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Securities Finance: A Case Study of the Regulatory Roadmap Necessary to Navigate the Challenges in the New Financial Services Environment

by Gregory J. Lyons and Michael P. McAuley

Securities finance, as described below, has been a core, comparatively low-risk of loss activity of many of the largest banking institutions in the world for a number of years. For several decades, the regulatory environment reflected this low risk by imposing limited burdens on banking institutions engaging in this activity. This stable regulatory structure, along with a favorable economic environment, enabled banks to increase their securities lending activities to meet an increasing global demand. The majority of the growth in the securities lending market occurred over the last 10 years, with the crest of assets on loan growing from approximately $500 billion in 1999 to $4 trillion in 2007-2008. This growth was driven mainly by an increase in the number of hedge funds and new investment strategies that employed short selling and hedging. It was also aided by the overall growth in the financing market, which increased demand for high-quality collateral, such as United States Treasury securities, and the overall volume of collateral trading. Securities finance and other custodial activities, such as foreign exchange, thus provided significant revenue to their institutions and also critical liquidity to the global economy.

Like virtually all activities of banking institutions, securities finance programs were adversely affected during the recent financial crisis, principally due to liquidity issues with the associated collateral pools. However, US and international regulatory trends create a number of unknown and potentially longer-term challenges to these programs. Unlike many proprietary trading and private fund investing activities, securities finance activities should not be absolutely precluded by the so-called Volcker Rule of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] Nonetheless, the large financial institutions engaging in securities finance ultimately will have to adapt to a myriad, and (despite statements by the G-20 to the contrary) largely uncoordinated, and in part, overlapping, array of US and international laws and regulatory proposals (e.g., the December proposals of the Basel Committee on Banking Supervision ("Basel Proposals") described in the January 2010 issue of this publication (available at www.debevoise.com)) affecting their operations generally and securities finance activities in particular.

Given the need for implementing regulations and transition periods, the exact impact of these various mandates on securities finance is not yet known. However, if the US and international regulators are not informed as to the actual nature of the risks involved and the potential adverse impact of overlapping new rules, the regulatory environment certainly could make it more costly, from capital, liquidity, operational and other perspectives, for the largest banks to continue to operate these programs at historical margins. The Basel Committee's conclusion after its recently finalized assessment of the economic impact of capital and liquidity requirements that there are clear net long-term economic benefits from increasing the minimum capital and liquidity requirements from their current levels, highlights that these current concerns are not illusory.

Indeed, the risk of punitive, overlapping and inconsistent burdens is even greater in this circumstance given the fact that rulemaking is simultaneously being conducted by US

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What's Inside

A New Era for Financial Supervision in the EU?

by Jeremy G. Hill and Edite Ligere

The financial supervisory landscape in the European Union ("EU") is changing. In late 2008 the EU Commission requested a high-level group, chaired by Jacques de Larosière, to report on proposals to strengthen European supervisory arrangements covering all financial sectors. The purpose of this report was to establish a more efficient, integrated and competitive and less risky European system of financial supervision. The de Larosière report, published on 25 February 2009, identified several serious supervisory failings that contributed to the recent financial crisis. It concluded that the EU's financial supervisory architecture should be reformed to make future supervisory failings less likely. On 27 May 2009, the EU Commission published a Communication setting out proposed changes to European financial supervision, based on the de Larosière report. These proposals were endorsed by the European Council on 19 June 2009. On 24 September 2009, the EU Commission published draft legislative proposals that are currently under consideration by the European Parliament and the European Council. They are expected to be adopted and come into force in the first half of 2011.

The main findings and recommendations of the de Larosière report

Examples of failings in the existing EU supervisory framework identified by the de Larosiere report are:

(i) ineffective early warning mechanisms;

(ii) lack of co-operation among financial supervisors;

(iii) lack of adequate macro-prudential supervision; and

(iv) lack of consistent supervisory powers across EU member states.

The report proposes the establishment of a new macro and micro-prudential supervisory framework, discussed in more detail below, to:

(i) reduce risk and improve risk management;

(ii) improve systemic shock absorbers;

(iii) weaken pro-cyclical amplifiers;

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(iv) strengthen transparency;

(v) properly align the incentives created by compensation packages; and

(vi) establish much stronger co-ordination among supervisors across the EU.

The proposed new macro-prudential supervisory framework

Under the proposals, macro-prudential supervision would be the responsibility of a new independent European Systemic Risk Board ("ESRB"). The ESRB would:

(i) develop a European macro-prudential perspective to address the problem of fragmented individual risk analysis at the national level;

(ii) enhance the effectiveness of early warning mechanisms by improving the interaction between micro- and macro-prudential analysis under a view that the soundness of individual firms too often has been supervised in isolation with little focus on the degree of interdependence within the financial system; and

(iii) ensure that risk assessments are translated into action by the relevant authorities.

The powers of the ESRB

The ESRB would not have any binding powers to impose measures on EU member states or national authorities. Its main role would be to identify systemic risks (actual and potential) and prevent or mitigate their impact on the financial system within the EU. The ESRB would have the power to issue risk warnings to avoid the build-up of wider problems and potential crises. If necessary, the ESRB could recommend specific actions to address any identified risks.

Such recommendations would not be legally binding. However, the addressee of the recommendations or warning would have to either comply or explain why compliance was not practical or possible.

The risk warnings or recommendations issued by the ESRB could be of a general nature or addressed to individual EU member states or financial institution. The ESRB would have the power to publish warnings and recommendations if, in its opinion, publication would be likely to make the warning or recommendation more effective. The ESRB would decide on a case by case basis whether warnings and recommendations should be made public. Given the high market impact on any potential financial institution of such warnings or recommendations, there is a potential legal issue as to whether the decision to publish would be a judicially reviewable act capable of annulment as a matter of EU law, just as there have been (albeit failed) challenges to the Commission's decision to publish letters announcing investigations for a company's alleged breaches of EU competition rules.

The composition of the ESRB

The ESRB would consist of: (i) a General Board, (ii) a Steering Committee and (iii) a Secretariat. The General Board would be the decision making body of the ESRB. It would be responsible for the adoption of the warnings and recommendations issued by the ESRB. The Chair of the General Board would be elected for 5 years from among the members of the General Board of the ESRB.

The Chair would:

(i) preside over the General Board as well as over the Steering Committee and instruct the Secretariat of the ESRB on behalf of the General Board;

(ii have the power to convene extraordinary meetings of the General Board of his own initiative;

(iii) have a casting vote; and

(iv) represent the ESRB externally.

The General Board would consist of: (i) the Governors of national central banks (currently 27), (ii) the President and the vice-President of the ECB, (iii) a Member of the European Commission and (iv) the Chairpersons of the three proposed new European Supervisory Authorities, all with voting rights. Decisions would be taken on a simple majority basis. The members of the General Board without voting rights would be high level representatives of the national supervisory authorities (27) and the President of the Economic and Financial Committee. With 61 members, there are serious doubts about the speed and efficiency of the General Board's decision-making process.

A Steering Committee is intended to assist the decision-making process of the General Board. It would prepare the meetings of the General Board, review the documents to be discussed and monitor the progress of ongoing work.

The ESRB as a whole would be accountable to the European Council and the European Parliament. It would have to submit bi-annual reports to the European Parliament and Council. More frequent reports could be required in times of widespread financial distress. The ESRB would meet at least quarterly and could meet more frequently in times of financial distress.

The proposed new micro-prudential supervisory framework

The proposals recommend the creation of a European System of Financial Supervisors ("ESFS") for the supervision of individual financial institutions ("micro-prudential supervision"). The ESFS would consist of a network of national financial supervisors working with three new European Supervisory Authorities ("ESAs") for the banking, securities and insurance and occupational pension sectors. These new ESAs, the European Banking Authority ("EBA"), the European Securities and Markets Authority

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("ESMA") and the European Insurance and Occupational Pensions Authority ("EIOPA") would replace the current Committee of European Banking Supervisors ("CEBS"), the Committee of European Securities Regulators ("CESR") and the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS").

The new authorities would play an important role in working towards a common EU financial services rulebook and drawing up interpretative guidelines to assist national authorities. The new ESAs are expected to reduce the likelihood for disagreement between national authorities by ensuring a more complete exchange of information between national supervisors and EU supervisory authorities.

Domestic financial institutions in Europe would continue to be supervised by national supervisors. Cross-border institutions would be supervised by colleges of supervisors. The Commission in its press releases has been keen to emphasise the continuing relevance of the existing college of supervisors structure, stating that it regards the colleges and the new authorities as complementary parts of the reform. The draft EU legislation which provides for the creation of the ESAs does not grant them any direct supervisory powers over any institutions, but does allow them to participate in the colleges themselves. The draft legislation preserves the possibility for subsequent legislation to grant supervisory powers for any particular category of institution.

