April 17, 2018

Bank Capital Requirements

Federal Reserve and OCC Propose Amendments to the Enhanced Supplementary Leverage Ratio Requirements for U.S. G-SIBs

On April 11, 2018, the Federal Reserve and the OCC issued a joint notice of proposed rulemaking (the "*NPR*")[1] to modify the enhanced supplementary leverage ratio ("*eSLR*") requirements for U.S. top-tier bank holding companies ("*BHCs*") that are identified as U.S. global systemically important BHCs ("*G-SIBs*") and their subsidiary insured depository institutions ("*IDIs*") that are state member banks, national banks, or Federal savings associations,[2] as well as to modify the Federal Reserve's total loss-absorbing capacity ("*TLAC*") leverage buffer and leverage-based long-term debt requirements for BHCs and U.S. intermediate holding companies ("*IHCs*") of non-U.S. G-SIBs.[3] The existing eSLR-related requirements became effective on January 1, 2018, and the TLAC-related requirements will become effective on January 1, 2019. Comments on the NPR are due within 30 days of its publication in the *Federal Register*,[4] notably shorter than the 60-day comment period for the Federal Reserve's April 10, 2018 proposal to significantly revise its Comprehensive Capital Analysis and Review ("*CCAR*") process and capital rules to, among other things, introduce a stress leverage buffer requirement applicable to the tier 1 leverage ratio.

Although the FDIC adopted eSLR requirements for state nonmember bank subsidiaries of U.S. G-SIBs in an interagency rulemaking with the Federal Reserve and the OCC in 2014, the FDIC did not join the other agencies in issuing the NPR.[5]

Specifically, the NPR proposes the following amendments to the eSLR:

- ***G-SIB Buffer.*** The NPR proposes to modify the current 2% eSLR leverage buffer applicable to U.S. G-SIBs. The supplementary leverage ratio ("*SLR*"), which, like the eSLR, became effective on January 1, 2018, requires advanced approaches banking organizations[6] to maintain a ratio of tier 1 capital to total leverage exposure of at least 3%.[7] In addition to this 3% minimum, U.S. G-SIBs currently must maintain a 2% leverage buffer under the eSLR to avoid limitations on distributions (including dividends and share repurchases) and discretionary bonus payments. The NPR would change the eSLR buffer for a U.S. G-SIB from 2% to 50% of its risk-based capital surcharge calculated under the Federal Reserve's G-SIB surcharge rule.[8]

- This proposed recalibration would make the eSLR similar to the leverage-based buffer in the Basel Committee's recently issued standards to finalize the Basel III capital framework, commonly referred to as "Basel IV."[9] Those standards introduce a leverage buffer for G-SIBs equal to 50% of their G-SIB surcharges. There are, however, two important differences between the NPR and the Basel IV leverage-based buffer. First, the eSLR is currently effective (which the NPR would not change), but the implementation date for the Basel IV leverage-based buffer is January 1, 2022. Second, the Federal Reserve's G-SIB surcharge rule generally results in higher surcharges than those calculated using the Basel Committee's methodology.[10]

- ***IDI "Well Capitalized" Requirement.*** In addition to U.S. G-SIBs, eSLR requirements currently apply to IDIs that are subsidiaries of U.S. G-SIBs (collectively, "*Covered IDIs*").[11] Among other requirements, a Covered IDI must maintain an SLR of at least 6% to qualify as "well capitalized" under the prompt correction action ("*PCA*") framework. The PCA framework establishes levels of capitalization at which an IDI will become subject to increasing limits on its activities as its capital deteriorates, and the "well capitalized" threshold is used to determine eligibility for many important regulatory purposes, including financial holding company status, streamlined application procedures, and exemptions from limitations relating to brokered deposits. Similar to the changes to the eSLR buffer for U.S. G-SIBs, for a Covered IDI that is subject to the PCA regulations of the Federal Reserve or the OCC, the NPR would supplant the current 6% "well capitalized" SLR threshold with an SLR threshold equal to 3% plus 50% of the risk-based G-SIB surcharge applicable to the Covered IDI's U.S. G-SIB holding company.

