Toronto Seminar Series

Tuesday, April 12, 2016

10:00AM – 2:30PM EDT

The Fairmont Royal York
100 Front Street West
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1. Presentation: Bank Regulatory Developments
2. Presentation: A Derivatives Update
3. Presentation: A FinTech Discussion
U.S. Bank
Regulatory Developments

April 2016
Agenda

• During this segment, we will address
  • The proposed TLAC requirements in the United States,
  • Comments and concerns raised regarding the U.S. Federal Reserve Board’s proposal,
  • The countercyclical buffer,
  • The reproposed single counterparty limits, and
  • What’s next
Total Loss-Absorbing Capacity
Objective of TLAC

• Where does TLAC fit in?
  • For Basel purposes, a bank must satisfy the minimum regulatory capital requirements
  • In addition to the minimum regulatory capital requirements, banks are subject to the capital conservation buffer and any applicable counter-cyclical capital buffer
  • In addition to that, G-SIBs must have “buffer” capital or a G-SIB “surcharge”
  • Finally, G-SIBs must meet TLAC requirements
    • TLAC would be relied upon to provide additional loss absorbency and facilitate resolution
Where does TLAC fit in?
The Financial Stability Board Principles
A timeline

- Financial Stability Board Proposal for Comment was issued in November 2014
- Comment period closed in February 2015
- FSB conducted a quantitative impact study (QIS) in which it collected information from G-SIBs
- The final TLAC principles were released on November 9, 2015.
The FSB Principles—overview

• Designed to facilitate orderly resolution of G-SIBs
  • 30 banks globally
  • Includes 8 US banks
• Calibration of minimum TLAC from January 1, 2019 of 16% of risk weighted assets (RWAs) rising to 18% from January 1, 2022 and from January 1, 2019, 6% of the Basel III leverage ratio denominator and from January 1, 2022, rising to 6.75% of the Basel III leverage ratio denominator
  • Phased in requirements for GSIBs headquartered in emerging markets
  • Tier 1 and Tier 2 Capital is “eligible”
  • Other eligible TLAC that is not regulatory capital
• Additional TLAC may be required for individual G-SIBs based on risk factors
• Two elements: Risk-weighted TLAC ratio and a TLAC leverage ratio
Regulatory capital instruments

• TLAC and regulatory capital instruments
  • The sum of a G-SIB’s resolution entity’s (1) T1 and T2 regulatory capital instruments that are in the form of debt, plus (2) other eligible TLAC that is not regulatory capital, is equal to or greater than 33% of the G-SIB’s minimum TLAC requirement
  • Regulatory capital instruments may count toward minimum TLAC requirement, subject to certain conditions:
    • CET1 regulatory capital instruments used to satisfy minimum TLAC requirement cannot also be used to satisfy capital buffers
    • Non-CET1 regulatory capital instruments must be issued under the laws of a jurisdiction in which resolution tools, statutory write-down or conversion powers are effective
    • Non-CET1 regulatory capital instruments issued by subsidiaries of the resolution entity, that are located in a different jurisdiction from the resolution entity, must be capable of being written down or converted to equity at the point of non-viability of the subsidiary without the subsidiary having to enter into a resolution proceeding
Regulatory capital instruments (cont’d)

- Regulatory capital instruments issued from entities forming part of a material subgroup may count toward minimum TLAC only to the extent that home and host country authorities agree conversion to equity would not result in a change-of-control.
TLAC eligibility criteria

- TLAC Eligibility Criteria:
  - External TLAC must be issued and maintained by resolution entities (except, in some circumstances, regulatory capital issued by a wholly and directly-owned funding entity will be eligible)
  - Paid-in, unsecured, not subject to netting
  - Perpetual or minimum remaining contractual maturity of one year (for any security with a redemption feature, first redemption date would be effective maturity date; “maturing” instruments would need to be replaced with new TLAC-eligible instruments)
  - Subject to certain limited exceptions, not funded directly by the resolution entity or a related party of the resolution entity
  - Eligible TLAC must contain a contractual trigger or be subject to a statutory mechanism which permits the resolution authority to write down or convert to equity
  - Certain instruments are not considered TLAC eligible, such as the following: insured deposits, liabilities arising from derivatives or debt instruments with derivative-linked features—e.g., structured notes, and non-contractual liabilities
Internal TLAC

