The Volcker Rule
2012 Banking Institute

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THE VOLCKER RULE RESTRICTIONS
General Prohibitions

- Section 619 of the Dodd-Frank Act, known commonly as the “Volcker Rule,” imposes certain restrictions on banking entities
  - Banking entities may not engage in proprietary trading, subject to certain exemptions
  - Banking entities may not make or retain an ownership interest in, or sponsor, a private equity fund or hedge fund, subject to certain exemptions
  - A banking entity that advises, manages, or sponsors a private equity fund or hedge fund – and all of the banking entity’s affiliates – are barred from engaging in certain transactions with the fund (referred to as Super 23A)
Rulemaking and Effective Dates

- The Fed, OCC, FDIC, SEC and CFTC recently proposed regulations to implement the Volcker Rule
  - The Fed, OCC, FDIC, and SEC comment period closed February 13th; the CFTC comment period closes April 16th
- These proposed regulations implement the Volcker Rule by further defining various provisions and the exemptions available to banking entities, but also add significant reporting and compliance obligations on banking entities that rely on certain exemptions
- The Volcker Rule becomes effective July 21, 2012, subject to a two-year conformance period for existing activities and existing fund investments
Scope of the Volcker Rule

- A banking entity includes:
  - an FDIC-insured bank or thrift
  - any company that controls an FDIC-insured bank or thrift (including a registered BHC or SLHC, but also including a “nonbank bank” holding company)
  - a foreign bank that maintains a branch or agency office in the U.S.
  - ... and any entity affiliated with any of the foregoing
Proprietary Trading

• The Volcker Rule bars *proprietary trading*, defined as a banking entity, acting as principal, purchasing or selling a *covered financial position* in a *trading account*.

• *Covered financial position* encompasses securities, derivatives, and commodity futures & options

• Under the regulations, *trading account* includes an account in which covered financial positions are bought and sold for short term profit
  
  – The proposed regs deem all accounts held by a registered dealer (including a non-U.S. dealer) as being a *trading account* (referred to as the “status” prong)
  
  – The proposed regs deem all accounts treated as Market Risk Capital Rule trading accounts to be *trading accounts* for Volcker Rule purposes
Proprietary Trading (cont’d)

- For banking entities that are not dealers and not subject to the Market Risk Capital Rules, an account is considered a \textit{trading account} if it is used primarily for short term purchases and sales (with a rebuttable presumption at 60 days)

  - Exemptions exist for repos, securities lending, liquidity management programs, trading in certain federal & state obligations, market-making, underwriting, hedging activity, trading on behalf of customer (\textit{i.e.}, brokerage and riskless principal trades), certain insurance company transactions, and certain offshore transactions

- However, several of these exemptions are subject to the compliance and/or reporting obligations included in the proposed regulations
Conflicts of Interest & High Risk Trading

- The Volcker Rule also has a catch-all provision that bars any trading activity, even if otherwise permissible under the Volcker Rule, if the trading activity:
  - Involves or results in a *material conflict of interest* between the banking entity and its clients, customers or counterparties
  - Results in the banking entity’s material exposure to a *high risk asset or high risk trading strategy*
  - Poses a *threat to the safety and soundness* of the banking entity or to the *financial stability* of the U.S.
The Volcker Rule bars a banking entity from having an ownership interest in or sponsoring a private equity fund or hedge fund.

The Volcker Rule defines a private equity fund or hedge fund as being a fund that is an investment company under the Investment Company Act of 1940 which would be required to register but for Sections 3(c)(1) or 3(c)(7).

The proposed regulations expand this to include foreign equivalent funds and commodity pools.

The proposed regulations use the term “covered fund” to describe the scope of funds covered.
Covered Funds (cont’d)

• **Ownership** is defined as having an equity-like ownership interest in the fund (not a debt interest)

• **Sponsoring** means being the general partner, trustee, or managing member, selecting or controlling fund management, or having a common name

• Exemptions exist for loan securitization SPVs, hedging positions, BOLI separate accounts, certain offshore fund investments, carried interest investments, JV operating companies, liquidity management subsidiaries, investments in SBICs, community development / public welfare funds investments, and DPC acquisitions
A separate exemption applies to sponsoring and seeding funds that are “organized and offered” by a banking entity in connection with bona fide trust, fiduciary, or advisory services, provided the banking entity must reduce its investment to certain de minimis levels within a year

- The banking entity’s investment in any one fund may not exceed 3% of the total outstanding ownership interests in that fund
- All such investments by the banking entity may not exceed 3% of banking entity’s Tier 1 capital & surplus
- Investments in covered funds must be deducted from the banking entity’s Tier 1 capital for bank regulatory calculations
The Volcker Rule also has a catch-all provision that bars any fund related activity, even if otherwise permissible under the Volcker Rule, if the activity:

- Involves or results in a material conflict of interest between the banking entity and its clients, customers or counterparties
- Results in the banking entity’s material exposure to a high risk asset or high risk trading strategy
- Poses a threat to the safety and soundness of the banking entity or to the financial stability of the U.S.
Super 23A

- The Volcker Rule prohibits a banking entity that advises, manages, or sponsors a covered fund (and any of the banking entity’s affiliates) from entering into a transaction with the fund that would be regulated under Section 23A of the Federal Reserve Act if the banking entity were a “bank” and the covered fund were a “nonbank affiliate”
  - Section 23A restricts “covered transactions” between an FDIC-insured bank and its affiliates by imposing quantitative and qualitative restrictions; exemptions in special circumstances are available upon application to the banking regulators
- Super 23A is more onerous than 23A because it creates an absolute bar on certain transactions, and applies to all entities affiliated with a bank, not just an FDIC-insured bank
Super 23A (cont’d)

• Thus, if a banking entity sponsors, advises, or manages a covered fund, neither it nor its affiliates may enter into:
  – Loans to the covered fund
  – Derivative transactions with the covered fund
  – Purchases of assets from the covered fund
  – Guarantees for the benefit of the covered fund
  – Any such transaction with a third party where the proceeds are transferred to, or benefit, the covered fund (e.g., a loan to a person that invests in the covered fund)

• There is a limited exemption for prime brokerage services

• Super 23A appears to have global reach
THE CONFORMANCE PERIOD & EXTENSIONS
Two-Year Conformance Period

- The Volcker Rule provides for a two-year “conformance period” before full compliance with the proprietary trading, covered fund, and Super 23A restrictions is required
  - The conformance period runs from July 21, 2012 through July 20, 2014
- During this period, a banking entity may continue to engage in any *pre-existing activity*, and may continue to hold any *pre-existing investments*, notwithstanding the Volcker Rule prohibitions
- Conformance period regulations were issued by the Fed in final form in February 2011
Proprietary Trading

• The regulations indicate that proprietary trading is considered a *pre-existing activity* that may be continued during the conformance period, provided the trading activity is not “expanded”
  – What constitutes an “expansion” of a pre-existing impermissible activity is a facts & circumstances test used by the Fed
  – Some confusion exists regarding the conformance period for proprietary trading because of language accompanying the recent proposed regulations (“A banking entity is expected to bring the prohibited proprietary trading activity of a trading unit into compliance with the requirements of the proposed rule as soon as practicable within the conformance period”)


Covered Fund Relationships

- The regulations indicate that covered fund investing and sponsorship is not considered an *activity* but rather an *investment*; thus while sponsorship relationships and investments created prior to the effective date may be maintained through the conformance period, no new covered fund investments may be made (unless required by a pre-existing contract), and no new prohibited fund sponsorship relations may be created, on or after July 21, 2012.

- The regulations do not address how the conformance period applies to Super 23A transactions.
• The conformance period does not defer the recordkeeping, reporting of trading-related quantitative measures, or compliance obligations imposed by the proposed regulations; under the proposed regulations, those will go into effect on July 21, 2012 (assuming the regulations go into effect that date)
  – The discussion accompanying the proposed regulations states that the quantitative measurement data “would not be used to identify prohibited proprietary trading” until after the end of the conformance period
Extension Requests

• The Volcker Rule permits a banking entity to apply for up to three consecutive one-year extensions to continue any impermissible trading activity or any impermissible covered fund sponsorship or investment
  – Based on language accompanying the proposed regulation, these extensions may be difficult to obtain with respect to trading activities
  – In effect, these extensions would enable a banking entity to maintain covered fund relationships (and perhaps trading activity) as late as July 2017
• In addition, the Volcker Rule permits a final, one-time five-year extension (i.e., in theory running until July 2022) for an investment in an illiquid fund
THE RULEMAKING PROCESS
Comment Letters

• The comment period for the banking regulators and the SEC closed on February 13, 2012
  – Almost 18,300 comment letters have been received (although 17,800 were form letters)
• The CFTC comment period commenced on February 14, 2012 and runs until April 16, 2012
• The banking agencies and the SEC are continuing to log comments after the close of the comment period
Outlook for July 21, 2012

- The restrictions on proprietary trading, covered fund relationships, and Super 23A transactions go into effect on July 21, 2012 regardless whether regulations have been issued (subject to the conformance period)
  
  - Unlike Title VII, the operative provisions of the Volcker Rule were not conditioned on the issuance of final regulations
  
  - Even then, it is not clear the regulators have the authority to delay the effective date of the operative provisions
  
  - The regulators have been asked whether Congress should extend the effective date and the regulators have declined to make the request
The recordkeeping, compliance, and reporting requirements are not imposed by statute but rather by regulation and therefore do not go into effect until the regulations become effective.

