Client Alert.

March 31, 2011

Dodd-Frank Act Rulemaking Update: Proposal for Living Wills and Credit Exposure Reports

On March 29, 2011, the Federal Deposit Insurance Corporation ("FDIC") approved a proposed rule, jointly written with the Federal Reserve Board of Governors ("FRB"),[1] concerning resolution plans and credit exposure reports (the "Proposed Rule"). The Proposed Rule marks the first of several rulemakings that are necessary to implement Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2] Section 165 requires enhanced supervision and prudential standards for (a) U.S. and foreign nonbank financial companies designated under Section 113 of the Dodd-Frank Act as systemically important and (b) bank holding companies and "foreign-based bank holding companies" with total consolidated assets of $50 billion or greater (collectively, "Covered Companies").[3]

This alert provides an overview of the Proposed Rule and a preview of what might be expected of the estimated 124 Covered Companies that would be required to comply with the Proposed Rule.[4]

Before we turn to the details of the Proposed Rule, we urge each Covered Company to prepare promptly, at a high level, a two-pronged response:

1. ***Comments to the FDIC and the FRB (the "Agencies").*** The Agencies have created a new paradigm for Covered Companies—one that effectively requires a Covered Company to develop a strategy to mitigate the risk that its failure would have on U.S. financial stability. Baseline formats for the resolution plans may already be available, including, for example, a Plan of Liquidation required for institutional debtors in bankruptcy proceedings or various other bankruptcy documents that address the Agencies' specific requirements (as described below). However, no matter what format is ultimately employed, assembling a resolution plan will be an extraordinarily ambitious undertaking, requiring detailed input from virtually every business unit.

   Covered Companies will soon have a 60 day opportunity to comment on and help shape this new paradigm. Specifically, the Agencies have requested comment on certain fundamental and key questions, including key definitions, the structure of the plan, and the rule's application to foreign-based organizations.

   THE AGENCIES HAVE CREATED A NEW PARADIGM FOR COVERED COMPANIES—ONE THAT EFFECTIVELY REQUIRES A COVERED COMPANY TO DEVELOP A STRATEGY TO MITIGATE THE RISK THAT ITS FAILURE WOULD HAVE ON U.S. FINANCIAL STABILITY.

2. ***Compliance.*** Even assuming the Agencies are entirely receptive to comments from the Covered Companies, a final rule on resolution plans will be issued no later than January 21, 2012, which means the first resolution plans could be required as early as July 2012 (see discussion on timing below). These plans will be unavoidably complex—possibly along the lines of what was required for institutions participating in the Basel II advanced approach—and every Covered Company should begin to build a structure and process for preparation of a plan. At a minimum, a Covered Company should appoint one or more senior executives with authority to manage the process and assign resources to complete the task.

OVERVIEW OF THE PROPOSED RULE

The Proposed Rule would require each Covered Company to submit periodically to the Agencies two separate reports: a Resolution Plan and a Credit Exposure Report. The Resolution Plan is a detailed plan for the rapid and orderly resolution of the Covered Company under the Bankruptcy Code, or other applicable insolvency regime, in the event of material financial distress or failure.[5] The FDIC has noted that extensive pre-planning is essential for the effective use of its powers under Title II of the Dodd-Frank Act, and that a well-developed Resolution Plan is critical for a rapid and orderly resolution.[6]

EVERY COVERED COMPANY SHOULD BEGIN TO BUILD A STRUCTURE AND PROCESS FOR PREPARATION OF A PLAN.

The Credit Exposure Report is a report on the nature and extent to which the Covered Company has credit exposure to significant nonbank financial companies and significant bank holding companies, as defined by the FRB (collectively, "Significant Companies"),[7] and vice versa. The FRB has long sought better measures of counterparty credit exposures to identify potential channels of financial contagion and systemic risk.[8]

For both Resolution Plans and Credit Exposure Reports, the Proposed Rule would require a U.S.-based Covered Company to provide information concerning its U.S. and foreign operations. The Proposed Rule would require a foreign-based Covered Company to provide information regarding its U.S. operations, an explanation of how resolution planning for its U.S. operations is integrated into the foreign-based Covered Company's overall contingency planning process, and information regarding the interconnections and interdependencies among its U.S. and foreign-based operations.

