The Volcker Rule and Systemic Regulation: Implications for Registered Funds and Advisers

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The outline highlights rulemakings promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") that may have an impact on mutual funds and advisers to mutual funds. Certain rulemakings may affect mutual funds and fund advisers directly, while others may affect funds and advisers indirectly, either because they are affiliated with firms that will be directly affected or because of their position as investors in portfolio companies that will be subject to the various rulemakings. Funds and advisers may also be affected due to their positions as investors in the financial markets, financial instruments, or financing vehicles that are affected by the rules. In this outline, we specifically focus on the Volcker Rule and rulemakings that will affect nonbank systemically important financial institutions.

I. **The Volcker Rule** (76 Fed Reg. 68846) (Proposed Rule – extended comment period ended February 13, 2012)

A. Implementing Dodd-Frank Act Section 619, the Federal Reserve Board ("FRB"), Securities and Exchange Commission ("SEC"), Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC") proposed these rules in October, 2011. The Commodities Futures Trading Commission ("CFTC") also proposed substantially identical rules in January 2012.

B. Comments on the FRB, SEC, FDIC, and OCC proposed rule were originally due in January 2012, but the comment period was extended to February 13, 2012. Comments on the CFTC proposed rule are due April 16, 2012.

C. The Dodd-Frank Act Volcker Rule provisions become effective 12 months after issuance of final rules by the FRB, SEC, FDIC, OCC, and CFTC, or July 21, 2012, whichever is earlier. Since no final rule has been issued, the effective date will be July 21, 2012.

D. The Dodd-Frank Act provides for the agencies to impose additional capital requirements and quantitative limits on systemically important, designated nonbank financial companies with respect to their proprietary trading and fund activities that would be prohibited by the Volcker Rule for banking entities. The agencies have not yet proposed any such requirements. Systemically important financial institutions are further discussed below in Section II.

E. Covered banking entities:

1. Insured depository institutions;

2. Companies that control insured depository institutions;

3. Companies treated as bank holding companies under section 8 of the International Banking Act of 1978; and

4. Any affiliate or subsidiary of the above entities.

5. The preamble to the proposed Volcker Rule notes that mutual funds would not be considered subsidiaries or affiliates of banking entities if the banking entity only provides advisory or administrative services to, has certain limited investments in, or organizes, sponsors and manages a mutual fund in accordance with the Bank Holding Company Act.

6. The ICI has commented that funds registered under Investment Company Act of 1940 should be excluded from the definition of "banking entity."

7. The ICI has commented that non-U.S. equivalents of U.S. registered funds should be excluded from the definition of "banking entity."

F. Prohibitions Against Proprietary Trading

1. Generally, prohibits covered banking entities from engaging in proprietary trading.

2. Definitions:

(a) Proprietary trading: engaging as principal for the trading account of the covered banking entity in any purchase or sale of one or more covered financial positions. Does not include acting solely as agent, broker or custodian for an unaffiliated third party.

(i) The ICI has commented that the initial presumption of principal trading as proprietary trading activity should be eliminated.

(b) Covered financial position:

(i) Any position, including any long, short, synthetic or other position in:

(1) A security, including an option on a security;

(2) A derivative, including an option on a derivative; or

(3) A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.

(ii) Excludes loans, commodities, or foreign exchange or currency.

(c) Trading account:

(i) Any account used by a banking entity to:

(1) Acquire or take one or more covered financial positions for the purpose of short-term resale, benefitting from actual or expected short-term pricing movements, realizing short-term arbitrage profits, or hedging such positions;

(2) Acquire or take one or more covered financial positions that are market risk capital rule covered positions if the banking entity or its holding company calculates risk-based capital ratio under the market risk capital rule;

(3) Acquire or take one or more covered financial positions for any purpose, if the covered banking entity is an SEC-registered or municipal securities dealer, registered government securities dealer, SEC-registered security-based swap dealer, CFTC-registered swap dealer, or otherwise engaged in the business of a dealer, provided the covered financial position is taken in connection with such business activities.

(ii) An account is presumed to be a "trading account" if it is used to acquire or take a covered financial position held for 60 days or less. The covered banking entity can show that the position was not acquired or taken principally for short-term resale, benefitting from actual or expected short-term pricing movements, realizing short-term arbitrage profits, or hedging positions.

