-looking and historical timelines for policy implementation, as well as links to source materials and Allen & Overy briefings on the relevant regulations.

European regulation

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD)

What is the policy?

Like the vast majority of new regulation facing the sector the AIFMD is a by-product of the financial crisis. In recognition of the size of investments now owned by alternative investment funds (**AIF**) and controlled by their alternative investment fund managers (**AIFM**), regulators see it as systemically important to have a co-ordinated pan-European Union (**EU**) approach as to how AIF should be managed, use depositaries and leverage, value their assets and market their interests to European-based investors. Compliance with this new approach will enable authorised AIFM to use a pan-EU marketing passport to distribute AIF to those target investors who are classified as MiFID "professional clients" (albeit to be worked out until 2018 over a series of phases).

When does it come into effect and what is going to happen before it does?

The AIFMD came into force on 1 July 2011 and, as a Level 1 EU directive, is due to be transposed into local law in each of the EU member states by 22 July 2013. Prior to that date the Level 2 measures which add further detail to the rules are to be finalised by the European Commission (the **Commission**). In November 2011 the European Securities and Markets Authority (**ESMA**) issued its final advice on a significant number of those Level 2 measures. It is expected that in mid-2012 the Commission will finalise the Level 2 measures and in early 2013 ESMA will finalise its Level 3 guidance. It is also currently expected that the Commission will not follow all of ESMA's advice in deciding on the Level 2 measures.

How could your asset management business be within its scope?

If your regular business is to take investment decisions for, or to provide risk management services to, any fund or other collective investment undertaking (which is broadly and vaguely defined in the AIFMD) which is not authorised as an UCITS (i.e. that fund is an AIF) then you are likely to be subject to the AIFMD. This is because you fall to be classified as an AIFM and the AIFMD looks to regulate each AIFM (rather than directly regulate the AIF it services). Once the AIFMD is transposed into local law its impact on each AIFM and that AIFM's AIF(s) will depend on whether that particular AIFM has its registered office in an EU member state (an **EU AIFM**) or outside the EU (a **Non-EU AIFM**), and whether a relevant AIF is authorised, registered or has its registered office in an EU member state (an **EU AIF**) or outside the EU (a **Non-EU AIF**).

If your business is indirectly appointed (e.g. as a sub-manager) to take investment decisions for, or to provide risk management services to, any AIF then your business may be subject to the AIFMD. This is either because (i) your relationship with the relevant AIF is such that you (rather than the directly appointed manager) are going to be characterised as the AIFM to that AIF or (ii) you are the delegate of the AIFM and that AIFM, if it is an EU AIFM, will be subject to rules on how it can delegate and its retention of liability (which it will probably want to contractually provide for in its delegation to you).

What will it mean for your business?

If you are an EU AIFM and have any AIF(s) that you want to market in your home state or other EU member states then from 22 July 2013 you will have to be authorised by your local regulator and conduct your business in compliance with the AIFMD. However, if you do not wish to market your EU AIF(s) in EU member states from that date, you will have one year to apply for authorisation. If you are already a MiFID firm, getting regulated as an AIFM may be as simple topping-up on your existing license with your regulator. However, the conduct of business upheaval is likely to be significant. For example, the AIFMD introduces rules on remuneration of employees in any authorised AIFM. Being regulated will also impact on the relationships that the AIFM's AIF has with its other service providers due to your status as an EU AIFM

requiring you to ensure the AIF(s) meets certain standards (e.g. on using leverage and having a depositary and an independent valuations process). This is likely to mean the contracts with those service providers need to be amended. If as an EU AIFM you market your relevant EU AIF(s) in the EU then you must use the pan-EU marketing passport, but for non-EU AIF(s) you can continue to market using any available private placement regimes (**PPRs**) which EU member states decide to retain post 22 July 2013 (n.b. there is nothing that obliges those members states with PPRs to do so), provided that such non-EU AIF(s) also meet certain requirements imposed by the AIFMD.

Read more

We have prepared a number of client bulletins that go into significant detail about the scope of the AIFMD as well as the conduct of business issues affecting asset managers and other service providers to AIF:

Analysing the impact of the AIFM Directive

We have also prepared a consolidated version of the AIFMD and the ESMA advice on the Level 2 measures as a useful tool for anyone looking into the detail of the rules and principles contained within the directive. This also available via the link above.