In an emergency (the existence of which would be determined by the Commission) the ERAs would have an important coordinating role between national supervisors and would be able to adopt decisions requiring supervisors to take action.

The ESAs would be duty-bound to consider only EU interests. The ESAs would be accountable to the Council (representing the Member States) and the Parliament (representing the Community). Given the recent and highly-publicised tensions between member states over financial regulatory reform, particularly between France and Germany, it is uncertain how this structure of accountability to the Council would operate in practice.

The objectives and powers of the proposed new ESAs

> **The new authorities would play an important role in working towards a common EU financial services rulebook and drawing up interpretative guidelines to assist national authorities. The new ESAs are expected to reduce the likelihood for disagreement between national authorities by ensuring a more complete exchange of information between national supervisors and EU supervisory authorities.**

The proposed new ESAs would:

- ensure a single set of harmonised rules, by developing binding technical standards in specific areas, and drawing up interpretive guidelines, which the national authorities will use in making individual decisions;
- ensure consistent application of the harmonised EU rules and assist the national supervisory authorities in doing so by facilitating dialogues and resolving issues between disputing national supervisory authorities. It is also proposed that a mechanism should be put in place to ensure compliance by national supervisory authorities with the harmonised rules. This would give the ESAs investigatory powers and the power to make recommendations, and will be backed up by recourse to the European Commission, presumably exercising its Article 226 EC enforcement powers, should recommendations be ignored. The details of these particular proposals have yet to be finalized;
- ensure a common supervisory culture and consistent supervisory practices (e.g. by developing common training programmes and observing meetings of the colleges of supervisors);
- have full supervisory powers for credit rating agencies and EU central counterparty clearing houses including powers of investigation, on-site inspections and supervisory decisions;
- ensure a coordinated response in crisis situations by facilitating cooperation and exchange of information, acting as mediator where required, verifying the reliability of relevant information, and assisting national supervisory authorities in making and implementing decisions;
- collect micro-prudential information by aggregating the information emanating from national supervisors, and set up and manage a central European database; and

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- undertake an international role in respect of certain supervisory activities.

The chairpersons of the new ESAs would be full-time independent professionals appointed for a period of five years. Each of the new ESAs would have a Board of Supervisors consisting of high-level representatives of the national supervisory authorities, representatives of the Commission, the ESRB and relevant supervisory authorities from European Free Trade Association-European Economic Area countries, which will have observer status. Unlike the ESRB, the ESAs would be dominated by regulators (rather than central bankers).

The new ESAs would act only where there is clear added value, such as the development of technical standards which would apply throughout the EU, and settlement of disagreements between national supervisors on matters which require cooperation. The areas where the authorities could act would be strictly defined by the EU Parliament and Council. The ESFS's performance would be evaluated after the third anniversary of its creation.

The Court of Auditors (not to be confused with the European Court of Justice) and the EU Anti-Fraud Office would have full competence to inspect the books of the ESAs. This is worthy of note, given the Court's often fractious relationship with the European Commission and its highly critical reports on Community finance. The accusation that the Court is in fact "*anti-communautaire*" has been levelled more than once, and given the Court's continuing difficulty in establishing a common auditing culture across its mandate it is worth noting that the ESAs' proposed objective of moving towards a common regulatory culture for the Union is a formidable task.

The costs of the proposed new ESAs would be split between member states and the EU on a 60% - 40% basis. This is stated to reflect the ongoing relevance of national regulators and is perhaps reflective of the recently re-stated Protocol on Subsidiarity in the Treaty of Lisbon.

The European Parliament's recent call for greater powers for the proposed new ESAs

Recently, the European Parliament called for greater powers for the ESAs. In particular, the European Parliament suggested that:

- the ESAs should have the power to issue decisions directly to a financial institution where a national supervisor has not been able to change practices that are considered unsound. They should also have the power to settle disputes between national supervisors, and supervise important cross-border financial institutions by acting through national supervisors;
- the ESAs should be established in Frankfurt, rather than being spread around the EU. However, it would be possible to have ESA representatives in the most important EU financial centers. It is interesting to note that on 13 July 2010, George Osborne, the UK's Chancellor of the Exchequer, indicated that broad agreement had been reached at the EU level to house the EBA in London;
- the ESRB should be able to monitor the build-up of risk in the EU economy in a fast and effective way. It should develop a common set of indicators to permit uniform ratings of the riskiness of specific cross-border financial institutions, and make it easier to identify the risks embedded in them. It should also establish colour-coded grades to reflect different levels of risk, and use the colours in its warnings or recommendations;
- the ESRB should have the power to summon the addressees of its recommendations so that they can explain the actions they have taken to take the ESRB's recommendations into account;
- the ESRB should be chaired by the President of the European Central Bank; and
- the ESRB's membership should be extended to include academics.

Conclusion

The extent to which the current proposals will change by the time they are finally adopted remains to be seen. It also remains to be seen whether the proposed overhaul of the EU's financial supervisory architecture will deliver any real change. It is worth remembering that, at present, the EU has no power to levy direct taxation on the citizens of the EU. Consequently, the costs of any financial disasters ultimately fall to national treasuries and taxpayers, not the EU.

Also, the political battle for jurisdictional control over the abode of the proposed new ESAs appears to be far from over. At present, it seems likely that the EBA would be based in London rather than Frankfurt. This is significant given the differences in approach to the reform of financial regulation between London and the rest of Europe.

In order to be effective, the proposed new supervisory regime will have to strike and maintain a delicate balance between the role of national regulators in whose interests it is to protect their own taxpayers from the consequences of financial disasters in other EU member states and the powers of the proposed new EU entities. Irrespective of precisely how the proposed new EU financial supervisory regime will work in practice, it seems reasonably certain that the landscape of European financial supervision will look very different in the future. ■

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Dodd-Frank Act – A Brave New World For U.S. Reinsurance Credit Rules?

by Thomas M. Kelly and John Dembeck

If you are a reinsurance lawyer or a financial accounting professional seeking simplicity and uniformity, what would you say to a law that would nullify all U.S. state reinsurance credit rules that are applied by non-domestic states on an extraterritorial basis in favor of reinsurance credit rules being applied only by the ceding insurer's domestic state? You would probably say you are all for it. In which case you will probably be all for §531(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted on July 21, 2010 as Public Law No. 111-203. Dodd-Frank Act §531(a) seeks to achieve the goal of the National Association of Insurance Commissioners ("NAIC") when it adopted its Credit for Reinsurance Model Act and Model Regulation – domestic state deference for reinsurance credit rules. However, that NAIC goal has not been achieved since some fifteen states subject non-domestic ceding insurers to their reinsurance credit rules. The purpose of this article is to explain what Dodd-Frank Act §531(a) does and explain what this change will mean for U.S. ceding insurers and their reinsurers.

Section 531(a) and its Effective Date

Let's start with the text – Dodd-Frank Act §531(a) provides that:

> If the State of domicile of a ceding insurer is an NAIC-accredited State, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for reinsurance for the insurer's ceded risk, then no other State may deny such credit for reinsurance.

There are a several words and phrases used in Dodd-Frank Act §531(a) that are specifically defined in the Dodd-Frank Act. These are the following, each of which is defined in Dodd-Frank Act §533:

> The term "ceding insurer" means an insurer that purchases reinsurance.
>
> The terms "State of domicile" and "domiciliary State" mean, with respect to an insurer or reinsurer, the State in which the insurer or reinsurer is incorporated or entered through, and licensed.
>
> The term "NAIC" means the National Association of Insurance Commissioners or any successor entity.

The term "reinsurance" means the assumption by an insurer of all or part of a risk undertaken originally by another insurer.

The term "State" includes any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the Northern Mariana Islands, the Virgin Islands, and American Samoa.

The Dodd-Frank Act provides that §531(a) will take effect upon the expiration of the 12-month period beginning on the date of the enactment of Title V, Subtitle B of the Dodd-Frank Act of which §531(a) is a part. Since the date of enactment was July 21, 2010, §531(a) will take effect July 21, 2011.

General Effect

U.S. federal law (the McCarran-Ferguson Insurance Regulation Act of 1945) declares that it is the intent of the U.S. Congress that the business of insurance be regulated by the states and no act of Congress may be construed to supersede any state law for the purpose of regulating the business of insurance unless the act specifically relates to the business of insurance. Dodd Frank Act §531(a) does just that.

The general effect of Dodd-Frank Act §531(a) can be summarized as follows – beginning July 21, 2011, a U.S. ceding insurer need not satisfy the reinsurance credit rules of any non-domestic state if the following two conditions are met: (i) the ceding insurer's domestic state is NAIC-accredited, and (ii) the ceding insurer's domestic state recognizes credit for reinsurance for its ceded risk. Currently, every state is NAIC-accredited. Therefore, if all reinsurance ceded by every U.S. ceding insurer were allowed reinsurance credit in the ceding insurer's domestic state, then the extraterritorial reinsurance credit rules of all fifteen states that apply their reinsurance credit rules to non-domestic ceding insurers would cease to apply to such reinsurance effective July 21, 2011 by virtue of preemption by Dodd-Frank Act §531(a).