- Material sub-groups in jurisdictions outside of a bank’s home country must have “Internal TLAC”
  - Eligibility Criteria: criteria for internal TLAC and for external TLAC are the same
  - Minimum size of internal TLAC: each material sub-group must maintain internal TLAC of 75% to 90% of the external minimum TLAC that would apply to the material sub-group if it were a resolution group, as calculated by the host country. In addition to the minimum, the host country could impose a firm-specific requirement as well.
  - Internal TLAC should be pre-positioned on-balance sheet at the material sub-groups; internal TLAC that is not pre-positioned should be readily available
FRB Proposal
Single point of entry resolution

Source: Moody’s Investors Service, Federal Deposit Insurance Corporation
The FRB released its proposal on October 30, 2015 which would establish for covered BHCs and covered IHCs an external TLAC requirement in the case of covered BHCs (and an internal TLAC requirement in the case of covered IHCs), a related TLAC buffer, a minimum long-term debt requirement for covered BHCs (and a minimum internal long-term debt requirement for covered IHCs), and a “clean holding company” requirement.

Premised on the view that TLAC alone is not sufficient to facilitate SPOE resolution.

As a result, the FRB approach differs from the FSB approach.

In addition, to avoid contagion risk, the FRB proposal also would penalize banks generally for holding unsecured debt of a covered BHC.
FRB proposal (cont’d)

• U.S. covered BHCs must maintain:
  • Outstanding eligible external long-term debt equal to the greater of: (i) 6% of RWAs, plus the applicable G-SIB buffer, and (ii) 4.5% of total leverage exposure, plus
  • Outstanding eligible external TLAC equal to the greater of: (i) 18% of RWAs (when fully phased-in), and (ii) 9.5% of total leverage exposure
  • An external TLAC buffer
External long-term debt

• What is eligible external long-term debt?
  • Debt securities issued directly by the covered BHC that:
    • Are unsecured
    • Are “plain vanilla”
    • Are governed by U.S. law
    • Have a remaining maturity of over one year
  • *Eligible external long-term debt with a maturity of less than two years would be subject to a 50% haircut*

• What is “plain vanilla” debt?
  • The debt cannot contain an embedded derivative, have a credit sensitive feature, contain any contractual conversion or exchange features, or include acceleration rights, other than on payment defaults
  • No structured notes
External TLAC

• What is eligible external TLAC?
  • The sum of (1) common equity Tier 1 capital and AT1 capital issued by the covered BHC, and (2) eligible external LTD

• What is the amount of the external TLAC buffer?
  • An external TLAC buffer is added on top of the 18% risk-based capital component of the external TLAC requirement, which can be met only with common equity Tier 1 capital
    • Equals the sum of 2.5%, any applicable countercyclical capital buffer, and the G-SIB surcharge calculated under Method 1

• What is the consequence of failing to meet the external TLAC buffer requirement?
  • Restrictions on distributions and discretionary bonuses (similar to CCB)
IHCs of Foreign G-SIBs

• A covered IHC would be subject to an internal LTD and an internal TLAC requirement
• FBOs with consolidated global assets of $50 billion or more and consolidated U.S. assets of $10 billion or more must establish an IHC
• The following are G-SIBs with an IHC requirement (based on FSB’s 11/2015 G-SIB list):

  HSBC  Mizuho
  BNP    SocGen
  Mitsubishi  Santander
  Deutsche  UBS
  Barclays  Credit Suisse
  RBS
IHCs of Foreign G-SIBs (cont’d)

• What is the internal LTD requirement?
  • Internal LTD will at least equal the greater of (i) 7% of RWAs, (ii) for covered IHCs subject to the Supplementary Leverage Ratio, 3% of total leverage exposure, and (iii) 4% of average total consolidated assets

• What is the internal TLAC requirement?
  • The internal TLAC requirement depends on whether the foreign G-SIB parent of the covered IHC will undergo SPOE or Multiple Point of Entry (MPOE) resolution
    • For SPOE, IHC would be required to keep outstanding eligible internal TLAC at least equal to the greater of: (i) 16% of RWAs (when fully phased in), (ii) for covered IHCs subject to the SLR, 6% of total leverage exposure, and (iii) 8% of average total consolidated assets
    • For MPOE, IHC would be required to keep outstanding eligible internal TLAC at least equal to the greater of: (i) 18% of the RWAs (when fully phased in), (ii) for covered IHCs subject to the SLR, 6.75% of total leverage exposure, and (iii) 9% of average total consolidated assets
Eligible internal LTD