(iii) Excludes accounts to the extent the account is used to acquire or take a position in one or more covered financial positions:

(1) That arise under a written repurchase or reverse repurchase agreement under which the covered banking entity has agreed to purchase and sell a stated asset, at stated prices, on stated dates or on demand with the counterparty;

(2) That arise under certain written securities lending agreements under which the covered banking entity lends or borrows a security temporarily to or from another party;

(3) For the bona fide purpose of liquidity management in accordance with certain written liquidity management plans;

(4) That are acquired or taken by a covered banking entity that is a registered derivatives clearing organization.

3. Exemptions:

(a) Underwriting activities.

(b) Market making-related activities.

(i) The ICI has commented that the market making exemption should be tailored to accommodate less liquid markets and securities.

(c) Risk-mitigating hedging activities.

(i) The ICI has commented that the hedging exemption should be clarified so as to not impair the liquidity of the markets.

(d) Other trading activities:

(i) Purchases or sales of obligations of the United States, any state, political subdivision or an agency thereof, including instruments issued by the Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution.

(1) The ICI has commented that the government obligations exemption should cover all municipal securities and non-U.S. government securities.

(ii) Purchases or sales on behalf of customers, if:

(1) The purchase or sale is conducted by a covered banking entity acting in a fiduciary capacity for a customer, is conducted for the account of the customer, and involves solely covered financial positions of which the customer is beneficial owner;

a. In a footnote, the preamble to the proposed rule notes that trading by banking entities acting as investment advisers on behalf of mutual funds would be permitted as long as the criteria above were met.

(2) The covered banking entity is acting as riskless principal in a transaction in which, after receiving an order to purchase or sell a covered financial position from a customer, the covered banking entity purchases or sells the position for its own account to offset a contemporaneous sale to or purchase from the customer; or

(3) The covered banking entity is an insurance company that purchases or sells a covered financial position for a separate account.

(iii) Purchases or sales by a regulated insurance company for its general account conducted in compliance with state law.

(iv) Purchases or sales occurring solely outside the United States, if:

(1) The covered banking entity is not directly or indirectly controlled by a U.S. banking entity; and

(2) The purchase or sale is conducted pursuant to paragraph (9) or (13) of section 4(c) of the Bank Holding Company Act.

(3) The ICI has commented that Regulation S standards should be used for purposes of determining what is "solely outside the U.S."

(e) Exempted activities must still comply with reporting and recordkeeping requirements and must not cause material conflicts of interest, constitute high-risk trading strategy or exposure to high-risk assets, or threaten financial stability or banking entity safety and soundness.

(f) The ICI has commented that authorized participant transactions related to registered exchange-traded funds should be exempted from the proprietary trading prohibition.

(g) The ICI has commented that asset-backed commercial paper and municipal tender option bond programs should be exempted from the proprietary trading prohibition.

G. Prohibitions Against Investments in Covered Funds

1. Generally, prohibits covered banking entities, as principal, directly or indirectly, from sponsoring, acquiring or retaining any ownership interest in any covered fund.

2. Definitions:

(a) Covered fund:

(i) Any issuer that would be an investment company but for Investment Company Act of 1940 sections 3(c)(1) or 3(c)(7);

(ii) Any issuer organized or offered outside of the United States that would be a covered fund were it organized or offered under the laws, or offered to one or more residents, of the United States;

(iii) Any commodity pool, as defined under the Commodity Exchange Act; or

(iv) Any similar fund as designated by the regulators by rule.

(v) Excludes joint ventures, acquisition vehicles, certain wholly-owned subsidiaries, loan securitization vehicles and certain other widely-used corporate structures.

(vi) The ICI has commented that funds registered under the Investment Company Act of 1940 should be excluded from the definition of "covered fund."

(vii) The ICI has commented that non-U.S. equivalents of U.S. registered funds should be excluded from the definition of "covered fund."

(b) Sponsor:

(i) To serve as a general partner, managing member, trustee or commodity pool operator of the fund;

(ii) In any manner, selecting or controlling a majority of the directors, trustees or management of a fund; or

(iii) Sharing the same name or a variation of the same name with a fund.

(c) Ownership interest:

(i) Any equity, partnership, or similar interest in a covered fund, or any derivative of such an interest.