Because the statute is self-executing, but has a conformance period, the regulators may not feel compelled to issue final regulations that will be effective July 21, 2012.

- The principal impact will be lack of clarity around new covered fund investments or sponsorships, which would be prohibited.

Chairman Bernanke has announced that the regulations will likely not be issued by the deadline, and Secretary Geithner has urged that the agencies take time if needed.
Outlook for the Final Rules

- “Abandon and start over” seems unlikely
- Some changes are likely, especially with respect to the extra-territorial reach, venture funds, and sovereign debt issues, as well as the non-statutory provisions (i.e., the compliance and reporting obligations)
- However, many of the prohibitions in the Volcker Rule are statutory and the regulators have limited ability to disregard statutory language
NEXT STEPS FOR BANKING ENTITIES
Impact Analysis

- Conduct an impact analysis and gather facts about existing activities
  - Identify all trading accounts
  - Identify all covered fund sponsorships and investments
  - Identify all covered fund advisory & management relationships (relevant for Super 23A)
- Document existing activities and investments that are in existence as of July 20, 2012; this is critical for reliance during the conformance period
  - It is in your best interest that existing activities be construed in the broadest possible terms, especially regarding geographies and products involved
Strategic Changes

• To minimize impact, develop strategic alternatives and recommend changes based on activities identified, e.g.:
  – Many exemptions contain conditions that will need to be satisfied, e.g., the “organized and offered,” carried interest, the market-making, and hedging exemptions
  – Consolidation of trading units can simplify reporting
  – Non-U.S. banks should begin isolating their U.S. facing trading and funds business to minimize the impact
  – Super 23A

• More urgency exists around developing a strategy for a banking entity’s covered fund activities because the conformance period does not allow any new relationships
Trading Units

- Identify the *trading units*
  - Compliance, recordkeeping and reporting must be established at the *trading unit* level
  - *Trading unit* is a three- (or more) level concept that simultaneously refers to the trading desk, the business unit, and the enterprise
Quantitative Measure Reporting

- Implementation of the quantitative measures for trading activity will be costly, burdensome, and time consuming
  - Reporting of quantitative measures is required for the market-making, underwriting, hedging, and trading in government obligations exemptions
  - There are up to 22 quantitative measures that must be gathered at the trading unit levels, as frequently as daily, and reported to the agencies at the end of each month
  - The scope of the reporting is in part dependent on the size of the global book
Compliance

- Begin framing compliance and risk management programs
  - The compliance and risk management required is highly complex, especially for banking entities with larger trading portfolios or covered fund relationships; more than 50 compliance categories are included in the proposed regulations and Appendix C, with several hundred discrete compliance deliverables
- It is important not to rely solely on Appendix C, because (inexplicably) some requirements are reflected only in the commentary or regulation text
Review and Revise Compensation

- The proposed regulations require that compensation of employees involved in certain exempted activities (such as underwriting, market-making, or hedging trading exemptions) be “designed not to reward proprietary risk-taking”

- The proposed regulations’ covered fund “organized and offered” and carried interest provisions also may require changes to compensation structures
QUESTIONS
2012 Banking Institute
Dodd-Frank Act: Regulatory Implementation

Title VII: Derivatives

Dan Waldman, Arnold & Porter
GENERAL OVERVIEW OF TITLE VII OF DODD FRANK

• Central Principles:
  – Comprehensive regulation of swaps dealers and major swap participants
  – Mandatory clearing and exchange trading of standardized swaps
  – Increased transparency both to the public and to the regulators
  – Enhanced regulatory authority
    • Position Limits
    • Anti-manipulation and anti-disruptive practices prohibitions
    • Whistleblower provisions
ISSUES THAT WILL AFFECT BANKS IN TITLE VII

• Dealer registration
• Bank push out provision
• Mandatory clearing and exchange trading
• Margin rules
• Special forex rules
• Position limits
• Enforcement authority
• Volcker Rule
Definition of Swap Dealer

• The Dodd-Frank Act defines a swap dealer broadly as an entity that: holds itself out as a dealer; makes a market in swaps; regularly enters into swaps with counterparties as an ordinary course of business for its own account; or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

• CFTC rule proposes a “functional” test for defining a dealer
  – Dealers accommodate demand from other parties
  – Dealers use their own standard terms or arrange terms in response to customer’s interest
  – Dealers create new swaps at their own initiative
Outside the Definition of Swap Dealer

• Swap dealers under the Dodd-Frank Act do not include:
  – entities that are entering into the swaps to hedge their own accounts; or
  – entities that engage in swaps in a "de minimis" quantity. "De minimis" was very narrowly defined in the proposed rule, including no more than $100 million in notional and fewer than 20 swaps with no more than 15 counterparties. Category may be expanded. Up to $3 billion?

MAJOR ISSUE: HOW BROAD WILL THIS BE DEFINED? Does a bank or other OTC participant that simply enters into a small number of swaps with to clients fit within the definition? If a bank offers retail FOREX products to customers wishing to hedge their currency risks qualify as a swap dealer?
Swaps in connection with Loan Origination

Swaps entered into by a bank with a customer in connection with originating a loan with that customer are not considered “swap dealing.”
Definition of Major Swap Participant

- Entity that maintains a substantial position in swaps (excluding hedge positions) that create substantial counterparty exposure and that could have serious adverse effects on financial stability on banking system or financial markets or
- Entity that has a substantial swaps position and is highly leveraged and not subject to capital requirements imposed by a federal banking regulator.
- Broad definition of maintaining a “substantial position”
- Few market participants likely to qualify, AIG, GE Capital?
Regulatory Requirements Applicable to Swap Dealers and Major Swap Participants

- Registration
- Margin and capital
- Reporting and recordkeeping
- Business conduct standards
- Documentation standards
- Risk management standards, position limit monitoring, diligent supervision, business continuity and disaster recovery
- CCO obligations
- Collateral management standards
- Conflicts of interest
Bank Push Out Provision

- Swap dealing activity will have to be put in a separately capitalized affiliate.
- Initial legislative proposal would have forced banks to divest all swaps activities to an affiliate.
- Last minute compromise: Banks may maintain their derivatives business in products that are tied to hedging for the banks own risk.
  - Such products would likely include interest rate and foreign exchange instruments as well as certain credit products held for hedging purposes.
  - However, trades in agriculture products, energy swaps, and uncleared commodities would likely have to be spun off to the bank’s affiliates.
Bank Push Out Provision (cont’d)

• Also of note in Section 716: Any credit default swaps that remain in the bank, must be cleared through a central clearinghouse.
Clearing Requirements

• Mandatory Clearing of Swaps and Security Based Swaps for those swaps that are eligible for clearing.
  – Title VII of the Dodd-Frank Act mandates that the regulators (CFTC and SEC) determine which type of swaps are eligible for clearing.
  – Most of the swaps that will be eligible for clearing will be **standardized** swaps; swaps that are liquid and not too complex. Some estimates are 70-80% of the market is clearable. More complex swaps with customized terms will probably be permitted to trade bilaterally, but must be publicly reported.

**MAJOR ISSUES:** What types of products will be considered clearable and subject to mandatory clearing? Will the agencies provide clear guidance through rulemakings or will they leave much of the determination of products that must be cleared to the registered clearinghouses?
Clearing Exemptions

• Non-financial entities who use swaps to hedge commercial risk are exempt from mandatory clearing.
• CFTC and SEC are also considering an exemption for small banks, savings associations, farm credit institutions and credit unions with less than $10 billion in assets.
Exchange Trading Requirements

• Mandatory Trading on Registered Exchanges:
  – If a contract is listed for trading and required to be cleared, it must also trade on a registered exchange. Registered exchanges include Designated Contract Markets or:
  – Newly created Swap Execution Facilities.

MAJOR ISSUES: What types of products will be traded or accepted on exchanges? Will there be categories of trades that are clearable but not exchange traded?
Swap Execution Facilities

• A SEF is defined in the Dodd-Frank Act as:
  – a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of swaps between two persons and is not a designated contract market.

MAJOR ISSUES:  How broad will the CFTC and SEC define Swap Execution Facilities? Specifically, how will facilitation be defined? Will the agencies permit individual negotiation? Will they require pre-trade transparency?
Margin for Uncleared Swaps

• Regulators have proposed minimum initial and variation margin requirements for uncleared swaps.
• Swap dealers and MSPs must post and collect margin from other dealers and MSPs and segregate the initial margin with third party custodians.
• Swap dealers and MSPs must collect margin from high risk financial end users.
• Swap dealers that are banks must collect margin from low risk financial end users and non-financial end users subject to permissible credit thresholds.
OTC FOREX UNDER DODD FRANK

OTC FOREX=SWAPS

• If it’s OTC and it’s not spot, Dodd-Frank calls it a swap
  – The definition of “swaps” expressly excludes forward contracts on non-financial commodities and securities intended to be physically settled.
  – Treasury Secretary has authority to exclude Forex forwards and swaps between eligible contract participants from the statutory definition of swaps and has proposed such an exemption.
  – Other non exempt OTC Forex products, such as options, non-deliverable forwards and cross currency swaps would be subject to same regulatory regime applicable to other swaps (including swaps dealer/major swap participant registration and regulation, capital requirements, margin rules, disclosure requirements, position limits, clearing, ECP counterparty restrictions, etc.)
OTC RETAIL FOREX

• What is “retail” Forex?
  – Dodd-Frank amends the definition of “eligible contract participant” and thereby increases the “retail” forex market.
  – Hedge funds/commodity pools as retail Forex customers: the new look-through requirement.
OTC RETAIL FOREX (cont’d)

• Dodd-Frank extends the Commodity Exchange Act ban on retail Forex transactions to regulated financial institutions unless the applicable Federal banking agencies issue rules authorizing retail Forex transactions.

