In this Summer 2014 edition of our *Fund Finance Market Review*, we discuss some of the more noteworthy trends impacting the subscription credit facility and fund finance markets, including our views of the challenges and opportunities created by an increasingly prominent regulatory framework.

We also explore some of the new and accelerating sources of capital for funds, potential new facility products in response thereto and the shifting legal landscape affecting facility lenders.
# Fund Finance Market Review

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**Summer 2014 Subscription Credit Facility Market Review**

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On July 22nd and 23rd, we held our annual Fund Finance Mid-Year Market Update Panels, this year in Los Angeles and San Francisco (the “Market Updates”). Based on our experiences and the views expressed by the panelists at the Market Updates, capital call subscription credit facilities (each, a “Facility”) have continued their positive credit performance and growth momentum in the first half of 2014. Below we set forth our views of the current market trends and developments likely to be relevant for the remainder of 2014.

**Credit Performance**

- **2014 Year-to-Date Credit Performance**
  
  Mirroring all of 2013, Mayer Brown LLP has not been consulted on a Facility payment event of default or an institutional investor exclusion event in 1H 2014 and we are not aware of any existing Facilities under credit duress. All five of the bank panelists speaking at the Market Updates reported consistent credit performance across their portfolios so far this year.

- **Short Term Credit Forecast**

  **Fund Investment Performance.** There is an abundance of data that forecasts continuing positive Facility credit performance on the macro level for the foreseeable future. Private equity funds of virtually all asset classes and vintages (each, a “Fund”) have achieved positive investment return performance in the recent past. The Cambridge Associates LLC US Private Equity Index® (the “C-A Index”) shows one-year and three-year returns as of December 31, 2013 of 20.6% and 14.9%, respectively, and Preqin reports promising current aggregate cumulative returns for Funds of virtually all vintages and geographies. This positive performance has continued into 2014, with Preqin reporting as one example a 6.3% average increase in net asset value (“NAV”) for real estate Funds in 1H 2014. While positive Fund investment performance enhances Facility repayment prospects in its own right, Fund limited partners (each, an “Investor”) with demonstrable NAV in a Fund are highly incentivized to fund future capital calls (“Capital Calls”) and avoid the severe default remedies typical in a Fund partnership agreement (each, a “Partnership Agreement”). Setting aside the well-established, enforceable contractual obligations of the Investors, it is difficult to foresee widespread Investor funding defaults in the near term when the vast majority of existing Funds have generated positive returns.

  **Harvest Events and Investor Distributions.**
  
  Additionally, there is generally positive liquidity data at virtually every level of the Fund structure relevant for Facility lenders (“Lenders”). Private equity-backed investment exits in 2014 have continued and built upon the robust harvest activity in 2013, with 394 transactions valued at $137 billion in Q2 2014 alone.
events of course lead to Investor distributions, and distributions are at record levels. In 2013, Fund distributions to Investors greatly exceeded capital contributions called and funded, with Funds in the C-A Index calling $56.3 billion, while distributing $134.6 billion (the largest yearly amount since the C-A Index’s inception). On a global basis, $568 billion was distributed back to Investors in 2013 (up 49% from 2012). Investors receiving significant distributions forecasts well for their ability to fund future Capital Calls.

Secondary Funds. The fundraising success of secondary Funds, Facility borrowers in their own right, has created an unprecedented volume of dry powder available to offer exit opportunities to any Investor that experiences liquidity challenges and needs to exit a Fund position. In fact, the single-largest Fund closed in Q2 2014, and the single largest secondary Fund to close in history was the Ardian Secondary Fund VI, closing on $9 billion in April. There has reportedly been $15 billion raised by secondary Funds in 1H 2014 and there are multiple premier Sponsors in the midst of fundraising with significant interim traction. This significant growth in secondary Fund dry powder creates a readily available market for any Investor wishing to transfer, whether for diversification purposes or because of financial distress, and the current secondary market is very active. The first half of 2014 saw more than $16 billion of secondary transactions (an annualized pace that would exceed 2013 by over 10%) and it has been reported that the Montana Board of Investments received more than 40 offers for eight Fund positions that it recently put out for bid. If the Facility market performed extremely well during the financial crisis when the secondary Fund market was a fraction of what it is today, today’s secondary Funds market with some $50 billion in dry powder certainly provides Lenders a far greater buffer to any initial collateral deterioration.

Long-Term Credit Forecast Concerns

Despite the nearly uniform positive trending in the data above supporting Facility credit performance, none of it goes to the heart of the fundamental credit underwriting premise of a Facility. That is, that the Investors’ uncalled capital commitments are unconditionally due, payable and enforceable when called, regardless of Fund investment performance, NAV, receipt of distributions, market liquidity or Investor transfers. And from this vantage point, the 2014 year-to-date trending has been far less beneficial for Lenders. We have for some time been noting that Facility structures have been drifting in favor of the Funds and that Lenders have become increasingly comfortable going incrementally down the risk continuum, at least for their favored Fund sponsors (“Sponsors”). In fact, at the end of 2013, we gave the view that much of the trending (as an example, the including of certain historically excluded Investors in borrowing bases at limited concentrations) seemed perfectly rational and completely supportable by the available Investor funding data. But as 2014 has progressed and the downward trending has continued, we are seeing the emergence of structural issues in prospective Facilities that we believe further conflict with Lenders’ general expectations as to the appropriate allocation of risk between the Lenders, Funds and Investors. While the Facility market is far from uniform and every particular Facility needs to be evaluated in its own context, there are a number of emerging credit concerns we think Lenders should rightfully put heavy emphasis on. Examples include Partnership Agreements that fail to appropriately contemplate or authorize a Facility, overcall limitations structured so tightly that the degree of overcollateralization buffering Investor defaults is insufficiently adequate to cover the Facility obligations in a period of distress, lack of express Investor obligations to fund without setoff, counterclaim or defense, and Fund vehicles being formed in non-US partnership structures that require the Fund to issue some form of equity shares or certificates each time a Capital Call is funded. And there are others. Our view has been, and remains, that the most likely way a Lender will suffer losses in this space is not via widespread Investor credit deterioration, but rather via a Sponsor or Fund failing to meet its contractual obligations to Investors,
ultimately resulting in a dispute and an Investor enforcement scenario. Thus, Lenders should thoughtfully contemplate documentation and structural risks that undermine their expected enforcement rights. If this downward trending on the risk continuum continues at its current pace, we ultimately see an inflection point where particular Lenders determine that certain proposed structures simply drift too far from the fundamental tenets of a Facility and no longer meet the investment grade credit profile expected in a Facility.

**Facility Market Expansion**

**Fundraising**

Fund formation in the first half of 2014 has remained positive and generally consistent with levels seen in 2013. 417 Funds had their final closing, raising $236 billion in capital commitments in 1H 2014. The “flight to quality” trend has continued, with fewer Funds being formed but raising more capital, with the average Fund size in Q2 2014 being the largest to date. We continue to think this trend towards consolidation slightly favors incumbent and larger Lenders at the expense of new entrants and smaller institutions. Experienced Sponsors are more likely to have existing relationships with incumbent Lenders in multiple contexts and larger Funds need larger Lender commitment sizes in Facilities. We note, however, that several smaller Lenders have greatly increased their maximum hold positions and have created syndicate partnerships to effectively compete.

**Deal Volume and Pipeline**

Facility deal volume remains robust and likely above 2013’s pace, although we hesitate to confirm the double-digit growth we forecasted in January based on the available anecdotal evidence alone. The pipeline of both large syndicated transactions and bilateral deals forecasts well for the remainder of the year. We expect 2014 deal volume to ultimately finish ahead of 2013, albeit perhaps by only single digits.

**Growth Prospects**

The Facility market, in our view, still projects substantial opportunity for future growth. With global dry powder now at an all-time high of $1.16 trillion as of the end of Q2 2014, up a full 8% from the end of 2013, there is simply a greater and increasing pool of collateral available to support Facilities. And if you take a ratio of Facility size to Fund uncalled capital across a large portfolio of Facilities (admittedly not a statistic clustered close to the mean) and determine an average percentage, say 30%, you could project out a potential Facility market size of well over $300 billion. As most market participants estimate the current Facility market to be less than $200 billion, it does appear that plenty of existing Funds have yet to benefit from Facilities. When you combine this room for further penetration into Funds new to Facilities with the greater volume of Funds presently fundraising (estimated currently around 2,000), the increasing use of returned capital mechanics to refresh dry powder and the greater use of Facilities throughout the entire Fund life cycle, it seems evident that the opportunity for outpaced growth remains.

**Facility Market Trends**

There are a number of interesting trends in the Facility Market itself that are impacting both transaction structures and terms. We highlight below a few that are most impactful.

**Extensive Refinancing Activity**

Many Facilities of 2011 or so vintage have been coming up for renewal and the vast majority have been extending instead of terminating. Lenders are increasingly comfortable extending Facilities beyond Fund investment periods (subject to appropriately supportive language in Partnership Agreements) and Funds appear to be valuing the liquidity and other utility of a Facility well into their harvest periods. Virtually all Facilities coming up for renewal have been pricing flat to down, further encouraging their extension. We expect the volume of amend and
extend activity to increase slightly towards year-end, mirroring an uptick we experienced in 2H 2011.

Transaction Structures

Structural Evolution. The evolution of Fund structures continues to complicate Facility structures, as the incorporation of multiple Fund vehicles, in an effort to optimize investment structure for Investors, is continuing and perhaps accelerating. Separately managed accounts, co-investment vehicles, joint ventures and parallel funds of one are all increasingly common, each of which stress the traditional commingled Fund collateral package for a Facility. As the various vehicles often have challenges being jointly and severally liable for Facility obligations, Lenders are increasingly finding themselves with Facility requests involving single-Investor exposures. Interestingly, in certain instances, these single-Investor exposure structures are leading back to the delivery of Investor acknowledgment letters (which have been in certain cases trending out of the commingled Fund market), as Lenders seek credit enhancements to offset the lack of multiple Investor overcollateralization.

Umbrella Facilities. We are seeing increased appetite for umbrella Facilities (multiple Facilities for unrelated Funds advised by the same Sponsor but documented on the same terms in a single set of loan documents). In fact, Mayer Brown LLP has closed more umbrella Facilities in 1H 2014 than in all of 2013.

Hedging Mechanics. Embedding hedging and swap collateralization mechanics into Facilities has also accelerated in 1H 2014. While extending Facility collateral to cover collateralization requirements under ISDAs entered between the Fund and the Lender has existed in the bilateral Facility market for some time, including clear structural borrowing base allocation, tracking and measurement mechanics in syndicated Facilities is relatively new.

Regulatory Impact

The regulatory landscape continues to occupy a substantial amount of Lender and Sponsor time. Analyzing Facilities for compliance with the final Volcker Rule, for appropriate risk weighting under Basel III and other regulatory capital regimes and the appropriate outflow analysis under the minimum liquidity coverage ratio promulgated by the US regulatory agencies all require thoughtful care in application to Facilities, especially in light of the speed of Facility structural evolution. We expect the regulatory environment will be increasingly relevant throughout 2014 and that Lenders may ultimately need to structure around, or price, for their increasing regulatory requirements, particularly around Facility unfunded revolving commitments.10

Legal Developments

Cayman Islands Legal Developments

Two new statutory enactments have occurred in the Cayman Islands in 1H 2014, both of which are in small part helpful to Lenders. The first, the Contracts (Rights of Third Parties) Law, 2014, was enacted on May 21, 2014. Although not explicit as to Facilities, the new law allows third parties not party to a contract (such as a Partnership Agreement) to rely on and enforce provisions that are intended by the contracting parties to benefit the third parties, even though the third parties are not signatories. This brings Cayman Islands’ third-party beneficiary law closer in line with other jurisdictions and can ultimately accrue to the reliance and enforcement benefit of Lenders if Partnership Agreements are expressly drafted to do so. The second key change is the enactment of the revised Exempted Limited Partnership Law, 2014, which took effect on July 2, 2014 and is a comprehensive revision of previous Cayman Islands exempted limited partnership law. While few of the changes are relevant for Facilities, the new law does expressly confirm that any right to make Capital Calls and to receive the proceeds thereof vested in a general partner or the Fund shall be held by the general partner as an asset of the Fund, thus providing greater certainty of a Fund’s right to...
grant security in the right to issue and enforce Capital Calls.\footnote{11}

\textbf{Case Law Development: Wibbert v. New Silk}

A case of interest to Lenders, \textit{Wibbert Investment Co. v. New Silk Route PE Asia Fund LP, et al.}, is pending in the New York state courts. While no mention of a Facility is evident in the pleadings, the case is illustrative of the type of fact pattern and dispute that could potentially find a Lender in an enforcement scenario. In this case, the Investor, Wibbert Investment Co. (\textquotedblleft Wibbert\textquotedblright), alleges, among other things, that the Fund failed to disclose the occurrence of a key person event after a principal of the Sponsor was charged and convicted of insider trading and that the Fund\textrsquo;s general partner committed gross negligence and/or willful malfeasance. The Fund fully contests the claims and the facts are in dispute. Wibbert has declined to fund a Capital Call and alleges that the Fund has threatened to implement default remedies as a result. On June 17, 2014, at Wibbert\textrsquo;s request, the New York Supreme Court, Appellate Division, granted a preliminary injunction in favor of Wibbert barring the Fund from declaring Wibbert in default and from exercising default remedies while the case proceeds. The ruling is currently on appeal. While the facts of this case are highly unique and have involved extensive publicity in connection with the trials and convictions of certain of the principals, the case does stand as evidence of why Lenders may want to consider the importance of a contractual obligation on Investors to fund Capital Calls to Lenders without setoff, counterclaim or defense. The case merits further attention and monitoring as it proceeds.\footnote{12}