In conjunction with these amendments to the eSLR, the Federal Reserve proposed corresponding modifications and technical amendments to its TLAC rule:

- ***Recalibrating Leverage-Based Capital Buffer.*** The Federal Reserve's TLAC rule requires a U.S. G-SIB to maintain a buffer of at least 2% of its total leverage exposure (the denominator for the SLR and eSLR), in addition to satisfying the minimum 7.5% leverage-based TLAC requirement. This buffer is similar to the buffers in the Federal Reserve's capital rules, and a breach would also result in graduated restrictions on the U.S. G-SIB's ability to make distributions and discretionary bonus payments. Similar to the changes for the eSLR, the NPR would supplant the 2% buffer with a buffer equal to 50% of the U.S. G-SIB's risk-based G-SIB surcharge.

- ***Eligible Long-Term Debt Requirements.*** The Federal Reserve's TLAC rule requires U.S. G-SIBs to maintain eligible long-term debt ("*LTD*") of 4.5% of total leverage exposure. As described in the preamble to the final TLAC rule, this 4.5% requirement was calibrated by subtracting a 0.5% balance sheet depletion allowance from the amount required to satisfy the eSLR (*i.e.*, 5%).[12] Consistent with the eSLR modifications, the NPR proposes to change the leverage-based LTD requirement for U.S. G-SIBs to 2.5% (*i.e.*, 3% minus the 0.5% allowance for balance sheet depletion) plus 50% of the firm's risk-based G-SIB surcharge.

- ***Technical Changes to the TLAC Rule.*** The NPR would also make "minor amendments" to the Federal Reserve's TLAC rule:

    - ***Haircut for LTD Instruments Nearing Maturity.*** Eligible LTD that has a remaining maturity of one year (365 days) or more, but less than two years (730 days), is subject to a 50% haircut for purposes of the LTD requirements but not the minimum TLAC requirements. Currently, the 50% haircut also applies to the calculations for the TLAC buffer requirements applicable to U.S. G-SIBs and U.S. IHCs of non-U.S. G-SIBs ("*Covered IHCs*"). The NPR would eliminate the 50% haircut for purposes of the TLAC buffer calculations "to ensure that LTD is calculated the same way for all TLAC requirements."[13] Relative to the current TLAC buffer calculation formula, the effect of this will be favorable to U.S. G-SIBs and Covered

IHCs in that it will generally increase the amount of CET1 capital available to satisfy the TLAC buffer requirements.

- ***Technical Changes Applicable to Covered IHCs.*** An institution that becomes a Covered IHC after adoption of the TLAC rule must comply with the rule within three years of becoming a Covered IHC. Currently, an institution that becomes a Covered IHC must comply with the requirements of the TLAC rule beginning three years (1,095 days) after the *earlier* of the date on which (i) the U.S. non-branch assets of the global systemically important foreign banking organization that controls the Covered IHC equaled or exceeded $50 billion and (ii) the foreign banking organization that controls the Covered IHC became a global systemically important foreign banking organization. The NPR would revise this calculation to be the *later*, rather than the *earlier*, of the two events, consistent with the Federal Reserve's description in the preamble accompanying the release of the final TLAC rule.[14] In addition, the proposal would conform the description of the methodology to calculate a Covered IHC's eligible LTD to match the description for calculating a U.S. G-SIB's eligible LTD.

Impact Assessment. The Federal Reserve estimates that the proposed changes would reduce the required amount of tier 1 capital for U.S. G-SIBs by approximately $400 million, which is approximately 0.04% of total U.S. G-SIB tier 1 capital as of the third quarter 2017.[15] This estimate takes into account both the amount of tier 1 capital required to avoid restrictions based on the capital buffer requirements in the Federal Reserve's capital rules, as well as the amount of tier 1 capital necessary to satisfy the minimum tier 1-based capital requirements in the Federal Reserve's CCAR stress tests (*i.e.*, to "pass" the CCAR quantitative assessment). Taking into account only the amount of tier 1 capital required to avoid restrictions based on the capital buffer requirements in the Federal Reserve's capital rules (*i.e.*, disregarding CCAR-related capital constraints), the proposed changes are estimated to reduce the required amount of tier 1 capital by approximately $9 billion,[16] which, according to the figures cited by the Federal Reserve, represents approximately 0.9% of total U.S. G-SIB tier 1 capital as of the third quarter of 2017. This differentiation illustrates how CCAR is typically the binding capital constraint for large BHCs, particularly U.S. G-SIBs.