• Bank regulators have issued authorizing rules that include requirements relating to disclosure, recordkeeping, financial reporting, business conduct, capital and margin.
Position Limits

• Position limits will be imposed by the regulators on any swaps on nonfinancial commodities (e.g. energy, metals, agricultural commodities) that provide a “significant price discovery function”: considerations for significant price discovery include:
  – price linkage to traded contracts
  – the potential for price arbitrage between the swap and a contract on the traded platform.

**MAJOR ISSUES** Will CFTC have sufficient market information to devise sensible limitations? Limits have been challenged in court.
Enforcement Authority In OTC Context

• Title VII substantially increases the CFTC’s enforcement authority in the context of derivatives trades
• New Liability Provisions for OTC trades
• New fraud liability provisions that parallel Section 10(b) of the Exchange Act with respect to securities. Section 4b of the Commodity Exchange Act amended, adding language that prohibits derivatives participants from:
  – employing any device, scheme, or artifice to defraud;
  – making any untrue statement of material fact or omitting any statement of material fact necessary in order to make the statements made misleading;
  – or engaging in any act, practice or course of business which operates as a fraud or deceit upon any person.
Enforcement Authority In OTC Context (cont’d):

• “Disruptive Practices”: Dodd Frank provides the CFTC with enforcement authority over market participants that engage in “disruptive practices.” The Act defines such disruptive practices to include: activities violating bids or offers; intentional or reckless disregard for the orderly execution of transactions during the closing period of a market; and “spoofing” (bidding or offering with the intent to cancel the bid or offer before execution).

• Anti-Manipulation: Dodd-Frank also expands the CFTC’s anti-manipulation authority, and broadens the types of activities that are considered manipulation. For instance, it reduces the scienter requirement for manipulation in the reporting context by changing the standard of such conduct to include acting in reckless disregard of the fact that such report is false, misleading, or inaccurate.

**MAJOR ISSUES:** Will the CFTC and SEC provide greater guidance on what kind of trading is actionable? How best can traders be counseled to avoid new enforcement pitfalls?
Volker Rule (Title VI of Dodd-Frank)

- Under these provisions, subject to certain exemptions, federal regulators must issue regulations to prohibit “banking entities” (i.e., insured depository institutions, their holding companies, non-US banks with branches or agency offices in the US, and any affiliate or subsidiary of such entities) from engaging in proprietary trading, sponsoring or investing in hedge funds and private equity funds, and having certain financial relationships with those hedge funds or private equity funds for which they serve as investment manager or investment adviser.
Volker Rule (Title VI of Dodd-Frank) (cont’d)

• A systemically significant non-bank financial company supervised by the Federal Reserve that engages in such activities would be subject to rules establishing enhanced capital standards and quantitative limits, but such activities would not be prohibited.
Questions?

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Federal Reserve Proposes Enhanced Prudential Standards for Large Financial Institutions

On December 20, 2011, the Board of Governors of the Federal Reserve System (Board) issued a proposed rule and request for public comment¹ (Notice) to implement provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA).² Sections 165 and 166 require the Board to impose enhanced prudential standards on certain large bank holding companies (BHCs) and on nonbank financial companies designated for Board oversight by the Financial Stability Oversight Council (FSOC).³ These statutory provisions and the regulations proposed by the Board will create significant new obligations and, in some instances, restrictions on the largest participants in the US financial system. The Board has asked for feedback on all aspects of the proposed regulations, including in response to 95 specific questions posed in the Notice. Comments are due March 31, 2012.

Purpose
The recent financial crisis revealed significant limitations in the prudential regulation of large and systemically significant financial companies. At the peak of the crisis, it became clear that many institutions' capital levels were insufficient to support their risk profiles, and that even institutions with adequate capital were, in times of extreme stress, vulnerable to crippling liquidity challenges that rendered capital cushions nearly meaningless. Further, it became evident that neither regulators nor the industry itself fully appreciated the extent to which the largest industry participants, as frequent counterparties, were exposed to one another, such that the failure of one institution could have a “domino effect” on others. It was equally apparent that regulators and the industry alike did not comprehend the extent to which institutions had leveraged themselves and taken on significant amounts

³ Section 113 of the DFA authorizes the FSOC to designate a US nonbank financial company for supervision by the Board if the FSOC determines, pursuant to factors set forth in the DFA, that the US nonbank financial company could pose a threat to the financial stability of the United States. To date, no such designation has been made.
of risk through derivative transactions and other “exotic” instruments, which both caused and amplified the losses experienced during the financial downturn. These factors combined to force an unprecedented level of government intervention to prevent the failure of several of the largest US financial institutions, confirming that those institutions were, in fact, “too big to fail.”

Sections 165 and 166 of the DFA seek to address a number of these concerns and to reduce the moral hazards associated with a presumption of government support in times of stress. The provisions’ goal is to ensure that large and systemically important institutions can survive future instances of severe market dislocation, or that, if not, the impact of their failure on other market participants will be minimized. Particular emphasis is placed on tightening the requirements governing the financial condition, risk management, and contingency planning of the largest and most interconnected institutions in the United States, so as to prepare proactively for the next market crisis. Although BHCs have always been subject to prudential regulation and agency guidance in these areas, these requirements will be new to nonbank entities, and in any event the DFA specifically requires the Board to impose requirements that go beyond what is currently expected of BHCs.

Significantly, the proposed regulations are not intended solely to strengthen the resiliency of large companies. In some cases, the goal is also to prompt certain large institutions to rein in their activities to address the unintended and undesirable consequences of “too big to fail.” To that end, the Board expects that the proposed regulations, which increase in stringency according to the systemic risk posed by an entity, will provide an incentive for financial companies to reduce their systemic footprint—and thereby their systemic risk. The Board views this process as a means of “encourag[ing] covered companies to consider the external costs that their failure or distress would impose on the broader financial system, thus helping to offset any implicit subsidy they may have enjoyed as a result of market perceptions of implicit government support.”

Scope

The regulations proposed in the Notice address seven primary areas: risk-based capital and leverage, liquidity, single-counterparty credit limits, overall risk-management and risk committees, stress tests, debt-to-equity limits, and early remediation requirements. Each of these areas is discussed below. In most instances, the proposed rules will apply to two categories of institutions (each a “Covered Company”): (i) BHCs with US$50 billion\(^4\) or more in consolidated assets and (ii) nonbank financial companies designated by the FSOC for Board supervision. With respect to the latter category, the Board acknowledges in the Notice that its exiting BHC-focused regulations and guidance will not in every instance translate well to non-BHC entities, and comments are specifically invited regarding what characteristics of nonbank Covered Companies should be considered in determining how to apply each of the seven areas listed above to such entities.

In addition to Covered Companies, BHCs and state member banks with US$10 billion or more in consolidated assets will be subject to the Notice’s stress-test requirement, and publicly traded BHCs with US$10 billion or more in consolidated assets will also be subject to the risk-committee requirements proposed in the Notice. Savings and loan holding companies (SLHCs) and foreign banking organizations\(^5\) (FBOs) are, to differing degrees, covered by portions of Sections 165 and 166 and by the rules proposed in the Notice, but, as discussed below, the Board has largely excluded them from the initial scope of the Notice in favor of forthcoming proposed rulemakings that will address SLHCs and FBOs directly.

Timing of Implementation

The Board has sought in the proposed rulemaking to establish initial and ongoing compliance timeframes that

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\(^4\) Whether a BHC satisfies the US$50 billion requirement will be based on the average of the BHC’s total consolidated assets as reported to the Board for the four previous quarters on Federal Reserve Form FR Y-9C (Consolidated Financial Statements for Bank Holding Companies). The US$10 billion threshold applicable to the stress-test requirements discussed herein is calculated in a similar fashion.

\(^5\) FBOs include any foreign nonbank financial company supervised by the Board or any foreign-based bank holding company.
allow institutions sufficient time to implement the necessary internal processes. In recognition of the significant time and resources that many institutions will need to dedicate to achieving compliance with the proposed regulations, the Board has proposed an implementation period of approximately one year from the effective date of the final regulations, or from the date an entity becomes subject to the final rules. The Board has also proposed an ongoing reporting/compliance schedule that seeks to coordinate both new and existing requirements. “For example,” the Notice states, “the requirement that Covered Companies conduct stress tests is specifically timed to coordinate with the reporting requirements associated with the capital plan, and the capital plan and stress test requirements are specifically timed to minimize overlap with resolution plan update requirements.” The Board has specifically requested feedback on the proposed implementation and compliance schedule.

