SULLIVAN & CROMWELL LLP

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Systemically Important Financial Companies

Federal Reserve Issues Proposed Rules Implementing Enhanced Prudential Supervision Regime

SUMMARY

On December 20, 2011, the Board of Governors of the Federal Reserve System ("FRB") issued for public comment a notice (the "Notice") of proposed rulemaking (the "Proposed Rule(s)") implementing the wide-ranging enhanced prudential standards and early remediation requirements that will apply to (i) bank holding companies ("BHCs") with $50 billion or more in total consolidated assets ("Covered BHCs") and (ii) nonbank financial companies designated as systemically important by the Financial Stability Oversight Council ("FSOC") ("Covered Nonbank Companies" and, together with Covered BHCs, "Covered Companies"). These rules are mandated by Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The Notice is 173 pages and poses 95 specific questions. Comments are due by March 31, 2012.

In order to prevent or mitigate risks to U.S. financial stability that may arise from the material financial distress, failure, or ongoing activities of large, interconnected financial institutions, Section 165 of Dodd-Frank requires the FRB to establish prudential standards for Covered BHCs and Covered Nonbank Companies that must be "more stringent" than those applicable to non-covered companies and must increase in stringency as the size and complexity of the Covered Company increases. Under the statute, the FRB must establish enhanced prudential standards for:

- risk-based capital requirements and leverage limits;
- liquidity requirements;
- overall risk management requirements;
- resolution plan and credit exposure reporting; and
- concentration/credit exposure limits.

With the exception of the resolution plans, which were the subject of a previous rulemaking, and credit exposure reporting, which remains pending, each of these enhanced standards is addressed in the Proposed Rules.[1]

The FRB is also authorized, but not required by Section 165, to establish additional standards regarding:

- contingent capital;
- enhanced public disclosures;
- short-term debt limits; and
- any other prudential standards the FRB determines to be appropriate.

The Proposed Rules do not address these standards.

The Proposed Rules also implement Section 166 of Dodd-Frank, which requires the FRB to establish requirements to provide for the early remediation of financial distress of a Covered Company in order to minimize the possibility that the company will become insolvent and pose a risk to U.S. financial stability.

The requirements generally would become effective on the first day of the fifth calendar quarter after the effective date of the final rule (or the date a company becomes a Covered Company), although certain requirements have different transition provisions, which are noted in the relevant sections below.

OVERVIEW

In general, the same set of enhanced prudential standards would apply to Covered BHCs and Covered Nonbank Companies alike, although the FRB may, on its own volition or in response to a recommendation by the FSOC, tailor their application to different companies on an individual basis or by category. The Notice refers generally to the statutory authority to differentiate among Covered Companies based on size and a number of other factors. The Proposed Rules do not, however, provide any details as to whether, how or where this differentiation will occur, with the exception of a special rule for "major" Covered Companies (that is, those with over $500 billion in assets) with respect to single-counterparty credit limits. The Notice explains that this discretionary authority to tailor the applications of standards will be particularly important with respect to Covered Nonbank Companies that are organized and operated differently than banking organizations. In these cases, the FRB would assess the characteristics of the particular company after its designation by the FSOC, including its business model, capital structure, and risk profile, to determine how the requirements in Sections 165 and 166 should be applied to that company.

An inherent premise of the Proposed Rules appears to be that these enhanced standards are not only necessary to reduce the potential and impact of failure of Covered Companies, but to reduce a perceived advantage of size. For example, the Notice recites the need for heightened standards because of the "market perception" that some companies are "too big to fail" and refers to higher standards as "helping to offset any implicit subsidy as a result of market perceptions of implicit market support." The Proposed Rules do not, however, analyze the impact of the new Dodd-Frank resolution regime (Title II) on both the reality and perception of too big to fail. Nor do they provide any detailed analysis of such offset.

The Notice contains several statements that suggest an objective of encouraging at least the very largest financial institutions not to grow further or even to reduce their size. Specifically, although not included in the Proposed Rules, the Notice contemplates eventual adoption of the Basel global systemically important banks ("G-SIBs") special 350 basis point surcharge for companies that increase their systemic footprint. In addition the Notice refers to the Proposed Rules as "provid[ing] incentives for covered companies to reduce their systemic footprint."

The Proposed Rules reflect a much more aggressive, granular, and hands-on approach to the supervision and regulation of large BHCs. The Proposed Rules provide a high degree of detail and specificity with respect to process in such areas as liquidity and risk management and stress tests, but relatively little specificity in such other areas as capital and liquidity ratios. Accordingly, the requisite ratios will continue to be, at least for the time being, predominantly a function of supervisory discretion with respect to individual Covered Companies.

Finally, the Proposed Rules continue, and indeed accelerate, the FRB's specific direction of active board participation in the operation of large BHCs. Among the principal areas detailing board duties and responsibilities are liquidity and risk management and stress tests.

SCOPE OF APPLICATION

Although the Proposed Rules nominally apply to Covered Nonbank Companies as well as BHCs with $50 billion or more in total consolidated assets, there are few substantive rules proposed for Covered Nonbank Companies. This undoubtedly reflects the fact that although the FSOC has promulgated proposed regulations describing the manner in which it intends to carry out its authority to designate nonbank financial companies as subject to Section 165, to date the FSOC has yet to make any designations.[2] It also may reflect the difficulty of devising rules that could apply to the different types of U.S. and non-U.S. nonbank financial companies potentially subject to designation, which include savings and loan holding companies ("SLHCs"), insurance companies, private equity firms, hedge funds, asset management companies, and financial guarantors.

Some of the new requirements would apply to certain companies that are not Covered Companies:

- Although Sections 165 and 166 generally do not by their terms apply to SLHCs unless they are designated by the FSOC, the FRB intends to issue a separate proposal to apply the enhanced standards to all SLHCs with $50 billion or more in total consolidated assets and substantial banking activities (including savings association subsidiaries that comprise 25% or more of the SLHC's total consolidated assets or themselves have $50 billion or more in total consolidated assets) as a safety and soundness matter.
- As required by Dodd-Frank, the requirement to conduct annual stress tests applies to any financial company with more than $10 billion in total consolidated assets that is regulated by a primary federal financial regulatory agency.[3]

- As required by Dodd-Frank, the requirement to establish a risk committee applies to any BHC with $10 billion or more in total consolidated assets that is publicly traded.
- The FRB reserves authority to impose one or more of the standards on a BHC or SLHC that is not a Covered Company if the FRB determines it is necessary or appropriate to protect the safety and soundness of the company or to promote financial stability.