\textbf{Case Law Development: TL Ventures, Inc.}

In June 2014, the US Securities and Exchange Commission (the \textquotedblleft SEC\textquotedblright) brought a pay-to-play case against a Sponsor pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (the \textquotedblleft Advisers Act\textquotedblright), to our knowledge the first such case brought by the SEC. The SEC alleged that an associate of TL Ventures, Inc. made a $2,500 campaign contribution to the Mayor of Philadelphia and a $2,000 campaign contribution to the Governor of Pennsylvania at a time when the Pennsylvania State Employees\textrsquo; Retirement System was an Investor in Funds sponsored by TL Ventures, Inc. Both the Mayor and the Governor have vested authority to appoint certain people with influence as to investment selection. The SEC alleged that this action violated Section 206(4) and Rule 206(4)-5 of the Advisers Act, noting that it need not allege or demonstrate a showing of \textit{quid pro quo} or actual intent to influence an elected official by the Sponsor. The Sponsor, without admitting or denying the relevant subject matter, consented to an order with the SEC to resolve the matter. As Lenders are increasingly reviewing side letters between governmental Investors and Funds that contain withdrawal and/or cease-funding rights if prohibited political contributions are made or improperly disclosed, Lenders must bear in mind that such a circumstance may not be purely hypothetical and that even the most innocent and well-intentioned political contributions may trigger the withdrawal rights.\footnote{13}

\textbf{LSTA Model Credit Agreement Provisions}

On June 25, 2014, the Loan Syndications and Trading Association\textsuperscript{\textregistered} published an exposure draft of its Model Credit Agreement Provisions. The proposed revisions include a host of technical revisions, but the two most relevant revisions relating to Facilities include an extensive set of mechanics governing facility extensions and changes to the lender assignment and participation provisions, including certain prohibitions of assignments or participations by lenders to competitors of the borrower or institutions the borrower has requested in advance be disqualified for assignments or participations. August 8, 2014 is the current target date the LSTA plans to publish the revisions. A copy of the exposure draft is available to LSTA members on the LSTA\textquotesingle s website at http://www.lsta.org/legal-and-documentation/primary-market.\footnote{14}
Conclusion

We project a robust Facility market to continue in 2H 2014 building on the growth and positive momentum to date, but with competitive, structural and underwriting challenges at the margins. We expect the number of Facilities consummated will continue to grow at an outpaced but measured rate, reflective of the time-consuming nature of educating new Sponsors of the utility and benefits of a Facility. We continue to anticipate excellent credit performance throughout the remainder of 2014, but recommend caution to Lenders as certain emerging Facility structures reallocate the traditional Facility risk allocations among Lenders, Funds and Investors and stress some of the most fundamental tenets of a Facility. ✷

Endnotes

1 Mayer Brown LLP would like to thank the panelists at the Market Updates. In Los Angeles: Kristin Rylko, Partner, Mayer Brown LLP (Moderator), John Gilb, Senior Managing Director, CBRE Global Investors, Ann Richardson Knox, Partner, Mayer Brown LLP, Nick Mitra, Executive Director, Natixis, Matt Posthuma, Partner, Mayer Brown LLP, Tom Soto, Managing Director, TCW, Emily Stephens, Managing Director, Oaktree Capital Management, LLP, David Wasserman, Executive Director, Sumitomo Mitsui Banking Corporation, and Tom Wuchench, Partner, Simpson Thacher & Bartlett LLP. In San Francisco: Zac Barnett, Partner, Mayer Brown LLP (Moderator), Scott Case, Global Head of Private Equity Services, Silicon Valley Bank, Kevin Dunwoodie, Principal, Pantheon, Jeff Johnston, Managing Director and Head of Subscription Finance Origination, Wells Fargo Bank, N.A., Mary Touchstone, Counsel, Simpson Thacher & Bartlett LLP, Matt McCormick, Vice President, Stockbridge, Wes Misson, Attorney, Mayer Brown LLP, and Robert Wood, Director, Bank of America, N.A.


4 Preqin PE Q2, page 8.

5 See C-A Benchmark, Figure 1, page 6; Preqin PE Q2, page 2.


7 See Preqin PE Q2, Figure 1, page 5.

8 Id., page 2.

9 Id., page 3.


12 The case is Wibbert Investment Co. v. New Silk Route PE Asia Fund LP, et al., case number 650437/2013, in the Supreme Court of the State of New York, County of New York.

13 The case is In the Matter of TL Ventures Inc., case number 3-15940, before the SEC.

14 Special thanks to Mayer Brown LLP summer associates, Kim Perez, 3L, University of North Carolina School of Law, and Daniel Waxman, 3L, Wake Forest University School of Law, for their research contributions to this article.
Subscription Credit Facilities and the Volcker Rule

On December 10, 2013, the federal financial agencies (the “Agencies”) approved joint final regulations (the “Final Regulation”) implementing section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule. Section 619 added a new section 13 to the Bank Holding Company Act of 1956 (the “BHCA”), which generally prohibits any banking entity from engaging in proprietary trading and acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with, a hedge fund or a private equity fund. Banks and other lending institutions (“Lenders”) commonly provide loan facilities to private equity funds (“Funds”) that are secured by, or otherwise look to repayment from, the uncalled capital commitments of the Fund’s limited partner investors (each a “Subscription Facility” or a “Facility”). In the typical Facility, the Lender does not directly sponsor, invest in or manage its Fund borrower, but rather only provides extensions of credit. Lenders frequently inquire to ensure their Facilities are in compliance with the Final Regulation. This Legal Update clarifies why most Facility structures will not run afoul of the Final Regulation’s prohibition against acquiring or retaining an ownership interest in a covered fund and what parameters a Lender should maintain to ensure continuing compliance.

Covered Funds as Subscription Facility Borrowers

In order to be subject to the Volcker Rule, a Fund must be a “covered fund,” as defined under the Final Regulation. A “covered fund” includes any issuer that relies solely on the section 3(c)(1) or 3(c)(7) exceptions from the definition of “investment company” under the Investment Company Act of 1940 (the “1940 Act”). It also includes any “commodity pool” under the Commodity Exchange Act that shares characteristics of an entity excluded from the 1940 Act under section 3(c)(1) or 3(c)(7). With respect to US banking entities only, a covered fund would also include any non-US fund owned or sponsored by the US entity itself or an affiliate if the fund would rely on section 3(c)(1) or 3(c)(7) if it were subject to US securities laws. A majority of Fund borrowers in Facilities, in our experience, will be covered funds, as they frequently rely on section 3(c)(1) or 3(c)(7).

Subscription Facility Loans, not Ownership Interests

To the extent that an entity is a covered fund and is not covered by an exclusion, a Lender that is a banking entity under the Volcker Rule is generally prohibited from acquiring or retaining any “ownership interest” in the covered fund.
While it may seem inherent on its face that a debt facility like a Facility is not an “ownership interest” in even the most expansive interpretation, the Final Regulation does define “ownership interest” broadly to mean any equity, partnership or “other similar interest.” The Final Regulation provides that “other similar interest” includes an interest that (i) has the right to participate in the selection or removal of a general partner, director, investment manager or similar entity (excluding certain creditor’s rights); (ii) has the right to receive a share of the fund’s income, gains or profits; (iii) has the right to receive underlying assets of the fund after all other interests have been redeemed or paid in full (excluding certain creditor’s rights); (iv) has the right to receive excess spreads under certain circumstances; (v) has exposure to certain losses on underlying assets; (vi) receives income on a pass-through basis; or (vii) has a synthetic right to receive rights in the foregoing. Accordingly, while a debt interest generally would not be considered an ownership interest, to the extent that a debt security or other interest in a covered fund exhibits any of the foregoing characteristics, it would be considered an ownership interest. The “other similar interest” component makes the definition of “ownership interest” broad and requires specific application to the facts of a given transaction.

The good news for Lenders is that debt interests held in a classic Facility, absent some atypical degree of control over the Fund or pricing mechanic, are unlikely to be considered an “ownership interest” because the loan documents for a Facility generally do not provide the Lender with any of the rights described in subclauses (i)–(vii) above. The Agencies additionally provided explicit clarifying guidance on this: An “ownership interest” generally does not include “typical extensions of credit the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate.” Thus, the Lender in a Facility does not directly have an equity stake in the Fund or any rights that amount to an ownership interest under the Volcker Rule.

**Default Remedies and Collateral Foreclosures**

While certain events may give rise to an event of default under a Facility and provide the Lender with the ability to accelerate the debt and enforce remedies against the Fund, including the ability to charge step-up default interest, such enforcement rights are in line with typical extensions of credit and are not akin to “an ownership interest” for Volcker purposes. The Agencies expressly carved out such rights in the commentary: “the Agencies believe[d] that a loan that provides for step-up in interest rate margin when a covered fund has fallen below or breached a NAV or other negotiated covenant would not generally be an ownership interest.”

Similarly, rights to participate in the selection or removal of the fund’s management are expressly subject to a creditor’s right to exercise remedies upon the occurrence of an event of default as well.

Even where a Lender obtains an ownership interest in a Fund by the exercise of remedies during a default (a circumstance potentially relevant to Lenders under hybrid structures that also take a security interest in the underlying assets or in the insolvency of a fund of funds borrower), the rule-makers provided an exception. This exception for ownership interests acquired in the ordinary course of collecting a “debt previously contracted” (“DPC”) means that a Lender, as a secured party, that has covered fund ownership interests as collateral securing a Facility may foreclose on its security interest and thereby take possession and dispose of such ownership interests without violating the Volcker Rule. The Final Regulation expressly sanctions the ownership and sale of the covered fund ownership interest in such a DPC context, provided that the Lender acquiring an ownership interest in a covered fund “divests the financial instrument as soon as practicable, and in no event may the banking entity retain such instrument for longer than such period permitted by [its primary
regulator]," typically within approximately two years, subject to possible extensions.7

Facility Limitations
We do advise Lenders to be conscious of the definition of “other similar interest” and curtail their creativity to structures that will not run afoul of the Final Regulation. For example, any sort of warrant or other equity kicker, equity conversion feature, step-up in spread based on Fund performance or the like would all require a hard look under the Final Regulation.

Conclusion
We think it is highly unlikely that a Facility Lender, absent unusual control or profit-sharing mechanics in respect of a Fund borrower, could be deemed to hold an ownership interest in such covered fund under the Final Regulation solely as result of the typical Facility lending relationship. ◆

Endnotes
1 If the Lender is the sponsor, investment advisor or investment manager of the Fund, significant additional compliance obligations are implicated which are beyond the scope of this Legal Update. Similarly, if the Fund borrower is itself sponsored or advised by a banking entity subject to the Final Regulation, additional analysis is required by the Lender.
2 For an in-depth review of the Volcker Rule, please see Mayer Brown’s Legal Report, “Final Regulation Implementing the Volcker Rule.”
3 A fund that is not an “investment company” in the first place or that is able to rely on an exception or exemption under the 1940 Act other than section 3(c)(1) or 3(c)(7) generally is not a covered fund. For example, a real estate fund that invests solely in real property rather than in securities is not an investment company, while a real estate fund that invests in a mix of real property and real estate-related securities may be able to rely on section 3(c)(5)(C) of the 1940 Act. In either case, the fund would not be a covered fund. In addition, even if an entity relies on section 3(c)(1) or 3(c)(7) of the 1940 Act, the entity is not a covered fund if it falls within a Volcker Rule exclusion. The Final Regulation expressly excludes from the definition of a “covered fund” various types of entities, including, among others, certain “foreign public funds” that are analogous to US-registered investment companies, foreign pension and retirement funds, and qualifying loan securitizations and asset-backed commercial paper conduits. If a fund is not an investment company in the first place or is covered by a Volcker Rule exclusion, a banking entity may not only invest in or sponsor the fund without needing to comply with a Volcker Rule exemption but it may also engage in covered transactions with the entity without regard for the so-called Super 23A prohibition.
4 Final Regulation Preamble at 5706.
5 Final Regulation Preamble at 5707.
6 Final Regulation Preamble at 5706.
7 Final Regulation Preamble at 5782.
As the Subscription Facility market continues to grow and mature, lenders willing to include the widest range of investors within the borrowing availability (the “Borrowing Base”) may enjoy a competitive advantage against lenders that have a relatively more narrow set of investors they will advance against, all things being equal. One way to potentially expand the borrowing capacity under a Subscription Facility is for a lender to advance against more of the governmental investors in the fund and, in particular, governmental investors that are public retirement systems (each a “System”).

Historically, full Borrowing Base credit (typically a 90% advance rate) is given to investors that are systems with (a) a senior unsecured debt rating (or its equivalent) of BBB+ or better by Standard & Poor’s Financial Services LLC or Baa1 or better by Moody’s Investors Service, Inc., and (b) a minimum funding ratio above a specified threshold (typically 90% if the investor’s rating is BBB+/Baa1 or equivalent and no minimum for investors with higher credit ratings). These rating and funding ratio criteria are often referred to as the “Applicable Requirement” in a Subscription Facility. Where it can be established that a state, county, municipality or other governmental subdivision is ultimately responsible for the obligations of a System, a lender can reasonably look past the System’s own credit profile and, instead, to the credit rating and quality of the responsible governmental entity in determining if the Applicable Requirement has been satisfied, or whether the System investor otherwise merits inclusion in the Borrowing Base, perhaps at a lower advance rate (typically 60–65% of the unfunded Capital Commitment). Thus, establishing a credit linkage between a System and a creditworthy responsible governmental entity may provide a way for a lender to get comfortable advancing against the unfunded Capital Commitment of a System investor that would otherwise not satisfy the Applicable Requirement on its own.

Below we outline a few alternate approaches and factors that a lender may use to assess whether an adequate...
credit linkage exists between a System and a responsible governmental entity.

**Overview of Public Retirement Systems**

Systems are created and administered under the laws of a state (the “Plan Sponsor”) to provide pension and other retirement benefits to employees of governmental units such as states, cities and counties. Systems typically hold substantial reserves available for investment in a diverse array of financial products and often rely on significant investment returns to supplement the participating employee and employer contributions used to fund retirement benefits for the System’s participants.

A System can be organized to provide benefits for employees of a single governmental unit or employees of multiple governmental units. A single-employer system is a System that provides benefits for employees of only one governmental entity, often the Plan Sponsor. Some common examples of a single-employer System are those that provide benefits to retired state judges or state legislators. In such a System, the relevant state would be the only employer of the individuals covered by the System. A multi-employer system is a System that covers the employees of more than one governmental entity. An example of a multi-employer System is a System that provides retirement benefits to a state’s public safety personnel. Such a System may cover employees of many different governmental entities, such as state university police departments, county sheriffs’ departments and city fire departments.