Savings and Loan Holding Companies and Foreign Banking Organizations

As noted above, both SLHCs and FBOs are subject to certain of the DFA provisions implemented by the proposed regulations. Other provisions will be applied at the Board’s discretion. To that end, the proposed regulations themselves, as a technical matter, cover both types of entities. However, the Notice delays the effective date of a majority of the rules proposed in the Notice with respect to SLHCs and FBOs until further rulemakings can be issued.

SLHCs: The DFA requires that all financial companies with US$10 billion or more in total consolidated assets whose primary federal regulator is the Board, which includes SLHCs, conduct an annual stress test. Moreover, although not specifically required by the DFA, the Notice states that the Board will apply the DFA’s enhanced prudential standards and early remediation requirements to SLHCs with “substantial banking activities,” meaning any SLHC that has US$50 billion or more of total consolidated assets and either (i) has savings association subsidiaries that comprise a quarter or more of the SLHC’s total consolidated assets or (ii) controls one or more savings associations with US$50 billion or more in total consolidated assets. The Board will also retain the ability to apply the enhanced standards to any other SLHC as determined on a case-by-case basis on safety and soundness grounds. However, because the proposed rule presupposes that an entity is already subject to consolidated capital requirements, which are still in development for SLHCs, application of the Notice’s proposed regulations will be delayed until at least such time as the Board finalizes its capital requirements for such entities.

FBOs: Sections 165 and 166 apply to FBOs that have US banking operations6 and global consolidated total assets of US$50 billion or more. In crafting regulations to address FBOs, Section 165(b)(2) of the DFA instructs the Board to “give due regard to the principle of national treatment and equality of competitive opportunity” and to “take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States.” In recognition of the limitations of existing international agreements on bank regulation and the complex structures and operations of many FBOs, the Board states that crafting suitable rules to apply Sections 165 and 166 to FBOs will be “difficult” and therefore largely exempts FBOs from coverage under the proposed rules in favor of specially tailored rules that are in development. We anticipate that such forthcoming rules for FBOs will attempt to create a regulatory structure as identical as possible to the one proposed in the current Notice, so as to apply similar standards to foreign- and domestic-based organizations alike. In the meantime, foreign-owned domestic BHCS with total consolidated assets of US$50 billion or more will be subject to the proposed rules as would any other similarly situated BHC.

Specific Requirements

1. Risk-Based Capital Requirements and Leverage Limits

To address deficiencies identified in capital levels in stressed environments, and more generally to ensure a
Federal Reserve Proposes Enhanced Prudential Standards for Large Financial Institutions

forward-thinking approach to capital management efforts at large institutions, the proposed rule would extend the application of the Board’s recently adopted Capital Plan Rule to all Covered Companies, including nonbank financial companies designated by the FSOC. That rule, currently applicable only to BHCs, will require all Covered Companies to meet several risk-based and leverage capital requirements. The compliance date for the proposed capital planning and minimum capital requirements will generally be the later of the effective date of the proposed rule or 180 days after Board designation as a Covered Company.

All Covered Companies will be required to submit annual capital plans to the Board demonstrating in detail the company’s ability to maintain capital above the Board’s minimum risk-based capital ratios (total capital ratio of eight percent and tier 1 capital ratio of four percent) and tier 1 leverage ratio (four percent) under both baseline and stressed conditions over a minimum nine-quarter, forward-looking planning horizon. In addition, Covered Companies will be required to demonstrate an ability to maintain a minimum tier 1 common risk-based capital ratio of five percent over the same planning horizon and under the same conditions. A Covered Company unable to satisfy these requirements generally will be prohibited from making any capital distributions until it provides a satisfactory capital plan to the Board. Covered companies may seek reconsideration or hearing of Board objection by written request.

In certain circumstances the proposed rule will require Covered Companies to obtain prior approval from the Board before making a capital distribution. The Board could require prior approval even where it has previously provided nonobjection to the company’s capital plan if, among other things, the company’s capital levels fall below Board requirements or the distribution would result in a material adverse change to the organization’s capital, liquidity, or earnings structure.

Additionally, the proposed rule will subject nonbank Covered Companies to the same minimum risk-based capital and leverage requirements as BHCs and require them to report risk-based capital and leverage ratios to the Board. Nonbank Covered Companies will be required to hold capital sufficient to meet (i) a tier 1 risk-based capital ratio of four percent and a total risk-based capital ratio of 8 percent, as calculated according to the Board’s risk-based capital rules, and (ii) a tier 1 leverage ratio of 4 percent as calculated under the Board’s leverage rule. A Covered Company that fails to meet these requirements will be required to notify the Board immediately.

Finally, under the proposed rule’s “reservation of authority,” the Board could in its discretion require any Covered Company to hold additional capital or subject any Covered Company to other requirements or restrictions if it decided the proposed rule did not adequately mitigate the risks posed by the company to US financial stability.

The proposed rule also contemplates, but does not yet propose, a risk-based capital surcharge, ranging from 100 to 350 basis points based on an entity’s systemic footprint, to be levied on a subset of Covered Companies known as Global Systemically Important Banks (G-SIBs). The proposed rule contemplates phasing in the capital surcharge from 2016 to 2019 and requests feedback on how best to craft and implement the surcharge.

2. Liquidity Requirements
Currently, the Board oversees liquidity risk management at BHCs primarily through supervisory guidance rather than regulatory requirements. This approach, while serving well under normal market conditions, proved insufficient in stressed scenarios where traditional sources of liquidity became unavailable amid a broader market paralysis. The proposed rule addresses this shortcoming by requiring all Covered Companies to take a number of prudential steps to manage liquidity risk, with the goal of forcing institutions to develop a better understanding of their liquidity needs under a variety of economic conditions, to identify and shore up areas that present unacceptable liquidity exposure, to

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8 12 C.F.R. part 225, Appendix A and G.
9 12 C.F.R. part 225, Appendix D, section II.
monitor liquidity on an ongoing basis, and to prepare in advance for potential liquidity needs. The requirements increase in stringency based on the systemic footprint of the Covered Company. The specific steps required of Covered Companies include:

- Developing comprehensive and dynamic cash flow projections arising from contractual maturities, new business, funding renewals, customer options, and other potential events that may impact liquidity;
- Conducting monthly and ad hoc stress testing of the company’s activities, exposures, and risks, including off-balance sheet exposures, based on the various process and system requirements imposed by the proposed rule;
- Maintaining a liquidity buffer of highly liquid, unencumbered assets that is sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios;
- Establishing and updating at least annually a detailed Contingency Funding Plan describing the policies, procedures, and action plans for managing liquidity stress events;
- Establishing and maintaining limits on potential sources of liquidity risk, including limits on (i) concentrations of funding in particular instruments, counterparties, counterparty types, or other liquidity risk identifiers; (ii) the amount of specified liabilities that mature within various time horizons; and (iii) off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events;
- Monitoring liquidity risk related to collateral positions, liquidity risks across the enterprise, and intraday liquidity positions; and
- Comprehensively documenting all material aspects of the company’s liquidity risk-management processes and compliance with the proposed rule and providing such documentation to the Board upon request.

The proposed rule will place much of the responsibility for compliance with these and additional liquidity requirements with the company’s board of directors, risk committee, and senior management. The board of directors will be required to establish the Covered Company’s overall liquidity risk tolerance (defined as the acceptable level of liquidity risk the Covered Company may assume in connection with its operating strategies) at least annually and to review compliance with that level at least semi-annually. The board of directors will also be required to approve the company’s Contingency Funding Plan at least annually.

Ongoing liquidity risk-management obligations will be substantial. A company’s risk committee will be required to review and approve the liquidity costs, benefits, and risk of each significant new business line and product prior to implementation, as well as the liquidity stress testing, liquidity buffer, and limits on liquidity risk outlined above. The risk committee will also be required to review the comprehensive cash flow projections, liquidity risk-management information used to assess liquidity risk, and an independent validation of the liquidity stress tests. The company’s senior management will be responsible under the proposed rule for implementing the liquidity risk strategies, policies, and procedures and for reporting regularly to the risk committee on the company’s liquidity risk profile. Finally, the proposed rule requires an independent review of the company’s liquidity risk-management activities to be performed at least annually.

The proposed rule also contemplates, but does not propose, specific quantitative liquidity requirements consistent with the international standards of Basel III. These requirements are to be implemented by Basel Committee member countries in 2015 and 2018.

It is clear that these new rules will require Covered Companies to dedicate significant resources to liquidity planning, monitoring, and maintenance. The enhanced liquidity rules will almost certainly require greater liquidity reserves than currently exist at Covered Companies. As the kinds of highly liquid collateral necessary to offset risky activities typically yield relatively small returns, this result may lead to a migration of certain higher-risk activities
to smaller or non-US firms that are not subject to these enhanced rules.

The Board has asked for comments on all aspects of its proposal for enhanced liquidity standards, including whether other possible approaches, such as limits on short-term debt, should be considered as alternative or additional methods for safeguarding liquidity positions at Covered Companies.