Although Sections 165 and 166 of Dodd-Frank apply to foreign banking organizations that have U.S. operations with $50 billion or more in total consolidated assets, the FRB has temporarily deferred the release of proposed rules for foreign banking organizations. Instead, the Proposed Rules would apply only to a U.S. BHC subsidiary of a foreign banking organization if the subsidiary itself has $50 billion or more in assets, but would not extend to the other U.S. operations of a foreign banking organization.[4] This approach will create a further incentive for non-U.S. banking organizations with U.S. bank subsidiaries to create a structural separation of those subsidiaries from their U.S. nonbank subsidiaries.[5]

RISK-BASED CAPITAL AND LEVERAGE REQUIREMENTS

The Proposed Rules' treatment of enhanced risk-based capital requirements and leverage limits applicable to Covered Companies under Section 165(b)(1)(A)(i) of Dodd-Frank may be more significant for what it does not address than for what it does address at this stage of regulatory reform. The Proposed Rules require that:

- Covered BHCs must comply with "any regulations adopted by the FRB relating to capital plans and stress tests"; and
- each Covered Nonbank Company must:
  - calculate its minimum risk-based and leverage capital requirements as if it were a bank holding company in accordance with the FRB's requirements for bank holding companies (including (i) risk-based capital requirements, whether under the general risk-based capital rule or, if the Covered Nonbank Company has $250 billion or more of total consolidated assets or $10 billion or more of foreign exposures, under the advanced "Basel II" approach, (ii) leverage capital and (iii) market risk rules);
  - maintain a Tier 1 risk-based capital ratio of 4%, a total risk-based capital ratio of 8% and a Tier 1 leverage ratio of 4%; and
  - comply with FRB regulations relating to capital plans and stress tests as if the covered company were a bank holding company.

The Notice indicates that, under the FRB's current regulations, the applicable FRB regulations relating to capital plans and stress tests are those added to Regulation Y in December 2011 implementing the Comprehensive Capital Analysis and Review (or "CCAR") program on an on-going basis.[6]

The Notice describes the FRB's "plans" to meet Section 165(b)(1)(A)(i)'s requirements for enhanced risk-based capital and leveraged standards as a "two-part effort." The first part is the limited provisions of the Proposed Rules described above. The second part will involve a quantitative risk-based capital surcharge for Covered Companies or a "subset" of Covered Companies. The FRB indicated in the Notice that the capital surcharge will be consistent with the Basel Committee's surcharge proposal for G-SIBs released by the Basel Committee in final form on November 4, 2011.[7] The FRB:

- indicated that it intends to issue a concrete proposal for implementation of a risk-based capital surcharge for Covered Companies, or a subset thereof, based on the Basel Committee approach, and also notes that the FRB contemplates that its surcharge would be implemented on the same timeline as the Basel Committee's proposed surcharge as to G-SIBs, with final rules adopted in 2014 and phased-in from 2016-2019;
- did not indicate how it would implement mechanical adjustments that would need to be made to the Basel Committee's G-SIB surcharge approach if it were made applicable to a broader group of covered companies than the eight U.S. bank holding companies that the Financial Stability Board ("FSB") indicated are expected to be subject to the G-SIB capital surcharge.[8]

As to what the FRB did not address in Proposed Rules, industry participants had anticipated that the FRB's capital-related rules under Section 165 as initially proposed might address aspects of the Basel III capital framework[9] as expected to be implemented in the United States, including issues relating to calculation methodology. The FRB notes in the Notice that it "is working with the other U.S. banking regulators to implement the Basel III capital reforms in the United States," but did not address (i) any substantive aspects of its implementation plans, other than its intention to adopt a surcharge based on the Basel Committee framework as described above, or (ii) whether the Basel III capital framework's provisions will be made applicable to all banking organizations in the United States or only a subset of banking organizations.

LIQUIDITY REQUIREMENTS

As in the case of capital requirements, the FRB is addressing the enhanced liquidity requirements of Section 165(b)(1)(A)(ii) for Covered Companies in "stages." Further, as is the case with the capital provisions, the liquidity provisions add little in the way of specific quantitative requirements other than references to a general intention to incorporate the Basel III requirements. In two key respects, however, there are differences. The first relates to the significant concerns that have been raised about the calculation methodology for the Basel liquidity coverage ratio ("LCR") and net stable funding ratio ("NSFR") proposed under Basel III. Unlike the Section 165 capital discussion, the liquidity discussion suggests that the FRB is advocating for more changes. Second, the provisions in the Proposed Rules with respect to liquidity are substantially more extensive than are the provisions with respect to capital. As the FRB notes in the preamble, the proposed requirements build upon guidance previously adopted by the FRB and other U.S. Federal banking agencies.[10] Importantly, the Proposed Rules with respect to liquidity focus on prudential steps to manage liquidity risk, albeit in a detailed manner, as opposed to imposing specific and prescriptive liquidity ratios like the LCR and the NSFR included in the Basel III final liquidity framework.[11]

The FRB notes that it intends to "implement the second stage" of a regulatory liquidity framework for Covered Companies through

> "one or more future proposals that would require covered companies or a subset of covered companies to satisfy specific quantitative liquidity requirements that are derived from, or consistent with, the international liquidity standards incorporated into Basel III." (Emphasis added.)

Although there has been a good deal of discussion among industry participants, the FRB and the other U.S. banking agencies concerning whether the Basel III liquidity framework will apply to all U.S. banking organizations or only to larger banking organizations, the FRB does not expressly address that issue in the Proposed Rules other than, by referring to a "subset" of Covered Companies, implicitly acknowledging that the scope of the Basel III liquidity framework's application is open. It is worth noting that the FRB does not use this "subset" formulation when discussing the application of the Basel III capital rules. The FRB reaffirms in the Notice its belief that the eventual introduction of the Basel III liquidity standards, as modified through the observation period, will be important to establish a rigorous liquidity framework.

The Proposed Rule's liquidity-related provisions cover, among others, the following areas:

- ***Corporate Governance Provisions.*** The Proposed Rules include extraordinarily detailed provisions with respect to responsibilities of the board of directors and its risk committee as well as senior management. It also includes a requirement for independent review. The provisions include the following:
  - The board of directors (or the risk committee) must establish the Covered Company's "liquidity risk tolerance" at least annually. "Liquidity risk tolerance" is defined as the "acceptable level of liquidity risk a Covered Company may assume in connection with its operating strategies," taking into account, among other factors, the Covered Company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors.
  - The risk committee or a designated sub-committee of the risk committee must review and approve the liquidity costs, benefits and risks of each significant new business line and each significant new product before the Covered Company implements the line or offers the product.
  - The board of directors must review and approve the Covered Company's contingency funding plan at least annually and whenever the Covered Company materially revises the plan.
  - The risk committee or a designated sub-committee must conduct quarterly reviews of key liquidity metrics, including the cashflow projections discussed below to the extent they use time periods in excess of 30 days, the liquidity stress testing process and its results discussed below, the size and composition of the liquidity buffer described below, and the specific limits on potential sources of liquidity risk discussed below.