Impact on U.S. Ceding Insurers

The following discussion assumes that, for a given U.S. ceding insurer, its domestic state is NAIC-accredited and the domestic state recognizes credit for reinsurance for the insurer's ceded risk. Consequently, non-domestic state reinsurance credit rules will be preempted on and after July 21, 2011 (provided that Dodd-Frank Act §531(a) is then and thereafter remains in effect).

Extraterritorial Reinsurance Credit Rules. On and after July 21, 2011, a state's extraterritorial reinsurance credit rules will only apply to that state's domestic ceding insurers – their application to non-domestic

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ceding insurers, whether foreign licensed insurers or accredited reinsurers, will be preempted. Keep in mind that the operative phrase of Dodd-Frank Act §531(a) is "no other State may deny such credit for reinsurance." This not only includes laws and regulations, such as New York's Regulation 20 (general reinsurance credit rules, including the life mirror reserve rule), 114 (single beneficiary reinsurance trusts), 133 (letters of credit) and 102 (risk transfer), but arguably also includes any interpretations of such laws and regulations. The New York Insurance Department appears to have taken the first step to expressly acknowledge the preemptive effect of Dodd-Frank Act §531(a) in that, on July 22, 2010, it released for comment a proposed 10th Amendment to Regulation 20. The proposed 10th Amendment to Regulation 20 adds the following new §125.1 which tracks the wording in Dodd-Frank Act §531(a): "This Part [Regulation 20] shall not apply where the state of domicile (other than New York) of a ceding insurer is an NAIC-accredited state, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for reinsurance for the insurer's ceded risk." It is hoped that the New York Insurance Department will make similar amendments to its other reinsurance credit regulations, Regulations 133, 114 and 102, to make it clear under what conditions these regulations will apply to non-domestic ceding insurers.

New York Domestic Ceding Insurers. Since New York's reinsurance credit rules are considered among the toughest in the U.S., New York domestic ceding insurers may find themselves at a competitive disadvantage to non-New York domestic ceding insurers in that they alone will, by law, be subject to the New York reinsurance credit rules after July 21, 2011. The New York Insurance Department has in recent years considered reforming its reinsurance credit rules – possibly making them more like the NAIC Model Act and Model Regulation. Since most of the substantive New York reinsurance credit rules are in regulations promulgated by the New York Superintendent of Insurance and not law, many of these reforms can be accomplished by the amended regulations promulgated by the New York Superintendent of Insurance rather than by statutory amendment which would require legislative action. Now may be the time to finally achieve this goal of New York reinsurance reform so as to make a level playing field for New York domestic ceding insurers after July 21, 2011. Yet, the New York Insurance Department does not seem to be heading in that direction. While its proposed 10th Amendment to Regulation 20 released for comment on July 22, 2010 goes beyond the NAIC Model Act and Model Regulation and allows reduced collateral requirements for cessions to highly creditworthy unauthorized reinsurers, it does not eliminate the mirror reserving rule for ceded life, annuity and accident and health risks, a provision that is not part of the NAIC Model Act and Model Regulation.

Deference to Domestic State Rules – Accredited Reinsurer. Currently, if a 50-state licensed U.S. ceding insurer cedes to a unauthorized reinsurer domiciled in the U.S. that qualifies as an accredited reinsurer in the ceding insurer's domestic state, in order for the ceding insurer to be eligible for reinsurance credit in all states, the unauthorized reinsurer must be accredited as a reinsurer in certain states in which it is not licensed that impose their reinsurance credit rules on non-domestic ceding insurers. On and after July 21, 2011, the accredited reinsurer need only be accredited in the ceding insurer's domestic state to achieve the same effect.

Since New York's reinsurance credit rules are considered among the toughest in the U.S., New York domestic ceding insurers may find themselves at a competitive disadvantage to non-New York domestic ceding insurers in that they alone will, by law, be subject to the New York reinsurance credit rules after July 21, 2011.

Deference to Domestic State Rules – Multiple Beneficiary Trust Agreement. Some U.S. ceding insurers cede risks to non-U.S. reinsurers that use a multiple beneficiary trust as security for such reinsurance. If the trust is intended to qualify for credit for reinsurance ceded by a U.S. ceding insurer domiciled in any state on and after July 21, 2011, then, notwithstanding Dodd Frank Act §531(a), the trust will have to satisfy the reinsurance credit rules of all states of domicile of all

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ceding insurers as well as those of states that apply their reinsurance credit rules on a extraterritorial basis. However, if such a trust is designed to be eligible security for reinsurance ceded by one or more ceding insurers domiciled in a single state (e.g., a non-U.S. reinsurer that assumes risks only from its affiliated U.S. ceding insurers all of which are domiciled in the same state), then the trust need only satisfy the ceding insurer's domestic state reinsurance credit rules on and after July 21, 2011.

Deference to Domestic State Rules – Reinsurer Domiciled in Another State. NAIC Model Act §2.C allows reinsurance credit for reinsurance ceded to a reinsurer that is domiciled in a state that employs standards regarding credit for reinsurance substantially similar to those applicable under the ceding insurer's domestic state provided that the reinsurer (i) maintains a surplus of at least $20 million, and (ii) submits to the authority of the ceding insurer's domestic state to examine its books and records. In its December 2009 survey of credit for reinsurance laws, the Reinsurance Association of America reports that over two-thirds of the states employ this provision in their reinsurance credit rules. However, this provision is not widely used since, for a 50-state licensed ceding insurer, all states that apply their reinsurance credit rules on an extraterritorial basis would have to allow reinsurance credit on this basis. Since New York and California are among the states that do not allow reinsurance credit on this basis, this provision is currently not an effective means of assuring nationwide credit for ceded reinsurance. However, since on and after July 21, 2011, only the ceding insurer's domestic state reinsurance credit rules will apply, if this provision is included in the ceding insurer's domestic state reinsurance credit rules and the reinsurer satisfies the $20 million surplus requirement and submits to the authority of the ceding insurer's domestic state to examine its books and records, then reinsurance credit will be allowed the ceding insurer in every state. As a consequence, Dodd-Frank Act §531(a) will substantially improve the viability of this reinsurance credit provision for ceding insurers domiciled in states that include this provision in their reinsurance credit rules.

[S]ince on and after July 21, 2011, only the ceding insurer's domestic state reinsurance credit rules will apply, if the ceding insurer's domestic state allows credit for reinsurance ceded to an unauthorized reinsurer that posts an alternative form of security that the domestic state insurance regulator accepts, then reinsurance credit will be allowed the ceding insurer in every state.

Deference to Domestic State Rules – Any Other Form of Security Acceptable to the Commissioner. NAIC Model Act §3.D allows credit for reinsurance ceded by a domestic ceding insurer to an unauthorized reinsurer in the amount of funds held by or on behalf of the ceding insurer as security, provided that the security is held in the U.S. subject to withdrawal solely by, and under the exclusive control of, the ceding insurer. The security may be in the form of "[a]ny other form of security acceptable to the commissioner." Like NAIC Model Act §2.C discussed above, this provision is not widely used since, for a 50-state licensed ceding insurer, all states that apply their reinsurance credit rules on an extraterritorial basis would have to allow reinsurance credit on this basis. Since New York and California have no such provision in their reinsurance credit rules corresponding to NAIC Model Act §3.D, these states have no such discretion to allow an alternative form of security. Therefore, this provision is currently not an effective means of assuring nationwide credit for ceded reinsurance. However, since on and after July 21, 2011, only the ceding insurer's domestic state reinsurance credit rules will apply, if the ceding insurer's domestic state allows credit for reinsurance ceded to an unauthorized reinsurer that posts an alternative form of security that the domestic state insurance regulator accepts, then reinsurance credit will be allowed the ceding insurer in every state. As a consequence, Dodd-Frank Act §531(a) will substantially improve the viability of the "other form of security acceptable to the commissioner" provision for ceding insurers domiciled in states that include this provision in their reinsurance credit rules. Based on our experience, ceding insurers have been pursuing alternative forms of

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security with greater frequency in recent years – hence the NAIC's decision to issue guidance on this subject on March 15, 2009 ("it is the opinion of the NAIC that commissioners should utilize this authority on a case-by-case basis only after careful and thorough evaluation of all information relevant to the situation").