3. Single-Counterparty Exposure Limits
Much of the government’s justification for its large-scale intervention in financial markets was the avoidance of a potential domino effect that could have followed the failure of the largest financial institutions. To limit the mutual interconnectedness of large institutions, Section 165(e) of the DFA requires the Board to impose concentration limits on Covered Companies. The Board must limit a Covered Company’s credit exposure to any unaffiliated company to 25 percent of the Covered Company’s capital stock or surplus, or a lower percentage that the Board deems necessary. The regulation must become effective no earlier than July 2013 and no later than July 2015. The Board indicated in the Notice that periodic credit exposure reporting requirements, also required by the DFA, will be developed in coordination with these single-counterparty exposure limits.

Credit Exposure Limits
The proposed rule would limit the aggregate net credit exposure10 of a Covered Company to any unaffiliated counterparty to 25 percent of the capital stock and surplus of the Covered Company. The aggregate net credit exposure of a Covered Company to any counterparty is calculated on a consolidated basis with respect to both parties, although the Board has invited comments on whether such consolidation is appropriate. Furthermore, the proposed rule would limit the aggregate net credit exposure of a “major covered company”(defined as a BHC with US$500 billion or more in total consolidated assets or a FSOC-designated nonbank company) to any unaffiliated “major counterparty” (defined as a “major covered company” or an FBO that is or is treated as a BHC and has total consolidated assets of US$500 billion or more) to 10 percent of the capital stock and surplus of the “major covered company.” The proposed exposure limits will be in addition to the loan-to-one-borrower and investment limits imposed on depository institutions, and the Board has asked what conflicts may arise out the interaction of these various requirements.

Credit Exposure Calculation
Net credit exposure is defined as gross credit exposure adjusted for certain netting agreements or eligible collateral, guarantees, or derivatives. Under the proposed rule, a Covered Company would have gross credit exposure to a counterparty if it engages in any of the following types of credit transactions, with the amount determined according to specific provisions—including in some cases specific multiplier tables—in the proposed rule:

- Loans and leases
- Debt and equity securities
- Repurchase and reverse repurchase agreements
- Securities borrowing or lending transactions
- Committed credit lines
- Guarantees and letters of credit
- Derivative transactions between the Covered Company and the counterparty
- Credit or equity derivative transactions where the Covered Company is the protection provider

The proposed rule includes detailed procedures for calculating the value of the above transactions. The Board has asked for comments on possible impediments to its proposal for calculating gross credit exposure and whether additional or alternative valuation methodologies should be considered.

For purposes of calculating gross credit exposure to a counterparty, the proposed rule restates the “attribution rule” in Section 165(e) of the DFA, which provides that if the proceeds of a credit transaction between a Covered Company and any person are used for the benefit of, or

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10 The Board has asked whether, in certain circumstances, limits on gross credit exposure may also be appropriate.
transferred to, a company, the Covered Company must treat the credit transaction as one with that company. The Board recognizes that the attribution rule, if interpreted too broadly, "would lead to inappropriate results and would create a daunting tracking exercise for Covered Companies." It therefore sought to "minimize the scope of application of this attribution rule," and the proposed rule seeks feedback on its efforts to do so.

To arrive at the amount of net credit exposure, gross credit exposure may be adjusted using the following considerations:

- Bilateral netting agreements, with respect to repurchase and reverse repurchase transactions and securities lending and borrowing transactions;
- Market value of any eligible collateral for a credit transaction, as such value is adjusted as set forth in the proposed rule;
- The unused portion of a credit extension, under certain enumerated circumstances;
- Any "eligible guarantee" from an "eligible protection provider," as such terms are defined in the proposed rule, that covers the credit transaction;
- The notional amount of any "eligible credit or equity derivative" from an "eligible protection provider" that references the counterparty, as such terms are defined in the proposed rule; and
- The face amount of a short sale of the counterparty's debt or equity security (i.e., sale of a security that the Covered Company does not own).

When a credit transaction between a covered company and a counterparty is covered by an eligible guarantee or an eligible credit or equity derivative, the above adjustments to the gross credit exposure would be mandatory, and the covered company would substitute credit exposure to the guarantor or the protection provider for credit exposure to the counterparty for purposes of the proposed rule.

The proposed rule would exempt certain categories of credit transactions from the limits on credit exposure, including intraday credit exposure to a counterparty and claims involving the United States and its agencies and certain government sponsored entities. Notably, transactions with US state and local governments and with foreign sovereigns are not exempt, and such parties and are treated as counterparties for purposes of the proposed rule—a decision regarding which the Board has invited feedback.

**Compliance**

A Covered Company must comply with the limits on credit exposure on a daily basis, as of the end of each business day, and must submit a monthly report to the Board demonstrating such compliance. Accordingly, a Covered Company must value many types of credit exposure and related collateral on a continuous basis. There are limited exemptions from this daily compliance requirement where the amount of a Covered Company's capital stock and surplus decreases (which results in a decrease in the credit exposure limit), or where there is a business combination involving either a Covered Company or its counterparties, although compliance must be re-established promptly—typically within 90 days.

We anticipate that the effort needed to achieve compliance with the exposure limits as drafted will be substantial, particularly for very large institutions. As an initial matter, each Covered Company will need to make a qualitative and quantitative assessment throughout the organization of all forms of credit exposure (both direct and “attributed”), all offsets to credit exposure, and all counterparties. Once that process is complete, a Covered Company must determine which counterparties are affiliated with one another, and therefore must be consolidated, for calculation of single-counterparty exposure—a massive undertaking in the case of large multinational enterprises. Finally, these same factors must be monitored throughout the organization on an ongoing, real-time basis in order to satisfy the daily compliance requirement under the proposed rule. In view of the size of some organizations and the sheer volume of transactions that will require tracking and aggregating, implementation of this mandate, if left in its current form, will be daunting.
4. Risk Officer and Risk Committee

A significant component of the government’s effort to head off future crises is to require better risk management at large financial institutions. While all banking institutions are already required to have risk-management practices in place, the DFA goes a step further by requiring the establishment of a formal risk committee at large financial institutions. Such requirements, in most instances, would also be new to nonbank financial companies that may become subject to the DFA requirements.

As mandated by Section 165, the Board is proposing that publicly traded nonbank Covered Companies and publicly traded BHCs with US$10 billion or more in total consolidated assets establish a risk committee of the board of directors to document and oversee enterprise-wide risk-management policies and practices. The proposed rule will require certain procedures for risk committees, including a formal, written charter that is approved by the company’s board of directors, regular meetings, full documentation and maintenance of records of proceedings, and direct reporting to the company’s board of directors. The risk committee’s substantive duties would include reviewing and approving an institution-appropriate risk-management framework that includes the company’s stated risk limitations for each business line, processes for identifying and reporting risks and deficiencies, and specification of management’s authority to carry out risk-management duties. The proposed rule would also require Covered Companies to appoint a chief risk officer who will implement and maintain the risk-management framework and practices approved by the risk committee.

The proposed standards would be more stringent for risk committees of Covered Companies than for other entities subject to the risk committee requirement. The Board expects the expertise of the risk-committee membership to be commensurate with the complexity and risk profile of the organizations. Thus, the requirements of the proposed rule would increase in stringency with the systemic footprint of the company. Additionally, all banking organizations supervised by the Board must continue to follow existing Board guidance on risk management.

The Board has requested feedback on whether it should establish independence and competence requirements for service as a member of the risk committee or as the chief risk officer, or whether the proposed rules are sufficient. The Board has also asked for comments on the appropriate role of members of the risk committee in overseeing enterprise-wide risk management, the scope of that role, and how to ensure that the committees are sufficiently supported to carry out their duties. As the parameters of potential director liability will flow from these requirements, institutions that are potentially subject to the proposed rule will want to consider these questions carefully and respond as appropriate.

5. Stress Tests

The proposed rules implement Section 165’s requirement that the Board conduct annual stress tests of Covered Companies under baseline, adverse, and severely adverse scenarios, and publicly disclose information on the company-specific results of those tests. The supervisory tests would evaluate whether each Covered Company has the necessary capital to absorb losses under the “normal” and adverse economic and financial conditions of the designated scenarios. This evaluation would include a review, among other things, of the Covered Company’s estimated losses, pre-provision net revenue, allowance for loan losses, and the impact of those factors on the company’s capital position. The Board would update the scenarios each year to reflect changes in the outlook for economic and financial conditions.

The Board intends to conduct the supervisory stress tests using data supplied by each Covered Company. The tests would use information regarding the company’s on- and off-balance sheet exposures to evaluate the sensitivity of the company’s revenues and expenses to several economic and financial scenarios. The Board will issue a separate proposal outlining the specific data requirements. The Board will also publish a separate overview of its methodology for the supervisory stress tests.
Additionally, the proposed rules implement Section 165’s requirement that any financial company regulated by a primary federal financial regulatory agency that has more than US$10 billion in total consolidated assets conduct its own annual stress test, and that Covered Companies conduct additional semi-annual stress tests. For the semi-annual company-run test, a Covered Company would be required to create and employ its own scenarios reflecting a minimum of three sets of economic and financial conditions—baseline, adverse, and severely adverse conditions—and any additional conditions that the Board requires. The company must then report to the Board the results of the stress tests, publish a summary of the results, and take the results of the stress tests and the Board’s analyses thereof into account in making appropriate changes to the company’s capital structure, concentrations, and risk positions. The Board may also require other actions consistent with safety and soundness of the company.