EUROPEAN MARKETS INFRASTRUCTURE REGULATION (EMIR)

What is the policy?

EMIR is the primary vehicle through which the EU is delivering on the G20 commitment for mandatory clearing of standardised derivatives by the end of 2012. It mirrors similar initiatives in the US (as part of the Dodd-Frank Act) and elsewhere globally. The intention is to ensure efficient, safe and sound derivatives markets, reducing counterparty and operational risks, increasing transparency and enhancing market integrity. A key element to this is the increased use of clearing structures through central counterparties (**CCPs**).

EMIR introduces a mandatory CCP clearing obligation for "financial counterparties" in respect of certain "standardised" OTC derivatives – the clearing obligation does not extend to non-financial counterparties except those that deal in material volumes. There are also potentially significant requirements in relation to OTC transactions which are not centrally cleared and reporting obligations for all OTC derivatives.

Certain elements of the regime remain unclear, particularly in relation to the extra-territorial effect of the requirements for business with a non-EU element and how EMIR requirements will interact with similar legislative initiatives elsewhere, such as Dodd-Frank and related rule making currently in progress in the US.

When does it come into effect and what is going to happen before it does?

It is anticipated that the primary EU legislation will be finalised early in 2012. Since it is in the form of an EU Regulation, it will be binding and directly applicable in all EU member states without any further national implementation. However, various significant elements of the new regime are reliant on further guidance from ESMA which will be developed during the course of 2012. The point at which various obligations will actually come into force therefore remains unclear.

The Commission previously stated its intention that the mandatory clearing obligation would come into force by the end of 2012 but the extent of work remaining to be done means that this may be in doubt.

How could your asset management business be within its scope?

The definition of "financial counterparties" who will be subject to the mandatory clearing obligation captures a broad range of EU authorised entities, including UCITS, institutions for occupational retirement provision (subject to delayed implementation for certain pension funds) and AIFs under the AIFMD. Even if you do not meet the "financial counterparty" definition, if you engage in material volumes of OTC derivative trading other than for

commercial hedging purposes (above a threshold which remains to be set by ESMA) for your clients, you or other asset managers they employ could cause them to become subject to the mandatory clearing obligation.

The process of identifying which types of OTC derivative will be considered sufficiently standardised to be made subject to the mandatory clearing obligation has not yet commenced and will be part of ESMA's function. In principle, OTC derivatives referencing any type of underlying (including interest rates, FX, credit, commodities, equities) could be caught provided they meet the objective eligibility criteria established in EMIR. In practice, we expect that the regime will focus at the outset on the most liquid, vanilla contract types for which CCPs at that stage currently have live cleared offerings (in particular, interest rates, credit indices and possibly FX).

What will it mean for your business?

For those who are subject to the mandatory clearing obligation and deal in eligible derivatives, they will be obliged to clear them either by becoming a clearing member of a relevant CCP or becoming a client of an entity which is a clearing member. You will therefore need to consider establishing any such necessary clearing relationships well in advance of the introduction of the obligation.

Cleared business will be subject to very different documentation, risk management (including CCP margin requirements) and cost considerations from OTC dealings (eg. the delivery of liquid assets or cash as margin) so the impact on your business should be assessed as early as possible.

For OTC derivatives business that you continue to be able to undertake on an uncleared basis, there will also be new prescriptive rules issued by ESMA to govern operational and credit risk which will lead potentially to intrusive levels of regulatory engagement in determining collateral levels and related risk management processes for the remaining OTC derivatives market. Guidance is awaited on the details of this aspect.

Read more

Information regarding EMIR and related guidance is contained in the "Clearing" section of GlobalView and will be updated as matters progress.

UCITS IV & V DIRECTIVES

What is the policy?

The UCITS Directive, which set-out the first EU harmonised regulatory regime for European-based retail funds, has largely contributed to the development of the European investment funds industry allowing managers to distribute their UCITS in EU member states. UCITS is now considered to be a worldwide label of quality for retail funds deriving mainly from their investment rules and protections granted to the end-investors. The UCITS IV Directive aims to simplify and reduce the cost of passporting UCITS in EU member states and sets-up a management passport for the benefit of European managers.