The Proposed Rule would require that each Covered Company submit a Resolution Plan within 180 days of the effective date of a final rule (or within 180 days after the company becomes a Covered Company), and annually thereafter. A Covered Company would also be required to file an updated Resolution Plan within 45 days after any "material change," which is broadly defined in the Proposed Rule.[9] A Covered Company would be required to submit a Credit Exposure Report no later than 30 days after the end of each calendar quarter; however, the Proposed Rule does not provide a deadline for the initial Credit Exposure Report.

A Covered Company's board of directors would be required to approve the initial and each annual Resolution Plan. A delegee of the board of directors may approve updates to a Resolution Plan (i.e., a Resolution Plan update required because of a material change).[10] The Proposed Rule would not require board of directors' approval for Credit Exposure Reports.

CONTENTS OF A RESOLUTION PLAN

Under the Proposed Rule, a Resolution Plan would include seven parts:

1. ***Executive Summary –*** The first part of a plan would summarize the key elements of the Covered Company's strategic plan, any material changes from the most recent filing, and any actions taken by the Covered Company to improve the effectiveness of the Resolution Plan or address any material weaknesses of the plan.

2. ***Strategic Analysis –*** The strategic analysis would describe how, in practice, the Covered Company would be resolved under the Bankruptcy Code. This analysis would include (a) an identification of baseline assumptions; (b) a plan to utilize resources (e.g., funding, liquidity, and capital resources, as well as support functions) to facilitate an orderly resolution of "material entities," "core business lines," and "critical operations," as these terms are defined in the Proposed Rule, under different stress scenarios; (c) a strategy to ensure that any insured

depository institution subsidiary would be adequately protected from risks arising out of nonbank subsidiaries; and (d) a plan demonstrating how core business lines and critical operations could be resolved and how the Covered Company could be transferred to potential acquirers.

3. ***Description of Corporate Governance Structure for Resolution Planning –*** This portion of the plan would describe the integration of resolution planning into the Covered Company's corporate governance structure and would identify the senior management official(s) primarily responsible for overseeing compliance with the rule.

4. ***Description of Overall Organization Structure –*** The organizational description would include (a) a hierarchical list of all material entities, as well as jurisdictional and ownership information and a mapping to core business lines and critical operations; (b) an unconsolidated balance sheet and a consolidating schedule for all entities that are subject to consolidation; (c) information regarding material assets, liabilities, derivatives, hedges, capital and funding sources, and major counterparties; (d) an analysis of the potential effects of the bankruptcy of a major counterparty; and (e) material trading, payment, clearing, and settlement systems utilized by the Covered Company.

5. ***Description of Management Information Systems –*** The plan would describe the management information systems that support a Covered Company's core business lines and critical operations. This part of the plan would include information on legal ownership, intellectual property rights, and a plan for continued availability of systems that support core business lines and critical operations.

6. ***Description of Interconnections and Interdependencies –*** This description would identify interconnections and interdependencies (a) among the Covered Company and its material entities and affiliates and (b) among the Covered Company's critical operations and core business lines. The plan also would describe how the Covered Company would ensure continued availability and sustained service levels during material financial distress or insolvency.

7. ***Identification of Supervisory Authorities and Regulators –*** Finally, the Resolution Plan would identify the Covered Company's supervisory authorities and regulators, including information concerning the foreign supervision of material foreign-based subsidiaries or operations. The Resolution Plan would also describe a plan to continue processes and systems to collect, maintain, and report the information and other data underlying the Resolution Plan.

AGENCIES ARE THINKING BROADLY ABOUT RAPID AND ORDERLY RESOLUTION; THUS, COVERED COMPANIES WILL HAVE TO ADDRESS HOW MATERIAL DISTRESS OR FAILURE WOULD AFFECT MOST ASPECTS OF THEIR BUSINESS

CONTENTS OF A CREDIT EXPOSURE REPORT

Under the Proposed Rule, each Covered Company would be required to submit a quarterly Credit Exposure Report that sets forth the nature and extent of its credit exposure to each Significant Company *and* the nature and extent of each of those company's credit exposures to the Covered Company. The Proposed Rule would require each Covered Company to report exposures associated with

- Extensions of credit, including loans, leases, and funded lines of credit, as well as intra-day credit;
- Committed but undrawn lines of credit;
- Deposits and money placements;

- Repurchase agreements, reverse repurchase agreements, securities borrowing transactions, and securities lending transactions (each, on a gross and net basis);
- Guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit);
- Purchases of or investments in securities issued by Significant Companies;
- All counterparty credit exposure (on a gross and net basis) in connection with a derivative transaction; and
- Any other transactions that result in credit exposure that the FRB determines to be appropriate.