6. Debt-to-Equity Limit
Section 165(j) of the DFA requires the Board to limit a Covered Company’s debt-to-equity ratio (calculated as the ratio of a company’s total liabilities to its total equity capital less goodwill) to 15 to 1, upon a determination by the FSOC that the company poses a grave threat to the financial stability of the United States and that the limit is necessary to mitigate the risk posed by the company to the financial stability of the United States. It also requires the Board to establish procedures and timelines for complying with the limit. The proposed rule would require a Covered Company to comply with the limit within 180 days of receiving written notice from the FSOC of its determination under Section 165(j) of the DFA. It would allow the Board to extend the time for compliance for up to two additional periods of 90 days each. The limit would cease to apply upon notice from the FSOC that the company no longer poses a grave threat to the financial stability of the United States and that the imposition of the limit is no longer necessary.

7. Early Remediation
While Congress and the Board obviously hope that the enhanced prudential standards created by the DFA and the proposed rules will prevent further crises, a framework is nonetheless established in the proposed rule, consistent with Section 166 of the DFA, for the Board to take specific steps to address weaknesses and, if necessary, failures of Covered Companies. The process established in the proposed rules is intended to go beyond the Prompt Corrective Action mechanism used by the federal banking agencies, which mandates progressively stronger remedial action as the condition of an insured depository institution deteriorates and which was criticized as insufficient to protect the deposit insurance fund in recent years. In addition to Covered Companies, the Board also would impose early remediation requirements on SLHCs with substantial banking activities once the Board has established risk-based capital requirements for them.

Under the proposed rule, the Board would impose certain remediation requirements on Covered Companies based on various triggering events, including the Board’s existing definitions of minimum risk-based capital and leverage ratios, the results of the Board’s supervisory stress tests under the proposed rule, market indicators, and weaknesses in complying with enhanced risk-management and liquidity standards under the proposed rule. The Board would like to be advised of any possible alternative or additional triggering events that may be employed in the proposed rulemaking. The Board is also particularly interested in comments regarding the market indicators it has proposed as triggering events for remedial actions.

11 The Board has asked for feedback on the benefits and drawbacks of company-specific disclosures and whether any alternatives should be considered.
The proposed rule establishes four levels of remediation requirements that are designed to identify emerging issues before they develop into larger problems. At the first level—heightened supervisory review—the Board would conduct a targeted review of the Covered Company to determine if it is experiencing financial distress or material risk-management weaknesses such that it should be moved to the next level of remediation. At the second level—initial remediation—a Covered Company would be subject to restrictions on growth and capital distributions. At the third level—recovery—a firm would face growth and capital-distribution prohibitions, executive compensation limitations, and capital raising requirements. Finally, at the fourth level—recommended resolution—the Board would determine whether to recommend that the firm be resolved under the orderly liquidation authority created by the DFA. Required actions would vary based on the severity of the situation.

The proposed early remediation regime would be in addition to the Board’s other supervisory processes with respect to Covered Companies and would in no way diminish the Board’s authority to initiate administrative actions, under Section 8 of the Federal Deposit Insurance Act and elsewhere, to address supervisory concerns.

Conclusion
The proposed regulations are a significant step towards implementing the enhanced prudential standards mandated by the DFA. While the rules attempt to create a more resilient and potentially less-interdependent industry, the implementation of the rules will not be without cost. In recognition of the far-reaching impact of this rulemaking, the Board has posed nearly 100 specific questions in the Notice that address multiple aspects of each element of the proposal. Industry participants that may be subject to these proposed rules should give careful consideration to their feasibility and whether better, less onerous alternatives may be available that would achieve the results required under the DFA. Large SLHCs and FBOs, for which similar rulemakings are forthcoming, will certainly wish to review the current proposal in the context of their unique organizational structures to assist the Board in crafting appropriate implementing regulations.

We hope you have found this Advisory useful. If you would like more information or assistance in addressing the issues raised in this Advisory, please feel free to contact:

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FDIC Finalizes Dodd-Frank Act Living Will Requirements for Systemically Important Companies

On September 13, 2011, the Federal Deposit Insurance Corporation (FDIC) approved a Final Rule that requires certain bank holding companies, foreign banks or companies, and systemically important nonbank financial companies, to periodically submit resolution plans, or “living wills,” describing how they can be resolved in an orderly manner under the Bankruptcy Code in the event of material financial distress or failure. Once approved by the Board of Governors of the Federal Reserve System (FRB), the Final Rule will be issued jointly by the FDIC and the FRB (collectively, the “Agencies”). Implementing Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Final Rule establishes rules and requirements regarding the submission and content of a resolution plan, as well as procedures for review of the plan by the Agencies. In April 2011, the Agencies released for public comment a proposed version of the resolution plan rules (Proposed Rule). The Final Rule reflects a number of significant changes that were largely prompted by comments submitted by banking organizations, industry groups, and other interested parties.¹

The Dodd-Frank Act required that the Agencies jointly issue final rules no later than January 21, 2012. The FDIC staff proposed to the Board of Directors of the FDIC that the effective date of the Final Rule be 30 days after its publication in the Federal Register. The Final Rule will likely become effective prior to the statutory deadline.

I. Who is “Covered” By the Final Rule?

The following companies are required to submit resolution plans under the Final Rule (collectively, the “Covered Companies”):

- Nonbank financial companies that have been designated by the Financial Stability Oversight Counsel (FSOC) as being systemically important under Section 113 of the Dodd-Frank Act and therefore are supervised by the FRB;²

¹ As a complement to the Final Rule, the FDIC also approved on September 13 an Interim Final Rule that requires each US insured depository institution with $50 billion or more in total assets to submit a plan for the resolution by the FDIC, as receiver, of such institution in the event of the institution’s failure. Currently, 37 insured depository institutions are covered by the Interim Final Rule. Comments on the Interim Final Rule are due on November 21, 2011.

² The FSOC has not yet finalized the regulations which establish the standards for designation as a...
Bank holding companies that have US$50 billion or more in total consolidated assets; and

Foreign banks or companies that are, or are treated as, bank holding companies under Section 8(a) of the International Banking Act of 1978, and that have US$50 billion or more in total consolidated assets.

The Agencies have estimated that there are 124 companies that would be subject to the Final Rule. To mitigate the possibility of balance sheet manipulation to escape the Final Rule's coverage, the Final Rule provides that once a bank holding company becomes a Covered Company, it will remain so until it has less than US$45 billion in total consolidated assets, as determined based on the most recent annual or, as applicable, the average of the four most recent quarterly reports. Such a company may become a Covered Company once again if it reports US$50 billion in total consolidated assets on its most recent annual report or, as applicable, the average of its four most recent quarterly reports.

II. Timeframe for Submission

The Final Rule provides Covered Companies with more time to prepare and submit resolution plans than would have been provided under the Proposed Rule. Under the Proposed Rule, resolution plans for all Covered Companies would have been due 180 days following the effective date of the rule. Under the Final Rule, each Covered Company is required to submit its initial resolution plan on a staggered basis depending on the size of the company's US-based nonbank operations as of the effective date of the Final Rule. A Covered Company must submit its initial resolution plan in accordance with the following schedule:

- By July 1, 2012 if it has US$250 billion or more in total nonbank assets (or, in the case of a foreign-based company, in total US nonbank assets);
- By July 1, 2013 if it has US$100 billion or more in total nonbank assets (or, in the case of a foreign-based company, in total US nonbank assets);
- By December 31, 2013 if it has less than US$100 billion in total nonbank assets (or, in the case of a foreign-based company, in total US nonbank assets).

A company that becomes a Covered Company after the effective date of the final rule must submit its resolution plan by the July 1 following the date it becomes a Covered Company, provided that it has been a Covered Company for at least 270 days. While the Final Rule is unclear on this point, it appears that if a company has become a Covered Company less than 270 days before July 1, such company would be expected to file its initial resolution plan by the end of the 270 day period. For example, with respect to a company that becomes a Covered Company with US$100 million or more in total nonbank assets on May 1, 2013, it appears that such company would be expected to file its initial resolution plan by January 27, 2014.

The Final Rule requires each Covered Company to submit updated resolution plans annually on or before the anniversary of its initial submission date. The Agencies may jointly modify the date for an initial or annual submission so long as they provide written notice of such determination no later than 180 days prior to the date upon which they are requiring the resolution plan to be submitted. In addition to the initial and annual submissions of resolution plans, each Covered Company is required to provide the Agencies with notice no later than 45 days after any event or change in circumstances that results in, or could reasonably be foreseen to have, a "material effect" on the resolution plan, unless its annual resolution plan is due within 90 days. The notice must describe the material event and explain why it may require changes to the resolution plan. The material event must be addressed in the Covered Company's next resolution plan.

III. Informational Content of a Resolution Plan

A Covered Company domiciled in the United States is required to provide detailed information outlined in the Final Rule with regard to both its US operations and its foreign operations. A foreign-based Covered Company is required
to provide such information regarding its US operations, an explanation of how resolution planning for its US operations is integrated into its overall resolution planning, and a description of the interconnections and interdependencies among its US operations and its foreign-based operations.