The retirement benefits offered by a System may be structured in a variety of ways. Here, we will focus on Systems that are organized as defined-benefits Systems, where the employees covered by the System will contribute a statutorily determined percentage of their income during the term of their employment in return for a defined level of benefits during their retirement. Many states have constitutional protections safeguarding the pension benefits accrued by public employees during their careers. These constitutional provisions can prevent Plan Sponsors from reducing the level of benefits promised to public workers, causing Plan Sponsors to focus on ways to increase the System’s assets rather than reduce pension liabilities to ensure the financial health of the System.

**Credit Linkage to Plan Sponsors**

By demonstrating that a creditworthy governmental entity is ultimately responsible for the funding obligations of a System, a credit linkage analysis provides valuable underwriting information and may facilitate inclusion of a System in the Borrowing Base. Because the statutory regimes used to govern Systems are varied and often complex, a credit linkage review calls for a thorough analysis by counsel of multiple sources of state and local law, including state constitutions, statutes, ordinances and case law, as well as statements and financial reports issued by both the Plan Sponsor and the System. There are a number of ways that a Lender can attempt to link the credit rating of a System and its Plan Sponsor, some of which are quite direct while others are more attenuated. It is important to note, however, that the degree of connectivity between a System and its Plan Sponsor required to establish a sufficient credit linkage to permit inclusion of a System Investor’s unfunded Capital Commitments in the Borrowing Base will differ based on the preferences of the relevant Lender. We will focus on two of the more popular methods used to demonstrate such a credit link in more detail below.

**PLAN SPONSOR’S ASSUMPTION OF LIABILITY OF SYSTEM’S INVESTMENT OBLIGATIONS**

Perhaps the most straightforward way to establish a credit linkage is to research and locate a source of law that expressly provides that the Plan Sponsor is responsible for the liabilities of the System. In the best case scenario, such a law would expressly designate all of the System’s liabilities as direct obligations of the Plan Sponsor. In such a situation, a Lender can take comfort that the rated Plan Sponsor is ultimately responsible for funding the
investment-related obligations of the System. The laws in this area, however, are seldom so clear, and a careful legal analysis will need to be undertaken to assess the extent to which the Plan Sponsor actually assumes the System’s liabilities. For example, the laws may provide that the Plan Sponsor assumes operational and administrative liabilities of the System but be silent as to investment liabilities or benefit obligations. This type of limited assumption of liability would likely not include the assumption of the System’s obligation to fund Capital Contributions to a Fund. Thus, a Lender may not be comfortable advancing against a System Investor in reliance on such a limited assumption of liability and may need to undertake a different analysis to establish whether an adequate credit link exists to include such an Investor in the Borrowing Base.

**PLAN SPONSOR’S RESPONSIBILITY FOR FUNDING THE SYSTEM**

When clear statutory or case law evidence does not exist to establish credit linkage, another method that can be used involves conducting an analysis of the sources of the System’s assets to ascertain the extent to which the Plan Sponsor is responsible for providing funds to the System vis-à-vis other participating employers. If the System primarily receives its funding (i.e., its assets) from the Plan Sponsor, it may be reasonable for a Lender to consider the credit worthiness of the Plan Sponsor as a primary factor in deciding whether or not it will advance against a System Investor. The purpose of this funding analysis is to determine the percentage of a System’s assets that is coming from the Plan Sponsor in relation to other sources, thus illustrating for each entity its level of responsibility for funding a System’s liabilities.

A System is often funded primarily by the three following sources: (i) employee contributions deducted from each participating employee’s salary, (ii) employer contributions required to be made under the law and (iii) investment gains earned through investment of the System’s reserves. According to data gathered in 2010 by the US Census Bureau, from 1995–2010, 68 percent of public pension fund receipts came from investment earnings, 11 percent came from employee contributions and about 21 percent came from employer contributions. Employer contributions are the only System assets that are funded directly from the coffers of Plan Sponsors; as such, the key task in conducting a funding responsibility analysis is to review applicable laws to determine the required annual employer contributions for each participating employer.

Once the amount each participating employer is required to contribute annually to a System has been determined, the next step in a funding analysis is to establish the percentage of employer contributions coming into the System that has historically come from each participating employer (including the Plan Sponsor) by reviewing the System’s financial, actuarial and other information. This information will help a Lender assess the degree to which the Plan Sponsor has been responsible for providing funds to the System that, when extrapolated, may give the Lender enough comfort that the Plan Sponsor will provide adequate assets to the System to fund Capital Contributions going forward so as to enable the Lender to include the System Investor in the Borrowing Base.

With respect to a single-employer System, the sole employer (i.e., the Plan Sponsor) would be the only governmental unit responsible for providing funds to the System, making a credit linkage easier to establish. When analyzing a multi-employer system, however, it can become significantly more challenging to establish a credit linkage between the System and its Plan Sponsor.

In some cases, the Plan Sponsor of a multi-employer System assumes responsibility for funding the employer contributions of some or all of the other participating employers. For example, the Illinois Teachers’ Retirement System is a multi-employer System consisting of approximately 1,000 governmental units, where approximately 95 percent of the
employer-provided funding for the Illinois Teachers’ Retirement System is the responsibility of the State of Illinois.9

More typically, with respect to multi-employer Systems, each governmental unit participating as an employer in the System is only responsible for making a required employer contribution for its own employees. In this scenario, a funding analysis requires locating and reviewing the financial, actuarial and other information related to the System to determine the extent to which the Plan Sponsor is responsible for funding the System relative to other participating employers in order to establish the extent to which the Plan Sponsor is supporting the System.

An additional layer of complexity is added when a Lender is considering advancing against a public pension fund that holds assets of multiple Systems. This situation can arise when a state that sponsors multiple Systems seeks out ways to reduce the administrative burden of operating multiple Systems by creating, for example, a common pension fund that collects, pools and invests moneys received from several different Systems (a “Common Fund”).10

When such a Common Fund is established to facilitate investment activities, the funds of each System may be invested jointly, while the gains and losses of the Common Fund are allocated among each System on a pro rata basis. In this scenario, again, a funding analysis calls for locating and reviewing the financial, actuarial and other information related to the Common Fund and each System participating in the Common Fund to determine the extent the Plan Sponsor is responsible for funding the assets of each System and, ultimately, the Common Fund relative to other participating employers.

ADDITIONAL CONSIDERATIONS

In deciding whether to advance against a System, in addition to a credit linkage analysis, there are other potential factors that a Lender may wish to consider and discuss with its counsel. For example, a Plan Sponsor of a System may have enacted a statutory regime that helps ensure that sufficient funds will be made available to the System for it to meet its liabilities.11 In such a case, a Lender may become more confident in the overall creditworthiness of the System and may become comfortable advancing against a System (perhaps at a lower advance rate and/or with tight concentration limits) despite the lack of credit linkage to the Plan Sponsor.

Lenders should also be aware of a Plan Sponsor’s ability to adjust the accrued liabilities of the System. As mentioned above, in many instances, System benefits are protected by state constitutional provisions. Certain states, such as Arizona, Illinois, Michigan and New Jersey, have pending cases relating to recently enacted pension reforms touching on this issue. These cases may have implications for the ability of Plan Sponsors in those states to limit their benefit liabilities as a means of managing the fiscal health of a System. As such, Lenders participating in the Subscription Facility market will want to consult with counsel familiar with these issues as they look to advance funds against Capital Commitments made by Investors that are Systems. Finally, it is important to note that, when a Lender is advancing against a governmental entity, it should consider the extent to which the entity may be able to use sovereign immunity defenses to impede enforcement of its contractual obligations in federal and/or state court.12

Conclusion

As the Subscription Facility market becomes increasingly competitive, a Lender’s ability to provide Borrowing Base credit for a greater number of a Fund’s Investors is one way for a Lender to distinguish itself from its competition. By analyzing the legal regime and publicly available financial and other information about a System and its sources of funding, a Lender may be able to establish sufficient credit linkage between a System Investor and a more creditworthy Plan Sponsor, facilitating inclusion of such an Investor in the Borrowing Base. ◆
Endnotes

1 For a more detailed description of the subscription facility market and features of the subscription credit facility product in general, please see Mayer Brown’s Fund Finance Markets Legal Update “Summer 2013 Subscription Credit Facility Market Review.”

2 For a discussion of key competitive and other trends in the Subscription Facility market, please see Mayer Brown’s Fund Finance Markets Legal Update “Winter 2014 Subscription Credit Facility Market Review.”

3 For the sake of simplicity, we use the term “System” as encompassing both the legal entity established to administer pension benefits and the related retirement/pension fund that holds assets in trust to pay liabilities.

4 In a Subscription Facility, a governmental plan Investor’s “funding ratio” is typically defined as the percentage obtained by dividing (i) the actuarial present value of the assets of the Investor by (ii) the actuarial present value of the plan’s total benefit liabilities.

5 The Plan Sponsor of a System does not necessarily have to be an employer of employees covered by the System. For example the Public School Teachers’ Pension and Retirement Fund of Chicago was created and is governed under the laws of the State of Illinois, but does not cover employees of the State of Illinois. For illustrative purposes, this article focuses on Systems that have Plan Sponsors participating as employers in the System.

6 For example, Article 13, Section 5 of the Illinois Constitution provides that membership in a pension system of any governmental unit in the state is “an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.”


10 The Common Pension Funds established by the State of New of Jersey Department of the Treasury, Division of Investments are examples of Common Funds. The Division of Investments uses the Common Pension Funds to invest and manage the collective assets of seven different Systems: the Police & Firemen’s Pension Fund, the Judicial Retirement System, the Police & Firemen’s Retirement System, the Prison Officers Pension Fund, the Public Employees’ Retirement System, the State Police Retirement System and the Teachers’ Pension and Annuity Fund.

11 The laws and regulations related to the funding of the Missouri Education Pension Trust (the “MEPT”) serve as an interesting example of such a regime. The State of Missouri has established the MEPT to invest the assets of the School Retirement System of Missouri and the Public Education Employee Retirement System of Missouri. The State of Missouri does not guarantee the liabilities of the MEPT or assume responsibility for making employer contributions on its behalf, yet in recent years the employer contributions have been very high and often exceed the annual required contribution (determined in accordance with Governmental Accounting Standards Board accounting standards). This high rate of contribution may be due to the fact that if any employer fails to transmit the full amount of its actuarially required employee and employer contributions to MEPT, that employer will be responsible for twice the amount owed, and MEPT is empowered to bring suit against the responsible party to collect the funds, thus incentivizing the participating employers to stay current on their contributions. See Mo. Rev. Stat. § 169.030.2, Mo. Code. Regs. Ann. tit. 16 §§0-2.010(6), Mo. Rev. Stat. § 169.620 and Mo. Code. Regs. Ann. tit. 16 §0-6.020(6).

12 For a more thorough analysis on sovereign immunity concerns related to Subscription Facilities, see Mayer Brown’s November 2012 Legal Update “Legal Sovereign Immunity Analysis In Subscription Credit Facilities.”


Leverage and Liquidity Requirements Under Basel III

J. Paul Forrester
Kevin P. Hawken

On January 12, 2014, with the concurrent endorsement of the Group of Central Bank Governors and Heads of Supervision (GHOS), the Basel Committee on Banking Supervision (BCBS) issued additional information regarding the leverage and liquidity requirements under Basel III, including the following:

- The full text of Basel III’s leverage ratio (Leverage Ratio) framework and related disclosure requirements that modifies the earlier consultative proposal issued in June 2013;
- Proposed revisions (the Consultative Document) to the Basel III framework’s Net Stable Funding Ratio (NSFR) modifying the earlier consultative proposal issued in December 2009 and Basel III agreement of December 2010 (as revised in June 2011);
- Disclosure standards for the Liquidity Coverage Ratio (LCR), including a template for such disclosure, reflecting additional work undertaken at the direction of the GHOS;
- Guidance for supervisors on market-based indicators of liquidity; and
- Modification of the LCR to permit (with national discretion) restricted-use committed liquidity facilities (RCLFs) provided by central banks to be included in the LCR’s high-quality liquid assets (HQLA).

The effect of these changes and additional guidance on the US rules to implement Basel III is unclear. In particular, the reaffirmation by BCBS of a minimum three percent Leverage Ratio is not consistent with the US proposed minimum requirement of five percent in the case of large, systemically important banking organizations that would be subject to the supplementary leverage ratio. Also, in light of current reports of ongoing discussions among international regulators regarding a more restrictive leverage ratio, it is perhaps significant that the BCBS states that, based on the parallel run period, final adjustments to the definition and calibration of the ratio will occur by 2017 when the requirement will migrate to a Pillar 1 treatment on January 1, 2018.

Leverage Ratio

The Basel III framework introduced a simple, transparent, non-risk-based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to:

- Restrict the buildup of leverage in the banking sector to avoid destabilizing deleveraging processes that can damage the broader financial system and the economy; and
- Reinforce the risk-based Basel III requirements with a simple, non-risk-based “backstop” measure.

BCBS is of the view that:

- A simple leverage ratio framework is critical and complementary to the risk-based capital framework; and
A credible leverage ratio is one that ensures broad and adequate capture of both the on- and off-balance sheet sources of banks’ leverage.

The Leverage Ratio implementation began with bank-level reporting to national supervisors from January 1, 2013, with required disclosure starting from January 1, 2017 with expected migration to mandatory Pillar 1 treatment (minimum capital requirement) from January 1, 2018.

The Basel III leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), being the following ratio (expressed as a percentage):

\[
\text{Leverage ratio} = \frac{\text{Capital measure}}{\text{Exposure measure}}
\]

with the requirement being a minimum of three percent during the parallel run period (i.e., from January 1, 2013 to January 1, 2017).

- **Capital Measure** means Tier 1 capital under the risk-based capital framework (as defined in paragraphs 49-96 of the Basel III framework), taking into account permissible transitional arrangements under Basel III.