The Proposed Rule would also require a description of the systems and processes that the Covered Company uses to (a) collect and aggregate the data underlying the Credit Exposure Report and (b) produce and file the Credit Exposure Report.

In the Supplementary Information to the Proposed Rule, the Agencies acknowledge that there are several other Dodd-Frank Act related initiatives concerning counterparty credit exposure limits and stress testing. The Agencies commit to coordinating and harmonizing, to the extent possible, the reports required by all of these credit exposure initiatives, including those required by the Proposed Rule, to minimize redundant data collections and maximize data quality.

Covered Companies should view the comment period on the Proposed Rule as an opportunity to shape the discussion about how the elements of the Credit Exposure Reports could be covered by such other initiatives.

AGENCY REVIEW OF THE RESOLUTION PLANS

Under the Proposed Rule, the Agencies would initially review a Resolution Plan to determine whether it appears to be "informationally complete," and therefore accepted for further review, within 60 calendar days of receipt. If, however, the Agencies determine that a Resolution Plan is "informationally incomplete," the Agencies would jointly inform the Covered Company in writing concerning the additional information required. The Covered Company would generally be required to resubmit an informationally complete Resolution Plan, or the necessary supplemental information, within 30 days after receiving written notice.

After a Resolution Plan is accepted for further review, the Agencies would review the plan for its compliance with the requirements of the Proposed Rule. If, based on this review, the Agencies determine that the Resolution Plan is not credible or would not facilitate an orderly resolution, the Agencies would notify the Covered Company in writing, specifically identifying the deficiencies.

THESE TASKS WILL NECESSARILY REQUIRE EXPERTISE IN THE BANKRUPTCY CODE AND BANKRUPTCY PROCESS, AS WELL AS A DEEP UNDERSTANDING OF OTHER RESOLUTION REGIMES, INCLUDING THE ORDERLY LIQUIDATION AUTHORITY UNDER TITLE II

Generally, within 90 days of receiving a notice of deficiencies, a Covered Company would be required to submit a revised Resolution Plan. The Proposed Rule would require that revised Resolution Plan include a detailed discussion of (a) the revisions that address the identified deficiencies; (b) any planned changes to the Covered Company's business operations and corporate structure to facilitate implementation of the revised Resolution Plan, along with a timeline for the planned changes; and (c) why the Covered Company believes that the revised Resolution Plan is credible and would result in an orderly resolution.

If the Covered Company fails to submit a revised Resolution Plan that adequately addresses the identified deficiencies, the Agencies may jointly subject the Covered Company or any of its subsidiaries to more stringent capital, leverage, or liquidity requirements, or restrictions on growth, activities, or operations. Moreover, if, within two years of the imposition of

the more stringent requirements, the Covered Company fails to submit a revised Resolution Plan that adequately addresses the identified deficiencies, the Agencies may issue an order directing the Covered Company to divest certain assets or operations that the Agencies determine are necessary to facilitate an orderly resolution. Before issuing any such order, the Agencies must consult with each member of the Financial Stability Oversight Council that has primary supervisory authority for any subsidiary of the Covered Company, as well as any other supervisor, including foreign supervisors, that the FRB considers appropriate.

OTHER PROVISIONS OF THE PROPOSED RULE

A few last points for the sake of completeness: First, the Proposed Rule would be non-binding (e.g., in a bankruptcy proceeding or in a liquidation under Title II of the Dodd-Frank Act). Second, the Proposed Rule does not provide for a private right of action based on a Resolution Plan. Third, the Agencies would be jointly authorized to enforce the Proposed Rule, under jointly issued orders. Fourth, the Proposed Rule would provide for the confidential treatment of Resolution Plans and Credit Exposure Reports for any Covered Company requesting such treatment, consistent with the Agencies' information disclosure and availability rules. Finally, it should be noted that the Proposed Rule provides the minimum informational content requirements: the Supplementary Information states that, in some cases, such minimum requirements may not be sufficient for large, complex companies.

