DechertOnPoint

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A legal update from Dechert's Financial Services and Financial Institutions Groups

Federal Reserve Board's Enhanced Supervision Standards Could Raise Significant Issues for Money Fund Sponsors

The Federal Reserve Board ("FRB") recently proposed rules to establish certain enhanced prudential standards under the Dodd-Frank Act for bank holding companies ("BHCs") with $50 billion or more of assets ("Large BHCs") and nonbank financial companies that are designated as systemically important financial institutions ("SIFIs") (collectively, "Covered Companies"). Perhaps the most significant of these proposed rules is a set of limitations on counterparty credit exposure. Under the proposed rule, the credit exposure of a fund or other investment vehicle ("Fund") generally would not be attributed to its sponsor or advisor. However, the FRB, noting the support that sponsors of money funds provided to their sponsored money funds during the financial crisis, has raised the possibility that the final rule could be modified to require the aggregation of the credit exposure of a Fund with that of its sponsor or advisor. Such aggregation could have significant consequences in regard to both the calculation of credit exposure and the management of compliance with such limitations. It also could impact a determination by the Financial Stability Oversight Council ("FSOC") whether to consider the Funds that are sponsored or advised by a company when evaluating whether that company should be reviewed or ultimately designated as a SIFI. Parties that could be affected should consider filing comments. The comment deadline is March 31, 2012.

Proposed Rule

The proposed credit exposure limits are intended to reduce interconnectedness among large financial institutions and thereby reduce the risk of financial contagion. A Covered Company and its subsidiaries' aggregate net credit exposure to any unaffiliated company and such company's subsidiaries (collectively, a "Counterparty") would not be permitted to exceed an amount equal to 25% of the Covered Company's capital stock and surplus. However, when a Covered Company and its Counterparty were both either a BHC with $500 billion or more of total consolidated assets or a SIFI of any size, the aggregate net credit exposure limit would be reduced to 10% of the Covered Company's capital stock and surplus.

Rule of Attribution

A critical question regarding these limits is when to treat two or more related entities as being part of a single Covered Company or Counterparty. Under the proposed rule, a company would be combined with (i) any entity of which it owns, controls or holds with the power to vote 25% or more of a class of voting securities or owns or controls 25% or more of the total equity or (ii) any entity that it consolidates for financial reporting purposes. This test *differs* from the standard definition of control found in the Bank Holding Company Act ("BHCA") and the FRB's Regulation Y (i) by not including the "controlling influence" standard of Regulation Y, a flexible standard that has created some vexing issues in bank recapitalization transactions, and (ii) by including a consolidation test. The FRB has stated that "a simpler, more objective definition of control is more consistent with the objectives of single-counterparty credit limits."

Under the proposal, a company would not be deemed to control a Fund that it sponsors or advises unless it owns or controls 25% or more of the voting securities or total equity of the Fund, or

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includes the Fund in its consolidated financial statements. Accordingly, unless either control test was met, the credit exposure of a Fund to a Counterparty would not be aggregated with the credit exposure of its sponsor or advisor to the same Counterparty. Similarly, the credit exposure of a Covered Company to a Fund would not be aggregated with the credit exposure of the Covered Company to the Fund's sponsor or advisor unless the sponsor or advisor controlled the Fund under the tests described above.

Support Given to Money Funds and the Rule of Attribution

The FRB has observed in the proposal that the general rule of non-attribution may be at odds with the support that many money funds received from their sponsors during the recent financial crisis to enable those money funds to meet investor redemption requests without selling assets in fragile and illiquid markets. The FRB further stated that, in view of the strong incentives a Covered Company may have to provide support in times of distress to money funds and certain other Funds it sponsors or advises, the FRB is seeking comment on whether such Funds should be considered part of a Covered Company for purposes of the counterparty credit limits. Specifically, the proposal asks whether the definition of "subsidiary" in the proposed rule should be expanded to include any investment fund or vehicle advised or sponsored by a Covered Company or any other entity.

Such an approach could significantly increase a Covered Company's credit exposure to a Counterparty, notwithstanding that the attribution would be based on relationships that are not maintained for the benefit of the Covered Company, but rather are entered into on behalf of and for the benefit of investors in a Fund sponsored or advised by the Covered Company.

It is important to note that under the proposed rule, a broad range of transactions would be treated as credit exposures, including (i) loans by a Covered Company to a Counterparty, (ii) debt and equity securities held by a Covered Company that are issued by a Counterparty, (iii) repurchase and reverse repurchase agreements, (iv) securities borrowing and lending transactions, (v) committed credit lines extended by a Covered Company to a Counterparty, (vi) guarantees and letters of credit issued by a Covered Company on behalf of a Counterparty, and (vii) certain derivative transactions.

Moreover, a Covered Company would be required to treat a transaction with a third party as a credit exposure to a Counterparty to the extent the proceeds of the transaction were used for the benefit of, or transferred to, the Counterparty.

Potential Collateral Implications

A decision by the FRB to treat a Fund sponsored or advised by a Covered Company as part of the Covered Company could have other significant collateral consequences. For example, the argument used by the FRB in this context might also be used by the FSOC to support the inclusion of sponsored or advised Funds with a nonbank financial company for purpose of evaluating whether the company should be designated as a SIFI. See our October 2011 *DechertOnPoint* "FSOC Issues New Proposed SIFI Designation Rule."

It should also be noted that the FRB, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission all have indicated in the preambles to their proposed rules implementing the Volcker Rule that an entity such as a mutual fund would generally ***not*** be treated as a subsidiary or affiliate of a banking entity if the banking entity only provides advisory or administrative services, has certain limited investments, or organizes, sponsors or manages the mutual fund in accordance with the BHCA. See our October 2011 *DechertOnpoint*, "Volcker Rule Regulations Proposed."

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