When does it come into effect and what is going to happen before it does?

The UCITS IV Directive came into force in 2009 and had to be implemented in each EU member state by 1 July 2011. Member states were given an additional year, until 30 June 2012, to implement the requirement for UCITS to be marketed using key investor information documents (**KIIDs**) instead of simplified prospectuses. Between 1 July 2011 and 30 June 2012, if the local regulator has put rules regarding KIIDs in place, it is possible to market a UCITS with either a simplified prospectus or KIID. As of 1 July 2012, the use of KIIDs will be mandatory throughout all EU member states and simplified prospectuses will not be permitted anymore.

In spite of the July 2011 deadline, most EU member states have not yet fully implemented the UCITS IV Directive (e.g. as of early November 2011, neither Poland, Italy nor Spain had fully implemented the UCITS IV Directive). The Level 2 measures were adopted on 1 July 2010.

How could your asset management business be within its scope?

If you are a UCITS management Company or its delegate then you will benefit from the UCITS IV Directive reducing the previousbarriers affecting UCITS. The marketing process under UCITS IV is simpler and faster as it only requires a notification to be sent from the UCITS home regulator to the host regulator. The old lengthy local registration process subject to the approval of the local regulator is no longer applicable. The host regulator cannot deny the registration of a structured UCITS, even though it may have doubt about the eligibility of the underlying financial index of the structured UCITS under the UCITS Directive.

As a result of the management passport, a UCITS management company is now authorised to set-up and manage UCITS established in another EU member state on a cross-border basis or through a branch. There is no longer any need to go through a local UCITS management company to set up and manage local UCITS.

The implementation of UCITS IV is an opportunity for the rationalisation of the products range with the new feeder/master and cross border merger regimes, subject to the expected clarification of the applicable tax treatment. This rationalisation will improve the competitiveness of European asset management activities through economies of scale in the marketing of UCITS (mainly through feeder funds) and trigger the increase of the assets under management per UCITS.

What will it mean for your business?

Based on the management passport, the delegation route as well as the up-coming new regulatory synergies with the AIFM regulated status, it is a good time to revisit your organisation and location of fund management companies within or outside the EU to ensure that the investment management, risk management, administrative and marketing functions are run in the best EU or non-EU location, whether within entities locally regulated or not. This may entail a regulatory arbitrage between core and non-core fund/asset management activities driven by a cost/profitability approach.

Next step: UCITS V

The Commission intends to strengthen the strict liability of UCITS depositaries and regulate the remuneration of the employees of UCITS managers in a manner similar to the measures set out for AIFM under the AIFMD, i.e. aligning the interests of UCITS managers with those of investors and reducing systemic risk.

Read more

We have prepared a bulletin on the interactions and overlaps between AIFMD, UCITS IV & V Directives and MFID:

AIFMD, UCITSD and MiFID: Interactions and Overlaps

MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II (MIFID II)

What is the policy?

The Commission cites several reasons for the revision of MiFID, one of which is investor protection. One aspect of this is the Commission considers that banks and other financial intermediaries give tainted advice, as they are strongly motivated by inducements paid by product providers such as asset managers. The Commission also considers that this applies to asset managers that allocate products for which they receive retrocession payments, rather than stocks or bonds. The Commission intends to prohibit the acceptance of inducements by asset managers. As regards advisors, they will be given the choice to either inform the client that their advice is not independent – in which case they can continue to

receive inducements – or to tell their clients that their advice is independent, which means that they would no longer be able to accept inducements.

When does it come into effect and what is going to happen before it does?

MiFID II will probably come into force in 2012, and will have to be implemented by EU member states in 2014 at the latest. While few market participants think that the proposed rules on inducements will become more liberal, it is known that some members of the European Parliament want to ban advisers from accepting inducements completely, rather than giving them the choice of declaring themselves as non-independent.

How could your asset management business be within its scope?

If you are an asset manager that makes, or whose funds make, retrocession payments then you will be indirectly affected by MiFID II. Your third party distributors, who receive those retrocession payments when selling your products will no longer be allowed to accept such fees. Therefore, they may be more inclined to sell other, non-retrocession paying products. Fund-linked insurance products may be favoured by distributors, as such products are not currently be caught by the revised Directive.