• What are the requirements for eligible internal LTD?
  • Same general requirements as those applicable to eligible external LTD
  • In addition, eligible internal LTD:
    • Is required to be held by foreign parent
    • Must be contractually subordinated to the covered IHC’s third-party liabilities
    • Is required to contain contractual provisions pursuant to which the FRB could cancel the internal LTD or convert it into equity on a going-concern basis (without entering resolution) upon the occurrence of certain conditions
Eligible internal TLAC (cont’d)

• What is the required amount of internal TLAC?
  • Eligible internal TLAC equals the sum of (i) common equity Tier 1 capital and AT1 capital issued by the covered IHC to its foreign parent, and (ii) the covered IHC’s eligible external LTD
  • With respect to the RWA component of the internal TLAC requirement, an internal TLAC buffer would apply on top of the 16 or 18% risk-based capital component that could be met solely with common equity Tier 1 capital in an amount equal to the sum of 2.5% and any applicable countercyclical capital buffer (equal to the existing capital conversation buffer now applicable to IHCs under the capital rules)
Clean Holding Company

• What is the clean holding company requirement?
  • The proposal sets out a “clean holding company” requirement, which has two parts:
    • First, a covered BHC would be prohibited from
      • Engaging in short-term borrowings,
      • Entering into QFCs,
      • Issuing guarantees of subsidiary liabilities that could create cross-default, set-off or netting rights for creditors of the subsidiary
    • Second, a covered BHC’s third-party non-contingent liabilities (other than those related to eligible external TLAC) that are pari passu with or junior to its eligible external LTD to a cap of 5% of the value of its eligible external TLAC
  • The clean holding company requirement applicable to IHCs differs from the requirement applicable to U.S. G-SIBs as it does not provide for the 5% bucket of non-contingent liabilities
Regulatory capital deduction

- Banks, savings and loans, and similar entities with total assets of more than $1 billion would suffer from a regulatory capital deduction for any investments in unsecured debt issued by covered BHCs (including eligible external LTD) in excess of certain thresholds.
Timing

- As proposed, covered BHCs would be required to comply with the external LTD and TLAC requirements by January 1, 2019, but the RWA component of the external TLAC requirement would be phased in with an initial 16% requirement applicable as of January 1, 2019, and the final 18% requirement applicable as of January 1, 2022. The clean holding company requirement would be applicable as of January 1, 2019.
- Covered IHCs would be subject to similar effective dates and phase-ins.
- The regulatory capital deduction would become effective as of January 1, 2019.
Views regarding the FRB Proposal
Issues arising under FRB proposal

• During the comment period, market participants have raised a significant number of concerns with the FRB proposal on such topics as:
  • Competitive issues
  • The definition of “eligible debt securities”
  • Structured notes
  • Covenants contained in senior note indentures
  • Disclosures relating to these instruments and investor protection issues
  • Liquidity
  • Internal TLAC
Competitive issues

• Many commenters noted that the FRB proposal went beyond the FSB Principles and would be significantly more onerous for US G-SIBs and covered FBOs
  • For example, under FRB, the TLAC requirement is effectively 20.5% of RWA (versus 18% of RWA)
  • The FSB Principles note an expectation that entities will maintain 33% or more of TLAC in debt but the Principles do not impose a separate LTD requirement
  • The FSB Principles do not impose a clean holding company requirement
  • For FBOs, there is no recognition of the MPOE approach and FBOs assert that the costs of internal TLAC will be quite burdensome
Definition of eligible debt securities

• Generally, commenters agreed that the FRB proposal’s definition of eligible debt securities was too narrow and should be revised to:
  • Address structured notes, as discussed later;
  • Address covenants, as discussed later;
  • Include debt governed by the laws of non-U.S. jurisdictions; and
  • Include securities convertible or exchangeable into the G-SIB’s equity
Structured note definition

- A “structured note” is a debt instrument that:
  - Has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of any asset, entity, index, or embedded derivative or similar embedded feature;
  - Has an embedded derivative or similar embedded feature that is linked to one or more equity securities, commodities, assets, or entities;
  - Does not specify a minimum principal amount due upon acceleration or early termination; or
  - Is not classified as debt under U.S. generally accepted accounting principles.
Structured note definition (cont’d)

• Definition clearly applies to both principal-protected and non-principal protected structured notes.