Specifically, each resolution plan must include the following components:

**Executive Summary.** An executive summary must summarize the key elements of the Covered Company’s strategic plan, material changes from the most recently filed plan, and any actions taken by the Covered Company to improve the effectiveness of the plan, or remediate or mitigate any material weaknesses or impediments thereto.

**Strategic Analysis.** A resolution plan must include a detailed and comprehensive strategic analysis describing the Covered Company’s plan for rapid and orderly resolution in the event of material financial distress or failure of the Covered Company. The strategic analysis must include any key assumptions and supporting analysis for the resolution plan, and it must address a number of areas set forth in the Final Rule.

**Corporate Governance.** This component must include a detailed description of how resolution planning is integrated into the corporate governance structure of the company, including identification of the senior management official(s) primarily responsible for overseeing the plan.

**Organizational Structure.** The resolution plan must include detailed information about the Covered Company’s organizational structure, including a hierarchical list of all material entities (including ownership, jurisdiction, and management information on each entity), critical operations and core businesses, financial statements, capital and cash flows, liabilities, off-balance sheet exposures, trading and derivatives activities, hedging activities, major counterparties, and trading systems.

**Management Information Systems.** This component must include a mapping of the key management information systems and applications to the material entities, critical operations, and core business lines of the company. The plan must also describe the process for supervisory and regulatory agencies to access such systems and applications.

**Interconnections and Interdependencies.** The resolution plan must identify the interconnections and interdependencies among the company and its material entities, critical operations, and core business lines, including shared resources, funding arrangements, credit exposures, and cross-entity arrangements.

**Supervisory and Regulatory Information.** The resolution plan must identify all the federal, state, or foreign agencies with supervisory authority or responsibility over the Covered Company and its material entities, critical operations, and core business lines.

**IV. Tailored Resolution Plans**

In response to comments on the Proposed Rule, the Final Rule permits smaller, less complex bank holding companies and foreign banking organizations that predominately operate through one or more insured depository institutions (or, in the case of a large number of foreign banking organizations subject to the rule, one or more branches or agencies) to elect to file a “tailored” resolution plan that focuses only on resolution of the company’s nonbank operations and business lines subject to the Bankruptcy Code, and the interconnections of such operations with those of its US insured depository institution(s) and, in the case of a foreign banking organization, its branches and agencies. A Covered Company may elect to file a tailored resolution plan if, as of the end of the prior calendar year, it had less than US$100 billion in total nonbank assets (or, in the case of a foreign-based company, in total US nonbank assets), and total insured depository assets comprise 85 percent or more of the company’s total consolidated assets (or, in the case of a foreign-based company, the assets of its US insured depository institution operations, branches, and agencies comprise 85 percent or more of its US total consolidated assets).
A Covered Company must submit written notice of its intent to submit a tailored resolution plan no later than 270 days prior to its required submission date. Within 90 days of receiving such notice, the Agencies will determine whether the Covered Company will be allowed to submit a tailored resolution plan or whether it must nonetheless submit the full resolution plan.

V. Agency Review Process and Consequences of Noncompliance

The Final Rule requires the Agencies to review a resolution plan within 60 days of submission and determine jointly whether the resolution plan is incomplete or that additional information is necessary to facilitate review. If the resolution plan is incomplete, the Covered Company will have 30 days to submit a revised plan. If the Agencies determine that the resolution plan is not credible or would not facilitate an orderly resolution of the Covered Company under the Bankruptcy Code, then they will notify the Covered Company that the plan is deficient and such company must submit a revised plan addressing the deficiencies within 90 days of receipt of such notice. The Final Rule permits the Agencies to extend these timeframes on their own initiative or in response to an extension request.

The preamble to the Final Rule states that the Agencies do not anticipate that initial resolution plans will be found to be deficient, but rather that such plans will serve as a foundation for more robust annual resolution plans over the next few years. Recognizing that resolution plans will vary by company, the Agencies have stated that their evaluation of the plans will take into account variances among companies in their core business lines, critical operations, domestic and foreign operations, capital structure, risk, complexity, financial activities, and size, among other things. The Agencies have indicated that they expect the review process to evolve as Covered Companies gain more experience in preparing their resolution plans.

If a Covered Company fails to timely submit a resolution plan or such plan fails to remedy the deficiencies identified by the Agencies, then the Agencies may subject the Covered Company or any of its subsidiaries to more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations. Such requirements or restrictions will apply until the Agencies determine that the Covered Company has submitted a revised resolution plan that adequately remedies the deficiencies. If the Covered Company does not submit a revised resolution plan that adequately remedies the deficiencies within two years of the imposition of the requirements or restrictions, then the Agencies in consultation with the FSOC, may order the divestiture of assets or operations as they deem necessary to facilitate an orderly resolution of the Covered Company under the Bankruptcy Code.

VI. Confidentiality

One of the major concerns expressed in many of the comments on the Proposed Rule was the extent to which information submitted in connection with a resolution plan would receive confidential treatment, given that the Final Rule requires Covered Companies to submit very detailed, internal proprietary information that would not normally be made available to the public. Commenters expressed concern that the Proposed Rule did not provide adequate assurance that resolution plans would be kept confidential, particularly given the public disclosure requirements of the Freedom of Information Act (FOIA). The Final Rule attempts to address this concern by explicitly permitting a Covered Company that submits a resolution plan to request confidential treatment in accordance with exemption 4 of FOIA (i.e., the exemption for trade secrets and commercial or financial information), and the corresponding regulatory exemptions of the Agencies. However, while the preamble to the Final Rule suggests that some information will be subject to exemption 8 of FOIA as “confidential supervisory information” (i.e., the “examination exemption”), the absence of explicit language in the Final Rule makes it unclear the extent to which confidential treatment will be granted under exemption 8 of FOIA.

The Final Rule states that each resolution plan must be divided into a public section and a confidential section. The public section of the resolution plan must include the executive summary. The Final Rule lists 11 types of information that must be included in the executive summary...
to the extent material to an understanding of the covered company, including:

- The names of material entities;
- A description of core business lines;
- Consolidated or segment financial statements regarding assets, liabilities, capital, and major funding sources;
- A description of derivative activities and hedging activities;
- A list of memberships in material payment, clearing, and settlement systems;
- A description of foreign operations;
- The identities of material supervisory authorities;
- The identities of the principal officers;
- A description of the corporate governance structure and processes related to resolution planning;
- A description of material management information systems; and
- A description, at a high level, of a Covered Company’s resolution strategy.

A Covered Company must submit a properly substantiated request for confidential treatment of any information in the confidential section of its resolution plan that it believes is subject to protection from disclosure under exemption 4 of FOIA. The Agencies will determine at their discretion whether to grant FOIA exemption requests. Thus, confidentiality will likely remain a highly controversial issue as Covered Companies begin to submit their initial and annual resolution plans.

VII. Interplay Between the Final Rule and the Interim Final Rule

As a complement to the Final Rule, on September 13, 2011, the FDIC approved an Interim Final Rule that requires each US insured depository institution with US$50 billion or more in total assets to submit a plan for the resolution by the FDIC, as receiver, of such institution in the event of the institution’s failure (the “IDI Interim Final Rule”). The IDI Interim Final Rule followed a Notice of Proposed Rulemaking that was published in the Federal Register on May 17, 2010, requiring Special Reporting, Analysis, and Contingent Resolution Plans at Certain Large Depository Institutions. That proposed rule would have required each insured depository institution with greater than US$10 billion in total assets that is owned or controlled by a holding company with more than US$100 billion in total assets to submit to the FDIC a resolution plan demonstrating the insured depository institution’s ability to be separated from its parent structure and resolved in an orderly fashion. In response to comments related to the passage of the Dodd-Frank Act, the FDIC delayed the issuance of the IDI Interim Final Rule to coordinate with the rulemaking implementing Section 165(d). Furthermore, to align the IDI Interim Final Rule more closely with the Section 165(d) rule, the FDIC raised the minimum asset size for a covered insured depository institution (CIDI) from US$10 billion to US$50 billion and eliminated the requirement that the CIDI be owned or controlled by a holding company with US$100 billion in assets or more.

The FDIC drafted the IDI Interim Final Rule to closely correspond with the informational requirements of the Final Rule. The IDI Interim Final Rule specifically provides that an insured depository institution may incorporate data and other information from its holding company’s resolution plan. Currently, with the exception of three thrifts covered by the IDI Interim Final Rule, the holding companies of each insured depository institution covered by the IDI Interim Final Rule are required to file resolution plans under the Final Rule which implements Section 165(d) of the Dodd-Frank Act.

The IDI Interim Final Rule states that it was meant to complement the Final Rule and avoid duplication of costs and efforts on insured depository institutions and their holding companies. However, the IDI Interim Final Rule and the Final Rule serve different purposes. The IDI Interim Final Rule requires a CIDI to submit a resolution that should enable the FDIC, as receiver, to resolve the institution in a manner that ensures that depositors receive access to their insured deposits within one business day of the institution’s failure (two business days if the failure occurs on a day other than Friday), maximize the net present value from the sale or disposition of its assets, and minimize the amount of any loss.
realized by the creditors in the resolution. The Final Rule, on the other hand, is focused on minimizing systemic risk in the resolution of the Covered Company in order to protect the financial stability of the United States while maximizing recovery for the creditors.