What will it mean for your business?

Selling your funds may become less attractive for your third party distributors. This is true for all funds that pay retrocessions. While some fund products that pay little or no retrocession fees may not be affected by the proposals, products such as ETFs may be caught by other current ESMA proposed changes. For example, synthetic ETFs, which do not physically replicate an index, but through a total return swap, may be adversely affected by MiFID II if they can no longer be sold on an "execution-only" basis. Rather, synthetic ETFs may be considered "complex products", which can only be sold subject to the seller having conducted an appropriateness test. The need to conduct such a test may act as a disincentive for the selling of such complex unds.

Read more

We are preparing a number of bulletins providing more information about MiFID II. The bulletin linked to below explains in more detail the new rules applicable for banks who distribute products to retail clients:

MiFID Review: the impact on your business with private clients

SOLVENCY II

What is the policy?

Solvency II is the new prudential regime for most insurers and reinsurers authorised in the European Economic Area (**EEA**) which will replace the existing framework for prudential supervision. A key aim is to align each undertaking's solvency requirements and assets with the risks inherent in its business.

When does it come into effect and what is going to happen before it does?

The transposition date for Solvency II is not yet final. However, it is likely that Solvency II will have to be transposed into Member State law by 1 January 2013, and will apply to insurers and reinsurers from 1 January 2014. The Level 2 measures, which contain the detailed provisions of the Solvency II regime, are not yet final, but are expected to be published in the second or third quarter of 2012.

Why does Solvency II matter for asset management?

Insurers and reinsurers are important institutional investors: European insurers and reinsurers are the largest investors in Europe in absolute terms and the largest debt investors (Fitch 2011). Investment by insurers and reinsurers accounts for 30% of European managers' assets under management (Fitch: 2011). Solvency II will affect investment decisions taken by insurers and reinsurers in the following ways:

- firms using a standard formula to calculate their solvency requirement will be required to apply a specified capital charge for the assets they hold. Riskier assets are likely to attract a larger capital charge, making them more "expensive" to hold. Anecdotally, high rated fixed income is likely to be less expensive than equity;
- it seems likely that insurers and reinsurers will no longer be subject to express asset and counterparty concentration requirements. Insurers and reinsurers will, instead, be guided by the amount of capital they have to hold against each asset (by way of a capital charge), and by the "prudent person principle". The prudent person principle requires firms to invest only in "assets and instruments whose risks [it] can properly identify, measure, monitor, manage, control and report" and to invest in a manner which ensures the "security, quality, liquidity and profitability of the portfolio as a whole"; and
- investment by insurers and reinsurers in securitisations is likely to be more costly as a result of higher capital charges imposed in relation to asset-backed securities, and more practically difficult as a result of onerous due diligence requirements proposed to be imposed in relation to such investments.

Does Solvency II have any extra-territorial effect?

Solvency II contains a concept of "third country equivalence" which permits entities in non-EEA jurisdictions to be treated favourably in certain respects (especially in relation to the group solvency requirement). Countries seeking third country equivalence could implement Solvency II-like rules in order to gain equivalence, which might be expected to mean a similar treatment of assets to that set out in Solvency II.

Asset Managers from outside the EEA seeking to court investment by EEA insurers will need to be mindful of the regulatory treatment their offering will receive under Solvency II.

US regulation

INVESTMENT ADVISERS ACT OF 1940 – REGISTRATION AND REPORTING REQUIREMENTS

What is the policy?

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank Act**) eliminated the "private adviser exemption" upon which many advisers or managers (including advisers or managers based outside of the US) had relied in order to avoid registering as an "investment adviser" with the US Securities and Exchange Commission (**SEC**). Instead, the Dodd-Frank Act now provides for three limited exemptions from registration for advisers to "private funds", the most relevant of which are the Foreign Private Adviser Exemption and the Private Fund Adviser Exemption.

The Foreign Private Adviser Exemption is available to any investment adviser that (i) has no place of business in the US, (ii) has, in total, fewer than 15 clients in the US and/or investors in the US in private funds advised by the investment adviser, (iii) has aggregate assets under management attributable to such U.S. clients and investors of less than US$25 million, and (iv) does not generally hold itself out to the US public as an investment adviser.