Although the board of directors is ultimately responsible for liquidity risk, the Proposed Rules require senior management to establish and implement liquidity risk management strategies, policies and procedures in the first instance. They also require each Covered Company to have a review function that is independent of management functions that execute funding (that is, independent of the Treasury function).

- ***Cashflow Projections.*** The Proposed Rules require Covered Companies to produce comprehensive cashflow projections that, among other things, take into account cash flows arising from assets, liabilities and off-balance sheet exposures over "short-term and long-term periods that are appropriate to the Covered Company's capital structure, risk profile, complexity, activities, size, and other risk related factors." They also require Covered Companies to identify and quantify discrete and cumulative cashflow mismatches. Unlike the Basel III liquidity framework (with the LCR's 30-day time horizon and the NSFR's one-year time-horizon), the Proposed Rules accord the Covered Company some discretion in establishing appropriate periods.

- ***Liquidity Stress Testing.*** The Proposed Rules require Covered Companies to regularly stress test cashflow projections, developed as described above, and to use those stress tests in determining the size of their liquidity buffers, discussed below.

  - The stress tests must incorporate a range of stress scenarios, taking into consideration, among other things, market stress, idiosyncratic stress and combinations of the two, and address potential actions of other market participants experiencing liquidity stress.

  - The time horizons, at a minimum, must include an overnight time horizon, a 30-day time horizon, a 90-day time horizon and a one-year time horizon.

  - This stress testing must incorporate the following assumptions:

    - for the first 30 days of a liquidity stress scenario, only highly liquid assets that are unencumbered may be used as a cashflow source to offset projected funding needs;

    - for periods beyond the first 30 days, highly liquid assets that are unencumbered and other "appropriate funding sources" may be used as cashflow sources;

    - if an asset is used as a cashflow source, the fair value of the asset "must be discounted to reflect any credit risk and market volatility of the asset"; and

    - assets used as funding sources must be "sufficiently diversified."

- ***Liquidity Buffer.*** The Proposed Rules require Covered Companies to maintain a liquidity buffer of "highly liquid assets" that are "unencumbered." The liquidity buffer must be 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, using the liquidity stress testing referenced above. For purposes of the liquidity buffer:

  - The term "highly liquid assets" is defined to mean cash, securities issued or guaranteed by the U.S. government, a U.S. government agency or a U.S. government-sponsored agency, or any other asset that the Covered Company demonstrates to the satisfaction of the FRB has low credit and low market risk, is traded in an active secondary two-way market that has observable prices and meets other standards, and is of a type that investors historically purchased in periods of financial market distress during which market liquidity is impaired. The definition of highly liquid assets does not align with the definition of liquid assets in Basel III's LCRs in a number of respects, including in that the proposed definition:

    - it does not include securities of foreign sovereigns or public sector entities, except possibly pursuant to the third prong of the test; and

    - it does not differentiate between different types of highly liquid assets as a proportion of the total amount of highly liquid assets (where the LCR divides liquid assets into "Level 1" and "Level 2," with Level 2 assets – which include Fannie Mae and Freddie Mac debt and guaranteed mortgage-backed securities – being limited to 40% of total liquid assets).

  - The Proposed Rules define the term "unencumbered" broadly to mean that the asset is not pledged in any respect, subject to legal or contractual restrictions on liquidation or transfer, or designated as a hedge in a trading position. Where Basel III provides that short-term (30-day or less) repos and reverse repos should be assumed to be unwound for purposes of LCR calculations, the proposed liquidity buffer does not assume that they are unwound.

- ***Contingency Funding Plan.*** The Proposed Rules require each Covered Company to "establish and maintain a contingency funding plan that sets out the Covered Company's strategies for addressing liquidity needs during liquidity stress events." The contingency funding plan must:
  - include a quantitative assessment incorporating information generated by the stress testing described above;
  - include an event management process that sets out the Covered Company's procedures for managing liquidity during identified liquidity stress events;
  - include procedures for monitoring emerging liquidity stress events; and
  - provide for periodic testing of the components of the contingency funding plan to assess its reliability during liquidity stress events.
- ***Specific Limits.*** The Proposed Rules require each company to establish or maintain limits on potential sources of liquidity risk, including (i) concentrations of fundings by instrument type, single counterparty, counterparty type, secured and unsecured funding, and other liquidity risk identifiers, (ii) the amount of specified liabilities maturing within various time horizons, and (iii) off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events. The Proposed Rules do not set forth numeric standards for these items but, instead, require that the limits "must reflect the Covered Company's capital structure, risk profile, complexity, activities, size, other appropriate risk-related factors, and established liquidity risk tolerance."
- ***Monitoring.*** The Proposed Rules include a variety of monitoring requirements, including with respect to "liquidity risk exposures and funding needs within and across significant legal entities, currencies, and business lines" and (ii) intraday liquidity positions.

SINGLE-COUNTERPARTY CREDIT LIMITS

In one of Section 165's most significant provisions, subsection (e) requires the FRB to establish single-counterparty concentration limits for Covered Companies to help limit systemic risks to a Covered Company posed by the failure of a single unaffiliated firm. Section 165(e) prohibits a Covered Company from having credit exposure to any unaffiliated company that exceeds 25% of the Covered Company's consolidated capital stock and surplus[12] and permits the FRB to impose a lower limit if necessary to mitigate risk to U.S. financial stability. The FRB's proposed concentration limit is, in fact, two-tiered—a 25% limit on aggregate net credit exposure between a Covered Company and any single unaffiliated counterparty and a more stringent 10% limit for aggregate net credit exposures between a "major Covered Company" and a "major counterparty." A Covered Company or counterparty is considered "major" if it has $500 billion or more in total consolidated assets. A "major" counterparty includes any major Covered Company and any foreign banking organization that is treated as a BHC (and its subsidiaries) that has total consolidated assets of $500 billion or more.

Covered Company and Its Subsidiaries

These limits apply on a consolidated basis to a Covered Company and its subsidiaries. For this purpose, a "subsidiary" is a company that is directly or indirectly controlled by another company, and "control" means (i) owns or controls with power to vote 25% or more of a class of voting security of the company;

(ii) owns or controls 25% or more of the total equity of the company; or (iii) consolidates the company for financial reporting purposes. Unlike the BHC Act and the FRB's Regulation Y, this definition of "control" explicitly includes the 25% of total equity test but does not have a "controlling influence" prong. The definition of "subsidiary" would not include a fund or other vehicle that is sponsored or advised by a Covered Company unless it is also controlled (that is, the Covered Company owns or controls more than 25% of the fund's voting securities or total equity and the fund is consolidated with the Covered Company for financial reporting purposes). The FRB requests comment on whether that exclusion is appropriate, particularly in light of the support that some money market mutual fund sponsors provided during the financial crisis.