- **Exposure Measure** generally follows the accounting value, subject to the following:
  - on-balance sheet, non-derivative exposures are included in the exposure measure net of specific provisions or accounting valuation adjustments (e.g., accounting credit valuation adjustments); and
  - netting of loans and deposits is not allowed.

Unless otherwise specifically provided, banks must not take account of physical or financial collateral, guarantees or other credit risk mitigation techniques to reduce the exposure measure.

A bank’s total exposure measure is the sum of the following: (i) on-balance sheet exposures; (ii) derivative exposures; (iii) securities financing transaction (SFT) exposures; and (iv) off-balance sheet (OBS) items. The specific treatments for these four main exposure types are defined below.

- **On-Balance Sheet** - Banks must include all balance sheet assets in their exposure measure, including on-balance sheet derivatives collateral and collateral for SFTs (other than on-balance sheet derivative and SFT assets covered under Derivative Exposures below); however, for consistency, balance sheet assets that are deducted from Tier 1 capital (as set forth in paragraphs 66 to 89 of the Basel III framework) may be deducted from the exposure measure, while liability items (for example, any fair value or similar accounting value adjustments for gain or loss on derivative or other liabilities due to changes in the bank’s own credit risk) must not be deducted.

- **Derivative Exposures** – Generally, banks must calculate their derivative exposures, including where a bank sells protection using a credit derivative, as the replacement cost (RC) for the current exposure plus an add-on for potential future exposure (PFE). If the derivative exposure is covered by an eligible bilateral netting contract, an alternative treatment may be applied. Written credit derivatives are treated the same as cash instruments (e.g., loans or bonds). Generally, collateral received does not reduce the derivative exposure. Similarly, a bank must gross up its derivative exposure for collateral provided if the collateral reduced the accounting value of the exposure.

- **Securities Financing Transaction Exposures** – Generally, the gross exposure adjusted by (i) excluding the value of the securities received if the bank reported the securities as an asset in its balance sheet, (ii) netting all cash payables and receivables with the same SFT counterparty as long as all related SFTs have the same final settlement date, set-off is legally enforceable and the parties have agreed to net settlement, and (iii) a counterparty credit risk measure (being the current exposure without a PFE add-on).

- **Off-Balance Sheet Items** – OBS items include commitments (including liquidity facilities),
whether or not unconditionally cancellable, direct credit substitutes, acceptances, standby letters of credit and trade letters of credit. As under the risk-based capital framework, OBS items are converted to credit exposure equivalents by using specified credit conversion factors (CCFs) applied to the related notional amounts.

Banks are required to publicly disclose their Leverage Ratios from January 1, 2015 using a consistent and common disclosure of the main components of the Leverage Ratio and including a summary comparison table on a common disclosure template included in the full text.3

Net Stable Funding Ratio

The net stable funding ratio (NSFR) is defined as the amount of available stable funding (ASF) relative to the amount of required stable funding (RSF). While many of the components of the NSFR are the subject of international agreement, some remain subject to national discretion. In addition, the NSFR is to be supplemented by supervisory assessment that may result in more stringent requirements to reflect a bank’s funding risk profile.

“Available stable funding” is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR, which extends to one year. The amount of such stable funding required of a specific institution is a function of the liquidity characteristics and residual maturities of the various assets held by that institution as well as those of its off-balance sheet (OBS) exposures.

The NSFR requirement is expressed as follows:

\[
\frac{\text{Amount of ASF}}{\text{Amount of RSF}} \geq 100\%
\]

With underlying concepts that are similar to those used for the LCR, the amount of ASF is measured based on the broad characteristics of the relative stability of an institution’s funding sources, including the contractual maturity of its liabilities and the differences in the propensity of different types of funding providers to withdraw their funding.

The amount of ASF is calculated by first assigning the carrying value of an institution’s capital and liabilities to one of five categories as presented in the table in Annex A. The amount assigned to each category is then multiplied by an ASF factor, and the total ASF is the sum of the weighted amounts. Carrying value represents the amount at which a liability or equity instrument is recorded before the application of any regulatory deductions, filters or other adjustments. For maturity determinations, investors are assumed to exercise a call option on the earliest possible date and, for funding options at the bank’s discretion, banks must assume that they do not exercise such options.

Similar to ASF, the amount of RSF is measured based on the broad characteristics of the liquidity risk profile of an institution’s assets and OBS exposures. The amount of required stable funding is calculated by first assigning the carrying value of an institution’s assets to the RSF categories listed. The amount assigned to each category is then multiplied by its associated RSF factor and the total RSF is the sum of the weighted amounts added to the amount of OBS activity (or potential liquidity exposure) multiplied by its associated RSF factor as set forth in Annex B.

The NSFR also assigns an RSF factor to certain OBS as shown in Annex C.

Comments on the Consultative Document were due by April 11, 2014.

Liquidity Coverage Ratio Disclosure

The LCR disclosure standards are to apply to all internationally active banks on a consolidated basis and are expected to apply no later than January 1, 2015. Apart from the quantitative LCR components,4 the standards require sufficient qualitative discussion to facilitate an understanding of the data provided.

The disclosure is to be public and to follow the template,5 but the standards also require disclosure of additional quantitative information relating to internal liquidity risk measurement and management. While not requiring their use, the standards
refer approvingly to the several monitoring tools for assessing liquidity risk that are included in the Basel III liquidity risk framework.

**Market-Based Liquidity Indicators**

The guidance on the use of market-based indicators of liquidity reflects additional work directed by GHOS in January 2013 and is intended to assist supervisors in their evaluation of the liquidity profile of assets held by banks and to promote greater consistency in HQLA classifications across jurisdictions for purposes of the LCR.

**Restricted Committed Liquidity Facilities Conditionally Permitted as HQLA for the LCR**

The BCBS has decided to modify the LCR to permit national regulators to modify the definition of HQLA to include greater use of committed liquidity facilities (CLFs) provided by central banks. Previously, the LCR only permitted CLFs in jurisdictions that lacked sufficient HQLA. The BCBS has determined that, subject to certain conditions and limitations, regulators in any jurisdiction may allow banks to use a restricted version of a CLF as HQLA.

**Endnotes**

1. Described in our earlier related Legal Update.
2. The BCBS notes that the specified approach refers to the Current Exposure Method (CEM) under Basel II and that it is considering alternatives to the CEM.
3. See p. 11 of the full text for the template.
4. A template for LCR common disclosure is also included in the standards at p. 4.
5. See Annex 1 included in the standards for an explanation of the disclosure template.
6. See our earlier related Legal Update for a description of the US LCR implementation proposal.
### ANNEX A

#### AVAILABLE STABLE FUNDING (ASF)

<table>
<thead>
<tr>
<th>ASF Factor</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>100%</td>
<td>Regulatory risk-weighted capital before deductions (other than Tier 2 instruments with a maturity of less than one year);</td>
</tr>
<tr>
<td></td>
<td>Any other capital instrument with an effective residual maturity of one year or more (excluding any instruments with explicit or embedded options that, if exercised, would reduce the maturity of the instrument to less than one year); and</td>
</tr>
<tr>
<td></td>
<td>The total amount of secured and unsecured borrowings and liabilities (including term deposits) with effective residual maturities of one year or more (paragraph 18)</td>
</tr>
<tr>
<td>95%</td>
<td>“Stable” non-maturity (demand) deposits and term deposits with residual maturities of less than one year provided by retail and SME customers (paragraph 19)</td>
</tr>
<tr>
<td>90%</td>
<td>“Less stable” non-maturity (demand) deposits and term deposits with residual maturities of less than one year provided by retail and SME customers (paragraph 20)</td>
</tr>
<tr>
<td>50%</td>
<td>Funding (secured or unsecured) with a residual maturity of one year or less provided by non-financial corporate customers;</td>
</tr>
<tr>
<td></td>
<td>Operational deposits;</td>
</tr>
<tr>
<td></td>
<td>Funding with residual maturity of less than one year from sovereigns, public sector entities (PSEs) and multilateral and national development banks; and</td>
</tr>
<tr>
<td></td>
<td>Other funding (secured and unsecured) not included in the categories above with residual maturity of not less than six months and less than one year, including funding from central banks and financial institutions (paragraph 21)</td>
</tr>
<tr>
<td>0%</td>
<td>All other liabilities and equity not included in above categories, including liabilities without a stated maturity and, if positive, derivatives payable net of derivatives receivable</td>
</tr>
</tbody>
</table>

### ANNEX B

#### REQUIRED STABLE FUNDING (RSF)

<table>
<thead>
<tr>
<th>RSF Factor</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>Coins and banknotes immediately available to meet obligations;</td>
</tr>
<tr>
<td></td>
<td>Central bank reserves (including required and excess reserves); and</td>
</tr>
<tr>
<td></td>
<td>Unencumbered loans to banks subject to prudential supervision with residual maturities of less than six months (paragraph 29)</td>
</tr>
<tr>
<td>5%</td>
<td>Unencumbered Level 1 assets, excluding assets receiving a 0% RSF as specified above, including marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs, the Bank for International Settlements, the International Monetary Fund, the European Central Bank and European Community, or multilateral development banks that are assigned a 0% risk-weight under the Basel II Standardized Approach for credit risk; and</td>
</tr>
<tr>
<td></td>
<td>Certain non-0% risk-weighted sovereign or central bank debt securities as specified in the LCR (paragraph 30)</td>
</tr>
</tbody>
</table>
### ANNEX B (continued)

<table>
<thead>
<tr>
<th>REQUIRED STABLE FUNDING (RSF)</th>
<th>RSF FACTOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Unencumbered Level 2A assets, including marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs or multilateral development banks that are assigned a 20% risk weight under the Basel II Standardized Approach for credit risk and corporate debt securities (including commercial paper) and covered bonds with a credit rating equal or equivalent to at least AA– (paragraph 31)</td>
<td>15%</td>
</tr>
<tr>
<td>• Unencumbered Level 2B assets, including: residential mortgage-backed securities (RMBS) with a rating of at least AA; corporate debt securities (including commercial paper) with a credit rating of between A+ and BBB--; and exchange-traded common equity shares not issued by financial institutions or their affiliates; Any HQLA that are encumbered for a period of six months or more and less than one year; All loans to banks subject to prudential supervision with residual maturity of six months or more and less than one year; Deposits held at other financial institutions for operational purposes, as outlined in LCR paragraphs 93–104, that are subject to the 50% ASF factor in paragraph 21 (b); and All other non-HQLA not included in the above categories that have a residual maturity of less than one year, including loans to non-bank financial institutions, loans to non-financial corporate clients, loans to retail customers (i.e., natural persons) and small business customers, and loans to sovereigns, central banks and PSEs (paragraph 32)</td>
<td>50%</td>
</tr>
<tr>
<td>• Unencumbered residential mortgages with a residual maturity of one year or more that would qualify for a 35% or lower risk weight under the Basel II Standardized Approach for credit risk and other unencumbered loans not included in the above categories, excluding loans to financial institutions, with a residual maturity of one year or more, that would qualify for a 35% or lower risk weight under the Basel II Standardized Approach for credit risk (paragraph 33)</td>
<td>65%</td>
</tr>
<tr>
<td>• Other unencumbered performing loans that do not qualify for the 35% or lower risk weight under the Basel II Standardized Approach for credit risk and have residual maturities of one year or more, excluding loans to financial institutions; Unencumbered securities that are not in default and do not qualify as HQLA according to the LCR including exchange-traded equities; and Physical traded commodities, including gold (paragraph 34)</td>
<td>85%</td>
</tr>
<tr>
<td>• All assets that are encumbered for a period of one year or more; If positive, derivatives receivable net of derivatives payable; and All other assets not included in the above categories, including non-performing loans, loans to financial institutions with a residual maturity of one year or more, non-exchange-traded equities, fixed assets, pension assets, intangibles, deferred tax assets, retained interest, insurance assets, subsidiary interests and defaulted securities (paragraph 35)</td>
<td>100%</td>
</tr>
</tbody>
</table>
### ANNEX C

#### OFF-BALANCE SHEET ITEMS (OBS)

<table>
<thead>
<tr>
<th>OBS FACTOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>5% of the currently undrawn portion</td>
</tr>
</tbody>
</table>

- Irrevocable and conditionally revocable credit and liquidity facilities to any client

- Other contingent funding obligations, including products and instruments such as:
  - Unconditionally revocable credit and liquidity facilities;
  - Trade finance-related obligations (including guarantees and letters of credit);
  - Guarantees and letters of credit unrelated to trade finance obligations; and
  - Non-contractual obligations such as:
    - Potential requests for debt repurchases of the bank’s own debt or that of related conduits, securities investment vehicles and other such financing facilities;
    - Structured products where customers anticipate ready marketability, such as adjustable rate notes and variable rate demand notes (VRDNs); and
    - Managed funds that are marketed with the objective of maintaining a stable value (paragraph 38)

  National supervisors can specify based on national circumstances

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**Notes**

1. Meeting all requirements under Basel III and only including amounts after any transitional arrangements have expired under fully implemented Basel III (i.e., as in 2022).
2. Unless otherwise specified, references to paragraphs in these Annexes are to numbered paragraphs in the BCBS consultative document for the NSFR.
3. Defined in LCR paragraphs 75-78.
4. Defined in LCR paragraph 73.
7. Defined in LCR paragraph 73.
10. Defined in LCR paragraph 50.
11. Defined in LCR paragraph 52.
12. As defined and subject to the conditions set forth in LCR paragraph 54.
13. As defined in the LCR.
Structuring Credit Facilities for Defined Contribution Plan Funds

Zachary K. Barnett
Lennine Occhino
Mark C. Dempsey

Over the last ten years, there has been a steady trend transition from defined benefit plans to defined contribution plans. As further evidence of this trend, as recently as the end of the fourth quarter of 2013, defined contribution plan (“DC”) assets amounted to $5.9 trillion, compared to just $3.0 trillion in assets for private-sector defined benefit (“DB”) plans.1 At the same time, DC plan fiduciaries are seeking to achieve the historically higher returns of DB plans by venturing into alternative investments (real estate, private equity and hedge funds). In the face of the large amounts of capital now being funded to DC plans and the desire by DC plan fiduciaries to improve returns, fund sponsors have been actively courting such DC plans and establishing investment vehicles tailored to the needs of such DC plans (such investment vehicles are referred to herein generally as “DC Funds”).