The Private Fund Adviser Exemption is available to any investment adviser solely to private funds that have less than US$150 million in assets under management from the US. This exemption would be available to a non-US adviser whose activities in the US are limited solely to managing

qualifying private funds, provided that, if the non-US adviser has a place of business in the US, it manages in aggregate less than US$150 million in private fund assets from such US place of business. A non-US adviser may advise non-US clients other than private funds from outside the US. A Private Fund Adviser would be deemed an "**Exempt Reporting Adviser**" and, while not required to register as an investment adviser with the SEC, must comply with certain reporting requirements regarding the private funds they advise and background information on their business operations.

When does it come into effect?

Any "investment adviser" that does not meet one of the three limited exemptions provided for in the Dodd-Frank Act must become registered with the SEC by March 30, 2012. However, because an initial application for registration can take up to 45 days to be approved by the SEC, advisers or managers should file their applications by February 13, 2012. Exempt Reporting Advisers must file their initial reports on Form ADV by March 30, 2012.

What will it mean for your business?

European asset managers will have to determine whether they fall into any of the exemptions from registration provided for in the Dodd-Frank Act, which requires a detailed facts and circumstances analysis. For example, calculating the number of US clients and investors may require looking through private funds to determine who would be an "investor" or a "client" for purposes of the Foreign Private Adviser Exemption. If it is determined that none of the exemptions are available, you must register with the SEC by completing Parts 1, 2A and 2B of Form ADV. In addition, registered investment advisers are required to adopt and implement policies and procedures that are reasonably designed to prevent and detect violations of the Investment Advisers Act of 1940 and other federal securities laws, as well as a written code of ethics. If you are deemed an Exempt Reporting Adviser, you must complete certain sections of Part 1 of Form ADV. Both the full registration and the reporting requirement for Exempt Reporting Advisers can be significant undertakings due to the detailed information requested. Asset managers should also take note that the SEC's Division of Enforcement recently announced that it will be scrutinizing Forms ADV to determine whether investment advisers have filed false or misleading information, and recent SEC enforcement actions have focused on advisers' compliance infrastructure.

Read more

We have prepared a client bulletin that goes into significant detail as to the scope of the registration and reporting requirements:

The Volcker Rule and Foreign Banks, Part II: The "Foreign Funds Exemption" and the Outer Limits of Extraterritorial Reach

SECURITIES EXCHANGE ACT OF 1934 – LARGE TRADER REPORTING

What is the policy?

In order to enhance its ability to monitor and investigate the impact active market participants have on the securities markets, the SEC recently adopted new Rule 13h-1, which is likely to impose significant disclosure obligations and other compliance burdens on market participants deemed to be "**Large Traders**". A Large Trader is a US or non-US market participant that directly or indirectly exercises investment discretion over one or more accounts and effects transactions (including the exercise or assignment of certain option contracts) for the purchase or sale of any National Market System (**NMS**) security for or on behalf of such accounts by or through one or more US-registered broker-dealers in an aggregate amount equal to or exceeding: (i) 2 million shares or shares with a fair market value of US$20 million during a calendar day; or (ii) 20 million shares or shares with a fair market value of US$200 million during a calendar month. Once a market participant qualifies as a Large Trader, it must file Form 13H to disclose a fair amount of information, including the types of business the Large Trader or its affiliates engage in, a description of the Large Trader's operations and trading strategies, whether the Large Trader or any of its affiliates is registered with the US Commodity Futures Trading Commission (**CFTC**) or regulated by a foreign regulator, and an organizational chart illustrating the Large Trader, its parent company (if any), its affiliates

that exercise investment discretion over NMS securities (**Securities Affiliates**), and its CFTC-registered affiliates. A parent company can file one Form 13H on behalf of all of its Large Trader subsidiaries as long as it "controls" such subsidiaries.

When does it come into effect?

Rule 13h-1 became effective as of October 3, 2011. Large Traders must identify themselves to the SEC by submitting an initial Form 13H within 10 days of meeting the aggregate thresholds discussed above, and subsequently submit an Annual Filing every year. Large Traders are also required to amend the Form 13H if the information therein becomes inaccurate.