Counterparty

The proposed credit limit would apply to any single unaffiliated counterparty. While the Proposed Rule defines counterparty exposure to include a counterparty's subsidiaries, it may have been meant to apply also to exposure to affiliates of the counterparty that are not subsidiaries. The credit limit applies to sovereign entities, including the United States and all of its agencies, U.S. states, and foreign sovereigns. Under the proposal, this would include all of the agencies, instrumentalities and political subdivisions (including any municipalities) of a state or foreign sovereign entity. Certain credit exposures to the U.S. government are exempt from the credit exposure limit, however, as discussed below.

The Notice notes that, under the proposed reservation of authority, the FRB may determine to look through CDOs or other obligations issued by an SPV to its sponsor or issuer of the underlying assets or to look through to the underlying assets only if the SPV failed certain discrete concentration tests (such as having more than 20 underlying exposures).

Credit Transactions

The proposed limit applies to a "credit transaction," which is broadly defined to include:

- an extension of credit to the counterparty, including loans, deposits, and lines of credit, but excluding advised or other uncommitted lines of credit;
- repurchase or reverse repurchase agreements;
- securities lending or borrowing transactions;
- a guarantee, acceptance or letter of credit;
- a purchase of or investment in securities issued by the counterparty;
- any credit exposure to the counterparty in connection with a derivative transaction with the counterparty;
- any credit exposure to the counterparty in connection with a credit derivative or equity derivative transaction with a third party where the reference asset is an obligation or equity security of the counterparty; and
- any functional equivalent of the transactions listed above or any similar transaction determined by the FRB to be a credit transaction for these purposes.

Calculation of Credit Exposures

The proposal specifies methodologies for determining a Covered Company's credit exposure under each type of credit transaction listed above. With respect to loans and leases, the exposure is the amount owed, while the exposure under a committed credit line is equal to the face amount of the line. With respect to debt securities held for trading or available for sale, the exposure is the greater of the amortized purchase price of the security and its market value; with respect to those held to maturity, the exposure is the amortized purchase price. The exposure under equity securities held by the covered company is equal to the greater of the purchase price and market value. The exposure under repurchase agreements and securities lending transactions is determined on the basis of the amount of cash or the market value of the securities transferred to its counterparty by the Covered Company, plus, in the case of securities transferred by the Covered Company, an add-on (on the basis of prescribed haircuts) to reflect the volatility in their value.

The FRB acknowledged in the Notice that reliance on market value for purposes of determining exposure with respect to certain types of assets may cause the counterparty's exposure to rise simply because the market price of the securities rises. However, the FRB concluded that this rule would "merely reflect[] the covered company's greater financial exposure to the counterparty and reduces the covered company's ability to engage in additional transactions with a counterparty as the covered company's exposure to the counterparty increases." The exposure with respect to those assets will be subject to a floor equal to the price that the Covered Company paid to acquire the asset.

The methodology proposed for valuing the credit exposure from derivative transactions may provide insight into how the FRB proposes to calculate these credit exposures in the context of Section 23A of the Federal Reserve Act and the FRB's Regulation W (transactions with affiliates) and other areas where Dodd-Frank requires that credit exposures from derivative transactions be covered (lending limits, for example). Under the proposal, a derivative transaction that is not subject to a "qualifying master netting agreement" would be valued in an amount equal to the sum of (i) the current exposure of the derivatives contract equal to the greater of the mark-to-market value of the derivative contract and zero and (ii) the potential future exposure of the derivatives contract, calculated by multiplying the notional principal amount of the derivative contract by the appropriate conversion factor based on the remaining maturity of the contract, as specified in the proposal.[13] Derivative contracts that are subject to a "qualifying master netting agreement" are valued at an amount equal to the exposure at default as calculated under the FRB's advanced approaches capital rules.[14]

Netting

A Covered Company may net its gross exposure to a counterparty for purposes of applying its single-counterparty credit limit under limited circumstances described in the Proposed Rules. The gross exposure under derivative contracts that are subject to a qualified master netting agreement may be calculated on a net basis, as described above.

Repurchase and reverse repurchase transactions and securities lending and borrowing transactions that are subject to a bilateral netting agreement may be calculated on a net basis under the bilateral netting agreement. A counterparty may also reduce its credit exposure to reflect the market value of "eligible collateral," as adjusted by the mandated haircuts and subject to other limitations, although the Covered Company must take the market value of the collateral (up to the amount of the obligation secured) into account in calculating its credit exposure to the issuer of that collateral. The Notice observes that some Covered Companies may choose not to take collateral into account in calculating their exposure in view of the operational burden that doing so would impose.

If a Covered Company has received an "eligible guarantee," "eligible credit derivative" or "eligible equity derivative,"[15] the Covered Company would be required to take that guarantee into account both by reducing its net exposure to the guaranteed counterparty and by increasing its exposure to the relevant protection provider. The FRB noted that it proposes to impose this requirement so as to ensure that concentrations in exposures to guarantors are captured by the regime. The FRB also solicited comment on whether it should be even more conservative with respect to guarantors – whether it should "penalize financial sector interconnectedness" by requiring that the Covered Company recognize gross credit exposure to both the original counterparty and the eligible protection provider.

While the proposal recognizes netting rights with respect to derivatives, repurchase agreements and securities lending transactions, it does not explicitly address other forms of bilateral or multilateral setoff netting, even where those rights would be enforceable in bankruptcy.

Exemptions

The proposal includes certain exemptions, including those for claims that are fully guaranteed as to principal and interest by the United States and its agencies, Fannie Mae and Freddie Mac (while under conservatorship), any other GSE obligations as determined by the FRB, and intraday credit exposure.

Attribution Rule

The proposal includes the statutory attribution rule, which requires a Covered Company to treat a transaction with any person as a credit exposure subject to the limit on exposure to a counterparty to the extent the proceeds of the transaction are used for the benefit of, or transferred to, the counterparty. The FRB does note, however, that "an overly broad interpretation of the attribution rule in the context of Section 165(e) would lead to inappropriate results and would create a daunting tracking exercise." As a result, the FRB proposes to limit application of the attribution rule to those situations where it is necessary to prevent evasion of the credit limit, which is a departure from the broad manner in which the FRB applies the attribution rule in the context of Section 23A of the Federal Reserve Act.