Access to a line of credit offers a number of benefits to both DC plan fiduciaries and DC Fund sponsors. A credit facility can help DC plan fiduciaries and DC Funds manage the daily liquidity required by DC plan participants and fiduciaries, as well as provide bridge capital to fund DC Fund investments. While alternative investments (real estate, private equity and hedge funds) are typically illiquid, the higher rates of return offered by such investments may offset the risks to DC plans and fiduciaries caused by such illiquidity, particularly when a credit facility can mitigate much of the illiquidity concerns.

This Legal Update provides background on a number of issues for DC Fund sponsors and for lenders (each, a “Lender”) in connection with a credit facility to a DC Fund (such credit facilities referred to herein generally as “Facilities”). It also proposes structural solutions for certain of those issues.

Facility Size and Uses
Compared to credit facilities provided to typical private equity funds or private equity real estate funds, Facilities for DC Funds tend to be rather small in relation to the total size of the DC Fund. While Facilities may vary, they are often 10-20% of the total DC Fund size. While there is potential for Facilities to grow in size relative to DC Fund size as Lenders get more comfortable lending to DC Funds and DC Funds continue to find new ways to take advantage of the liquidity provided by a Facility, limitations on collateral (discussed below) and the DC Fund’s need for liquidity may prevent such Facilities from reaching the relative size of credit facilities traditionally sought by other types of private equity funds or real estate funds.

Historically, DC Funds have relied upon Facilities primarily for standby funding to match redemption requests of DC plan participants to the timing of redemption windows of the DC Fund’s underlying

1 See the Pension Benefit Guaranty Corporation’s Website at http://www.pbgc.gov.
investments. Accordingly, such Facilities have generally been used infrequently, and have not typically maintained long-term outstanding balances beyond redemption windows of the DC Fund's underlying investments. For DC Funds that have longer track records and historically reliable streams of participant cash inflows, Facilities could potentially be used to fund investments in advance of capital contributions from DC plan participants. Fiduciary concerns related to increased leverage and potential losses for DC plan participants, however, may prevent the use of Facilities as a means to further leverage investments.

Structuring/Security Issues

BORROWER STRUCTURES

DC Funds rely on a number of different legal structures and pooling vehicles, including separate managed accounts, collective investment trusts and insurance company separate accounts. A description and summary of these structures and vehicles is beyond the scope of the Legal Update, but it is important to recognize that each of these structures and vehicles carries distinct legal consequences that shape a Facility's structure. It is important for Lenders to fully understand the relationship between DC Funds and the actual borrower under the Facility. Some structures used by DC Funds do not utilize a separate legal entity for the borrower, rather the borrower consists solely as a specific set of assets or funds within a larger legal entity. It is important to consult with legal counsel not only to ensure that Lenders have sufficient legal recourse with respect to a Facility's borrower, but also to protect corporate formalities of the DC Fund related to distinct pools of assets belonging to one or more related legal entities.

SECURITY AND COLLATERAL

While a subscription-backed credit facility looks to a fund's investors for repayment and as the ultimate collateral, the participant-funded nature of DC Funds is not compatible with such an approach. Instead, Lenders can rely upon a variety of security packages tied to a DC Fund's investments for collateral. Collateral packages for Facilities typically fall into three categories: illiquid investments, liquid investments and distributions proceeds. A pledge of illiquid investments, such as interests in private equity funds, real estate funds or hedge funds may be complicated by transfer restrictions applicable to such interests. Moreover, any such pledge may also require additional consents from third-party entities. An indirect pledge of such interests could be structured with a pledge of the equity of an aggregating vehicle that holds such underlying investments. Careful review of the underlying investment documentation must then be undertaken to ensure that the indirect pledge does not breach any transfer restrictions or require any third-party consents.

In addition to illiquid investments, DC Funds typically hold certain liquid investments in the form of cash/cash equivalents or other liquid securities. DC Funds rely upon such liquid investments to support liquidity requirements of DC plan participants and to aggregate cash inflows pending new investments. Liquid investments are unlikely to be subject to transfer restrictions or consent requirements and, to the extent such liquid investments are held in one or more securities accounts with the Lender, perfecting rights in the collateral is usually straightforward.

Lastly, the collateral package could include a pledge of distribution proceeds from a DC Fund's underlying investments, along with one or more account(s) held with the Lender into which such proceeds are deposited. Again, careful review should be undertaken to ensure that such a pledge does not breach any of the underlying investment documentation.

Of course, given the creditworthiness of the borrower, the reliability of DC plan contributions, the value of the underlying DC Fund investments and the multiple sources of repayment, a Lender may also be comfortable offering a Facility on an unsecured basis.
ERISA CONCERNS

Facilities for DC Funds may present different ERISA concerns as compared to credit facilities for more traditional private equity funds or real estate funds. Unlike other fund-financing products where ERISA issues are focused on seeking comfort that loan parties will not be deemed to hold “plan assets,” DC Funds, by their nature, may hold “plan assets” and accordingly are subject to ERISA, including ERISA’s prohibition on party-in-interest transactions. In a Facility, the primary concern under ERISA arises with respect to any relationships between the Lender, the DC Fund itself and/or the underlying DC plans taking part in DC Funds, due to the fact that such relationships may give rise to prohibited transaction excise tax penalties for the Lender.

Conclusion

While to date Facilities for DC Funds have been relatively rare, as more fund sponsors seek to establish DC Funds, the opportunity is ripe for new market participants. With a careful review of the legal structure of a DC Fund, including with respect to the borrowing entity for the Facility, and attention to the collateral package, a Facility can be structured to provide important and often vital liquidity to a DC Fund while still satisfying the Lender’s credit criteria. Please contact any of the authors with questions regarding DC Funds and the various structures for effectively establishing Facilities for such entities.

Endnotes

1 Investment Company Institute, “The US Retirement Market, Fourth Quarter, 2013.” Table 1.
3 For a general description of ERISA issues related to lending to real estate, private equity and other investment funds, please see “Subscription Credit Facilities: Certain ERISA Considerations,” Fund Finance Market Review, Mayer Brown, Summer 2013.
4 Employee Retirement Income Security Act of 1974, as amended, and the rules and regulations promulgated thereunder by any US governmental authority, as from time to time in effect.
5 “Plan Assets” has the meaning given in 29 C.F.R. §2510.3-101, et seq., as modified by Section 3(42) of ERISA.
Many hedge funds, private equity funds, and other types of pooled investment vehicles rely on exclusions from the definition of “investment company” provided under Sections 3(c)(1) or 3(c)(7) (each, a “Covered Fund”) of the Investment Company Act. Rule 3c–5 under the Investment Company Act permits a knowledgeable employee of such Covered Funds, and a knowledgeable employee of certain Affiliated Management Persons,1 to invest in a Covered Fund that relies on Section 3(c)(1) without being counted toward the 100-person limit imposed upon a Section 3(c)(1) fund. The rule also permits such employees to invest in a Covered Fund that relies on Section 3(c)(7) without having to be a qualified purchaser with respect to a Section 3(c)(7) Fund and without being counted for purposes of determining whether a Section 3(c)(7) fund is owned exclusively by qualified purchasers.

Rule 3c–5 defines the term “knowledgeable employee” to include two categories:

- “Executive officers,” which term includes the “president, any vice president in charge of a principal business unit, division or function (such as sales, administration, or finance), and other officers who performs a policy making function, or any person who performs similar policy making functions” for a Covered Fund or an Affiliated Management Person of the Covered Fund; and
- Non-executive employees (other than those performing solely clerical, secretarial or administrative functions) who regularly participate in the investment activities of a Covered Fund or an Affiliated Management Person of a Covered Fund, provided such employee has been performing such functions and duties on behalf of the Covered Fund or Affiliated Management Person or substantially similar functions or duties for or on behalf of another company for at least 12 months.

Principal Business Units

In respect of whether an activity or function rises to the level of principal status, the SEC Staff confirmed its view that:
• The principal status of an adviser’s unit, division, or function depends on the relevant facts and circumstances of a particular investment manager’s business operations;
• Several business units, divisions, or functions within an adviser may each be considered a principal unit, division, or function; and
• The unit, division, or function of an adviser need not be part of the investment activities of a Covered Fund to be considered a principal unit, division, or function.

While the Staff’s confirmation of these considerations is helpful, perhaps more notable is the Staff’s stated belief that Rule 3c–5 is intended to provide “flexibility in determining whether an individual is in charge of a principal business unit, division, or function.” In its request letter, the MFA suggested that activities could be “principal” if they were “high value” and integral to the investment manager’s operations. Certain examples were provided by the MFA in respect of certain information technology (“IT”) and investor relations functions, including, in the case of IT professionals, professionals (i) charged with building models and systems that translate into certain quantitative trade orders and (ii) who build performance and risk monitoring systems that interact with the investment program.

An investor relations function could be a principal unit if investor relations personnel conduct substantive portfolio reviews with investors and respond to substantive due diligence inquiries. The Staff agreed that such functions could be determined to be “principal,” while reiterating the fairly direct and critical ties to the investment manager’s investment program and investor due diligence, as opposed to inconsequential assistance.

The Staff’s guidance also seems to provide that the heads of certain functions may qualify as knowledgeable employees in addition to an investment manager’s chief operating officer and director of sales and marketing.

Further, the flexibility shown by the Staff, together with a framework for arguing that other functions may be integrally involved with the investment program, may prove particularly beneficial for smaller, flatter organizations where a certain individual may supervise few, if any, others, or may be the only individual (and, by default, the executive officer) leading such function. It is important to emphasize, however, that merely acting in such capacities alone will not make an individual a “knowledgeable employee.” The Staff indicated that such individuals “could” be determined to be knowledgeable employees, which is intended to emphasize that status alone will not make an individual a knowledgeable employee. A separate and independent determination is required to be made that such persons generally have such financial knowledge and sophistication and sufficient access to information about the Covered Fund in question in order to understand the strategy and risks inherent in such investments. As noted by the SEC Staff, an investment manager should be able to explain “the basis in [Rule 3c–5] pursuant to which the employee qualifies as a knowledgeable employee.”

Policy-Making Functions

With regard to policymaking functions, the MFA Letter essentially provides clarity around a “function over title” approach: regardless of their titles, employees can have a policy-making function and can meet the relevant standard either individually or as part of a committee or group. The MFA Letter clarifies that an employee need not even be an “officer” per se, and that policy-making may be viewed broadly, and can include active members of a group or committee that develops and adopts a manager’s policies, such as a valuation committee. Such logic arguably might be extended to active
members of other committees, including best execution, risk, operating and other committees that make policies on behalf of the investment manager, which may potentially significantly increasing the pool of potential knowledgeable employees.

**Participation in Investment Activities**

The MFA Letter significantly expands the SEC Staff’s guidance set forth in the 1999 no-action letter addressed to the American Bar Association (the “ABA Letter”). In the ABA Letter, the SEC stated that Rule 3c–5 is intended to cover non-executive employees only if they actively participate in the investment activities of the Covered Fund and certain other investment companies. The SEC further stated that the rule is intended to encompass persons who actively participate in the management of a fund’s investments, and not employees who merely obtain information regarding the investment activities of these funds.

The Staff noted that analysts, who research all potential portfolio investments and provide recommendations to the portfolio manager, could be determined to be knowledgeable employees. The Staff also noted that non-executive marketing and investor relations professionals, attorneys (even those who provide advice with respect to, or who participate in, the preparation of offering documents and the negotiation of related agreements), certain brokers and traders affiliated with the Covered Fund or an Affiliated Management Person, and financial, compliance, operational and accounting officers of a fund (including those who have management responsibilities for compliance, accounting and auditing functions of funds) would not qualify as knowledgeable employees under Rule 3c–5.

The MFA Letter makes clear that research analysts may qualify as knowledgeable employees, even if they provide analysis or advice to a portfolio manager with respect to only a portion of a Covered Fund’s portfolio (as opposed to the entire portfolio, which was suggested in the ABA Letter) and, importantly, that certain non-investment, non-executive personnel may qualify as knowledgeable employees if they regularly participate in the management of a Covered Fund’s portfolio (or a portion thereof).

While the ultimate determination is based on facts and circumstances, and must be made on a case-by-case basis, the SEC Staff noted explicitly that the following non-investment personnel may be knowledgeable employees:

- A member of the analytical or risk team who regularly develops models and systems to implement a Covered Fund’s trading strategies by translating quantitative signals into trade orders or providing analysis or advice that is material to the investment decisions of a portfolio manager (in contrast to someone who merely writes the code to a program used by the portfolio manager);
- A trader who is regularly consulted for analysis or advice by a portfolio manager during the investment process and whose analysis or advice is material to the portfolio manager’s investment decisions based on the trader’s market knowledge and expertise (in contrast to a trader who simply executes investment decisions made by the portfolio manager);
- A tax professional who is regularly consulted for analysis or advice by a portfolio manager typically before the portfolio manager makes investment decisions, and whose analysis or advice is material to the portfolio manager’s investment decisions, such as when a tax professional’s analysis of whether income from an offshore fund’s investment may be considered “effectively connected income” is material to a portfolio manager’s decision to invest in certain debt instruments (in contrast to a tax professional who merely prepares the tax filings for the Covered Fund); and
- An attorney who regularly analyzes legal terms and provisions of investments, and whose analysis or advice is material to the portfolio manager’s investment decisions, such as where the attorney’s legal analysis of tranches of a distressed debt
investment is material to a portfolio manager’s decision to invest in the loan (in contrast to an attorney who negotiates agreements that effectuate transactions evidencing the investment decisions of the portfolio manager or an attorney or compliance officer who evaluates whether an investment is permitted under a Covered Fund’s governing documents).

Treatment of Separate Accounts
The MFA Letter also provides that an employee can be regarded as participating in the investment activities of a Covered Fund if his or her functions relate to a portfolio, or portion of a portfolio, of a separate account for clients that are “qualified clients” and are otherwise eligible to invest in the private funds managed by the adviser and whose accounts pursue investment objectives and strategies that are substantially similar to those pursued by one or more of those private funds.