How could your asset management business be within its scope?

If your regular business is to exercise investment discretion over any accounts for which you enter into transactions involving US securities, you may be required to comply with Rule 13h-1. It is important to review your trading activity to determine whether you meet or exceed the aggregate thresholds discussed above.

What will it mean for your business?

If you determine that you meet the Large Trader definition, you will be required to complete and submit the Form 13H, as well as an Annual Filing and amended Form 13H whenever the filing becomes inaccurate for any reason. If your organization is on the borderline of the aggregate thresholds mentioned above, you can elect to either (i) voluntarily file Form 13H or (ii) not file Form 13H and instead monitor your aggregate trading activity to see whether the thresholds are triggered. However, if you follow the latter approach, it is important to remember that once the aggregate thresholds are triggered, you must file the Form 13H within 10 days. We caution that preparing a Form 13H can be a significant undertaking, and would likely take more than 10 days to prepare, especially if you elect to file one Form 13H at the parent company level.

Read more

We have prepared a client bulletin that goes into significant detail as to the scope of the Large Trader reporting requirements:

SEC Adopts New Rule Requiring Disclosure of Trading Activity

SECTION 619 OF THE DODD-FRANK ACT, AKA THE "VOLCKER RULE"

What is the policy?

In January 2010 following consultation with adviser and former regulator Paul Volcker, President Barack Obama proposed a rule (the **Volcker Rule**) aimed at restricting the ability of banks to engage in proprietary trading or own, invest in or sponsor hedge funds or private equity funds for their own profit. The simple principle behind the Volcker Rule was that financial institutions "should not be allowed to run … hedge funds and private equit[y] funds while running a bank backed by the American people". Despite no indication that funds had contributed to the financial crisis (and no attempt to link bank failure to private funds) the President's administration was determined to protect taxpayers from further bail-outs by limiting fund sponsorship and investment.

When does it come into effect and what is going to happen before it does?

On 21 July 2010 the Dodd-Frank Act, which at section 619 set forth guiding principles for the Volcker Rule, became law. In October 2011, four of the five federal agencies tasked with implementing the Volcker Rule published for comment their proposed implementing measures. The proposed rule is subject to comment until February 2012, and the Volcker Rule is due to become effective on 21 July 2012.

Once the Volcker Rule becomes effective, financial institutions have a two-year period to comply with its provisions. The compliance grace period ends on 21 July 2014, but after this date a financial institution can apply to the Board of Governors of the Federal

Reserve System (the **Board**) for up to three additional one-year extensions to the grace period (potentially extending the period for compliance to 21 July 2017). In seeking to apply these extensions it should be noted that there is no guarantee they will be granted by the Board, which has broad discretion to accept or deny applications. In addition to the three one-year extensions, the Volcker Rule also provides for a five-year "illiquid fund exemption" for financial institutions that had a contractual obligation in respect of an illiquid fund that was in effect on 1 May 2010 (potentially allowing maximum extension of the grace period to 21 July 2022 in respect of illiquid funds). The Board has indicated that it intends to apply the illiquid fund exemption in a restrictive manner, retaining wide discretion to deny applications and adopting a very narrow definition of "illiquid fund".

How could your asset management business be within its scope?

The Volcker Rule applies to any "banking entity", which is defined to include (i) any insured depository institution, (ii) any company that controls an insured depository institution, (iii) any non-US banking organization with a branch or agency in the US and (iv) any affiliate or subsidiary of any of the foregoing. Because the Volcker Rule defines "banking entity" so broadly, its provisions will apply to the asset management arm of any bank that is subject to oversight by the Board due to a branch or agency in the US.

What will it mean for your business?