Deference to Domestic State Rules – Application to Existing Reinsurance Agreements. Dodd-Frank Act §531(a) does not modify any contractual requirements of any existing or future reinsurance agreement. Consequently, if a previously executed reinsurance agreement entered into by a non-New York domestic ceding insurer expressly provides that the reinsurer must provide security that satisfies the reinsurance credit rules of New York, that provision will remain effective even after July 21, 2011. However, the ceding insurer and the reinsurer could agree to amend that reinsurance agreement to relieve the reinsurer of having to satisfy the New York reinsurance credit law requirements on or after July 21, 2011 (provided that Dodd-Frank Act §531(a) is then and thereafter remains in effect). That amendment could be entered into now to provide that any required compliance with the New York reinsurance credit rules will sunset effective July 21, 2011 (provided that Dodd-Frank Act §531(a) is then and thereafter remains in effect).

Deference to Domestic State Rules – New Reinsurance Agreements Executed Before July 21, 2011. Unauthorized reinsurers that enter into a new reinsurance agreement with a U.S. ceding insurer between now and July 21, 2011 may still be called upon to satisfy any applicable extraterritorial reinsurance credit rules since these rules remain applicable to U.S. ceding insurers until July 21, 2011. Consideration may be given to crafting these contractual provisions in such a way so as to assure that, by the terms of the agreement, the imposition of the extraterritorial reinsurance credit rules on the reinsurer will sunset effective July 21, 2011 (provided that Dodd-Frank Act §531(a) is then and thereafter remains in effect).

Impact on Reinsurers

U.S. Professional Reinsurers. Most U.S. professional reinsurers are licensed in all states so that any U.S. ceding insurer will be allowed credit for reinsurance ceded to it without the reinsurer having to post any security. After July 21, 2011, the need for licensing to achieve this same result will not diminish. If a U.S. professional reinsurer wants to continue to be able to offer credit for reinsurance ceded to it by a ceding insurer domiciled in any state without posting security, the reinsurer will have to be and remain licensed in all states. However, U.S. professional reinsurers will obtain a separate benefit under the Dodd-Frank Act. Pursuant to Dodd-Frank Act §532(a), beginning July 21, 2011, if the reinsurer's domestic state is NAIC-accredited, then the domestic state will be solely responsible for regulating the financial solvency of the reinsurer.[1]

Captive and Special Purpose Reinsurers. U.S. insurers use captive and special purpose reinsurers for various purposes including as part of a plan to issue catastrophe bonds, in the case of non-life insurers, and the reinsurance of XXX and AXXX liabilities, in the case of life insurers. The reinsurer is typically an unauthorized reinsurer. Beginning July 21, 2011, if the ceding insurer is licensed or accredited in but not domiciled in New York, the extraterritorial application of the New York reinsurance credit rules will be preempted by Dodd-Frank Act §531(a). Therefore, if the ceding insurer is licensed or accredited in but not domiciled in New York, these captive and special purpose reinsurance arrangements might be modified in any of the following ways:

- *Single Beneficiary Reinsurance Trust.* If reinsurance credit is allowed by the reinsurer posting security in the form of assets deposited in a single beneficiary reinsurance trust, then the parties could revise the reinsurance agreement and the related reinsurance trust agreement to allow investment in any additional trust assets permitted under the ceding insurer's domestic state reinsurance credit rules even if such asset is not a permitted trust asset under the extraterritorial reinsurance credit rules of a state, such as New York.
- *Letter of Credit as Permitted Trust Asset.* While the New York reinsurance credit rules do not allow, as a permitted form of security, depositing a letter of credit in a single beneficiary reinsurance trust, a number of state reinsurance credit laws and/or regulations do allow a letter of credit as a permitted trust asset. If the ceding insurer's domestic state reinsurance credit rules allow a letter of credit as a permitted trust asset, then the reinsurance trust could be modified to accommodate a letter of credit as a permitted trust asset.
- *Any Other Form of Security Acceptable to the Commissioner.* If the ceding insurer's domestic state reinsurance credit rules allow the use of "[a]ny other form of security acceptable to the commissioner" as provided in NAIC Model Act § 3.D, then the ceding insurer could seek to obtain its domestic state insurance regulator's consent to some alternative

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form of security in lieu of funds withheld, qualifying letters of credit or assets deposited in a single beneficiary reinsurance trust.

- *Reinsurer Domiciled in Another State*. If the ceding insurer's domestic state reinsurance credit rules allow credit for reinsurance ceded to a reinsurer satisfies the requirements of NAIC Model Act § 2.C, then, if the reinsurer is a U.S. captive or special purpose reinsurer that satisfies these requirements, reinsurance credit may be allowed for purposes of all states in which the ceding insurer is licensed without the reinsurer posting any security. For those states that have enacted the NAIC Model Act and Model Regulation wording, nothing in NAIC Model Act § 2.C(1) or Model Regulation § 6.A(1) treats a U.S. captive or special purpose reinsurer differently than any other "assuming insurer that is domiciled in . . . a state."
- *Accredited Reinsurer*. If the ceding insurer's domestic state reinsurance credit rules allow credit for reinsurance ceded to an accredited reinsurer, then, if the reinsurer is a U.S. captive or special purpose reinsurer that satisfies these accreditation requirements, reinsurance credit may be allowed for purposes of all states in which the ceding insurer is licensed without the reinsurer posting any security. For those states that have enacted the NAIC Model Act and Model Regulation wording, nothing in NAIC Model Act § 2.B(1)(c) or Model Regulation § 5.A(2) treats a U.S. captive or special purpose reinsurer differently than any other reinsurer that is "licensed to transact insurance or reinsurance in at least one state."

While the benefits of Dodd-Frank Act §531(a) will not be available until July 21, 2011, ceding insurers and reinsurers may be able to take action or make changes now that will take effect when that date arrives.

Disputes Over the Scope of Federal Preemption

The time may come when an insurer seeks to take advantage of federal preemption of state laws and regulations under Dodd-Frank Act §531(a) or any other federal preemption provision of Dodd-Frank Act Title V, Subtitle B, the "Nonadmitted and Reinsurance Reform Act of 2010," but finds that a state insurance regulator disagrees with that view and seeks to enforce its state laws and regulations. In that case, who will decide who its right – the insurer or the state insurance regulator? The answer is the federal courts.

There is no special provision relating to Dodd-Frank Act §531(a) that authorizes some person or agency to settle disputes regarding the scope of federal preemption under the Nonadmitted and Reinsurance Reform Act of 2010. While the Federal Insurance Office is also established under Dodd-Frank Act Title V, the functions of the Office and its Director do not include settling disputes regarding the scope of federal preemption under the Nonadmitted and Reinsurance Reform Act of 2010.

Disputes over the scope of preemption will likely be settled by federal courts, similar to the way they are settled now with respect to the scope of federal preemption of state laws and regulations under the Liability Risk Retention Act of 1986, under which risk retention groups and purchasing groups are preempted from the application of various kinds of state laws and regulations.

Conclusion

As indicated above, Dodd-Frank Act §531(a) opens a whole host of opportunities for ceding insurers (and their reinsurers) to consider what they will need in the future for reinsurance credit and reconsider what changes they may want to make to existing reinsurance agreements and security arrangements to remove unnecessary burdens imposed on them due to the application of extraterritorial reinsurance credit rules that will be preempted on and after July 21, 2011. Does that constitute a "Brave New World For U.S. Reinsurance Credit Rules"? We think it does. However, while Dodd-Frank Act §531(a) preempts non-domestic reinsurance credit rules, it does not make domestic state reinsurance credit rules uniform. Some other change will be needed to achieved uniformity such as complete federal preemption in this area under optional federal charter legislation or federal preemption of state reinsurance credit rules that do not meet a prescribed uniform standard. ■

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1. For this purpose, the term "reinsurer" is defined to mean "an insurer to the extent that the insurer – (i) is principally engaged in the business of reinsurance; (ii) does not conduct significant amounts of direct insurance as a percentage of its net premiums; and (iii) is not engaged on an ongoing basis in the business of soliciting direct insurance." A determination of whether an insurer is a reinsurer will be made under the laws of its state of domicile. Dodd-Frank Act §533(5).

The United States Significantly Expands its Iran Sanctions Regime

by Satish M. Kini and Michael G. Stern

On July 2, 2010, President Obama signed into law the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (the "Act"), which significantly expands U.S. sanctions against Iran. The Act imposes new and far-reaching requirements on both U.S. and internationally based companies in an effort to reduce Iran's access to refined petroleum products and to undermine that country's ability to develop nuclear and other weapons of mass destruction ("WMD") technology.

The Act creates potential liability and compliance obligations not only for firms in the energy industry that do business with Iran's oil and petroleum sectors but also for U.S. and internationally based financial services providers that provide lending, insurance underwriting and reinsurance services. Several provisions of the Act, particularly involving non-U.S. banks' access to U.S. banking and financial markets, will be implemented through important rules issued by the U.S. Treasury Department – the first of these rules was issued on August 16. This article summarizes the key provisions of the new law.