Employees of Relying Advisers in Control Relationships
The MFA Letter provides that knowledgeable employees of a filing adviser, or any of its relying advisers (as set out in the ABA’s 2012 no-action letter regarding which adviser entities have to file a Form ADV), may be treated as a knowledgeable employee with respect to any Covered Fund managed by the filing adviser or its relying advisers, provided that the employees meet the other conditions of the rule.

Other Employees
The SEC Staff emphasized that employees of an adviser other than those described in the MFA Letter may also qualify as knowledgeable employees for purposes of Rule 3c–5 depending on the relevant facts and circumstances relevant to an investment manager’s particular business.

Endnotes
1 The term “Affiliated Management Person” is defined in Rule 3c–5 to mean an affiliated person that manages the investment activities of a fund relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. The SEC Staff has also permitted Section 3(c)(1) and Section 3(c)(7) funds to treat employees who participate in the investment activities of a company that is excluded from the definition of investment company by Section 3(c)(2), 3(c)(3) or 3(c)(11) as a knowledgeable employee. See PPM America Special Investments CBO II, L.P. SEC No-Action Letter (pub. Avail. April 16, 1998) and the ABA Letter.

2 Whether an individual provides analysis or advice that is material to the investment decisions of a portfolio manager is a facts-and-circumstances determination based on whether a reasonable person would consider such analysis or advice to be important to the investment decision. See TSC Industries, Inc. v. Northway, Inc., 426 US 438 (1976). Generally, however, the analysis or advice must be material to the merits of buying, selling, or holding an investment. The SEC Staff does not believe that reviews, analysis or advice as to whether a potential investment is merely eligible for investment by the Covered Fund would be material to the investment decisions of a portfolio manager.
Does Volcker + Vickers = Liikanen?
EU Proposal for a Regulation on Structural Measures Improving the Resilience of EU Credit Institutions
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   This proposed legislation is the EU’s equivalent of Volcker and Vickers. It was initiated by the Liikanen report published on 2 October 2012 but the legislative proposal departs in a number of ways from the report’s conclusions. There are two significant departures: the legislative proposal contains a Volcker-style prohibition, which also departs from the individual EU Member States’ approach and, although the proposal contains provisions which mirror the Vickers ‘ring-fencing’ approach, they are not, in direct contradiction to Liikanen’s recommendation, mandatory.

Background
2. Post financial crisis, various jurisdictions have started to overhaul bank regulation and supervision. Bank structural reform is part of that agenda and involves separating retail and commercial banking from wholesale and investment banking, as well as outright prohibitions. The objective is to protect core banking activities and depositors from the ‘riskier’ trading activities, which have been deemed as ‘socially less important’, by reducing the risk of contagion spreading from trading activities to traditional retail banking and protecting the deposits of individuals and small businesses in the case of bank failure. In addition, bank structural changes are intended to reduce complexity and so improve the resolvability of banking groups. The EU has been concerned about banks which it terms “too big to fail,” “too big to save” and “too complex to manage, supervise and resolve.” It has been concerned that failure of these banks would be detrimental to the financial system in the EU as a whole. The EU also believes that these banks have an unfair advantage over smaller banks: it believes that the presumption that they would be bailed out rather than be allowed to fail provides an implicit guarantee which impacts their funding costs and leads to moral hazard and excessive risk-taking. These concerns and beliefs have led to a variety of legislative proposals and legislation.

3. Different jurisdictions have taken different approaches to bank structural reform. Reference has already been made to the UK and US legislation but France and Germany have also adopted legislation and the Belgian coalition government reached a political agreement in December 2013 on structural reform of its banking sector which it aims to finalise before elections in May 2014. One of the fundamental differences between the US and the approaches of the individual EU Member States has been the US preference for prohibition (or owner separation) as opposed to the EU Member States’ preference for ring-fencing (or functional separation/subsidiarisation). This difference means that the activities which the US has prohibited cannot be carried out
within a banking group at all whereas the activities on which the EU Member States have focused can be carried out within a distinct trading entity which is separate from the retail and commercial bank entity. The EU’s legislative proposal, by including elements of both approaches, blurs this distinction and creates a third approach to bank structural reform which is consistent with neither the US approach nor the approaches of the individual EU Member States.

4. The second significant difference in the approaches taken to date relates to the activities which the different jurisdictions have regulated. Broadly speaking, the US approach has prohibited proprietary trading, sponsoring private equity and hedge funds (known as “covered funds”), investing in covered funds and loans (known as “covered transactions”) to covered funds with which the banking group is involved. Proprietary trading is defined widely but there are a number of helpful exclusions and exemptions which narrow the scope of the prohibition, including a number of exclusions and exemptions to reduce the extraterritorial impact on non-EU banks, although, of course, there are conditions with which compliance is necessary before reliance can be placed on the exclusions and exemptions. There are similar exclusions and exemptions relating to the prohibitions on sponsoring and investing in covered funds and on covered transactions with covered funds. The Volcker rule is examined in detail in our legal reports “Final Regulation Implementing the Volcker Rule” and “The Volcker Rule—Application to Securitization Transactions.”

5. The UK approach (Vickers) focuses on a wider range of investment and wholesale banking. By prohibiting deposit-taking entities from ‘dealing in investments as principal,’ it requires most of the derivative and trading activity currently carried out by wholesale and investment banks to be carried out by a trading entity wholly separate from the retail bank. The French and German approach follow the ring-fencing approach of the UK but, like the US, have a narrower focus. Their approaches reflect the agreement reached by the two countries to push forward arrangements in the EU for the separation of “speculative activities” from deposit-related and customer-orientated activities. Thus the French legislation provides that proprietary trading and unsecured financing to alternative investment funds (“AIFs”) above a certain threshold (the “speculative activities”) must be carried out by a trading subsidiary separate from the retail banking entity. Similarly, the German legislation specifies certain high-risk activities (above a certain threshold in terms of overall trading activity), including proprietary trading, credit and guarantee business with certain AIFS (or equivalent funds which are high-leveraged or engaged in short selling) and certain forms of trading in one’s own name with the exception of market-making that must be ring-fenced and transferred to a separate trading entity.

6. Finally and amongst those jurisdictions that have chosen the ring-fencing approach, there is some difference in the strength of the ring-fence or the degree of functional separation required. The UK requires the ring-fenced body (“RFB”) to be legally, economically and operationally independent, to interact with the rest of the banking group on an arm’s length basis and to have its own capital and liquidity resources. The Prudential Regulation Authority (“PRA”) will make additional rules to ensure the integrity of the ring-fence and the independence of the RFB. The German legislation requires the RFB to be legally, economically and operationally independent, to interact with the rest of the banking group on an arm’s length basis and to have its own capital and liquidity resources, but does not give any guidance on how this should be achieved or should interact with German corporate law.
Liikanen...But Not As We Knew It

7. At the same time as individual jurisdictions were considering bank structural reform to deal with the issues summarised at paragraph 2 above, the EU was considering action, believing that inconsistent national legislation increases the possibility of distortions of capital movements and investment decisions, serves to make the structure and operation of cross-border banks more complex and increases fragmentation. In February 2012, the Commission established a High-level Expert Group to examine possible reforms to the structure of the EU’s banking sector, appointing Erkki Liikanen, Governor of the Bank of Finland and a former member of the European Commission, as the chairman. The Group presented its final report to the Commission on 2 October 2012, the Commission examined the possible reform options and their implications and, on 29 January 2014, it adopted a proposal for a regulation on structural measures improving the resilience of EU credit institutions plus a proposal on transparency of securities financing transactions aimed at increasing transparency in the shadow banking sector. This note focuses on the former proposal.

8. The UK government had considered adding a Volcker-style prohibition to the Vickers ring-fence established in the Banking Reform Act 2013 but rejected it because of concerns that defining proprietary trading as opposed to activities such as market-making was too problematic, the “technical challenges” that the US was experiencing in implementation and the fear that it would distract regulatory attention from the ring-fence. The EU, however, clearly did not share these concerns as their proposal departs from the approach taken by individual EU Member States and contains a Volcker-style prohibition, as well as provisions on ring-fencing. The main points of note are set out in the table below.

The main provisions of the EU proposal:

Scope

(a) It is proposed that the Volcker-style rule will apply to:

(i) EU G-SIIs (and all their branches and subsidiaries regardless of their location); and

(ii) banks that for three years have total assets of at least 30 billion euro and trading assets of 70 billion euro or 10% of total assets.

(b) The proposal does not make ring-fencing mandatory but requires national regulators to consider the possibility in relation to each individual deposit-taking bank (termed “core credit institution”) depending upon its risk profile. There is a wide definition of core credit institution.

(c) The EU proposal intends to have extraterritorial effect and apply to non-EU subsidiaries of EU banks, as well as effectively to non-EU banking groups with EU branches, unless the Commission deems the relevant non-EU jurisdiction equivalent to the EU regime but, although the stated intention is to create a level playing field in the EU, these provisions raise questions of legality and enforcement. National regulators may exempt a non-EU subsidiary of an EU bank from the ring-fencing requirements of the EU proposal in the absence of an equivalence decision if the relevant national regulator is satisfied that the subsidiary’s resolution strategy has no adverse effect on the financial stability of the Member State(s) where the parent and other group entities are established. There is no such additional exemption for EU branches of non-EU banks or in respect of the Volcker-style prohibition.
The Rules

(d) The EU Volcker-style rule prohibits proprietary trading (which is said to be narrowly defined), investments in AIFs save for closed-ended and unleveraged AIFs and investments in other entities which themselves engage in proprietary trading or investment in AIFs. This rule is considered in more detail at paragraphs 9–19 below.

(e) Unlike Liikanen, the EU proposal does not make separation of trading activities from retail and commercial banking mandatory. Instead it provides that national regulators must consider separation of trading activities (which is very widely defined to include almost all activities save those related to retail and commercial banking) from retail and commercial banking depending on the risk each individual core credit institution presents. The assessment of risk will be carried out on the basis of metrics set out in further legislation drafted by the European Banking Authority (“EBA”) and the Commission. Where the risk levels are exceeded and the national regulator determines that there is a threat to financial stability then the national regulator must impose a ring-fence on that particular bank, unless the bank can demonstrate that the regulator’s conclusions are not justified. These provisions are considered in more detail at paragraphs 20–39 below.

Individual Member State Derogations

(f) The Commission may grant individual deposit-taking banks within Member States (not individual Member States) a derogation from the ring-fencing requirements set out in the proposal where national legislation is equivalent to the EU legislation. At the time of writing, it appears that only the UK legislation is likely to meet the requirements of equivalence but that may depend on secondary legislation, which the UK has yet to adopt, which will provide the technical detail of the Vickers rule.

Timing

(g) On the basis that the final text of the Regulation is adopted by the European Parliament and Council by June 2015, it is proposed that the provisions will be phased in over a number of years: the Volcker-style prohibition will come into effect on 1 January 2017 and the provisions on ring-fencing will come into effect on 1 July 2018.

The Volcker-Style Prohibition

9. The introduction of a prohibition on proprietary trading, investment in AIFs and certain other entities is a major departure from the Liikanen recommendations. As noted above, none of the EU Member States which have introduced legislation to address bank structural reforms have adopted a Volcker-style prohibition. Although the US legislation is clearly the influence behind the provisions, the Commission has not taken exactly the same approach as Volcker.

Scope

10. The first thing to note is that, unlike the US rule, the EU Volcker-style rule is not intended to apply to all deposit-taking institutions. It is intended to apply to around 30 of the largest banks in the EU, those being:

(a) EU G-SIIs (and all their branches and subsidiaries regardless of their location); and

(b) banks that for 3 consecutive years have had total assets of at least 30 billion euro and trading assets of 70 billion euro or 10% of total assets.

The rule is intended to apply to the following entities within category (b):

(i) EU banks which are neither parent institutions nor subsidiaries, plus all their branches regardless of their location;

(ii) EU parent institutions, plus all their subsidiaries and branches regardless of their
location, when one of the group entities is an EU banks; and

(iii) EU branches of non-EU banks.

The intention appears to be that the assessment of total assets and trading assets is made at each individual entity level, including at branch level, rather than that an assessment should be made on a consolidated basis. It appears that the presence of an EU bank within a group could bring entities whose assets would not otherwise have to be assessed within the scope of the EU prohibition. The proposal contains some detail on how trading activities are to be calculated and the EBA shall be mandated to draft legislation to set out the exact methodology.

11. The EU prohibition will not apply to non-EU subsidiaries of EU banks and to EU branches of non-EU banks if the Commission deems the relevant non-EU jurisdiction equivalent to the EU regime. In considering equivalence, however, the Commission will look at whether the non-EU jurisdiction has requirements equivalent to both the Volcker-style and ring-fencing provisions. It is questionable whether any jurisdiction has requirements equivalent to both these provisions in the draft EU legislation. Like the Volcker rule, the effect of the EU rule is to prevent the prohibited activities being carried out within the banking group in its entirety. Thus bringing EU branches of non-EU banks within the scope of the EU prohibition is an attempt to bring the entire non-EU banking group within scope, unless it has equivalent legislation which is not currently likely. Whereas the objective is sensible— to create a level playing field in the EU and not give non-EU banking groups a competitive advantage—this raises questions and could precipitate a clash with the US, particularly if the EU rule imposes additional or different prohibitions to the Volcker rule.