(ii) Excludes carried interest under certain conditions

3. Exemptions:

(a) Sponsorship of a covered fund in connection with an investment advisory business, if:

(i) The covered banking entity provides bona fide trust, fiduciary, or investment advisory services;

(ii) The covered fund is organized and offered only in connection with such services and only to customers of such services;

(iii) Unless directly engaged in providing services to the covered fund, no director or employee of the entity takes or retains an ownership interest;

(iv) The entity does not guarantee or otherwise assume or insure the obligations or performance of the fund; and

(v) Certain other conditions are met, including compliance with rules designed to ensure that losses in a fund are borne solely by that fund's investors.

(b) Investments in a covered fund in connection with an investment advisory business, if the ownership interest is:

(i) A seed capital investment (generally limited to 1 year from establishment of the fund); or

(ii) A de minimis investment not exceeding 3% of the total outstanding ownership interests in the fund.

(c) Ownership interests in covered funds if made in connection with risk-mitigating hedging activities, if:

(i) The ownership interest is held in accordance with the entity's compliance program;

(ii) The ownership interest hedges or mitigates an exposure to the covered fund;

(iii) The ownership interest does not give rise to significant exposures not already present and not hedged contemporaneously;

(iv) The ownership interest is subject to review, monitoring, and management by the entity in compliance with the entity's compliance program;

(v) The compensation of persons performing risk-mitigating hedging activities is not designed to reward proprietary risk-taking; and

(vi) The covered banking entity documents the risk-mitigating purpose of the ownership interest, the underlying risks the interest is designed to reduce and the level of the organization establishing the hedge.

(d) Ownership interests in, and sponsorship of, covered funds by a covered banking entity not controlled by a banking entity organized under the laws of the U.S. if:

(i) The activity is conducted pursuant to paragraph 9 or 13 of Section 4(c) of the Bank Holding Company Act;

(ii) No ownership interest in the covered fund is offered for sale or sold to a resident of the United States; and

(iii) The activity occurs solely outside the United States.

(1) The ICI has commented that the SEC's Regulation S should be used to define what is "solely outside of the United States"

(e) Ownership interests in, and sponsorship of, loan securitization vehicles.

(i) Loan securitization vehicles are defined as issuers of asset-backed securities, the assets or holdings of which are solely comprised of loans, contractual

rights or assets directly arising from those loans, and certain derivatives that relate to the terms of such loans or contractual rights or assets and are used for hedging purposes

(f) Ownership interests in, and sponsorship of, an account used solely to allow the entity to purchase an insurance policy for which the entity is the beneficiary.

(g) Investments in small business investment companies, investments designed to promote the public welfare, and certain investments related to tax-qualified rehabilitated building or certified historic structure projects.

(h) The ICI has commented that asset-backed commercial paper and municipal tender option bond programs should be exempted from the covered fund provisions.

4. No covered banking entity that serves as the manager, adviser or sponsor to a covered fund, or that organizes and offers a covered fund, and no affiliate of such entity, may enter into a "covered transaction" with such fund or with any covered fund controlled by such fund.

(a) Covered transaction defined by Federal Reserve Act Section 23A and includes:

(i) Any loan or extension of credit;

(ii) Any purchase of or investment in securities issued by the fund;

(iii) The issuance of a guarantee, acceptance or letter of credit on behalf of such fund; and

(iv) Any derivatives transaction that involves the borrowing or lending of securities to the extent that the transaction causes the entity to have credit exposure to the fund.

(b) Excludes prime brokerage transactions subject to certain conditions and permitted investments in a covered fund, as discussed above.

(c) Transactions between a covered banking entity and any covered fund for which it serves as manager, adviser or sponsor, or that it has organized or offered, must be on arms'-length market terms.

(d) The ICI has commented that asset-backed commercial paper and municipal tender option bond programs should be exempted from the covered transactions prohibition.

5. No transaction or activity is permitted if the transaction or activity:

(a) Causes a material conflict of interest between the covered banking entity and its clients, customers or counterparties;

(b) Would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; or

(c) Would pose a threat to the safety and soundness of the banking entity or to U.S. financial stability.