On April 10, 2018, the Federal Reserve proposed substantial changes to CCAR and its capital plan rule in connection with the introduction of stress buffer requirements, including the elimination of the quantitative assessment and the introduction of a new stress leverage buffer applicable to the tier 1 leverage ratio.[17] Although both the eSLR-related proposal and the CCAR-related proposal include impact analyses, each impact analysis discusses the applicable proposal in isolation and neither addresses the cumulative impact of the proposals. The NPR does, however, seek comment on how the CCAR-related proposal would affect the proposed modifications to the eSLR requirements.[18]

For the lead IDI subsidiaries of U.S. G-SIBs, the NPR is estimated to reduce the amount of required tier 1 capital by approximately $121 billion.[19] The impact is much greater for Covered IDIs because the eSLR tends to be more binding for Covered IDIs than for their U.S. G-SIB holding companies for two reasons. First, the holding companies are subject to the risk-based G-SIB surcharge and post-stress capital requirements under CCAR and the Federal Reserve's capital plan rule. Second, the eSLR is calibrated at a higher level for Covered IDIs (6% versus 5% for their holding companies). On April 11, 2018, FDIC

Chairman Martin Gruenberg released a statement noting that the FDIC did not join the Federal Reserve and the OCC in issuing the NPR because it could result in "reductions in capital requirements" for insured depository institution subsidiaries of U.S. G-SIBs, adding that "[s]trengthening leverage capital requirements for the largest, most systemically important banks in the United States was among the most important post-crisis reforms."[20] If the NPR is adopted, the practical impact of the FDIC's not joining the Federal Reserve and the OCC is likely to be limited because U.S. G-SIBs are subject to the Federal Reserve's capital rules, and all the lead bank subsidiaries of U.S. G-SIBs are subject to the prompt corrective active regulations of the Federal Reserve or OCC.

Objectives of the NPR. The Federal Reserve and the OCC proposed the modifications in the NPR as part of their review of post-crisis reforms in order to "streamline and tailor the regulatory framework, while ensuring that [large banking organizations] have adequate capital to continue to act as financial intermediaries during times of stress."[21] The NPR confirms the Federal Reserve's and the OCC's views that "[l]everage capital requirements should generally act as a backstop to the risk-based capital requirements"[22] and, citing concerns raised by banking organizations over the past few years, acknowledges that the eSLR requirements have become a binding constraint, creating incentives for institutions subject to the eSLR to reduce participation in or increase costs for certain lower-risk, lower-return services (*e.g.*, secured repo financing, central clearing, and custodial deposit taking).[23] Although the NPR would lower the calibration for the eSLR and the degree to which the eSLR is a binding capital constraint, the NPR would not revise the definition of total leverage exposure (the denominator for the eSLR and SLR) to exclude exposures relating to those activities, such as U.S. Treasury securities held in connection with secured repo financing, initial margin in connection with central clearing, or central bank reserves in connection with custodial deposit taking. Accordingly, U.S. Treasury securities, initial margin, and central bank reserves would continue to contribute to eSLR- and SLR-based capital requirements and industry participants would presumably not consider the NPR to address sufficiently the concerns and incentives discussed above, as well as perceived fundamental flaws in the leverage ratio calculations.[24] Given that the NPR would effectively integrate the eSLR and the risk-based G-SIB surcharge, it also remains to be seen whether the NPR will give rise to additional concerns regarding the design and calibration of the Federal Reserve's G-SIB surcharge rule, which, as discussed above, generally results in higher surcharges than the Basel Committee's G-SIB surcharge methodology.[25]