12. Without an equivalent decision, the draft EU legislation provides that its Volcker-style prohibition will apply to non-EU subsidiaries of EU banks and effectively to non-EU banking groups that have an EU branch, within scope, but such purported extraterritorial application raises questions as to its legality and enforcement. In order for the prohibition to be effective, it, like the US Volcker prohibition, must apply throughout the whole banking group. How this will be applied to banking groups headquartered outside the EU and, arguably, subsidiaries established outside the EU is far from clear, particularly if there are significant differences with Volcker. It is also worth noting that the UK and the Council Legal Services have questioned the purported extraterritorial application of other recent pieces of EU legislation. In its legal challenge to the remuneration provisions of CRD IV, the UK has alleged that, to the extent that the cap on bankers’ bonuses is required to be applied to employees of institutions outside the EU, it infringes Article 3(5) of the Treaty on European Union and the principle of territoriality found in customary international law. A similar issue is currently being debated in the context of the financial transaction tax. The UK has issued proceedings arguing the decision permitting the adoption of the tax by a subset of the EU is unlawful because it authorises the adoption of an FTT with extraterritorial effects for which there is no justification in customary international law and the Council Legal Services has supported this argument. Thus the question of extraterritorial application is likely to be a contentious issue in the context of this dossier also.

The Prohibitions: Proprietary Trading

13. Chapter II of the proposal prohibits the largest banks and entities within their group from carrying out the following:

(a) proprietary trading, which is defined as using own capital or borrowed money to purchase, sell or otherwise acquire or
dispose of a financial instrument or commodity “for the sole purpose of making a profit for own account, and without any connection to actual or anticipated client activity or for the purpose of hedging the entity’s risk as a result of actual or anticipated client activity” through specifically dedicated desks, units, divisions or individual traders;

(b) with their own capital or borrowed money and for the sole purpose of making a profit for own account:

(i) acquiring or retaining units or shares in AIFs;

(ii) investing in financial instruments the performance of which is linked to shares or units in AIFs; and

(iii) holding any units or shares in an entity that engages in proprietary trading or acquires units or shares in AIFs.

There are some very limited exemptions to both the prohibitions at (a) and (b) above.

14. The Commission has indicated that it has learned from the US experience of implementing the Volcker rule. Rather than adopting a wide definition of proprietary trading with a number of specific exclusions and exemptions, it claims to have opted for a narrow definition with limited exclusions. Careful analysis will be required to assess whether the definition is as narrow as the Commission claims and whether the EU approach achieves the same result as the more detailed Volcker rule.

15. The narrow definition of proprietary trading is intended to satisfy France and Germany who were concerned to ensure that market-making was not restricted. It appears that both underwriting market making and it would fall out with the definition of proprietary trading as it will be argued that they are connected to client activity and does not have the sole purpose of making a profit for the bank. Trading in EU sovereign debt is expressly permitted. Entities can also trade in cash or defined cash equivalent assets (money market instruments) if they use their own capital as part of their cash management processes but concerns have been expressed that it does not seem that securities transactions for the purpose of liquidity management and riskless principal transactions will be permitted. Hedging for own purposes is permitted but only as set out in the definition of proprietary trading and so is limited to hedging as a result of actual or anticipated client activity.

16. The differences in approach between the US and EU rules are marked. The US approach is more sophisticated and consists of detailed and lengthy rules setting out exclusions and exemptions individually tailored to specific activities and situations, as well as the conditions with which there needs to be compliance in order to rely on the exclusions and exemptions. Setting out so much detail has been both challenging and time-consuming. It has also led to some unforeseen, and perhaps unintended, consequences. The EU approach is the diametric opposite: it consists of about a page and a half of relevant rules. Interestingly, there is no provision in the draft for significant level 2 legislation to add further detail to the high-level prohibitions set out in the proposal.

17. It could be said that the EU has taken a more pragmatic approach, opting for a principle-based, as opposed to the US rule-based, approach. It could be argued that a vast range of activities which could otherwise fall under the heading of ‘proprietary trading,’ including securities transactions for the purpose of liquidity management, riskless principal transactions and hedging activities, are ultimately connected to actual or anticipated client activity, even if indirectly. The lack of specified exemptions and exclusions in the EU rule could be said to create
uncertainty and the possibility of regulatory arbitrage, as much will depend on individual national regulator’s interpretation of the provisions, and to require individual consideration of each bank’s different activities but it does give banks a degree of latitude and flexibility by not setting out a finite set of permitted activities. This lack of certainty may make it difficult to draw exact comparisons with the Volcker rule in the abstract and in the absence of some indication as to how broadly—or narrowly—the national regulators will enforce the EU prohibitions.

The Prohibitions: Investment in AIFs and Other Specified Entities

18. In order to prevent evasion of the prohibition on proprietary trading, the proposal also provides that banks subject to the prohibition are prohibited from using their own capital or borrowed money to invest in or hold shares in AIFs (or certificates/derivatives linked to such shares) or entities that themselves engage in proprietary trading or invest in AIFs. The sole purpose of the banks’ activity must be to make a profit for their own account: this provision may give some additional flexibility. Unleveraged and closed-ended AIFs established in the EU or, if not established in the EU, marketed in the EU (arguably mainly private equity funds), venture capital funds, social entrepreneurship funds and the proposed European Long-Term Investment Funds are exempted from this prohibition as they are regarded as supporting the financing of the real economy. The Commission has stated that this provision is targeted at hedge funds but, as drafted, it has a far wider application as it would capture all leveraged and open-ended AIFs (plus AIFs which are unleveraged but not closed-ended) which could include, for example, a real estate fund, a fine art or wine fund, a retail investment fund or an investment company which is established or marketed in the EU. Banks to which these EU prohibitions apply will be able to continue providing banking/custody services to the AIFs within the scope of the prohibition.

19. Although the second prohibition again appears to have been mirrored on Volcker, there are disparities. The potential exemption of private equity funds from the prohibition is in direct contrast to the Volcker rule which prohibits investment in private equity and hedge funds. There is no equivalent in the EU rule to the Volcker prohibition on covered transactions with covered funds with which the banking group has other relationships. Further, the EU legislation does not, unlike earlier drafts and the Volcker rule, prohibit the sponsorship of AIFs. On the other hand, the limited exclusions as opposed to the myriad US exclusions and exemptions, means that this investment prohibition appears to go further than the Volcker rule in certain respects. In addition, and in a broader fashion than the Volcker rule, the EU rule has an indirect effect: it prohibits investment in any entity that itself engages in proprietary trading or invests in AIFs. This provision is exceptionally wide and its practical effect is questionable: it is not clear whether the Commission expects banks to carry out extensive due diligence of all entities into which they have already invested or into which they are considering investing. These disparities will be of particular concern to those banks—for example, EU branches and subsidiaries of US banks and US branches and subsidiaries of EU banks but also other third-country banks with a presence in both the EU and US—which are likely to have to comply with both Volcker and the EU prohibitions.

The Ring-Fencing Provisions

20. The discretionary nature of the ring-fencing provisions is another departure from the Liikanen Report. Chapter III of the proposal only mandates national regulators to review the
trading activities of each individual deposit-taking bank (termed “core credit institution”) in the EU and decide whether those activities create a threat to the financial stability of the core credit institution (“CCI”) itself or to the EU financial system as a whole. If so, the national regulator must prohibit the CCI from carrying out the specific risky trading activities, unless that institution convinces the regulator that such a decision is not justified. Such a decision would not prevent the identified trading activities being carried out elsewhere within the banking group.

Scope

21. A significant difference between the EU rules on ring-fencing and the UK legislation is that the EU rules are generally intended to apply to all banks that take deposits eligible under the Deposit Guarantee Scheme as provided for in the Deposit Guarantee Schemes Directive. This includes all deposits held by individuals and small, medium and large businesses but not financial institutions and public authorities. The UK approach has been to apply its ring-fencing legislation to deposit-taking banks but it intends to exempt the deposits of specified types of depositors in secondary legislation, as well as provide for a de minimis exemption. The draft secondary legislation provides that deposits of high net worth individuals who have chosen to deposit outside the ring-fence, deposits of large organisations and deposits of other financial institutions are not ‘core deposits.’ The EU approach is, therefore, to protect a wider range of deposits than the UK which may cause a problem when the UK seeks to apply for a derogation — see paragraphs 35–39 below.

22. As with the Volcker-style prohibitions, these provisions have extraterritorial effect. In the same way as set out at paragraph 10 above, they are intended to apply to an EU parent, and all its branches and subsidiaries regardless of their location, of a CCI, as well as to an EU branch of a non-EU bank. Thus the same issues as described in paragraphs 11 and 12 above apply. Non-EU subsidiaries of EU banks and EU branches of non-EU banks will be exempt from the ring-fencing provisions if the Commission has made an equivalence decision regarding the non-EU jurisdiction: we have already commented (at paragraph 11 above) on the likelihood of an equivalence decision given that it demands equivalence as to Chapter II (the EU Volcker-style prohibition) and Chapter III (the ring-fencing provisions). There is an additional option, however, for non-EU subsidiaries of EU banks: a national regulator may exempt the subsidiary if it is satisfied that there is a group-level resolution strategy agreed between the EU group level resolution authority and the third country authority and that strategy for the subsidiary does not have an adverse effect on the financial stability of the Member State(s) where the EU parent and other group entities are established. This exemption, therefore, necessitates the cooperation of the relevant EU resolution authority, although it does not make clear which authority ought to make the discretionary decision as to the effectiveness of the resolution strategy.

The Potential Ring-Fencing of Certain Trading Activities

23. National regulators appear to be given a significant degree of discretion in Chapter III. This does raise the issue of inconsistent approaches but the discretion conferred on regulators is not as wide as it initially appears. National regulators are required to assess the trading activities of CCIs. A wide definition of “trading activities” is given so that it essentially means all activities other than taking deposits eligible for deposit insurance, lending, retail payment services and a number of other retail and commercial banking activities. Trading in EU sovereign debt is
exempt from the obligation to review (and thus the power to separate) and the Commission has the same power as described in footnote 15 to adopt further secondary legislation to exempt trading in the sovereign debt of third countries. The regulators are directed to give specific attention to market-making (as it is closely related to proprietary trading), investing and sponsoring securitisations and trading in derivatives other than those that are specifically permitted for the purpose of prudent risk management (as the Commission believes that these latter activities played a key role during the financial crisis).

24. The national regulator must carry out its assessment of individual CCIs at least yearly and must use prescribed metrics when doing so. These metrics are:

(a) relative size and leverage of trading assets;
(b) relative levels of counterparty credit risk and market risk;
(c) relative complexity of trading derivatives;
(d) relative profitability of trading income;
(e) interconnectedness; and
(f) credit and liquidity risk arising from commitments and guarantees provided by the CCI.

The EBA will draft secondary legislation specifying how the metrics should be measured, giving further detail of the metrics and setting out a methodology for consistent measurement and application of the metrics. The Commission will also specify a limit for each metric above which the risk level of the relevant trading activity is deemed “individually significant” and set out the conditions which will trigger the exercise of the national regulator’s power to separate. Finally, the Commission will also draft legislation specifying certain types of securitisations which are not considered a threat to the financial stability of the CCI or the EU as a whole. It is, therefore, important that the proposal contains metrics which accurately measure the risks associated with trading activities and also takes into account risk mitigation techniques. The proposal does not, however, currently have regard to risk mitigation techniques such as netting, offsetting, diversification and portfolio compression nor prudent risk management and hedging techniques. It is also important that the Commission sets the limits and conditions at the correct level as these will determine the application of ring-fencing.

25. When the national regulator has carried out its assessment and concludes that the limits and conditions set out in the secondary legislation have been surpassed, a threat to the financial stability of the CCI or the financial system of the EU is deemed to exist and the regulator must commence the process whereby the CCI would be prohibited from carrying out the trading activities in respect of which the limits and conditions have been exceeded. Indeed, even where the limits and conditions are not exceeded, the national regulator may commence to consider such a prohibition if its assessment leads it to conclude that any trading activity, save trading in those derivatives that are specifically permitted for the purpose of prudent risk management, poses the threat outlined above. The regulator must consult with the EBA and communicate its conclusions to the relevant CCI, which is given two months to comment. Unless the CCI demonstrates that the conclusions are not justified, the national regulator shall prohibit the CCI from carrying out the specified trading activities.

26. The drafting of the provisions gives the national regulators little discretion to do other than make a decision to ring-fence the relevant trading activities away from the CCI when the limits and conditions set out in the secondary legislation are surpassed. The regulators do,
however, appear to have considerable discretion as to whether they are satisfied by the representations of the CCI concerned. This could lead to further inconsistencies of approach across different jurisdictions and even across banking groups. Once a decision to ring-fence any trading activity has been made by a national regulator, however, further provisions are triggered which mean that any CCI which has been subject to a ring-fencing decision, regardless of which or how many trading activities are ring-fenced or the extent to which the limits and conditions have been exceeded, can only use or sell derivatives to manage its own risk or to provide risk management services to customers as set out in the proposal. These provisions seem to render a national regulator’s decision to ring-fence only certain trading activities nugatory.

27. The proposal provides that a CCI that has been subject to a ring-fencing decision by a national regulator may use only credit, FX and interest rate derivatives which are eligible for clearing to hedge its overall balance sheet risk. This seems to link the derivatives that a ring-fenced CCI can use or sell to ESMA’s decision under EMIR on which class of derivatives are subject to the clearing obligation. Given that ESMA’s decision cannot be anticipated and that it is not clear that the clearing obligation will apply to any FX derivatives, this cross-reference appears peculiar. The CCI must also demonstrate to the national regulator that such hedging demonstrably reduces or significantly mitigates specific identifiable risks of its individual or aggregated positions. This wording mirrors the wording found in the Volcker rule and does not per se prohibit portfolio hedging.

28. A CCI that has been subject to a ring-fencing decision is permitted to use a slightly wider range of derivatives when selling them to clients for their risk management purposes. It can use credit, FX, interest rate and commodities (including emissions allowances) derivatives (but again only those eligible for clearing) provided that the sole purpose of the sale is to hedge credit, FX, interest rate or commodity risk and subject to caps on the resulting position risk which the Commission will set out in further secondary legislation. There are also restrictions on the range of types of ‘real economy’ clients that could benefit from such risk management services.