Prohibited Petroleum-Related Transactions

A key provision of the Act requires the President to impose sanctions on both U.S. and non-U.S. persons that "knowingly" engage in certain types of transactions involving Iran's petroleum industry. The knowledge standard can be met not only with actual knowledge, but also if a person or entity "should have known" of the sanctionable conduct.

The sanctionable transactions covered by the Act include:

- Investments of $20 million or more that "directly and significantly" contribute to the enhancement of Iran's ability to develop petroleum resources.
- Sales and exports of refined petroleum products to Iran that have a value of $1 million in a single transaction or $5 million in multiple transactions over the course of a 12-month period.
- Sales, leases and other provision of goods, services, technology and other support to Iran – that have a value at $1 million in a single transaction or, over the course of a 12-month period, have a value of $5 million – that "could directly and significantly" contribute to Iran's ability to import or produce refined petroleum.

The Act's prohibition on services and other support extends specifically to lending and other financing transactions. Thus, for example, financing the sale of $1 million of gasoline, diesel fuel or other refined petroleum products to Iran could trigger the imposition of sanctions under the Act.

Also, contracts to provide insurance or reinsurance could be deemed sanctionable support, although the Act provides an exception when an insurer has exercised "due diligence in establishing and enforcing" policies, procedures and controls to ensure that it does not contribute to Iran's ability to import refined petroleum products. Under the Act, only insurers (but not other types of financial services providers) appear to benefit from this due diligence exception.

Sanctions

Under pre-existing law (the Iran Sanctions Act of 1996), the President could impose an array of penalties on those engaged in prohibited transactions. Those pre-existing sanctions include – 1) denial of Export-Import Bank loans and guarantees, 2) export and import restrictions, 3) prohibitions on the receipt of large loans from U.S. financial institutions, 4) restrictions on dealings with U.S. government bonds and from serving as a repository for U.S. government funds and 5) prohibitions on entering into procurement contracts with the U.S. government.

The Act expands the list of potential sanctions by three. Under the Act, the President may prohibit – 1) any transactions in foreign exchange by the sanctioned party, 2) any transfers of credit or payments of the sanctioned party through U.S. financial institutions and 3) any person from participating in any property transactions with a sanctioned party (effectively blocking the assets of the sanctioned party).

The Act generally requires the President to impose three or more of the expanded set of available sanctions on those who engage in prohibited transactions. The Act retains the President's right to waive imposition of sanctions on non-U.S. persons, which waiver right also existed under prior law. The President's waiver authority, however, is subject to a more restrictive standard than had existed under previous law and may be exercised only on certification to Congress that the waiver is "vital to the national security interests of the United States."

Financial Institution Provisions

The Act also requires the U.S. Treasury Department to issue regulations designed to restrict foreign banks and other financial institutions engaged in certain types of transactions involving Iran from having dealings with U.S. financial institutions and the U.S. financial system. As described below, one set of those regulations was issued by the Treasury Department on August 16.

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First, the Act calls on the Treasury Department to issue rules to "prohibit or impose strict conditions on" the opening and maintenance of U.S. correspondent and payable-through accounts by a foreign financial institution that the Treasury Department finds "knowingly" (defined, as above):

- facilitates efforts of Iran or Iran's Islamic Revolutionary Guard Corps ("IRGC") to acquire or develop WMD or support international terrorism;
- deals with Iranians sanctioned by the UN Security Council;
- helps launder money to aid Iran's WMD program, support terrorism or help those sanctioned by the Security Council;
- helps the Iranian Central Bank to support any of the above-noted activities; or
- conducts significant business with the IRGC, its front companies or other Iranian institutions subject to U.S. sanctions.

The Act also requires the Treasury Department to proscribe regulations to prohibit U.S. financial institutions, and those controlled by U.S. financial institutions, from knowingly engaging in transactions with or benefiting the IRGC or any of its agents or affiliates whose property is blocked pursuant to U.S. sanctions laws.

Separately, the Treasury Department must issue rules to require U.S. financial institutions maintaining correspondent and payable-through accounts for foreign financial institutions to take one or more of the following actions: perform an audit of activities carried out by its foreign financial institution counterparts with respect to Iran; report to the Treasury Department on transactions or services relating to the above-noted prohibited activities; establish procedures to monitor whether a foreign institution has engaged in prohibited activities; and/or certify that, to the best of its knowledge, a foreign institution counterparty is not knowingly engaging in any prohibited activity. Under the Act, the terms "correspondent account" and "payable-through account" are defined with a cross-reference to the definitions contained in Title III of the USA Patriot Act. This cross-reference means that those terms are defined expansively and, as a result, will apply to virtually all account relationships involving foreign financial firms.

On August 16, the Treasury Department's Office of Foreign Assets Control ("OFAC") issued final regulations to implement the first of the Act's financial institutions requirements. (OFAC relied on a foreign affairs exception to avoid the Administrative Procedures Act's normal requirements of prior regulatory notice and opportunity for comment; the new rules are thus immediately effective, although OFAC has welcomed comment on or before October 15, 2010.) The new OFAC regulations provide, in principal part, that the Treasury Department will make a finding that a particular foreign financial institution has knowingly engaged in prohibited Iranian-related activities, in which case the Treasury Department either will impose strict conditions on accounts maintained by that institution with U.S. financial institutions or will prohibit the institution from having correspondent or payable-through accounts with U.S. financial institutions. If a foreign financial institution is designated under the new OFAC regulations, U.S. financial institutions generally will have 10 days to close out their correspondent and payable-through accounts with the designated foreign financial firm.

Government Contracting

Under the Act, anyone wishing to contract with the U.S. government will need to certify to not having engaged in any sanctionable transactions. In addition, persons that export "sensitive technologies" directly to Iran are disqualified from eligibility for U.S. government contracts. Sensitive technologies include equipment or technologies that restrict the free flow of unbiased information to Iran or disrupt, monitor or otherwise restrict the speech of the people of Iran.

Exports and Imports

The Act also contains a near total prohibition on exports to Iran from the United States or by a U.S. person. In addition, virtually all imports from Iran into the United States are prohibited. Only a few goods and services are permitted under exceptions, which are more narrowly drawn than under existing law.

* * *

The new Act represents one (albeit, important) part of the U.S. and international response to concerns about Iran's development of WMD and other domestic and international activities. The Act is coupled with new UN and European Union measures that also restrict transactions and activities with Iran. In addition, the U.S. Office of Foreign Assets Control has added a number of Iranian companies and banks to its lists of specially designated nationals, with whom U.S. persons may not do business. These actions, in total, represent a significant enhancement to the international restrictions on dealings with Iran. ■

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regulators and internationally through the Basel Committee. While the Basel Committee seeks to govern behavior principally via capital and liquidity restrictions, Dodd-Frank uses those tools but also other proscriptive measures. As a result, for example, even if they were deemed acceptable unto themselves if they were the principal restriction, the Basel Committee's capital and liquidity requirements are more likely to prove unduly burdensome on banks in light of the additional limitations imposed on them by Dodd-Frank. Indeed, even if the US and international regulators seek to impose broadly consistent capital requirements, the complexity of capital calculations may cause them to be additive in practice without industry input.

> [E]ven if they were deemed acceptable...unto themselves if they were the principal restriction, the Basel Committee's capital and liquidity requirements are more likely to prove unduly burdensome on banks in light of the additional limitations imposed on them by Dodd-Frank.

To seek to avoid a potentially unfavorable regulatory environment for these activities when the regulatory process concludes, the largest banks must create the uniform regulatory perspective not provided by the legislators and rulemakers to date by commenting on the various proposals in a consistent, comprehensive, cross-proposal manner. Fortunately in this regard, while Dodd-Frank does not create a favorable framework for large banks, much of the substance and clarification is left to regulators. Similarly, while the comment period has (at least purportedly) concluded for the Basel Proposals, related Basel Committee initiatives remain open for comment (and opportunity to substantively comment upon local jurisdiction implementation of the Basel Proposals likely still remains). Thus, while the volume of coming regulatory proposals is burdensome, it also presents an opportunity for a well-crafted industry response to at least reduce adverse consequences, and perhaps even bring a reasonable conclusion to this process.

To assist with this effort, this article seeks to provide a roadmap of the more significant US and international regulatory provisions relevant to this business so that affected institutions can seek to positively impact the outcome of the process. While the focus of the article is on securities lending, the regulatory concerns, and thus associated costs and burdens, are also (as indicated herein) similar for many of the other bilateral securities and derivatives activities of these institutions. Accordingly, this discussion also seeks to serve as a broader roadmap for commenting on these types of activities by large institutions, and particularly the large US-based banking institutions subject to (1) the full impact of Dodd-Frank, (2) the Basel Proposals, and (3) other government initiatives. To provide context, this article first describes securities finance, the issues associated with it during the financial crisis, and its historical regulatory framework. The article then discusses in greater detail the relevant regulatory proposals resulting from this process potentially affecting these programs (and by analogy, many securities and derivatives activities) in the post-crisis financial regulatory regime.