H. Covered banking entities that engage in proprietary trading or covered fund activities must develop a compliance program designed to ensure and monitor compliance with the prohibitions on proprietary trading and covered fund activities and that is commensurate to the entity's size, scope and complexity of activities and business structure, and that includes:

(a) Written policies and procedures to document and monitor trading activities and ensure their compliance with the proprietary trading and covered fund prohibitions;

(b) A system of internal controls designed to identify emerging areas of noncompliance;

(c) A management framework that clearly assigns responsibility and accountability for compliance;

(d) Independent testing of the compliance program's effectiveness;

(e) Training for trading personnel and managers;

(f) Recordkeeping to demonstrate compliance which can be provided to the appropriate agency upon request and which is retained for at least 5 years.

(g) Certain larger covered banking entities are subject to enhanced reporting and recordkeeping requirements for trading desks' purchases and sales of covered financial positions.

2. Covered banking entities that do not engage in proprietary trading or covered fund activity need not establish a new compliance program if their existing program includes measures designed to prevent proprietary trading and covered fund activities.

II. Rulemakings on Nonbank Systemically Important Financial Institutions ("SIFIs")

A. *Overview*.

1. Title I of the Dodd-Frank Act creates the Financial Stability Oversight Council ("FSOC"), which is responsible for monitoring and identifying systemic risks to the financial stability of the United States and designating systemically important (nonbank) financial institutions ("SIFIs") for supervision by the Federal Reserve.

2. SIFI designation results in consolidated FRB supervision and an array of enhanced prudential standards being applied to a designated firm.

3. The rulemakings to implement statutory obligations for SIFIs, some of which have not been finalized, are discussed below and include:

(a) Definitions of "Predominantly Engaged in Financial Activities" and "Significant" Nonbank Financial Company;

(b) Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies;

(c) Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies;

(d) Credit Exposure Reports;

(e) Assessment of Fees on Large Bank Holding Companies and Nonbank Financial Companies Supervised by the Federal Reserve to Cover the Expenses of the Financial Research Fund;

(f) Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II; Establishment of Risk-Based Capital Floor;

(g) Living Wills;

(h) Orderly Liquidation Authority; and

(i) Credit Risk Retention.

B. Federal Reserve Board: *Definitions of "Predominantly Engaged in Financial Activities" and "Significant" Nonbank Financial Company*. (76 Fed. Reg. 7731) (Proposed Rule – comment period ended March 30, 2011)

1. Defines terms that are used in various provisions of Title I of the Dodd-Frank Act, and especially in Section 113, discussed below, which authorizes FSOC to designate a nonbank financial company for supervision by the FRB.

2. Defines a SIFI "predominantly engaged in financial activities" as a company that:

(a) Has consolidated annual gross financial revenues in either of the two most recent fiscal years with 85% or more of the company's consolidated annual gross revenues;

(b) Has consolidated total financial assets in either of the two most recent fiscal years with 85% or more of the company's total consolidated assets; or

(c) That the FRB determines, based on facts and circumstances, has met either of the above criterion.

3. Defines a "significant nonbank financial company" as a nonbank financial company supervised by the FRB or any other bank holding company with $50 billion or more in total consolidated assets.

C. Financial Stability Oversight Council: *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*. (76 Fed. Reg. 64264) (Proposed Rule – extended comment period ended December 19, 2011)

1. Enables FSOC, by a vote of not less than 2/3 of its voting members, including the Chairperson, to subject a U.S. SIFI to FRB supervision and enhanced prudential standards.

2. Outlines the three-stage process by which FSOC makes a determination that a nonbank financial company predominantly engaged in financial activities in the U.S. could pose a threat to U.S. financial stability and should be designated for FRB supervision. Each stage of the evaluation process involves an increasing amount of information on the company.

(a) Stage 1: Designed to identify, using only publicly available data, those nonbank financial companies that should be subject to further review in Stages 2 and 3. A nonbank financial company will be further evaluated if it either is identified based on other firm-specific qualitative or quantitative factors or if it meets the total consolidated assets threshold in addition to any one of the other thresholds. The thresholds are:

(i) Total consolidated assets of $50 billion or more;

(ii) Credit default swaps outstanding for which the nonbank financial company is the reference entity of $30 billion or more;

(iii) Derivative liabilities of $3.5 billion or more;

(iv) Loans and bonds outstanding of $20 billion or more;

(v) Leverage ratio of total consolidated assets to total equity of 15 to 1; and

(vi) Short-term debt ratio of debt with a maturity of less than 12 months to total consolidated assets of 10%.