• However, the draft Notice states that: “The proposed definition of a structured note is not intended to include non-dollar-denominated instruments or instruments whose interest payments are linked to an interest rate index (for example, a floating-rate note linked to the federal funds rate or to LIBOR) that satisfy the proposed requirements in all other respects.”
Structured notes (cont’d)

• The Structured Products Association letter seeks:
  • Clarification that certain rate-linked notes are excluded from the definition of “structured note”
  • Clarification that debt referencing all benchmark rates are eligible securities

• The SPA letter also
  • Advances a proposal to permit structured notes that specify a readily ascertainable value
  • Suggests revisiting the 5% cap on liabilities

• The joint trade associations letter recommends permitting principal-protected structured notes provided that they are protected at par
Covenants

• Indentures for most G-SIB issuers would be considered “covenant lite”
• Covenants are limited to fundamental matters, such as maintaining corporate existence, remaining financial holding company or bank holding company, maintaining a trustee and paying agent, etc., but do not include any affirmative or negative covenants
• However, most indentures currently contain a provision that requires acceleration of payment obligations where breaches of covenants are not cured within a specified time period, usually 90 days
• Under the proposed FRB regulations, the acceleration upon unremedied covenant breach would render a security not eligible as LTD/TLAC; however, it is unlikely that the banking agencies were focused on this fundamental covenants or that these fundamental covenants would be seen as impediments to a resolution
Covenants (cont’d)

• Commenters have uniformly advocated that the FRB grandfather existing debt of G-SIBs (containing covenants)
• A few commenters quantify the “gap” if outstanding G-SIB debt is not grandfathered as requiring G-SIBs to raise up to an additional $550 billion of new, eligible LTD (compared to approximately $120 billion)
• A few commenters have suggested that eligible LTD should continue to be allowed to contain certain fundamental covenants, such as covenants regarding asset sales and other protective provisions (as far as debt investors are concerned)
Investor protection

• The market for these securities is not clear
  • The regulatory deduction for holding these instruments will narrow the potential pool of investors by excluding other banks
  • Certain funds may not be able to purchase debt securities that may become an equity security
  • To the extent that the securities are purchased by “retail” investors, additional concerns may arise

• Various commenters have raised investor protection concerns; they note that:
  • These securities will be complex and the risks associated with “bail in” will not be readily understood by investors
  • Investors will therefore not value the securities appropriately
  • Retirement savers, investing through pension funds and mutual funds, are significant holders of bank debt and, as such, would be affected by a “bail in” of these securities
Investor protection (cont’d)

• These commenters recommend that clear and comprehensive disclosure regarding the risks of an investment in the securities be required in offering materials; some recommend “cigarette warning” type risks—that is, front page warning disclosure in red lettering

• The events of the last several weeks relating to European bank issued contingent capital securities may affect regulatory views on the types of investors for whom these securities would be a suitable investment

• Alignment of interests
  • Various commenters note that the interests of senior management of G-SIBs ought to be aligned with the interests of holders of these instruments
  • They recommend that the FRB consider making mandatory that incentive compensation awarded to senior executives of G-SIBs be in the form of TLAC eligible securities
Liquidity

• Concerns already have arisen regarding the limited liquidity in the debt markets
• The proposal has been criticized as potentially contributing to more severe liquidity constraints; the limits on underwriting/market making will contribute further to liquidity constraints
Internal TLAC

• The FSB principles sets out an internal TLAC requirement, but the FRB proposal does not. The FRB solicits comments regarding an internal TLAC requirement.
• Various commenters question whether the LTD approach will lead to or facilitate an orderly resolution, especially when considered with the clean holding company requirement.
• Commenters note that the clean holding company requirement makes it less likely that a G-SIB parent would be in danger of default if one of its critical operating subsidiaries failed.
• Commenters note that G-SIBs should be required to downstream as equity certain amounts to systemically important operating subsidiaries.
Next Steps for G-SIBs
Preparing to comply

• Covered U.S. G-SIBs and covered IHCs will want to take stock of their outstanding debt securities in order to assess which securities meet the eligibility criteria, which requires:
  • Going back to the indentures (or similar agreements) governing the terms of outstanding debt securities in order to review the applicable default provisions
    • Inquiry would be made as to U.S. issuances, as well as all international offerings
    • Was any debt issued with additional relevant or unusual terms? Supplemental indentures?
  • Identifying which instruments qualify as “structured notes” (as defined in the FRB proposal), or that otherwise would not qualify as eligible debt securities, such as those with certain acceleration provisions
Preparing to comply (cont’d)

