2012 Mutual Funds and Investment Management Conference

Dodd-Frank Implementation: Are We There Yet?

Implications of the Volcker Rule and Systemic Risk Regulation

March 20, 2012

Presenters

Frances M. Stadler, Moderator
Investment Company Institute

Amy Friend
Promontory Financial Group, LLC

David A. Luigs
Debevoise & Plimpton LLP

Laura J. Merianos
The Vanguard Group, Inc.

David Oestreicher
T. Rowe Price Associates, Inc.

Areas of Focus

- Volcker Rule
- Systemic Risk Regulation
  - SIFI Designation
  - Regulation of SIFIs
  - Office of Financial Research

Volcker Rule

Volcker Rule: Statutory Prohibitions

- "Unless otherwise provided in this section, a banking entity shall not –
  - (A) engage in proprietary trading; or
  - (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund."

Volcker Rule: Permitted Activities

- Transactions in U.S., agency, GSE, state/municipal securities
- Underwriting, market making and risk-mitigating hedging
- Transactions "on behalf of customers"
- Foreign bank activities "solely outside the U.S."
- Other activities that regulators determine promote safety and soundness and financial stability

Issues of Concern to Registered Funds

- Overly broad definitions
  - "Banking entity"
    - Newly launched fund
  - "Covered fund"
    - "Commodity pools" and certain foreign funds

Issues of Concern to Registered Funds (cont'd)

- Exemptions too narrow
  - Authorized participants to ETFs
  - Asset-backed commercial paper and tender option bond programs
  - Municipal securities; foreign sovereign debt
  - Transactions in certain foreign securities

Issues of Concern to Registered Funds (cont'd)

- Impact on liquidity and functioning of the financial markets
  - Market making
  - Risk-mitigating hedging

Systemic Risk Regulation

SIFI Designation: Statutory Requirements

- FSOC authorized to designate on a 2/3 vote (must include Treasury)
- Standard – if:

  (1) material financial distress at the company, or

  (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities

  could pose a threat to U.S. financial stability
- Based on enumerated criteria or other risk-related factors

SIFI Designation: FSOC Rulemaking

- Supplemental Notice of Proposed Rulemaking (10/18/11)
  - Proposed rule text largely tracks statutory language
  - Proposed guidance outlines 3-stage evaluation process

SIFI Designation: FSOC Rulemaking (cont'd)

- Stage 1: initial identification
  - Company has $50 billion in total consolidated assets and meets one of five other tests relating to:
    - CDS outstanding
    - Derivative liabilities
    - Loans and bonds outstanding
    - Leverage ratio
    - Short-term debt ratio

SIFI Designation: FSOC Rulemaking (cont'd)

- Stage 2: "robust" evaluation of Stage 1 companies
  - Size
  - Lack of substitutes
  - Interconnectedness with other firms
  - Leverage
  - Liquidity risk and maturity mismatch
  - Existing regulatory scrutiny

SIFI Designation: FSOC Rulemaking (cont'd)

- Stage 3: in-depth review of companies being considered for SIFI designation
  - Will receive notice from FSOC
  - Evaluation of information collected directly from the company, including confidential business information

SIFI Designation: FSOC Rulemaking (cont'd)

- Asset managers "may pose risks that are not well-measured" by Stage 1 criteria
- FSOC to analyze:
  - Whether asset management companies pose any potential threats to U.S. financial stability
  - How best to address any such threats (i.e., SIFI designation/regulation or other regulatory means)

Implications of SIFI Designation

- Federal Reserve supervision of SIFI and its subsidiaries
- Federal Reserve-imposed enhanced prudential standards
  - Will also apply to bank holding companies with at least $50 billion in total consolidated assets

SIFI Regulation: Enhanced Prudential Standards

- Dodd-Frank Act requires:
  - Enhanced risk-based capital and leverage requirements
  - Enhanced liquidity requirements
  - Enhanced risk management and risk committee requirements
  - Single-counterparty credit exposure limits and reporting
  - Stress tests (by Federal Reserve/company)
  - Living will

SIFI Regulation: Enhanced Prudential Standards (cont'd)

- Federal Reserve proposal would apply "same set" of standards to large BHCs and SIFIs
  - Notes that Federal Reserve may tailor the standards to different companies either individually or by category
- Comments due April 30

Office of Financial Research

- Established within Treasury to support the work of FSOC and its member agencies
- Will collect and maintain data and perform systemic risk-related research
- Must issue rules to standardize the types and formats of data reported and collected on behalf of FSOC

Office of Financial Research: Authority

- "The Office may . . . require the submission of periodic and other reports from **any financial company** for the purpose of assessing the extent to which a financial activity or market in which the financial company participates, or the financial company itself, poses a threat to the financial stability of the United States."

Office of Financial Research: Funding

- Funded for first two years by Federal Reserve, then through assessments on large BHCs and SIFIs
  - Treasury proposal on OFR assessments pending