Implications of Other Regulatory Reforms. The NPR is designed to make the eSLR requirements "more consistent with the risk-based capital measures now in effect for G-SIBs."[26] However, the Federal Reserve and the OCC note that the NPR assumes that the components of the SLR use the current definitions of tier 1 capital and total leverage exposure in their capital rules and that "[s]ignificant changes to either of these components would likely necessitate reconsideration of the proposed recalibration as the proposal is not intended to materially change the aggregate amount of capital in the banking system."[27] Last month, the United States Senate approved a bill that would, among other things, require adjustments to the measure of total leverage exposure for custodial banks to exclude certain deposits with central banks.[28] Although not expressly stated, the NPR appears to suggest that the proposal may be revised if the legislation is enacted. Testifying before the House Financial Services Committee on April 17, 2018, Federal Reserve Vice Chairman for Supervision Randal Quarles observed that, if the legislation became law, the Federal Reserve and the OCC would need to evaluate the calibration of the NPR to take into account a revised eSLR denominator for certain institutions.[29]

Request for Comments. In soliciting comments on this NPR, the Federal Reserve and the OCC pose a number of questions regarding the proposed modifications to the eSLR- and TLAC-related requirements, as well as other possible modifications to the SLR and TLAC rule. Notable questions include:

- ***Other Adjustments to the SLR (Question #5).*** The NPR asks whether the Federal Reserve and the OCC should consider alternative approaches to relieve the binding effect of the eSLR/SLR requirements, including the pros and cons of excluding central bank reserves from the SLR denominator, a concept contained in the recent Senate regulatory reform bill (but applied on only a very limited basis).[30]
- ***Changing eSLR IDI PCA Requirement to a Buffer (Question #6).*** The NPR also requests comment on whether it would be more appropriate to apply the eSLR requirement to Covered IDIs as a capital buffer requirement (in the same manner as the eSLR is applied to their holding companies), rather than as a threshold for "well capitalized" status under the PCA framework.[31]
- ***Revisions to Minimum TLAC Leverage Requirement (Question #9).*** The NPR requests comment on whether any modifications to the current minimum 7.5% leverage-based TLAC requirement for U.S. G-SIB's would be appropriate to address the proposed changes to the eSLR- and TLAC-related requirements or "to address other changes in circumstances since the TLAC rule was finalized, such as new foreign or international standards related to total loss absorbing capacity or capital."[32] Question 9 also asks whether any modifications to the 7.5% leverage-based TLAC requirement "would be appropriate for other reasons, including modifications to match or better align with the TLAC rule's supplementary leverage ratio requirements for [C]overed IHCs (*i.e.*, a TLAC amount no less than 6 to 6.75 percent of the covered IHC's total leverage exposure) or with similar foreign or international standards or expectations."[33] The breadth and open-ended nature of Question 9 indicate that the Federal Reserve may be open to considering further amendments to the calibration of its TLAC rule beyond those proposed in the NPR.

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ENDNOTES

1 Federal Reserve, OCC, *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies*, *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180411a2.pdf.

2 FDIC, Federal Reserve, OCC, *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions*, 79 Fed. Reg. 24,258 (May 1, 2014). For a discussion of the eSLR, please see our Memorandum to Clients entitled *Bank Capital: Supplementary Leverage Ratio: Federal Banking Agencies Propose Revisions to the Supplementary Leverage Ratio's Exposure Measure and Approve Final Rules Implementing an Enhanced Supplementary Leverage Ratio for the Largest U.S. Banking Organizations* (Apr. 16, 2014), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Supplementary_Leverage_Ratio.pdf.

3 Federal Reserve, *Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations*, 82 Fed. Reg. 8266 (Jan. 24, 2017). For a discussion of the Federal Reserve's TLAC rule, please see our Memorandum to Clients entitled *Loss Absorbency Requirements: Federal Reserve Adopts Final TLAC and Related Requirements for U.S. G-SIBs and U.S. Intermediate Holding Company Subsidiaries of Non-U.S. G-SIBs* (Dec. 16, 2016), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Loss_Absorbency_Requirements_12_16_16.pdf.

4 At the time of publication of this Memorandum, the NPR has not been published in the *Federal Register*.

5 See Note 2.

6 Advanced approaches banking organizations are generally those with $250 billion or more in total consolidated assets or $10 billion or more in foreign exposures (including subsidiary depository institutions of BHCs that meet one of these thresholds). Intermediate holding companies ("*IHCs*") of foreign banking organizations that meet the advanced approaches definition are treated as advanced approaches banking organizations even though IHCs are not required to determine their risk-based capital ratios under the agencies' advanced approaches capital rules.