Compliance

As proposed, a Covered Company is required to be in compliance with the credit limit on a daily basis at the end of each business day and must submit a report to the FRB on a monthly basis demonstrating compliance. The proposal provides a 90-day cure period where the FRB will not subject the Covered Company to enforcement if the company is not in compliance as a result of a decrease in the Covered Company's capital, the merger of a Covered Company with another Covered Company, or the merger of two unaffiliated counterparties and the company uses reasonable efforts to return to compliance during the grace period.

Section 165(e) becomes effective three years after the effective date of Dodd-Frank (July 2013), and the FRB is authorized to extend the transition period for up to an additional two years. Under the Proposed Rules, a company that is a Covered Company on the effective date (or becomes a Covered Company before September 30, 2012) will be subject to the requirements beginning on October 1, 2013.

RISK MANAGEMENT AND RISK COMMITTEE

Risk Management

Under Section 165(b) of Dodd-Frank, the FRB must impose overall risk management requirements on Covered Companies. In addition, Section 165(h) of Dodd-Frank requires publicly traded Covered Companies and publicly traded BHCs with total consolidated assets of over $10 billion to establish risk committees.[16] The Proposed Rules apply the risk committee requirement to all Covered Companies rather than only to publicly traded Covered Companies. Although authorized to do so under Section 165(h), the FRB does not extend the risk committee requirement to publicly traded BHCs with total consolidated assets equal to or less than $10 billion.

In the Notice, the FRB stresses that the risk committee and risk management requirements supplement the FRB's existing risk management guidance and supervisory expectations, such as the FRB's Supervision and Regulation Letter SR 08-8.

Risk Committee Requirements

The Proposed Rules require that each Covered Company and publicly traded BHC having total consolidated assets over $10 billion have an enterprise-wide risk committee comprised of members of the company's board of directors. The risk committee must document, review, and approve the enterprise-wide risk management practices of the company. In fulfilling those responsibilities, the risk committee must oversee the operation of an appropriate enterprise-wide risk management framework[17] commensurate with the company's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. The committee must:

- have a formal, written charter, approved by the company's board of directors;
- have at least one member with "risk management expertise"[18] that is commensurate with the company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors;
- be chaired by an independent director;[19] and

- meet regularly and as needed, and fully document and maintain records of such proceedings, including risk management decisions.

Although the Proposed Rules require that one member of the risk committee have risk management expertise, the FRB expects that the expertise of the risk committee membership would be commensurate with the complexity and risk profile of the organization.

Additional requirements that apply only to risk committees of Covered Companies are that the risk committee:

- report to the board of directors directly;
- not be housed within another committee or be part of a joint committee; and
- receive and review regular reports from the Chief Risk Officer ("CRO"), whose employment is required as part of the overall risk management requirements as described below.

Overall Risk Management Requirements for Covered Companies

To satisfy the overall risk management requirement in Section 165(b), the Proposed Rules require that, in addition to meeting the risk committee requirements addressed above, a Covered Company have a CRO in charge of implementing and maintaining the company's risk management framework and practices approved by the risk committee and:

- have risk management expertise that is commensurate with the company's capital structure, risk profile, complexity, activities, size, and other risk-related factors that are appropriate;
- be compensated and provided appropriate incentive to provide an objective assessment of the risks taken by the company;
- report directly to the risk committee and the chief executive officer; and
- have direct oversight for risk management on an enterprise-wide basis.[20]

STRESS TESTS

Consistent with Section 165(i) of Dodd-Frank, the Proposed Rules require two distinct sets of stress tests: (i) an annual stress test conducted by the FRB for Covered Companies and (ii) annual and semi-annual stress tests conducted by the relevant company itself for Covered Companies and other U.S. BHCs and state member banks[21] having more than $10 billion in consolidated assets. The results of such stress tests are meant to be utilized by both the affected companies and the FRB in their respective capital planning and approval processes.

Under the Proposed Rules, BHCs that are subject to the stress test requirements would be required to comply as of the effective date of the final rule. For Covered Nonbank Companies and BHCs that meet the relevant asset thresholds after the effective date, the timing of compliance depends on the date of designation by the FSOC or the date the BHC meets the asset threshold.

Federal Reserve Conducted Stress Test

Under the Proposed Rules, the FRB would conduct an annual stress test of the capital of each Covered Company on a consolidated basis in order to "evaluate the ability of the covered company to absorb losses in adverse economic and financial conditions," including an analysis of "projected net income, losses and pro-forma, post-stress capital levels and ratios." The general purpose of the supervisory stress test is to "provide supervisors with forward-looking information to help them identify downside risks and the potential impact of adverse outcomes on capital adequacy at covered companies."

The supervisory stress test analysis would use a minimum of three FRB-generated economic and financial scenarios – baseline, adverse and severely adverse. The supervisory stress test itself would be based on data collected from Covered Companies. The FRB plans to issue separate proposals on the data collection requirements for the supervisory stress test. Once the relevant data is collected, the FRB would conduct its stress test analysis based on methodologies to be published in advance. This stress test would cover a time horizon of at least nine quarters. The Proposed Rules appear to contemplate that the same general methodologies would be used across Covered Companies for purposes of the supervisory stress test. The FRB's stress test analysis would focus on whether "the covered company has the capital, on a total consolidated basis, necessary to absorb losses under economic and financial market conditions as contained in the designated scenarios . . . " and would include "a review of the covered company's estimated losses, pre-provision net revenue, allowance for loan losses, and the extent of their impact on the company's capital levels and ratios, including regulatory capital ratios."

A summary of the results of these individual stress tests would be made public by the FRB on a company-specific basis, although the results would be communicated to the Covered Company in advance. A Covered Company would be expected to "take the results of the analysis conducted by the FRB under the Proposed Rules into account in making changes, as appropriate, to the company's capital structure (including the level and composition of capital); its exposures, concentrations, and risk positions; any plans of the company for recovery; and for improving overall risk management."

The FRB expects to publish the stress scenarios no later than mid-November, complete the supervisory stress tests by mid-February, communicate the results to Covered Companies by early March and publish the summaries of such results by early April of each year.