VIII. Conclusion
The Final Rule imposes significant planning and information-gathering requirements on Covered Companies and raises a number of important legal and practical considerations for Covered Companies. Although the Final Rule addresses many of the concerns raised in public comments, it leaves many key issues unanswered. For example, it lacks a clear, objective definition for what constitutes a “credible” resolution plan. It also does not address how, if at all, the Agencies will coordinate with foreign jurisdictions to achieve international consistency for Covered Companies with cross-border operations. For foreign-based Covered Companies, it remains unclear at a practical level just how such companies are to apply the Final Rule’s requirements to their relevant US operations. While the Final Rule attempts to address the important issue of the confidentiality of resolution plans, it is likely to remain a controversial issue and subject of great concern for Covered Companies.

The Agencies have recognized the significant burden associated with developing an initial resolution plan, as well as establishing the processes, procedures, and systems necessary to update the plan annually or as otherwise appropriate. The Agencies have postponed guidance on credit exposure reporting requirements and will likely issue such guidance in connection with the Board’s separate rulemaking regarding credit concentrations. While the staggered submission deadlines and opportunities to qualify to submit tailored plans provide some relief to smaller Covered Companies, the largest Covered Companies face a tremendous challenge to prepare initial resolution plans by July 2012. Given the broad scope of the Final Rule, Covered Companies need to start promptly gathering information and preparing initial resolution plans. Such companies will also need to devote substantial resources to updating their resolution plans annually because the Agencies expect that the initial plans will serve as a foundation for the development of more robust annual resolution plans over the coming years. It will be important for Covered Companies to open a dialogue with the Board and the FDIC during the development of their resolution plans. Maintaining an open line of communication with the Agencies will help ensure that the resolution planning process will result in a plan that meets the requirements of the Final Rule.

Arnold & Porter LLP is available to assist you in determining how the Final Rule and IDI Interim Final Rule may affect your business. For further information, please contact your Arnold & Porter attorney or:

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UNC School of Law Banking Institute 2012: Dodd-Frank Regulatory Implementation

Presented by
John L. Douglas

March 29, 2012

Source: The Economist
Dodd-Frank – A Wholesale Revision to the Financial System without a Clear Understanding of the Causes of the Crisis or the Proper Cures

1. Making financial institutions safer
   - Enhanced supervision and prudential rules
   - Volcker
   - Swaps and derivatives
   - Collins

2. Making financial institutions resolvable
   - Living wills
   - Orderly liquidation authority

3. Changing the way financial institutions operate
   - Durbin
   - Changed assessments
   - Risk retention and QRMs
   - CFPB

Davis Polk
Dodd-Frank Rulemaking Progress

As of March 1, 2012

- Missed Deadline: Proposed, 134
- Future Deadline: Not Proposed, 123
- Missed Deadline: Not Proposed, 24
- Future Deadline: Proposed, 20
- Finalized, 99
Dodd-Frank Rulemaking Progress By Agency

As of March 1, 2012

Bank Regulators (132)
- Future Deadline: Proposed, 9
- Finalized, 22
- Missed Deadline: Not Proposed, 6
- Missed Deadline: Proposed, 51
- Future Deadline: Not Proposed, 44

CFTC (64)
- Future Deadline: Not Proposed, 5
- Finalized, 36
- Missed Deadline: Proposed, 3
- Missed Deadline: Not Proposed, 19

SEC (98)
- Future Deadline: Not Proposed, 17
- Finalized, 18
- Missed Deadline: Proposed, 53
- Missed Deadline: Not Proposed, 7

Other (106)
- Future Deadline: Not Proposed, 57
- Finalized, 23
- Missed Deadline: Proposed, 8
- Missed Deadline: Not Proposed, 11

Rulemaking counts are based on estimates and require judgment.

Values Refer to Number of Rulemaking Requirements
The Volcker Rule: By the Numbers

Source: Davis Polk
Ending “Too Big to Fail” and Taxpayer Bailouts

“Several large, complex U.S. financial companies at the center of the 2008 crisis could not be wound down in an orderly manner when they became nonviable. Major segments of their operations were subject to the commercial bankruptcy code, as opposed to bank receivership laws, or they were located abroad and therefore outside of U.S. jurisdiction. The size and complexity of these institutions, and the inadequacy of the bankruptcy process as a means to preserve value after their failure, rendered these companies Too Big to Fail . . . By requiring detailed resolution plans in advance, and authorizing an on-site FDIC team to conduct pre-resolution planning, the SIFI resolution framework regains the informational advantage that was lacking in the crisis of 2008.” -- Sheila Bair
In the U.S. there are two overlapping rules requiring the submission of resolution plans:

- The 165(d) Rule, which requires submission of resolution plans by “covered companies”:
  - U.S. and foreign BHCs with total consolidated assets of $50 billion or more;
  - Certain other foreign banks and companies that are treated as BHCs and that have total consolidated assets of $50 billion or more; and
  - Nonbank SIFIs designated for heightened supervision under Title I of the Dodd-Frank Act (currently, there are none).

- The IDI Rule, which requires submission of resolution plans by covered insured depository institutions (“CIDIs”): IDIs with total consolidated assets of $50 billion or more.
Consequences of Failing to Submit a Credible Plan

165(d) Rule

- The FDIC and the Federal Reserve will jointly review a 165(d) plan.
- If they jointly determine that a plan is not credible or would not facilitate an orderly resolution of the covered company under the Bankruptcy Code, various consequences may follow.
  - As an initial consequence of failure to submit a revised plan that adequately remedies any deficiencies, the FDIC and the Federal reserve may jointly impose on the covered company (or any of its subsidiaries) more stringent capital, leverage or liquidity requirements or restrictions on growth, activities or operations.
  - If within the first two years following imposition of such requirements or restrictions the covered company fails to submit a revised plan that adequately remedies any deficiencies, the FDIC and the Federal Reserve may jointly require the covered company to divest assets or operations upon a joint determination that divestiture is necessary to facilitate an orderly resolution of the covered company under the Bankruptcy Code.
- “Credibility” is not defined.
- But the regulators have said, “There is no expectation by [the FDIC and the Federal Reserve] that . . . initial plan iterations . . . will be found to be deficient, but rather the initial resolution plans will provide the foundation for developing more robust annual resolution plans over the next few years following that initial period.”
Consequences of Failing to Submit a Credible Plan

IDI Rule

- An IDI plan is similarly subject to review, but the FDIC acting alone may determine an IDI plan to be deficient (cf., joint FDIC/Fed determination under the 165(d) Rule).

- The IDI Rule defines the credibility standard by which an IDI plan will be judged. **Credibility** means that a plan’s strategies for resolving the CIDI, and the detailed information required by the rule, are “well-founded and based on information and data related to the [CIDI] that are observable or otherwise verifiable and employ reasonable projections from current and historical conditions within the broader financial markets.”

- The IDI Rule permits the FDIC to require revisions to a plan deemed not to be credible, but it does not specify actions the FDIC will take if the CIDI fails to cure any deficiencies. Presumably the FDIC would rely on its generally applicable back-up enforcement authority under the FDIA.
Timing Considerations

**Staggered Initial Submissions.** There are three initial resolution plan submission dates based on a covered company’s total U.S. nonbank asset size:

- No later than July 1, 2012 for covered companies with $250 billion or more in total U.S. nonbank assets;
- No later than July 1, 2013 for covered companies with $100 billion or more, but less than $250 billion, in total U.S. nonbank assets; and
- No later than December 31, 2013 for covered companies with less than $100 billion in total U.S. nonbank assets.

**IDI Rule Timing Aligned.** A covered company and any of its CIDIs are subject to the same initial submission date for their 165(d) and IDI resolution plans.

**Board Approval.** Resolution plan must be approved by a covered company’s or CIDI’s board of directors prior to submission. (TOC adds apparent board “certification” requirement.)

**Annual updates.** Annual updates are required on the anniversary of the initial submission date.
## Number of Banks with Texas Ratios Greater than 75%: Top 15 States

<table>
<thead>
<tr>
<th>State</th>
<th>Median TX Ratio</th>
<th>Total Assets ($mm)</th>
<th>Total Deposits ($mm)</th>
<th>Number of Banks (4Q 2011)</th>
<th>Number of Banks (3Q 2011)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Georgia</td>
<td>148%</td>
<td>$20,015</td>
<td>$17,622</td>
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<td>Florida</td>
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<td>$31,119</td>
<td>$26,827</td>
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<td>Illinois</td>
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<td>Wisconsin</td>
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<td>Missouri</td>
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<td>North Carolina</td>
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<tr>
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<tr>
<td>Arkansas</td>
<td>89%</td>
<td>$4,551</td>
<td>$3,835</td>
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<td>12</td>
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Source: J.P. Morgan Chase
## For Additional Information

<table>
<thead>
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<th>CONTACTS</th>
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<th>FAX</th>
<th>EMAIL</th>
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