WHAT THIS MEANS TO COVERED COMPANIES

Ultimately, preparation of the initial Resolution Plan, Credit Exposure Report, and their respective periodic updates result in a significant and burdensome reporting requirement. Covered Companies will need to develop a clear framework to convey the required information, a mechanism to keep the required information current (including, potentially a central planning function), and a strategy to address the Agencies' fundamental concern with orderly liquidation and preservation of U.S. financial stability. It should also be noted that the Proposed Rule represents minimum requirements, and the Supplementary Information notes that, in some cases, such minimum requirement may not be sufficient for large, complex companies.

These tasks will necessarily require expertise in the Bankruptcy Code and bankruptcy process, as well as a deep understanding of other domestic and non-U.S. resolution regimes, including the orderly liquidation authority under Title II of the Dodd-Frank Act.[11] It is clear from the Proposed Rule and the associated Supplementary Information that the Agencies are thinking broadly about rapid and orderly resolution; thus, Covered Companies will have to address how material distress or failure would affect most aspects of their business—from corporate governance to risk management to management information systems. Covered Companies will also have to think strategically about what information they provide to the Agencies, and how to protect themselves against public disclosure of sensitive and proprietary information within their report.

If you are following regulatory developments, you may be interested in FrankNDodd, Morrison & Foerster's online resource that tracks rulemaking pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act. FrankNDodd features a robust search function that allows users to quickly navigate to particular sections of the Act and to find links to related regulatory materials as well as relevant MoFo commentary. Email questions@frankndodd.com for your password. FrankNDodd is a registered trademark of Morrison & Foerster LLP.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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[1] We expect that the FRB will approve the Proposed Rule within a few days.
[2] The full text of the Proposed Rule is available at http://www.fdic.gov/news/board/29Marchno4.pdf.
[3] The Proposed Rule would define "foreign-based bank holding company" as any foreign bank or company that is a bank holding company or is treated as a bank holding company under section 8(a) of the International Banking Act of 1978 and that had $50 billion or more in total consolidated assets, as determined based on the foreign bank's or company's most recent annual or, as applicable, the average of the four most recent quarterly Form FR Y-7Q filings.
A U.S. bank holding company's total consolidated assets would be determined based on the average of the company's four most recent Form FR Y-9C filings.
[4] The FDIC and the FRB estimate that 124 Covered Companies would be subject to the Proposed Rule (i.e., would be required to submit Resolution Plans and Credit Exposure Reports). As of year-end 2010, there were 34 U.S. bank holding companies with total consolidated assets of $50 billion or greater. Therefore, the 124 Covered Companies will include approximately 90 foreign-based bank holding companies or U.S. or foreign nonbank financial companies designated for enhanced supervision by the FRB under Section 113 of the Dodd-Frank Act.
[5] The Proposed Rule defines "rapid and orderly resolution" as "a reorganization or liquidation of the Covered Company . . . under the Bankruptcy Code that can be accomplished within a reasonable period of time and in a manner that substantially mitigates the risk that the failure of the Covered Company would have serious adverse effects on financial stability in the United States."
[6] 75 Fed. Reg. 64173, 64176 (October 19, 2010).
[7] The FRB recently issued a proposed rule that would define significant nonbank financial company and significant bank holding companies. 76 Fed. Reg. 7731 (February 11, 2011).
[8] See, e.g., Regulatory restructuring: Testimony before the H. Comm. on Financial Services (July 24, 2009) (testimony of Ben Bernanke, Chairman, Board of Governors of the Federal Reserve) available at www.federalreserve.gov/newsevents/testimony/bernanke20090724a.htm.
[9] The Proposed Rule defines "material change" to include events such as a significant acquisition; a significant sale or divestiture; the bankruptcy or insolvency of a material entity; a material reorganization; the loss of a material servicing subsidiary or material servicing contract; and the unavailability or loss of a significant correspondent or counterparty, among a litany of other events.
[10] In the case of a foreign-based Covered Company, a delegee of the board of the directors of such organization may approve the initial Resolution Plan and any updates to a Resolution Plan.
[11] An analysis of the Title II orderly liquidation authority and the Bankruptcy Code is available at http://www.mofo.com/files/Uploads/Images/100831TitleII.pdf.