I. An Overview of Securities Finance and its Historical Regulatory Environment

A. Securities Finance Overview and Issues in the Financial Crisis

In a typical agency[2] securities lending transaction, the lending agent, acting in a fiduciary capacity on behalf of its client, transfers the client's security to a borrower, typically a broker dealer. Full legal title to the security passes to the borrower. This is necessary because in many cases the borrower is using the security to settle a market transaction. In return for the security, the borrower transfers collateral in the form of cash or other securities equal to the value of the borrowed security plus an additional margin, typically 2-5 percent. This collateral value is adjusted each day based upon the changes in the value of the security lent and the collateral. Under the lending contract with the borrower, the lender also receives a bundle of contractual rights that creates a synthetic ownership interest for the lender during the term of the loan. These rights include the right to receive the value of any corporate action and the right to require the borrower to return the security at any time. The only economic right not included in this contractual bundle is the right to vote the security.

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Large institutional investors such as pension, sovereign wealth and mutual funds hire a securities lending agent to lend their portfolio securities. In the past this was usually their custodian, typically one of the largest US or international banks. However, advances in technology have made hiring a lending agent who is not the custodian a more common practice. In fact, many large investors employ multiple lending agents distributing lending mandates, much like they do investment management mandates.

In the United States, the predominant form of collateral is cash. Cash collateral is reinvested by the agent in accordance with investment management guidelines established by the lender. Accordingly, in a lending transaction collateralized by cash, there are really two separate transactions. First, there is the lending transaction, in which the lent security is exchanged for the cash collateral. Second, there is the investment transaction in which the cash collateral is used to purchase an investment, such as a repurchase agreement, a certificate of deposit, short-term commercial paper, corporate floating rate notes, or other similar instruments, often in a commingled investment pool.

In a lending transaction where the security is exchanged for cash or securities collateral, it is market practice for the lending agent to provide a borrower default indemnification. This means that the lending agent commits to its lending client that if the borrower fails to return the security when requested, the agent will liquidate the collateral provided by the borrower and use the proceeds to purchase a replacement security or credit the client's account with the cash value of the security. If the collateral is insufficient to purchase the security or credit the appropriate cash value, the agent agrees to make up the difference. The only exception is if the cash collateral is insufficient due to investment losses resulting from the reinvestment of the cash collateral. All risk with respect to the reinvestment of cash collateral is borne completely by the lending client, just like in virtually any other investment management arrangement.

Ironically, much of Dodd-Frank and the Basel Proposals address counterparty risk, which was not an issue for securities lending. There is a much smaller direct focus on the reinvestment of cash collateral, the area in which virtually all the issues existed during the crisis.

The effect of the borrower default indemnification is that the agent is intermediating the counterparty credit risk of the lending transaction. This borrower default indemnification provided by the agent has been treated by regulators as a third-party guarantee, with the capital and other ramifications described below. The securities lending market has seen several major defaults in which borrowers were unable to return securities as a result of bankruptcy or other reasons, including the Barings failure, the Malaysian currency crisis, and most recently, the Lehman bankruptcy. In all these cases no lenders or agents incurred any losses as the collateral was always sufficient to purchase replacement securities or credit the value of the loaned securities to the client's account.

During the recent financial crisis, all of the losses associated with securities lending occurred in the second transaction, the reinvestment of the cash collateral. The losses resulted from the default of the issuers of the securities purchased with the cash collateral, such as structured investment vehicles and commercial paper of bankrupt dealers, including Lehman. In addition, the frozen credit markets caused many of the securities in which the cash collateral was invested (as part of commingled collateral pools or otherwise) to become illiquid. Lenders increased the rebates paid to borrowers to keep loans outstanding or enter into new loans in order to meet margin calls. The large bank lenders sought to provide liquidity to their collateral pools by buying illiquid instruments, providing lines of credit, and even involving the collateral pools in a special liquidity program (the Money Market Investor Funding Facility) established by the Federal Reserve Board ("FRB").

Ironically, much of Dodd-Frank and the Basel Proposals address counterparty risk, which was not an issue for securities lending. There is a much smaller direct focus on the reinvestment of cash collateral, the area in which virtually all the issues existed during the crisis.[3] This absence of securities lending losses due to counterparty default should be emphasized

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in written and oral discussions with regulators as they develop their roles.

B. Historical Regulatory Treatment of Securities Finance Programs

To fully appreciate the changes coming in the new environment, it is necessary to understand the regulatory environment in which bank securities finance programs historically have operated. Until relatively recently, as stated above, banks principally received an excess margin of cash or US Treasuries as collateral when acting as lending agent. This high quality excess margin enabled banks to act as agents in securities finance programs, and provide the typical borrower default indemnification to their lending clients, with very little regulatory burden. Because indemnification is an off-balance sheet item, US banks incurred no leverage capital charge in operating these programs (and, until recently, non-US banks never even had to consider being subject to a leverage charge). In addition, the excess margin of cash or US Treasury collateral resulted in a zero percent risk capital charge for all banks under Basel I, and also generally resulted in the indemnified lending program being exempt from applicable lending limits. Liquidity and concentration limits were largely prudential concerns evaluated by regulators, and generally were not inhibiting given the secure nature of the collateral involved. Finally, the bank broker-dealer rule treats securities finance activities as traditional bank products, meaning that banks have been able to engage broadly in these activities without concern about having to register as broker-dealers.

More recently, as US broker borrowers have obtained relief under the customer protection rule to provide a wider range of collateral, and non-US brokers along with hedge, 130/30 and other funds not subject to the US broker-dealer customer protection rules have obtained greater prominence as securities borrowers, banks have begun to receive a greater level of corporate debt and equity securities as collateral. While under Basel I the risk-capital charge would have been significant for the borrower default indemnification provided under such a program, the banks obtained relief principally using the Value-at-Risk ("VaR") trading book approach incorporated in Basel II.[4] The leverage, bank-broker dealer and prudential limits similarly (generally) did not inhibit these programs. As a result, subject to potential lending limit concerns, banks even have been able to engage in securities finance activities with a broader range of collateral without material regulatory limitations.

II. New Capital Burdens

A. General New Capital Burdens on the Largest Banking Institutions

Although new niche entrants are appearing in this arena, the largest banking institutions generally remain the most active players in securities finance, typically because of their custody businesses and global reach. Moreover, until the past five or six years, technology did not permit securities lending to be conducted in a separate institution from custody. Wholly apart from any specific activity, as detailed in this section, Dodd-Frank[5] and the Basel Proposals[6] are expected to materially increase the capital requirements for these institutions. In commenting to and discussing with regulators these heightened capital and other requirements, banks can highlight that (1) the increased US capital requirements should as closely as possible parallel those set internationally by the Basel Committee, and (2) any increased burdens imposed by these more general capital requirements should at least partially offset any additional burdens (described in the next section) that otherwise may be imposed on securities finance, analogous bilateral securities, and derivatives activities.

More specifically as to <u>general</u> future capital requirements for large banks, Section 165 of Dodd-Frank requires the FRB to develop prudential standards for systemically significant nonbank financial institutions and bank holding companies with assets of at least $50 billion (which encompasses virtually all the major bank securities finance agents). Among other things, these prudential requirements require both risk-based and leverage requirements that are more stringent than those applicable to smaller depository institutions and further require those capital requirements to take into consideration off-balance sheet activities, such as exist in indemnified securities lending.

Moreover, the "Collins Amendment" in Section 171 of Dodd-Frank requires the banking agencies to establish leverage and risk-based capital requirements for the largest US banking holding companies (i.e., the ones typically engaged in securities lending) that are not less stringent (from a capital perspective) nor quantitatively lower than for US community banks as of the date Dodd-Frank was enacted (i.e., no evolution of the standards is permitted). For example, by 2016 the Collins Amendment will eliminate the ability of these large bank holding companies to include trust preferred securities and cumulative perpetual preferred securities in Tier 1 capital, thereby forcing a large percentage of their Tier 1 capital to consist of common stock or other less tax efficient instruments.

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(Conversations with regulatory staff have confirmed that the agencies intend to allow the largest banks to continue to apply Basel II, rather than the Basel I used by small banks, to calculate the denominator of risk capital programs.) The burden of these new provisions potentially is further exacerbated by the requirement in Section 606 of Dodd-Frank that all financial holding companies (not just their federally regulated bank subsidiaries, as has historically been the case), be well-capitalized and well-managed. These Dodd-Frank provisions thus will materially increase the quantity of capital required and decrease the possible components of that capital.