Company Conducted Stress Tests

Each Covered Company and each other U.S. BHC and state member bank having more than $10 billion in total consolidated assets ("over $10 billion covered companies") would be required to perform its own stress test to "assess the potential impact on . . . consolidated earnings, losses and capital of the company . . . , taking into account the current condition of the company and the company's risks, exposures, business strategies, and activities." Covered Companies would be required to conduct such stress tests on a semi-annual basis. Over $10 billion covered companies would be required to conduct such stress tests on an annual basis only. Such requirement would apply to both the holding company and each over $10 billion subsidiary bank of such holding companies.[22]

The annual company-administered stress test would be based on the same general supervisory scenarios as the test administered by the FRB. The FRB plans to separately publish the requirements for the specific stress test report and supporting data to be submitted by Covered Companies and over $10 billion covered companies. The other stress test for Covered Companies and over $10 billion covered companies would be conducted based on a minimum of three scenarios – baseline, adverse and severely adverse – developed by each company. The company administered stress test would also cover an at least nine quarter time horizon. Each Covered Company and over $10 billion covered company would use such scenarios "to calculate, for each quarter-end within the planning horizon, potential losses, pre-provision revenues, allowance for loan losses, and future pro forma capital positions over the planning horizon, including the impact on capital levels and ratios." A summary of the results of such company administered stress tests would also need to be made public by each Covered Company and over $10 billion covered company.

The annual stress test for both Covered Companies and over $10 billion covered companies would need to be filed with the FRB by January 5th with results being publicly disclosed by each company by early April of each year. The semi-annual stress test by Covered Companies would need to be filed with the FRB by July 5 with results being publicly disclosed by each Covered Company by early October of each year.

In addition, the Proposed Rules require each Covered Company and over $10 billion covered company "to establish and maintain a system of controls, oversight, and documentation, including policies and procedures, designed to ensure that the stress testing processes used by the company are effective in meeting the requirements of the proposed rule."

Finally, the Notice indicates that such stress tests "would be one component of the broader stress testing activities conducted by Covered Companies and over $10 billion companies…," including "testing of a range of potentially adverse outcomes across a wide set of risk types beyond capital adequacy, affecting other aspects of a company's financial condition."

Inter-relationships Among Stress Tests and Capital Planning Requirements

The Proposed Rules' supervisor and company administered stress tests, for Covered Companies at least, seem to be designed to work together and inform the creation and evaluation of the capital plans that are required under the recently finalized CCAR rules, referred to in the Notice as the "capital plan rule."[23] The timing for submission, completion and evaluation of the CCAR capital plans and such annual stress tests are consistent, subject to certain exceptions. Apart from the explicit statutory requirements for both supervisor conducted and company conducted stress tests in Section 165(i) of Dodd-Frank, the FRB indicates that the company administered stress tests are meant to capture "a range of factors, including idiosyncratic aspects of individual companies that a standardized supervisory stress test applicable across companies cannot be expected to cover as sufficiently as the companies' internal stress testing practices."

As such, it would appear that the CCAR rule and the Proposed Rules, when read together, would result in a Covered Company's CCAR capital plan being based on the company conducted stress tests and the FRB's review of such capital plan would, at least in part, rely on the Proposed Rules' supervisory stress test. It remains to be seen, however, how the various stress testing requirements in the Proposed Rules and the CCAR process will work together as a practical matter – for example, the FRB's 2011 CCAR instructions for most Covered Companies were built around two FRB scenarios (baseline and stressed) and two Covered Company created stress scenarios (baseline and at least one stressed).

EARLY REMEDIATION

The Proposed Rules also implement Section 166 of Dodd-Frank, which requires the establishment of an "early remediation" regime for Covered Companies. This regime is intended both to reduce the likelihood that a significant financial institution will fail, and reduce the risk posed to the financial stability of the United States if it does fail. The early remediation system is based upon the "prompt corrective action" regime, or "PCA," that currently applies to insured depository institutions under the Federal Deposit Insurance Act. It is intended, however, to require earlier action than PCA by mandating action on the basis of a range of financial triggers, rather than primarily on the basis of capital levels as under the PCA. Further, in view of concerns that regulators failed to take early action even when mandated under the PCA regime, Dodd-Frank specifies the types of actions that the FRB must take at both early and late stages of a Covered Company's financial distress.

The proposed "early remediation" rule establishes four levels of remediation requirements, of increasing severity as required (discussed below), and establishes five categories of "forward-looking" triggers. These triggers are based on:

- ***Capital and leverage***. Level 1 remediation will be triggered if the FRB determines that the Covered Company's capital structure, capital planning processes, or the amount of capital it holds is not commensurate with the level and nature of the risks to which it is exposed, even if the Covered Company is in compliance with minimum capital requirements. Additional levels of remediation will be required as capital levels decline, with Level 4 remediation required if the Covered Company has a total risk-based capital ratio of less than 6.0 percent, a Tier 1 risk-based capital ratio of less than 3.0 percent or a Tier 1 leverage ratio of less than 3.0 percent.
- ***Stress Tests***. Level 1 remediation will be triggered if a Covered Company is not in compliance with any of the FRB's capital planning and stress test regulations. Increasing levels of remediation are required if the results of the Covered Company's stress tests indicate that a breach of capital requirements would occur under the "severely adverse scenario" of its stress test, with Level 3 remediation required if the company's stress test results under the severely adverse scenario reflect a Tier 1 common risk-based capital ratio of less than 3.0 percent during any quarter in the planning horizon.

- ***Risk Management.*** Level 1 remediation will be triggered if a Covered Company has "manifested signs of weakness" in meeting the proposed risk management and risk committee requirements described above. Level 3 remediation will be required if the company is in substantial noncompliance with those requirements.
- ***Liquidity.*** Level 1 remediation will be required if a Covered Company has "manifested signs of weakness" in meeting the enhanced liquidity risk management requirements described above. Level 3 remediation will be required if the company is in substantial noncompliance with those requirements.
- ***Market indicators.*** Remediation may also be required based on publicly available market data that is identified by the FRB in a list of the market indicators and market indicator thresholds published by the FRB on a periodic basis. Level 1 remediation will be required if the FRB finds that any single market indicator has exceeded the market indicator threshold with respect to the company for a period defined by the board on that list. Further levels of remediation are not specified with respect to the market indicator triggers directly, but the review conducted through Level 1 remediation may identify other triggers that would mandate additional remediation measures. The initial market indicators proposed by the FRB include the following:
    - Equity-based triggers, consisting of an "expected default frequency" calculated using a model developed by Moody's Investors Service; a "marginal expected shortfall" measure relating to the company's stock price and volatility; the ratio of the market value of the company's equity to the sum of that value and the book value of its debt; and its "option-implied volatility," using a standard option pricing model.
    - Debt-based indicators, based on credit default swaps relating to 5-year senior debt of the company, and the company's subordinated bond spreads.