7 For more information on the SLR, please see our Memoranda to Clients entitled *Bank Capital Rules: Federal Reserve Approves Final Rules Addressing Basel III Implementation and, for All Banks, Substantial Revisions to Basel I-Based Rules* (July 3, 2013), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital%20_Rules_Basel_III_7_3_13.pdf, and *Bank Capital: Supplementary Leverage Ratio: Federal Banking Agencies Issue Final Rules Revising the Supplementary Leverage Ratio's Exposure Measure Denominator*, (Sept. 16, 2014), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Supplementary_Leverage_Ratio_09_16_14.pdf.

8 *See* 12 C.F.R. Part 217, Subpart H. For information on the Federal Reserve's implementation of the Basel Committee's G-SIB surcharge, please see our Memoranda to Clients entitled *Bank Capital Requirements: Federal Reserve Proposes Rule Establishing Common Equity Surcharge on U.S. Global Systemically Important Banks* (Dec. 14, 2014), *available at* https://sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_12_14_14.pdf, and *Bank Capital Requirements: Federal Reserve Approves Final Common Equity Surcharge for U.S. Global Systemically Important Banks* (July 29, 2015), *available at* https://sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_7_29_2015.pdf. For information on the Basel Committee's March 2017 proposal to change its G-SIB surcharge methodology, see our Memorandum to Clients entitled *Bank Capital Requirements:*

ENDNOTES (CONTINUED)

Basel Committee Proposes Changes to the G-SIB Capital Surcharge Assessment Framework (Apr. 6, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_04_06_2017.pdf..

9 Basel Committee, *Basel III: Finalising Post-Crisis Reforms* (Dec. 2017), *available at* https://www.bis.org/bcbs/publ/d424.pdf. For additional information regarding Basel IV, please see our Memorandum to Clients entitled *Bank Capital Requirements: Basel Committee Releases Standards to Finalize Basel III Framework* (Dec. 19, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_12192017.pdf.

10 The Federal Reserve's G-SIB surcharge rule includes two methodologies, the first of which is based on the Basel Committee's methodology, and the second of which has a different calibration and typically results in higher surcharges. U.S. G-SIBs are subject to the higher of the surcharges calculated using those two methodologies. For additional information, see Note 8.

11 The Federal Reserve's eSLR requirements apply to state member banks that are subsidiaries of a BHC that is identified as a U.S. G-SIB under the Federal Reserve's G-SIB surcharge rule. The OCC's eSLR requirements currently apply to national banks and Federal savings associations that are subsidiaries of U.S. top-tier BHCs with more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody. The NPR would also amend the OCC's eSLR requirements so that they would apply to national banks and Federal savings associations that are subsidiaries of a BHC that is identified as a U.S. G-SIB under the Federal Reserve's G-SIB surcharge rule. This change is not expected to change the scope of applicability of the OCC's eSLR requirements. The FDIC has also implemented eSLR requirements, which apply to state nonmember banks that are subsidiaries of U.S. top-tier BHCs with more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody. Although the FDIC did not join the Federal Reserve and the OCC in issuing the NPR, the practical impact of its not doing so is likely to be limited because U.S. G-SIBs are subject to the Federal Reserve's capital rules, and the lead bank subsidiaries of U.S. G-SIBs are subject to the prompt corrective active regulations of the Federal Reserve or OCC.

12 82 Fed. Reg. 8266, 8275.

13 NPR at 23.

14 82 Fed. Reg. 8266, 8292, fn 75.

15 NPR at 19.

16 NPR at 18.

17 The CCAR-related proposal will be addressed in a forthcoming Memorandum to Clients.

18 NPR at 22.

19 NPR at 20. For all Covered IDI subsidiaries subject to the Federal Reserve's and the OCC's prompt corrective action regulations, the estimated impact of the NPR is approximately $122 billion, *i.e.*, $1 billion higher.