Similarly at an international level, the Basel Proposals, currently scheduled to be finalized on or before the G-20 meetings in Seoul on November 11 and 12, 2010 (and certain elements, such as required capital ratios, are expected to be announced in September), are intended to further increase the capital and liquidity burdens on large international bank holding companies generally as they become effective over the coming years. In addition to generally increasing the capital requirements on these institutions, so-called Basel III (like the Collins Amendment in the US) is intended to reduce the types of capital that qualify as Tier 1 capital (eliminating hybrid and other "exotic" instruments from such treatment), and even create a new required capital ratio with a numerator consisting exclusively of common stock and equivalents. A new leverage requirement, which includes off-balance sheet items (potentially including broker-default indemnification, although likely with a conversion factor), also will ultimately be imposed.

On July 26, 2010, the Basel Committee released modifications that would relax somewhat the more stringent limitations in the Basel Proposals on deductions from Tier 1 capital as well as the counterparty credit risk charges and also extend the transition date (in certain cases, such as leverage, to 2018) for certain burdens. Nonetheless, the reduction in what constitutes Tier 1 capital, the increase in risk capital requirements for activities that involve counterparty credit risk, and the maintenance of at least some new quantitative liquidity requirements which will likely begin to be phased in around 2013, all are intended to increase the capital burdens on the largest banking institutions. The proposed capital buffer within the Basel Proposals and more recent countercyclical capital buffer proposed by the Basel Committee will serve to further the potential capital demands. As a result, the largest banks must seek to ensure, through comment letters and otherwise, that each regulator understands the impact of and variances from the others' rules to seek to avoid costly duplicative charges and burdens. Moreover, in commenting upon these general burdens, they also should seek to ensure that the relevant regulator considers these additional general burdens contemplated by Dodd-Frank and the Basel Proposals when evaluating whether any further charges (discussed in the next section) focused on securities finance (and analogous activities), are appropriate.

B. Potential Additional Capital Burdens for Bilateral Activities like Securities Finance

In addition to the general additional capital burdens discussed above, the largest banks could, absent regulator recognition that the new heightened general burdens are sufficient given the actual risks involved, have further capital burdens placed upon them with respect to these activities. In this regard, Section 165 of Dodd-Frank requires regulators to take into account off-balance sheet activities (which, as stated above, could include default indemnification) when imposing more stringent capital requirements on the largest banks. Section 171 of Dodd-Frank further requires the federal banking agencies to develop capital regulations for the largest banking institutions that address the risks of certain activities not only to the financial institution itself, but rather to the economy as a whole. Expressly included in the activities which those rules must address is securities finance (in addition to derivatives and other bilateral securities activities).

In addition, Section 210 of Dodd-Frank generally makes the Federal Deposit Insurance Act ("FDIA") resolution procedures that the Federal Deposit Insurance Corporation ("FDIC") currently employs with failed banks potentially applicable more broadly to any financial entity (other than an insurance company) if the Treasury Secretary (at the conclusion of a statutorily-required decision process) determines, among other things, that the typical resolution procedure for that entity would have serious adverse effects on financial stability in the United States. So, for example, if a large US broker-dealer borrower in a securities finance program is in danger of default, it may be subject, at least in large part, to FDIA procedures rather than US bankruptcy laws. Perhaps most notably in this regard, FDIA provides for a one-business-day stay for qualified financial contracts ("QFCs") subject to the new liquidation process, which term includes securities finance arrangements, if

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the QFC otherwise would be terminated by the insolvency of the broker or other entity. During that stay, the FDIC could, among other things, transfer securities lending arrangements to a bridge bank or acquiring party, potentially affecting rights under master netting and other arrangements. As a practical matter, the Treasury Secretary is likely to rarely invoke this special liquidation procedure. Nevertheless, preparing systems to protect their interests in the event of such an event will impose additional operational burdens and risk avoidance measures on the largest banks, and also may result in additional operational risk or other capital charges under Basel II. Stated differently, the additional risk management systems and capital costs associated with this new liquidation procedure should be considered by regulators when determining whether to impose further capital charges on securities finance programs.

The Basel Committee similarly proposes special burdens (and, indeed, as with capital, in many respects in similar ways) on securities finance programs in addition to the general enhanced capital requirements on the largest banking institutions described above. First, prior to the Basel Proposals, the Basel Committee finalized in July 2009 (with an implementation date no later than 2012) rules to significantly increase the capital required for assets in the trading book of these banks. The Basel Committee has stated that it anticipates the market risk capital requirements for large banks to increase three to four times in light of these new rules. Primarily in the case of principal or conduit lending, corporate debt and equity collateral, as well as many other securities finance and similar instruments, historically have generally been held in a bank's trading book. The Basel Proposals further burden the VaR models used by the largest banks by asserting that they do not adequately address the so-called "wrong-way" risks of securities finance programs. The Basel Proposals thus would require a more capital intensive stressed effective positive exposure to be used to calculate the exposure of default impact under Basel II, thereby increasing capital costs of indemnified and other lending programs.

[T]he new regulatory environment...could impose...restrictions and burdens on bank securities finance and analogous programs, in areas ranging from new limits on the overall size of exposure to a particular counterparty to liquidity requirements and operational burdens.

The Basel Proposals also focus not only on the risk of borrower default, but also the risk of market-to-market losses because of credit valuation adjustments by proposing to compel banks to treat the counterparty exposure as equivalent to a bond for capital purposes. The Basel Proposals also require a capital charge multiplier to the asset value correlation of certain financial institution counterparties, such as almost always exists in securities finance arrangements. Moreover, the minimum margin period (a component of the Internal Model Method ("IMM") under Basel II) would be extended to 20 days (from the typical 5 days) for securities finance netting sets if the number of trades at any point during a quarter exceeds 5,000, or if illiquid or bespoke collateral is used. Finally, inclusion in the leverage ratio of off balance sheet assets (which likely could include indemnification) by the Basel Proposals also may be problematic given the size of the exposures involved.

As stated above, the July 26, 2010 Basel Committee modifications to the Basel Proposals may assist with these issues to a certain extent by potentially permitting recognition of some hedging and other capital mitigants (as in the case of the bond exposure) and transition periods (e.g., the leverage ratio and longer term liquidity requirements) as well as other offsets, such as collateral. However, much of the Basel Proposals as they affect securities finance (and the other activities described herein) thus far has remained intact. Given the size of these programs, even incremental additional capital requirements on exposures could impose additional burdens (as with Dodd-Frank) upon the institution specifically related to these activities. Highlighting the overlap and unintended cumulative burden of Dodd-Frank and the Basel Proposals, and the absence of need for material additional capital burdens specific to these activities given the increase in general capital burdens and the actual

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risks involved, provides the largest banks the best opportunity to avoid the potentially adverse effect these capital revisions otherwise could have on their programs.

III. Other Banking Law Burdens

In addition to the capital implications listed above, the new regulatory environment also could impose other restrictions and burdens on bank securities finance and analogous programs, in areas ranging from new limits on the overall size of exposure to a particular counterparty to liquidity requirements and operational burdens. These also can be cited in comments and discussions with regulators to seek to both reduce those additional burdens given the capital constraints, as well as to highlight that any restraints beyond capital also decrease the need for capital deterrents to ensure that these programs are conducted in a safe and sound manner.

A. Exposure Limits.

Dodd-Frank imposes a number of new requirements limiting the total securities finance exposure of banking institutions both at the consolidated entity level and at the bank level. While the legislation may permit netting when considering these exposures, that is not mandated and thus banks should specifically recommend netting (both with respect to counterparties and collateral) and highlight the resulting reduction in exposure during this regulation process.

As to exposure limits at the consolidated entity level, Section 165 of Dodd-Frank limits the aggregate exposure of a systemically significant banking institution to any unaffiliated company to twenty-five percent of the banking institution's capital and surplus (or such lower amount as the FRB may by regulation determine appropriate). For these purposes, Dodd-Frank defines "credit exposure" broadly to expressly include exposures from securities finance (as well as repurchase agreements and derivatives). Moreover, for these institutions the FRB is permitted (but not required) to limit short-term debt, which, if such limitation is ultimately implemented by the FRB, presumably would include securities finance transactions.

At the bank level, Section 610 of Dodd-Frank amends the lending limits provisions applicable to national banks to expressly include exposures from securities finance arrangements (as well as derivatives). For securities finance transactions where an exemption is not available by virtue of having an excess margin of cash or Treasuries as collateral, this will make it clear (an earlier OCC interpretation had indicated indemnified securities lending should count toward lending limits) that a national bank's indemnification exposure with respect to a borrower cannot exceed, at most, twenty-five percent of its capital and surplus. Moreover, while these lending limits only apply to national banks (which comprise many US securities lending agents), the issue also is highly relevant to state banks because as a practical manner many states often construe their laws with a view to national bank limitations (and Dodd-Frank does require state lending limits to consider derivative exposures).