(b) Stage 2: Analysis of whether the nonbank financial company could pose a threat to U.S. financial stability based on information already available to FSOC through existing public and regulatory sources and any information voluntarily provided by the company. FSOC will evaluate the risk profile and characteristics of the nonbank financial company based on the six risk factors, discussed below, and a variety of quantitative and qualitative industry- and

company-specific factors. FSOC will also consider qualitative factors, including whether the resolution of the nonbank financial company could pose a threat to U.S. financial stability. FSOC also noted in the guidance that it may apply the Stage 2 criteria in the "context of stressed market conditions."

(c) Stage 3: Companies contacted by FSOC with a "Notice of Consideration" will likely be asked to provide additional non-public information to FSOC. The Stage 2 analysis will be expanded with information collected from other agencies or the nonbank financial company. FSOC will consider the resolvability of the firm, the opacity of its operations, its complexity and the extent to which it is already subject to regulatory scrutiny.

3. After completing Stage 3, FSOC must confer and vote (by two-thirds majority, including FSOC's Chair, the Secretary of the Treasury) on the proposed designation of a nonbank financial company. Prior to making such a proposed designation, FSOC must confer with the nonbank financial company's primary regulator or home-country supervisor and consider the firm's views. FSOC makes clear, however, that it would not be bound by those regulator views.

4. If FSOC determines by the requisite two-thirds vote that a nonbank financial company should be designated as a SIFI, FSOC will issue a Notice of Designation to the nonbank financial company, which allows the company an evidentiary hearing and, subsequently, resort to judicial review. At the evidentiary hearing, FSOC will determine again by a vote of two-thirds of its members, including an affirmative vote of the chairperson, whether to issue a final designation. FSOC is required to reevaluate each designation annually and to rescind a designation by a two-thirds vote if a company no longer meets the proposed rule's requirements.

5. Provides guidance on how FSOC will consider the six risk factors it has previously stated will provide an analytical framework for making designations:

(a) Size, defined as the amount of financial services or financial intermediation that a nonbank financial company provides;

(b) Interconnectedness, defined as the direct or indirect linkages between financial companies that may be conduits for the transmission of the effects resulting from a nonbank financial company's material financial distress or activities;

(c) Substitutability, defined as the extent to which other firms could provide similar financial services in a timely manner at a similar price and quantity should a company withdraw from the market;

(d) Leverage, defined as a company's exposure or risk in relation to its equity capital;

(e) Liquidity risk and maturity mismatch, where liquidity risk refers to the risk that a company may not have sufficient funding to meet short-term needs and where maturity mismatch refers to the difference between the maturity of a company's assets and liabilities; and

(f) Existing regulatory scrutiny, defined as the extent to which a nonbank financial company is already subject to regulation.

6. *Confidentiality.* FSOC requires that any "data, information, and reports" submitted to FSOC by companies under review be maintained as confidential. Additionally, any "non-publicly available data or information" submitted would not constitute a waiver of privilege under federal or state law. The proposed rule provides that any information submitted by a company under review remains subject to the provisions of the Freedom of Information Act.

7. *Emergency Exemption.* FSOC may forego the notice and procedural requirements if it finds that it is necessary to prevent threats posed by a nonbank financial company to the financial stability of the U.S.; such a finding requires a two-thirds vote, including the affirmative vote of the Chairperson.

(a) FSOC would provide written notice to the company within 24 hours after deciding to forego the notice and procedural requirements.

(b) The company may request an evidentiary hearing within ten days of receiving notice, and FSOC must hold the hearing within 15 days or receiving the request.

(c) Final determinations would be announced publicly and subject to judicial review.

8. FSOC recognizes in the preamble to the proposed rule that asset management companies may not be well-measured by the quantitative threshold approach. It further states that it will study potential threats to U.S. financial stability posed by asset management companies to determine whether such companies should be subject to the enhanced prudential standards discussed below. FSOC may issue guidance for public comment regarding potential thresholds relevant to asset managers.