The four levels of remediation are:

- ***Level 1:*** Heightened supervisory review, in which the FRB would conduct a targeted review of the Covered Company to determine if it should be moved to the next level of remediation. The FRB would be required to produce an internal report on the elements evidencing deterioration within 30 days of the Level 1 trigger breach and determine whether the company should be elevated to a higher level of remediation. The FRB would also be able to utilize its other supervisory powers, under the Proposed Rules and otherwise, to cause the Covered Company to address the problems identified as a result of this review.
- ***Level 2:*** Initial remediation, in which the Covered Company's growth and capital distributions would be restricted. The Covered Company would be prohibited from distributing, in any calendar quarter, more than 50% of the average of its net income for the preceding two calendar quarters. The Covered Company's growth would be restricted to no more than 5% growth in total assets or total risk-weighted assets per quarter or per annum, and would generally be prohibited from directly or indirectly acquiring controlling interest in any other company. The Covered Company would be subject to a memorandum of understanding with its regulators, and to any other limitations and conditions on its conduct or activities that the FRB deems appropriate. Although the MOU would be non-public, the other limitations imposed by a Level 2 determination may well require public disclosure under federal securities law.
- ***Level 3:*** Recovery, in which a firm would be subject to a prohibition on growth and capital distributions, limits on executive compensation, requirements to raise additional capital, and additional requirements on a case-by-case basis. The company would be required to enter into a written agreement with its regulators, which would be public, prohibiting all capital distributions, any quarterly growth in total assets or risk-weighted assets and any material acquisitions, and requiring the company to increase capital to restore the Covered Company's capital level to or above regulatory minimums. The Covered Company would be barred from making any increase in the compensation of its senior executive officers or directors or paying any bonus to them. If the company fails to meet the requirements of the written agreement it may be subject to divestiture requirements.

The FRB could require the Covered Company to conduct new elections for its board of directors, dismiss directors or officers, or hire new senior executive officers. The FRB may also impose any other limitations and conditions on its conduct or activities as it deems appropriate.

- ***Level 4:*** Recommended resolution, in which the FRB would consider whether to recommend to the Treasury Department and the FDIC that the firm be resolved under the orderly liquidation authority provided for in Title II of the Dodd-Frank Act.

DEBT-TO-EQUITY LIMITS FOR CERTAIN COVERED COMPANIES

Section 165(j) provides that the FRB must require a Covered Company to maintain a debt-to-equity ratio of no more than 15-to-1 upon a determination by the FSOC that (i) the Covered Company poses a grave threat to the financial stability of the United States and (ii) the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States. The Proposed Rule provides that the terms “debt” and “equity” for purposes of this ratio mean “total liabilities” and “total equity capital” as defined:

- in the case of a BHC, in the FRB’s Form FR Y-9C (Consolidated Financial Statements for Bank Holding Companies) or a successor form; and
- for a Covered Nonbank Company supervised by the FRB, in a report of financial condition that the Covered Nonbank Company will be required to file with the FRB pursuant to Section 161(a).

Total equity capital as reported on the Form FR Y-9C, and hence “equity” for purposes of the debt-to-equity ratio, is not Tier 1 capital, total capital or another regulatory capital measure but, instead, is GAAP shareholders’ equity before adjustment for various items taken into account in determining Tier 1 and total capital under existing regulations (e.g., net unrealized gains or losses on available-for-sale securities that are filtered out of regulatory capital measures, cumulative perpetual preferred stock included within shareholders’ equity but not recognized for regulatory capital purposes, and reductions for disallowed deferred tax assets, disallowed servicing assets, purchased credit card relationships, disallowed goodwill and other tangible assets).

A Covered Company that is required to satisfy the 15-to-1 debt-to-equity ratio must come into compliance with the ratio within 180 days after it receives written notice from the FSOC that the FSOC has made the necessary determinations regarding application of the ratio to the Covered Company. The 180-day period is extendible by the FRB upon request from the identified company for up to two additional periods of 90 days. Although the Proposed Rule does not establish a specific set of actions that must be taken by an identified company to achieve compliance, the Notice indicates that the FRB expects the identified company to come into compliance in a manner consistent with the company’s “safe and sound operation and preservation of financial stability.” The Notice notes as examples of actions to be taken “a good faith effort to increase equity capital through limits on distributions, share offerings or other capital raising efforts prior to liquidating margined assets.”

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ENDNOTES

1 The FRB and the Federal Deposit Insurance Corporation previously jointly issued a final rule to implement the requirement in Section 165(d) of Dodd-Frank that each Covered Company submit a plan for rapid and orderly resolution in the event of its material financial distress or failure. *See* Resolution Plans Required, 76 Fed. Reg. 67323 (Nov. 1, 2011).

2 The FSOC has issued three notices of proposed rulemaking regarding designation. *See* our memo "*Designation of Systemically Important Nonbank Financial Companies under Dodd-Frank,*" dated October 18, 2011, available at http://www.sullcrom.com/files/Publication/d246932a-0b62-4f7a-8b7c-76b19b6c8243/Presentation/PublicationAttachment/3cb7ce7f-c431-4c86-8897-76bcd1117d5a/SC_Publication_Designation_of_Systemically_Important_Nonbank_Financial_Companies_Under_Dodd_Frank.pdf.

3 12 U.S.C. 5365(i)(2). *See* 12 U.S.C. 5301(12) for the definition of primary financial regulatory agency.

4 With respect to a covered U.S. BHC subsidiary of a foreign banking organization that has relied on the FRB's Supervision and Regulation Letter SR 01-01, the U.S. BHC subsidiary would not have to comply with these requirements other than the liquidity and enterprise-wide risk management requirements and the debt-to-equity limit until July 21, 2015, consistent with the phase-in period under Section 171 of Dodd-Frank (the Collins Amendment).

5 This structural approach has already been adopted by several major non-U.S. banking organizations in response to the Collins Amendment.

6 12 C.F.R. 225.8. *See* 76 FR 76431 (Dec. 1, 2011). These provisions, which the Notice refers to as the "capital plan rule," currently apply to all U.S. bank holding companies with $50 billion or more in total consolidated assets and require, among other things, that bank holding companies subject to the rule submit annual capital plans to the FRB in which they demonstrate their ability to maintain capital above the FRB's minimum risk-based capital ratios under both baseline and stressed conditions over a minimum nine-quarter forward-looking planning horizon. The capital plan rule also requires bank holding companies to demonstrate the ability to maintain a minimum Tier 1 common risk-based capital ratio of 5% over the same planning horizon (under both baseline and stressed conditions). *See* our memo *"Bank Capital Plans – Federal Board Issues Final Rule Regarding Capital Plan and Foremost Test Stress Requirements for Certain Large Bank Holding Companies,"* dated November 29, 2011, available at http://www.sullcrom.com/files/Publication/98fdbafe-2326-48ee-b7fa-45ccbe44571b/Presentation/PublicationAttachment/cc880d1d-a8ac-4779-91bc-461cf78098e8/SC_Publication_Bank_Capital_Plans_11-29-11.pdf.