If an affiliate is the borrower (and pursuant to Section 608 of Dodd-Frank "affiliate" will now include any investment fund (whether or not a registered mutual fund and whether or not an investment is made) where the bank or an affiliate serves as investment adviser), Dodd-Frank also now expressly requires the securities finance arrangement to be treated as subject to the affiliate transaction rules, requiring the arrangement to be subject to both the quantitative and qualitative affiliate transaction limitations. An affiliated borrower is likely to be subject to these affiliate transaction rules by virtue of an indemnification, principal lending or conduit lending arrangement. This treatment appears broadly consistent with the treatment of similar securities loans to affiliates prior to Dodd-Frank, but applies more broadly given the expanded definition of "affiliate." Moreover, Section 608 of Dodd-Frank also makes the affiliate transaction rules more rigid by requiring the FDIC, rather than simply the primary federal bank regulator involved, to assent before any decision is made to grant a waiver from the affiliate transaction restrictions to permit, for example, banks to engage in indemnified lending with affiliated brokers using other than cash or Treasuries as collateral or to provide liquidity to their collateral pools in times of stress. Given that a principal focus of the FDIC is protecting the Deposit Insurance Fund, the requirement of FDIC involvement can be expected to both increase the burden to obtain a waiver and reduce the number of waivers granted. Indeed, as one indication of the FDIC's likely stance concerning granting leniency to the banking industry, FDIC Chairman Bair publicly spoke out against the limited relief offered by the Basel Committee in its July 26, 2010 modifications.

B. Liquidity Requirements.

Historically, bank liquidity requirements largely have been subject to a policy of regulatory discretion rather than express numerical requirements. However, the Basel Proposals would replace these limits on the largest banks with new short-, and potentially long-term, liquidity ratios designed to ensure that banks have high quality, highly liquid, and thus low-earning,

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assets in an amount correlated with the perceived potential liquidity outflows of its activities.[7] As a result, the more offsetting high quality, low-earning assets a particular activity requires, the greater adverse effect the activity can be expected to have on the overall net interest margin of the banking enterprise.

In this regard, the Basel Proposals potentially assume significant cash outflows (depending on the composition of counterparty collateral) related to securities finance programs, thereby requiring significant high quality liquid assets with respect to those outflows and a corresponding adverse impact on net interest margin. Perhaps even more problematic, the Basel Proposals provide local jurisdictions the discretion to take contingent funding liabilities and non-contractual obligations into account when determining necessary liquidity. As a result, the Basel Proposals provide the regulators discretion to include the cash collateral pools when evaluating liquidity.[8] Given their size the inclusion of the cash collateral pools for liquidity purposes could have a dramatic adverse effect on a particular institution's net interest margin. Such possible adverse consequences should allow banks to make a compelling case that they would not provide inappropriate support to their collateral pools.

IV. Securities Law Issues

The US and international banking laws are not the only changes potentially relevant to securities finance programs. Dodd-Frank and the Securities and Exchange Commission ("SEC") also have taken actions from a securities law perspective that will impact these activities. Banks also should include those issues in order to provide regulators a comprehensive framework to create appropriate regulations for securities finance and analogous activities. To provide context for those changes, prior to Dodd-Frank, the SEC only tangentially impacted the securities lending market through a myriad of rules and regulations applicable to broker dealers, mutual funds and money market funds. The demand side of the securities lending market is affected by the SEC's rules regarding short-selling and settlement requirements. Regulation SHO, promulgated under the Securities Exchange Act of 1934 ("Exchange Act"), requires that broker dealers locate a security to borrow prior to executing a short sale. Regulation 204 sets forth requirements for closing out open short transactions that have not settled in the required settlement period. During the financial crisis the SEC banned short selling in the shares of a large number of financial issuers. The agency also amended the settlement rules to require the close out of failing short sales almost immediately following settlement date in order to end the practice of naked short selling in which short sales could be executed without locating or borrowing shares to settle the transaction.

On the supply side, the SEC through a series of no-action letters issued over a number of years established the rules pursuant to which mutual funds registered under the Investment Company Act of 1940 (the "40 Act") could lend their portfolio securities. The 40 Act also sets forth the investment guidelines for money market funds. These guidelines are contained in Section 2a-7 and are often referred to as the 2a-7 guidelines. These guidelines affect the securities lending market because many mutual funds and some other institutional investors use money market funds as an investment vehicle for the cash collateral received in their lending transactions. Some lending agents have established dedicated 40 Act registered money market funds solely for the investment of securities lending cash collateral. In addition, many agent lenders offer nonregistered commingled vehicles not subject to rule 2a-7 that have investment guidelines that are similar but contain more risk in certain areas. These are usually referred to as being 2a-7-like investment vehicles. In effect, rule 2a-7 has become a risk benchmark for investment guidelines with respect to the investment of cash collateral.

Recently, the SEC amended rule 2a-7 to make the investment guidelines more conservative. This has reduced the yields on cash collateral for securities lenders who utilize money market funds and nonregistered vehicles with 2a-7-like guidelines thereby reducing overall securities lending revenue.

Moreover, Section 984(a) of Dodd-Frank now appears to give the SEC direct, broad authority over the securities lending market by amending Section 10 of the Exchange Act to make it unlawful to effect, accept or facilitate a transaction involving the loan or borrowing of securities in contravention of such rules and regulations that the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors. However, Section 984(b) of Dodd-Frank requires the SEC to promulgate rules within two years that are designed to increase transparency of information available to brokers, dealers and investors with respect to the lending or borrowing of securities. It is conceivable that this section limits the authority granted in 984(a) to just rules and regulations governing transparency. Nevertheless, questions like these and the absence of

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such rules and regulations will continue to foster uncertainty in the marketplace that requires focus by banking institutions.

When a broker needs to borrow a security to settle or hedge a transaction, the first place it generally looks to locate that security is in the accounts of its retail customers who have granted the broker the authority to borrow their fully-paid for securities. Dodd-Frank required brokers to immediately provide a notice to their retail customers with securities lending arrangements that they have the right to instruct the broker that their fully-paid securities are not be used in connection with short sales. This combined with new rules issued last year by FINRA placing additional restrictions on a broker's ability to borrow its clients fully-paid for securities may reduce this source of supply creating more demand for securities owned by institutional investors offered through lending agents.

Conclusion

While this article has focused on securities finance, as stated above, many of these concerns also apply to derivative and similar bilateral bank activities. Via the Volcker Rule, operational limits and enhanced liquidity and capital requirements, governments and regulators in the US and internationally have established a framework which, if unchecked, could make it substantially more burdensome for large banks to engage in these activities. Banks must be actively engaged in the various rulemaking processes to demonstrate the true level of risk associated with these activities and seek to minimize overlapping, inconsistent regulatory burdens. We are at the beginning of an unprecedented wave of rulemakings. Despite the unfavorable tone of Dodd-Frank, banks can still present a holistic, coherent, cross-regulator view to the agencies across the myriad regulations to seek to achieve a favorable result. Banks still remain very busy responding to the crisis and its ramifications, which makes the broad, aggressive initiative suggested in this article difficult to pursue. However, if the regulatory process concludes and the legal firmament hardens in an unfavorable manner, banks may find it more costly and capital intensive to operate their programs. ■

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1. On August 3, 2010, the principal drafters of the Volcker Rule, Senators Merkley and Levin, sent a letter to the regulatory agencies stating their expectation that their provisions will be stringently enforced. Our banking clients are evaluating the structure and financial support of their collateral pools to ensure they avoid, or comply with, the Volcker Rule. If the Volcker Rule or other issues discussed herein are interpreted to require banks to either diminish or dispose of their collateral pools (and not replace them with separate account relationships), the banks could face increased burdens with respect to asset/liability management and also could forfeit lending revenue if a third party must be hired to manage the collateral pools.

2. As referenced in other parts of this article, banks (and other financial institutions) also engage in principal lending (i.e., lending their own securities) and "conduit" lending (where they borrow a security from a lending client as a counterparty, and then immediately re-lend the security to the ultimate borrower). These transactions present many similar regulatory issues to the agency lending that is the principal focus of this article, although some material differences are noted herein.

3. As is discussed below, regulators do have discretionary authority to address the risks of cash collateral pools by, among other things, collapsing these off-balance sheet vehicles onto the affiliated bank's balance sheet for certain regulatory purposes.

4. See, e.g., Letter to Gregory Lyons, www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/2006.

5. For a comprehensive discussion of the potential impact of Dodd-Frank on large financial institutions, please see the January 2010 issue of this publication (available at www.debevoise.com).

6. For a comprehensive discussion of the Basel Proposals, please see the January 2010 issue of this publication (available at www.debevoise.com).

7. Dodd-Frank also requires regulators to impose more stringent liquidity requirements on the largest banks, but provides no framework as to how that mandate should be implemented.

8. In addition, under some circumstances, the reservation of authority under the variable interest entity rules described in the February 2010 issue of this publication (available at www.debevoise.com) provide US banking agencies the authority to collapse off-balance sheet vehicles for capital purposes.