D. Federal Reserve Board: *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*. (77 Fed. Reg. 594) (Proposed Rule – extended comment period ends April 30, 2012)

1. As required by Dodd-Frank Act Sections 165 and 166, imposes seven sets of requirements on SIFIs and bank holding companies with total consolidated assets of $50 billion or more (together, the "Covered Companies"), including:

(a) Risk-based capital and leverage limits;

(i) Requires a SIFI to comply with the FRB regulations related to capital plans, including an effective requirement to maintain a Tier 1 common capital ratio of 5% and stress testing requirements that apply to large bank holding companies, and to:

(1) Calculate its risk-based capital and leverage ratios as if it were a bank holding company ("BHC") in accordance with FRB minimum capital requirements for bank holding companies;

(2) Hold capital sufficient to meet a tier 1 risk-based capital ratio of 4% and a total risk-based capital ratio of 8%; and

(3) Hold capital sufficient to meet a tier 1 leverage ratio of 4%.

(ii) The FRB noted that it expects to propose a second phase of capital rules "shortly," to implement Basel III capital reforms and the capital surcharge for systemically important banks.

(b) Liquidity requirements;

(i) *Cash Flow Projections.* Requires a Covered Company to produce short- and long-term cash flow projections appropriate to the Covered Company's capital structure, risk profile, complexity, activities, size and other risk factors.

(ii) *Liquidity Stress Testing.* Requires a Covered Company to establish liquidity stress test policies and procedures and management information systems. Each Covered Company must periodically conduct the liquidity stress tests, the results of which will be used to establish a liquidity buffer and contingency funding plan, discussed below.

(1) Liquidity stress tests must use a variety of stress "scenarios" that could significantly impact a company's liquidity, address the potential impact of market disruptions on the Covered Company and other market participants, be forward-looking and incorporate potential changes and address various time horizons.

(2) Liquidity stress tests must incorporate certain assumptions about the limits to sources of funding during the relevant time horizons.

(iii) *Liquidity Buffer.* Requires a Covered Company, based on the results of the liquidity stress tests, to maintain a liquidity buffer of unencumbered, highly liquid assets sufficient to meet the company's projected net cash flows and any losses of current funding sources for 30 days under various scenarios.

(iv) *Contingency Funding Plan*. Requires a Covered Company to establish and update at least annually a contingency funding plan with a process to address liquidity needs during stress events, including quantitative information from the liquidity stress tests, a liquidity management process, procedures to detect emerging liquidity stress events, and periodic testing of the contingency funding plan.

(v) *Specific Limits.* Requires the board of directors of a Covered Company to establish limits on potential sources of liquidity risk, including concentrations in funding sources, the amount of specified liabilities that mature within various time horizons, and off-balance sheet exposures that could create funding needs during a stress event.

(vi) *Monitoring.* Requires a Covered Company to establish procedures to monitor its liquidity.

(vii) A Covered Company's board of directors, risk committee (discussed below), senior management, and an "independent review" function must implement the liquidity requirements.

(c) Single-counterparty credit limits;

(i) Generally, a Covered Company may not have a net credit exposure, aggregated across its subsidiaries, to any single unaffiliated counterparty exceeding 25% of the company's consolidated capital stock and surplus.

(1) "Major covered companies" – SIFIs and bank holding companies with more than $500 billion in total consolidated assets – are subject to a 10% credit exposure limit to any "major counterparty" – those that are major covered companies and their subsidiaries and any foreign banking organization with $500 billion or more in total consolidated assets.

(ii) "Net credit exposure" is defined broadly and includes loans, debt securities, repo agreements, securities lending transactions, credit lines, letters of credit, and derivative transactions. It exempts:

(1) Direct claims on, and the portions of claims guaranteed by, the United States and its agencies;

(2) Direct claims on, and the portions of claims guaranteed by, Freddie Mac and Fannie Mae while those companies operate under FHFA conservatorship or receivership, and any other obligations issued by a government-sponsored enterprise as determined by the FRB;

(3) Intraday credit exposures to a counterparty; and

(4) Any transactions the FRB specifically exempts if it finds it is in the public interest and consistent with the FRB proposed rules.

(iii) Requires a Covered Company to comply with the limits at the end of each business day and to submit a monthly report demonstrating daily compliance.

(iv) If a Covered Company falls out of compliance, it has a 90-day grace period, subject to an extension determined by the FRB, during which the company may not engage in credit transactions with the counterparty.