7 Basel Committee, *Global Systemically Important Banks: Assessment Methodology and Additional Loss Absorbency Requirement*. *See* our memo *"Bank Capital Requirements – Basel Committee Issues Final Rule Regarding Common Equity Surcharge for Global Systemically Important Banks,"* dated November 10, 2011, available at http://www.sullcrom.com/files/Publication/64ee9387-7414-40f6-8d0b-6f7c71cdf055/Presentation/PublicationAttachment/23157986-61ea-406d-8b1a-71ee9a9947c4/SC_Publication_Bank_Capital_Requirements_11-10-11.pdf.

8 The FSB was established in April 2009 by the G-20 as the successor to the Financial Stability Forum founded in 1999 by the G-7 Finance Ministers. *See* FSB, *Policy Measures to Address Systemically Important Financial Institutions* on November 4, 2011. The eight U.S. banks that have been identified as G-SIBs are Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street and Wells Fargo.

ENDNOTES (continued)

9 Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010, updated June 2011).

10 Supervision and Regulation Letter SR 10-6, *Interagency Policy Statement on Funding and Liquidity Risk Management* (March 17, 2010).

11 Basel Committee, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (December 2010).

12 Similar to the FRB's Regulation W; "capital stock and surplus" includes the balance of the allowance for loan and lease losses not included in tier 2 capital.

13 A similar approach is used for purposes of calculating risk-weighted assets under the FRB's Regulations H and Y.

14 To be a qualifying master netting agreement, (i) the contract must permit a counterparty to accelerate, terminate and close out all contracts under the agreement and to liquidate and apply collateral upon an event of default, including a bankruptcy event, provided that the exercise of such rights are not subject to a stay under applicable insolvency law; (ii) the Covered Company must have performed a legal review to conclude that the agreement is enforceable; (iii) the Covered Company must maintain procedures to identify changes in law; and (iv) the agreement must not contain a "walkaway" clause.

15 These instruments must, among other things, be issued by an eligible protection provider and meet the requirements in the Proposed Rules with respect to terms, conditions, and documentation.

16 Under the Proposed Rules, "publicly traded" means traded on a national securities exchange registered with the U.S. Securities and Exchange Commission or on a comparable non-U.S. based exchange. In particular, the non-U.S. exchange must be registered with, or approved by, a national securities regulatory authority and provide a liquid two-way market for the security.

17 A company's risk management framework must include:

(1) Risk limitations appropriate to each business line of the company;

(2) Appropriate policies and procedures relating to risk management governance, risk management practices, and risk control infrastructure for the enterprise as a whole;

(3) Processes and systems for identifying and reporting risks and risk-management deficiencies, including emerging risks, on an enterprise-wide basis;

(4) Monitoring of compliance with the company's risk limit structure and policies and procedures relating to risk management governance, practices, and risk controls across the enterprise;

(5) Effective and timely implementation of corrective actions to address risk management deficiencies;

(6) Specification of management and employees' authority and independence to carry out risk management responsibilities; and

(7) Integration of risk management and control objectives in management goals and the company's compensation structure.

18 "Risk management expertise" is defined in the Proposed Rules to include both an understanding of risk management principles and practices and relevant experience.

19 To be independent under the Proposed Rules, a director must (i) not currently be, or during the past three years have been, an officer or employee of the company; (ii) not be a member of the "immediate family" (as defined in 225.41(a)(3) of the FRB's Regulation Y) of a person who is, or

has been within the last three years an executive officer of the company as defined in the FRB's Regulation O; or (iii) be an independent director under Item 407 of the SEC's Regulation S-K, 17 CFR 229.407(a) or, in the case of a Covered Company that is not publicly traded in the United States, qualify as an independent director under the listing standards of a national securities exchange (as determined by the FRB on a case-by-case basis).

[20] This includes oversight for:

(1) Allocating delegated risk limits and monitoring compliance with such limits;

(2) Implementation of, and ongoing compliance with, appropriate policies and procedures relating to risk management governance, practices, and risk controls and monitoring compliance with such policies and procedures;

(3) Developing appropriate processes and systems for identifying and reporting risks and risk-management deficiencies, including emerging risks, on an enterprise-wide basis;

(4) Managing risk exposures and risk controls within the parameters of the company's risk control framework;

(5) Monitoring and testing of the company's risk controls;

(6) Reporting risk management deficiencies and emerging risks to the enterprise-wide risk committee; and

(7) Ensuring that risk management deficiencies are effectively resolved in a timely manner.

[21] National banks, state non-member banks and thrifts are not technically covered by the text of the Proposed Rules, but may presumably be picked up by subsequent conforming rules by the relevant agencies.

[22] The Proposed Rules indicate that the relevant Federal banking agencies will coordinate with each other in order to minimize the burden of compliance in such circumstances.

[23] *See* endnote 6. In addition, the preamble to the CCAR rule stated that the supervisory stress scenarios to be used thereunder would be the same as that for purposes of Section 165 of Dodd-Frank Act.

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CONTACTING SULLIVAN & CROMWELL LLP

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CONTACTS

New York

John E. Baumgardner, Jr.	+1-212-558-3866	baumgardnerj@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
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
David J. Gilberg	+1-212-558-4680	gilbergd@sullcrom.com
Andrew R. Gladin	+1-212-558-4080	gladina@sullcrom.com
David B. Harms	+1-212-558-3882	harmsd@sullcrom.com
Marion Leydier	+1-212-558-7925	leydierm@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
Richard A. Pollack	+1-212-558-3497	pollackr@sullcrom.com
Kenneth M. Raisler	+1-212-558-4675	raislerk@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com
Andrew S. Rowen	+1-212-558-3896	rowena@sullcrom.com
Donald J. Toumey	+1-212-558-4077	toumeyd@sullcrom.com
Marc R. Trevino	+1-212-558-4239	trevinom@sullcrom.com

Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com
Frederick Wertheim	+1-212-558-4974	wertheimf@sullcrom.com
Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com

Washington, D.C.

Andrew S. Baer	+1-202-956-7680	baera@sullcrom.com
Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
William F. Kroener III	+1-202-956-7095	kroenerw@sullcrom.com
J. Virgil Mattingly	+1-202-956-7028	mattinglyv@sullcrom.com
Robert S. Risoleo	+1-202-956-7510	risoleor@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
Stanley F. Farrar	+1-310-712-6610	farrars@sullcrom.com

London

George H. White III	+44-20-7959-8570	whiteg@sullcrom.com

Tokyo

Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com