29. The intention behind these provisions is not entirely clear but the drafting provides that using derivatives for their own risk management purposes and selling derivatives to clients for their risk management purposes are the only trading activities that can be carried out by a CCI subject to a ring-fencing decision. Article 11(1) provides that “A core credit institution that has been subject to a [ring-fencing] decision... may carry out trading activities to the extent that the purpose is limited to only prudently managing its capital, liquidity and funding.” The following article, which provides for the provision of risk management services to clients, is arguably inconsistent with the word “only” in Article 11(1) but it does appear that CCIs which have been subject to a ring-fencing decision cannot engage in any other trading activities save those specifically set out in Articles 11 and 12. For the avoidance of doubt, this would mean that those CCIs could not engage in market-making, underwriting, securitisation activities and trading in derivatives other than those set out in Articles 11 and 12 of the proposal. As a result, irrespective of the decision taken by the national regulator who may decide to separate only certain trading activities, the effect of Article 11(1) is to prevent the CCI subject to the ring-fencing decision from carrying out any trading activity other than the use of certain derivatives for the specified risk management purposes. This restriction is consistent with the UK approach to ring-fencing, which prohibits the RFB from
dealing in investments as principal which means that it cannot engage in market-making, underwriting and most of the derivative and trading activity currently being carried out by wholesale and investment banks.

30. The synergies with the UK legislation become even more apparent when consideration is given to the UK draft legislation published for consultation in July 2013 that permits RFBs to deal in derivatives to hedge their own balance sheet risks and to sell simple derivatives as risk management products to customers subject to safeguards. It ought to be noted, however, that the UK draft legislation includes additional exemptions from the excluded activity of dealing in investments as principal: these permit own asset securitisation and acquiring and selling shares in companies through debt-equity swaps. The EU draft legislation does not currently go so far.

31. France and Germany have not taken the same approach as the UK, however, but have focussed more specifically on prohibiting their RFBs from proprietary trading, trading for their own accounts in certain circumstances and lending to certain AIFs. The German law also provides for a number of exceptions, including hedging and market making.

Rules on Ring-Fencing

32. Unlike the Volcker-style prohibition, the effect of a ring-fencing decision does not prevent the trading activities that have been separated being carried out elsewhere in the banking group. Under the EU proposal, the separated trading activities may be carried out by a trading entity which is legally, economically and operationally separate from the CCI. The proposal contains provisions to achieve this level of separation including the following:

(a) a group which contains CCIs and trading entities shall be structured so that on a sub-consolidated basis two distinct sub-groups are created, only one of which contains CCIs;
(b) CCIs may only hold capital instruments or voting rights in a trading entity in prescribed circumstances and with the consent of the national regulator;
(c) CCIs and trading entities shall issue their own debt, provided this is consistent with the group’s resolution strategy;
(d) contracts between CCIs and trading entities shall be agreed on a third party basis;
(e) requirements regarding members of the management bodies of both types of entities;
(f) the names of CCIs and trading entities shall make clear whether they are CCIs or trading entities;
(g) limits on the intra-group exposure a CCI has to any entity outside its sub-group; and
(h) limits on the extra-group exposure a CCI can have to financial entities.

The proposal also provides that the trading entity may not carry out certain activities, those being taking deposits eligible for protection under deposit guarantee schemes and providing retail payment services as defined in the Payment Services Directive. It appears that, if an EU branch of a non-EU banking group is within the scope of the EU legislation, these provisions are intended to apply to the non-EU banking group.

33. When a CCI has been subject to a ring-fencing decision, or an entity has decided to separate trading activities on its own initiative, it or its EU parent must submit a separation plan to the national regulator within six months of the ring-fencing decision or at the start of the national regulator’s assessment period. The national regulator has six months to approve
the plan or require changes to be made. If a separation plan is not submitted, the national regulator shall adopt its own plan.

34. When consideration is given to the existing EU domestic legislation, the UK requirements on ring-fencing are most consistent with these provisions. The Banking Reform Act 2013 is a framework piece of legislation which sets out the key political choices which will give effect to Vickers but much of the technical detail will be found in subsequent secondary legislation and regulatory rules. Thus the Act requires the PRA to make rules governing the degree of separation between the RFB and the rest of the group, including rules to limit the shares and voting powers a RFB may have in another company, to ensure independence of decision-making in the RFB, to ensure the RFB does not rely on the provision of capital and liquidity resources of other members of the group, to restrict payments the RFB may make to other group members and to enter contracts with other members of the group on an arm’s length basis. In addition, the UK government has published draft legislation which prohibits RFBs having exposures to certain financial institutions.

Derogations from the Ring-Fencing Provisions

35. The EU proposal provides for the possibility of the Commission granting a derogation from the ring-fencing provisions at the request of a Member State which had in place on 29 January 2014 primary legislation which fulfils the criteria set out on the proposal. This means that only the UK, France and Germany would qualify for the derogation as they are the only EU Member States which have already adopted legislation. The Belgian coalition government has, however, committed to finalising its legislation on bank structural reform before the elections in May 2014 and other Member States may want an opportunity to introduce their own legislation. The Commission’s choice of cut-off date may, therefore, be challenged.

36. The EU proposal provides that, in order to qualify for a derogation, the aim of the domestic legislation, its material scope and provisions referring to the legal, economic and governance separation of deposit-taking entities must have an equivalent effect to the provisions of the draft EU legislation. For reasons set out above, it appears that the UK legislation is most likely to satisfy these requirements but, also as pointed out above, not all of the UK’s draft secondary legislation is consistent with the EU provisions. In addition to the exemptions mentioned at paragraph 30 above which permit RFBs to engage in their own asset securitisation and to acquire and sell shares in companies through debt-equity swaps, the UK’s draft legislation also provides for a de minimis threshold below which institutions will be exempted from ring-fencing and exemptions which will permit the deposits of larger organisations and high net worth individuals to be held outside the ring-fence. It is not clear whether these exemptions would prevent the UK’s legislation meeting the criteria necessary for a derogation. There is thus a risk that the UK will have to change its draft secondary legislation if it wishes to benefit from the derogation.

37. Even within France and Germany, it is considered that the French and German domestic legislation is less likely than the UK’s legislation to qualify for the derogation as the scope of the French and German ring-fencing provisions is less extensive than the EU proposal. The French banking market is already expressing concern at the possibility that UK banks may be the only banks which benefit from a derogation.

38. There are two other points of controversy as regards the derogation. First, it appears the intention of the Commission that, despite the fact that a Member State must apply for it, any
derogation should be granted on an individual deposit-taking bank basis, not on a jurisdictional basis. Article 21(1) provides that a derogation may be granted “to a credit institution taking deposits from individuals and SMEs that are subject to national primary legislation adopted before 29 January 2014 when the national legislation complies with the” requirements set out within the Article.

Article 21(2) envisages a derogation being withdrawn from a bank after the Commission has decided that the national legislation is not incompatible because that legislation no longer applies to a particular credit institution. Taking the UK’s legislation as an example and supposing that the exemptions referred to in the above paragraph are maintained, it is not clear whether a deposit-taking bank which takes advantage of the proposed de minimis exemption, for example, would be regarded as “subject to national primary legislation” so as to qualify for the derogation. It would be argued, of course, that such a bank is subject to the Banking Reform Act and is merely relying upon an exemption granted in accordance with it but, if that argument is valid, it is not clear why it would be necessary for derogations to be granted on an individual bank basis and not to all banks within a jurisdiction which has adopted national legislation having equivalent effect: the provision for a derogation on an individual bank basis presupposes that different decisions can be reached in respect of different banks within the same jurisdiction. Subsequent drafting does suggest that a Member State can apply for derogations in respect of a number of deposit-taking banks at the same time and that one single derogation would be granted. Further, if domestic legislation is to be regarded as equivalent to the EU legislation, it would seem inconsistent for a decision to be reached that it is only equivalent for certain banks but the drafting and intent requires clarification to ensure certainty.

39. The second point of controversy is that the draft EU legislation gives the Commission a discretion to decide whether or not to grant the derogation. It is for the Commission to decide whether the domestic legislation is compatible with the EU legislation and it also appears that the Commission is required to consider the potential impact of a derogation on the financial stability of the EU and the functioning of the internal market. Conferring such a discretion on the Commission will raise political and legal questions concerning whether and how the Commission can be given such a power.

40. The effect of the provision on derogations is that an EU cross-border banking group with a number of CCIs in different Member States (or potentially a number of CCIs in the same Member State) could obtain a derogation for some of those CCIs but could still be required to develop a separation plan that applies across its group if a derogation is not granted to all its CCIs.

What Happens Next?

41. The proposal must be adopted by the European Parliament and Council under the ordinary legislative procedure. Under this procedure, the Council and the Parliament are placed on an equal footing as the co-legislature. Both institutions will consider the Commission’s proposed text and reach an internal agreement as to a version that they can accept. Once they have reached this agreement, they and the Commission enter a process known as trialogues in an attempt to reach an agreed text for adoption as legislation. The agreed text must be adopted by a qualified majority of the Council and a simple majority of the Parliament.
42. The process for adopting EU legislation is thus both complex and lengthy. France, Germany and Italy have already made clear their objection to the proposal as a whole and the UK is likely to be concerned both at the Volcker-style prohibition it contains and the process necessary to obtain a derogation from the ring-fencing provisions. Given these concerns, significant amendments to the proposal, in Council at least, are to be expected. It is less clear how the new Parliament will view the proposal.

43. Agreement on a final version of the legislation is not expected before June 2015 and, on this basis, the Commission’s proposed timetable would see the prohibition on proprietary trading applying from 1 January 2017 and the provisions on separation of the trading activity applying from 1 July 2018. This timetable is not dissimilar to that which is expected to apply in the UK but is significantly behind the Volcker timetable: the Volcker conformance period ends on 21 July 2015 and banking entities must make good faith efforts to be in compliance by that date.

44. When considering the operational changes required by Volcker, Vickers, the French law on the separation and regulation of banking activities and the Trennungsgesetz, it would be prudent to bear in mind the likelihood of additional EU requirements, although there is as yet no certainty as to exactly what those requirements may be. In addition, banks which expect to be within the scope of the EU’s proposal should commence lobbying their own governments, the Commission and, after elections, the new European Parliament if, as appears likely, they are concerned by the EU proposal.

45. As currently drafted, the EU proposal is not consistent with any of the existing domestic legislation on bank structural reform, in the EU or in the US. The possibility of duplicative and conflicting requirements will be a concern for banks which are active cross-border as it raises the question whether a single banking model can be designed that complies with the legislative requirements in all relevant jurisdictions. If a single model is not possible, the cost of banking, and thus bank lending, could be increased and this will impact on the real economy and EU’s economic recovery. The EU’s legislative proposal could, therefore, adversely affect the very people who it is designed to protect. It is also hard to see how the EU’s proposal addresses the problem that the Commission itself identified of inconsistent national legislation. The EU legislation could itself increase the possibility of distortions of capital movements and investment decisions, make the structure and operation of cross-border banks more complex and increase fragmentation. In these circumstances, the necessity for this legislation may well be questioned: is EU legislation for bank structural reform necessary and proportionate in addition to banking union, CRD IV, the soon-to-be-adopted bank recovery and resolution directive and the domestic legislation already in place?

Endnotes
5 French law no. 2013-672 of 26 July 2013 on the separation and regulation of banking activities.
6 Trennungsgesetz (German Bank Separation Law) which is included in Article 2 of the Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen (Law concerning Separation of Risks and Restructuring and Winding-Up of Credit Institutions and Financial Groups), BGBl. 2013 I Nr. 47, 3090. The law was announced on 7 August 2013 and
Article 2 entered into force on 31 January 2014, although most of the rules in Article 2 are not applicable until 1 July 2015.

7 The text is not yet available but was approved in second reading on 14 February 2014 by the Belgian Federal Government.

8 See here http://www.mayerbrown.com/files/Publication/f95121f8-0c01-40f8-b14b-46379c2b118d/Presentation/PublicationAttachment/ddaf0395-d75d-4456-b143-6a026db6be71/Final-Regulation-Implementing-the-Volcker-Rule.pdf.

9 See here http://www.mayerbrown.com/files/Publication/b2ff45c7-4252-4bb4-8bc0-899c2914b6a8/Presentation/PublicationAttachment/9b7da3f6-47a6-4da5-8dfb-057f0893a0f/UPDATE-VolckerRule-Application_131219.pdf.

10 Dealing in investments as principal includes buying, selling, subscribing for or underwriting securities or contractually based investments.

11 As a strict matter of law, a branch does not have a legal identity separate to its parent but, although the drafting is not wholly clear, it does not appear to be the intention that branch assets are consolidated with those of its parent.

12 The Fourth Capital Requirement Directive which consists of a directive (2013/36/EU) and a regulation (575/2013).


14 Case C-209/13 United Kingdom of Great Britain and Northern Ireland v Council of the European Union.

15 The Commission may adopt further secondary legislation to exempt trading in the sovereign debt of third countries which have equivalent supervisory and regulatory requirements, exposures to which have 0% risk weighting under the Capital Requirements Regulation.

16 The drafting of Chapter III is currently ambiguous. Whereas the majority of Articles in Chapter III (for example, Articles 10(2), 10 (3), 11 and 12) refer to the subject of a ring-fencing decision being the EU core credit institution, Article 9(1) currently mandates the national regulator to assess the trading activities of a far wider group of entities, including the EU parent and all branches and subsidiaries in a group which contains a core credit institution, as well as EU branches of all credit institutions established in third countries.

17 Directive 94/19/EC.

18 There is no requirement for the branch or the non-EU bank to fall within the definition of a CCI. Thus it appears that EU branches of a non-EU bank may be within the scope of this provision when they would not be (because they would not fall within the definition of a CCI) if they were established in the EU as a subsidiary.

19 Although the ECB will assume its full supervisory tasks from 4 November 2014 and would thus be the relevant prudential regulator for the purposes of this proposal, national regulators will be responsible for the direct supervision of “less significant” banks and will assist the ECB in the ongoing day-to-day supervision of “significant supervised” banks. As a result, the possibility of inconsistent national approaches must remain.

20 The Commission may adopt secondary legislation adding to these classes of derivatives, including those that are not cleared.

21 Directive 2007/64/EC.

22 The draft Order provides that banks whose ‘core deposits’ do not exceed £25 billion will not be RFBs. It also provides that deposits of high net worth individuals who have chosen to deposit outside the ring-fence, deposits of large organisations and deposits of other financial institutions are not core deposits.
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