(d) Risk management requirements;

(i) *Risk Committee.* Covered Companies (and publicly traded BHCs with $10 billion in consolidated assets) must establish and maintain an enterprise-wide risk committee composed of members of its board of directors, and must:

(1) Have a formal, written charter approved by the board of directors;

(2) Include at least one member with risk management expertise commensurate to the company's risk profile;

(3) Be chaired by an independent director;

(4) Meet with "appropriate frequency and as needed";

(5) Fully document and maintain records of its meetings;

(6) For Covered Companies, the risk committee must be separate from other committees, must report directly to the board of directors, and must receive and review regular reports from the chief risk officer (discussed below); and

(7) Oversee the enterprise-wide risk management that is commensurate to the company's capital structure, risk profile, complexity, activities, size and other risk-related factors.

(ii) *Chief Risk Officer.* A Covered Company must employ a chief risk officer with risk management expertise commensurate to the institution's risk profile, who is appropriately compensated and incentivized to provide objective assessments. The chief risk officer reports directly to the risk committee and the chief executive officer and must oversee enterprise-wide risk management.

(e) Stress tests;

(i) A Covered Company is required to undergo both supervisory and company-run stress tests. Both types of tests are very similar to the Federal Reserve's Supervisory Capital Assessment Program and the Comprehensive Capital Analysis and Review for large bank holding companies.

(ii) *Supervisory Stress Tests.* In coordination with the appropriate primary financial regulatory agency, the FRB will conduct a stress test of a Covered Company's capital under various stress scenarios. Each Covered Company must submit certain consolidated data to the FRB. The FRB will publish a summary of the results and will communicate the results to the Company, which will be expected to make appropriate changes in accordance with such results.

(iii) *Company-Run Stress Tests.* Requires Covered Companies (and bank holding companies, state member banks, and savings and loan holding companies with $10 billion or more in consolidated assets) to conduct an annual stress test using various stress scenarios developed by the FRB. Covered Companies must also conduct an additional stress test each year. Companies must report the results of such tests and publicly disclose a summary of the results 90 days after reporting to the FRB.

(f) Debt-to-equity limits;

(i) If FSOC determines a Covered Company has been posing a "grave threat" to the U.S. financial stability, the Federal Reserve can require the company to achieve and maintain a debt-to-equity ratio of no more than 15-to-1 within 180 days.

(g) Early remediation requirements.

(i) Similar to, but more forward-looking and with different triggers and penalties than, the "prompt corrective action" regime applicable to insured depository institutions, these rules establish "triggering events" designed to identify emerging issues with four separate levels of remediation (discussed below) in each of five categories:

(1) Capital and leverage;

(2) Stress tests;

(3) Risk management;

(4) Liquidity; and

(5) Market indicators.

(ii) Upon a triggering event, a Covered Company must notify the FRB, or the FRB will notify a Covered Company if it learns a triggering event at the company has occurred.

(iii) Levels of remediation.

(1) Level 1: FRB will, within 30 days of a Covered Company entering Level 1, conduct a supervisory review. If, following the review, the FRB finds that the company is experiencing financial distress or material risk management weaknesses such that further decline is likely, the company will be subject to Level 2.

(2) Level 2: A Covered Company must comply with limits on capital distributions, daily average total assets, and daily average risk-weighted assets. A Covered Company is prohibited from merging, geographically expanding, and introducing new business lines and must enter into a confidential non-public memorandum of understanding. Additionally, a Covered Company will be subject to additional limitations at the discretion of the FRB.

(3) Level 3: A Covered Company is prohibited from making any capital distributions and increasing the compensation of, or pay any bonus to, senior executive officers or directors, and is subject to limits on its average total assets and average total risk-weighted assets. A Covered Company is prohibited from acquiring any interest in any company, geographically expanding, and introducing new business lines. A Covered

Company must enter into a memorandum of understanding that requires the company to raise additional capital and take other actions to improve its capital adequacy; if the company fails to comply, it may be required to divest assets identified by the FRB. The FRB may require a Covered Company to dismiss certain executive officers and conduct a new election for the board of directors.

(4) Level 4: The FRB considers whether the Covered Company poses a risk to the stability of the U.S. financial system, and may issue a written recommendation that the company be placed into resolution under the Orderly Liquidation Authority (discussed below).

2. Covered Companies are generally expected to comply with the requirements one year after the rules are promulgated or one year after a company becomes a Covered Company.