For all European banking entities, the Volcker Rule will require one or both of two courses of action:

- The banking entity will have to tailor its funds activities to fit in the Volcker Rule's "foreign funds exemption". We recently described the foreign funds exemption as well as issues surrounding its interpretation and future application in this e-Alert:

  The Volcker Rule and Foreign Banks, Part II: The "Foreign Funds Exemption" and the Outer Limits of Extraterritorial Reach

- If the foreign funds exemption is either not practicable or otherwise not desirable, the European banking entity will have to comply with the restrictions of the Volcker Rule. We give a general outline of these restrictions with interpretation of what they mean here:

  Walking a Narrow Path: The Proposed Volcker Rule and Bank-Affiliated Asset Managers

Read more

Including the items referenced above, we have prepared a number of client bulletins that go into significant detail as to the scope and meaning of the Volcker Rule:

Agencies release proposal to implement Volcker Rule and request comment

The Volcker Rule and Foreign Banks Part I

DODD-FRANK ACT – DESIGNATION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTIUTIONS (SIFIS)

What is the policy?

Congress created the Financial Stability Oversight Council (the **Council**) as part of the Dodd-Frank Act's efforts to mitigate the threat to US financial markets of systemic risk caused by the failure of a large banking entity or other large financial institution. The Council's task is to identify risks to the stability of the US financial markets. As part of this task, the Council is charged with designating certain large banking institutions and non-bank financial institutions as SIFIs. An institution that is deemed to be a SIFI is subject to enhanced regulation and supervision by the Board, as described below.

What types of companies are SIFIs?

SIFIs include (i) bank holding companies with US$50 billion or more in total consolidated assets (**Bank SIFIs**), and (ii) non-bank domestic or foreign companies that are predominantly engaged in financial activities in the United States (**Non-Bank SIFIs**). Bank SIFIs are easily identified, but the scope of Non-Bank SIFI status is unclear. The Dodd-Frank Act uses an assets and revenue test to determine whether a company is "predominantly engaged in financial activities," but provides the Council with the ability to develop the criteria and processes for determining when a company is a Non-Bank SIFI. The Council has issued, but not yet adopted, proposed rules setting forth a three-step process (in each step narrowing the universe of companies it is reviewing) and a six-factor framework (based on broad factors for consideration set forth in the Dodd-Frank Act) to determine when a non-bank company should be designated as a Non-Bank SIFI. The six factors the Council intends to use are:

- size;
- interconnectedness with the broader financial system;
- substitutability of the company's goods or services;
- leverage;
- liquidity risk and maturity mismatch; and
- existing regulatory scrutiny.

The Council will examine these categories from a qualitative perspective and, in the case of certain factors, using broadly applied quantitative thresholds.

What does designation as a SIFI mean for a company?

Companies that are designated Bank SIFIs or Non-Bank SIFIs are subject to enhanced oversight and regulation by the Board. The Dodd-Frank Act requires the Board to adopt certain stringent prudential standards that will apply to SIFIs. The Board recently proposed rules setting out these prudential standards. Notably, the proposed rules would not apply to non-US Bank SIFIs; the Board plans to issue a separate release addressing prudential standards for non-US Bank SIFIs in the near future. As proposed, SIFIs would:

- be required to submit an annual "capital plan" to the Board that describes, among other things, its projected capital holdings and uses of capital for the upcoming nine quarters;
- be required to meet certain capital requirements;
- be required to conduct periodic stress tests to measure liquidity needs and capital holdings under various stressed scenarios;
- be required to limit the SIFI's net credit exposure to any one counterparty;
- be required to create a risk committee of the SIFI's board of directors and designate a Chief Risk Officer;
- if deemed a "grave threat" to US financial stability, maintain a debt-to-equity ratio of no more than 15-to-1; and
- be subject to an escalating four-step early-remediation regime in the event the organization begins to deteriorate and create a "living will" that describes the SIFI's processes and procedures in the event it must wind down.

How could your asset management business be within its scope and what will it mean for our business?

As discussed above, the current rule proposal for regulating SIFIs only applies to domestic SIFI's and non-US Non-Bank SIFIs, but a subsequent rule proposal is expected shortly on regulating non-US Bank SIFIs. At this time our expectation is that the rule proposal for regulating non-US Bank SIFIs will be similar to the rule proposal discussed above. As a result, during the early part of 2012, non-US asset managers should follow the developments concerning the rule proposals for designating SIFIs and for regulating non-US SIFIs.

Read more

We have prepared a client bulletin that goes into significant detail as to the rule proposal for designating SIFIs: Designation of SIFIs: Uncertainty Lingers in the Wake of Proposed Rulemaking

Key contacts

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