20 FDIC, Statement of Martin J. Gruenberg, Notice of Proposed Rulemaking on Supplementary Leverage Ratio Issued by the Federal Reserve and OCC (Apr. 11, 2018), *available at* https://www.fdic.gov/news/news/speeches/spapr1218.html.

21 NPR at 9.

22 The FDIC has traditionally relied more heavily on the leverage ratio.

23 NPR at 11–12.

24 In its June 2017 and October 2017 reports recommending comprehensive changes in the current regulatory system for U.S. depository institutions and the U.S. capital markets, respectively, the

ENDNOTES (CONTINUED)

U.S. Department of the Treasury recommended that U.S. Treasury securities, initial margin for centrally cleared derivatives and cash on deposit with central banks be excluded from total leverage exposure. For a discussion of these recommendations, see our Memoranda to Clients entitled *Treasury Issues Comprehensive Report on Depository System Regulatory Reforms: Trump Executive Order Required Fundamental Reassessment of Existing Rules; Treasury Submits First of Four Reports Examining Existing Financial Regulatory Framework* (June 14, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Treasury_Issues_Comprehensive_Report_on_Depository_System_Regulatory_Reforms.pdf, and *Treasury Issues Comprehensive Report on Capital Markets Reform: Trump Executive Order Required Fundamental Reassessment of Existing Rules; Treasury Submits the Second of Four Reports Examining the Regulatory Framework of U.S. Capital Markets* (Oct. 11, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Treasury_Issues_Comprehensive_Report_on_Capital_Markets_Reform.pdf.

25 In its June 2017 and October 2017 reports, the U.S. Department of the Treasury also recommended revisiting and recalibrating the Federal Reserve's G-SIB surcharge rule. See Note 24.

26 NPR at 9–10.

27 NPR at 10.

28 *See* S. 2155, 115th Cong. § 402 (2018), *available at* https://www.congress.gov/115/bills/s2155/BILLS-115s2155es.pdf. For additional information, please see our Memorandum to Clients entitled *Financial Services Regulatory Reform Legislation: Senate Approves Bipartisan Regulatory Reform Bill* (Mar. 18, 2018), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Financial_Services_Regulatory_Reform_Legislation_3_18_2018.pdf.

29 *Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System*, 115th Cong. (Apr. 17, 2018), *available at* https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403293.

30 See Note 28.

31 NPR at 22.

32 NPR at 24.

33 NPR at 24.

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CONTACTING SULLIVAN & CROMWELL LLP

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CONTACTS

New York

Thomas C. Baxter Jr.	+1-212-558-4324	baxtert@sullcrom.com
Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Elizabeth T. Davy	+1-212-558-7257	davye@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Michael T. Escue	+1-212-558-3721	escuem@sullcrom.com
Jared M. Fishman	+1-212-558-1689	fishmanj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Wendy M. Goldberg	+1-212-558-7915	goldbergw@sullcrom.com
Charles C. Gray	+1-212-558-4410	grayc@sullcrom.com
Joseph A. Hearn	+1-212-558-4457	hearnj@sullcrom.com
Jeremy E. Knobel	+1-212-558-3172	knobelj@sullcrom.com
Shari D. Leventhal	+1-212-558-4354	leventhals@sullcrom.com
Erik D. Lindauer	+1-212-558-3548	lindauere@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Camille L. Orme	+1-212-558-3373	ormec@sullcrom.com
Stephen M. Salley	+1-212-558-4998	salleys@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
Donald J. Toumey	+1-212-558-4077	toumeyd@sullcrom.com
Marc Treviño	+1-212-558-4239	trevinom@sullcrom.com
Benjamin H. Weiner	+1-212-558-7861	weinerb@sullcrom.com

Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com
Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com
Washington, D.C.		
Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
William F. Kroener III	+1-202-956-7095	kroenerw@sullcrom.com
Stephen H. Meyer	+1-202-956-7605	meyerst@sullcrom.com
Jennifer L. Sutton	+1-202-956-7060	suttonj@sullcrom.com
Andrea R. Tokheim	+1-202-956-7015	tokheima@sullcrom.com
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
Los Angeles		
Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
William F. Kroener III	+1-310-712-6696	kroenerw@sullcrom.com
Tokyo		
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com