E. Federal Reserve Board: *Credit Exposure Reports*. (76 Fed. Reg. 22648) (Proposed Rule – comment period ended June 10, 2011)

1. Requires SIFIs to submit credit exposure reports to the FRB and the Federal Deposit Insurance Company ("FDIC").

2. Note: In the Enhanced Prudential Standards proposed rules, discussed above, it is indicated that these requirements will be finalized at a later date.

F. U.S. Department of the Treasury: *Assessment of Fees on Large Bank Holding Companies and Nonbank Financial Companies Supervised by the Federal Reserve to Cover the Expenses of the Financial Research Fund*. (77 Fed. Reg. 35) (Proposed Rule – comment period ends March 5, 2012)

1. Requires SIFIs and large bank holding companies (together, the "Assessed Companies") to pay a semiannual fee to cover the expenses of the Office of Financial Research ("OFR"), including expenses of the FSOC and certain expenses of the FDIC.

(a) The OFR was established by the Dodd-Frank Act to improve access to and transparency of financial data and information by conducting research related to financial stability and promoting best practices in risk management. This research is intended to support the work of the FSOC.

(b) The OFR has the ability to require BHCs and SIFIs, and under certain circumstances financial companies in general, to submit reports in order to assess threats to U.S. financial stability, though it must rely on regulatory or public information when possible. The reports could include information on the financial condition of the company, risk control systems and transactions with depository institution subsidiaries. The Director of the OFR may also, by subpoena, require such information, but only upon a written finding that such data is required and that the OFR has coordinated with the appropriate regulatory agency. The reports are to be kept confidential.

(c) The OFR will maintain a data center with all data collected from member agencies, commercial data providers, publicly available data and financial entities. The data center must also make a financial reference database publicly available.

(d) The OFR also must maintain a research and analysis center to develop metrics and reporting systems, monitor systemic risk levels, conduct research to improve regulation, evaluate stress tests, and promote risk management best practices.

(e) The OFR must report to Congress and the public on the developments in the financial markets and potential threats to financial stability, and must collaborate with foreign governments, multilateral organizations and the financial industry to establish international standards for financial stability policies.

2. Amount of assessments paid would be based on the size of an Assessed Company's total consolidated assets. Total consolidated assets are determined by the Assessed Company's recent regulatory filings (*e.g.* the FR Y-9C for bank holding companies and the FR Y-7Q for foreign bank holding companies).

G. Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation: *Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II; Establishment of Risk-Based Capital Floor*. (12 C.F.R. Part 3; 12 C.F.R. Parts 208 and 225; 12 C.F.R. Part 325) (Finalized)

1. Establishes minimum risk-based capital requirements for SIFIs and others, including a total risk-based capital ratio of 8% and a Tier 1 risk-based capital ratio of 4%.

2. Prescribes methods of calculations for risk-based capital ratios.

H. Federal Reserve Board, Federal Deposit Insurance Corporation: *Living Wills.* (12 C.F.R. Part 243; 12 C.F.R. Part 381) (Finalized)

1. Requires a SIFI and large BHC to submit to the FRB, FDIC and FSOC a resolution plan, or "living will," for the company's rapid and orderly resolution under the Bankruptcy Code in the event of material financial distress or failure.

2. Living will must include:

(a) Information on the extent to which any insured depository institution affiliated with the company is protected from risks arising from affiliate activity;

(b) Descriptions of the company's ownership structure, assets, liabilities and contractual obligations;

(c) Identification of cross-guarantees tied to different securities;

(d) Identification of major counterparties; and

(e) Certain other elements.

I. Federal Deposit Insurance Corporation: *Orderly Liquidation Authority.* (12 C.F.R. Part 243; 12 C.F.R. Part 381) (Finalized)

1. Outlines a comprehensive framework for the FDIC's orderly liquidation authority which may be invoked for SIFIs, including matters related to the appointment of the FDIC as receiver and the administrative process for the determination of claims against a company under receivership. Additional rules are expected.

J. Securities and Exchange Commission, Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Department of Housing and Urban Development: *Credit Risk Retention*. (76 Fed. Reg. 24090) (Proposed Rule – extended comment period ended August 1, 2011)

1. Requires SIFIs that are securitizers of asset-backed securities generally to keep some "skin in the game" by retaining an economic interest in a portion of the credit risk of the assets collateralizing the asset-backed security.