• Identifying outstanding debt securities that benefit from a BHC guarantee and reviewing the terms of all such guarantees
• Reviewing governing law for the outstanding debt securities: are securities governed by U.S. law?
• Reviewing maturities, as well as put/call features that would affect effective maturities
Preparing to comply (cont’d)

- Amendments
  - On a go forward basis, should the issuer put in place new indentures (for debt securities to be issued in the future)?
  - Can the issuer amend the terms of outstanding notes and issued guarantees? With or without holder consent?
  - Is a liability management exercise required?
    - FRB notice contemplates replacing “near eligible” debt with eligible debt
    - This could be accomplished through consent solicitations and exchange offers
      - What price would debtholders seek?
  - Consider the “cap” for certain liabilities that do not meet the criteria for “clean holding companies”
    - How will a G-SIB use this “cap”?
    - Assessing liabilities that are not consistent with the clean holding company requirement also will require significant time and effort
Preparing to comply (cont’d)

• FBOs subject to the IHC requirement likely are already well along the way in formulating their IHC compliance plan
• Now, they will have to consider the requirements that would be applicable to their IHCs, and how these differ from the requirements to which the foreign parent will be subject to as a result of the FSB TLAC requirement
  • Is foreign bank a SPOE or MPOE institution?
  • Will the IHC be a “resolution entity”?
  • Which securities qualify for FSB’s “internal TLAC” requirement but not for FRB’s “internal TLAC” requirement?
Countercyclical Capital
Countercyclical Capital

• On December 21, 2015 the FRB, in consultation with the other banking agencies, released a proposed policy statement for public comment that detailed the approach for the countercyclical capital buffer
• Countercyclical capital buffer (CCyB) is applicable to Advanced Approaches Institutions
• CCyB is weighted based on a banking organization’s particular composition of private-sector credit exposures across national jurisdictions
• CCyB is intended to function as an extension of the Capital Conservation Buffer
• The FRB voted to set the CCyB amount at zero percent; once fully phased in, the CCyB, will range from zero percent of RWAs to 2.5 percent
How CCyB will be set

- Goal of the CCyB is to augment the resiliency of large banking organizations when there is an elevated risk of above-normal losses
- Above-normal losses frequently follow periods of rapid asset price appreciation or credit growth (“bubbles”)
- CCyB is intended to increase during times of stress on the financial system and reduce when vulnerabilities of the stability of the financial system subside
- FRB, working with OCC/FDIC, will set the CCyB
- CCyB will fluctuate for each Advanced Approaches Institution
Factors FRB intends to consider

- FRB intends to consider:
  - Financial-system vulnerabilities, such as leverage in the system, maturity and liquidity transformation, etc.;
  - Financial and macroeconomic quantitative indicators, such as funding spreads, CDS spreads, volatility, etc.; and
  - Relevant empirical models.
Communication of the CCyB with the public

- FRB will:
  - Review financial conditions regularly throughout the year,
  - Expect to consider the applicable level of the U.S. CCyB at least annually, and
  - Communicate regularly with the public regarding its assessment of U.S. financial stability.
Monitoring of the CCyB

- FRB will monitor for several potential consequences resulting from changes to the CCyB, including, but not limited to:
  - Whether changes in the CCyB result in changes to risk-based capital ratios at Advanced Approaches Institutions, and whether such changes are achieved passively through retained earnings, or actively through changes in capital distributions or in risk-weighted assets;
  - The extent to which loan growth and spreads on loans issued by Advanced Approaches Institutions change relative to loan growth and loan spreads at banking organizations not subject to the CCyB; and
  - The extent to which adjustments by Advanced Approaches Institutions to higher capital buffers lead to the migration of credit market activity outside of those banking organizations, such as to the non banking financial sector.
Single Counterparty Exposures
Reproposed Rules

• On March 4, 2016, the FRB reproposed rules that would establish single counterparty credit limits for U.S. bank holding companies and foreign banking organizations with at least $50 billion in total consolidated assets
• The FRB also issued a white paper that provides the analytical and quantitative reasoning
• Original proposals were issued in December 2011 and December 2012
• Objective is to reduce interconnectedness in the financial system
• Comment period closes June 3, 2016
Section 165(e) of the Dodd-Frank Act

• Requires the FRB to establish single-counterparty credit limits for bank holding companies with assets of $50 billion or more and designated SIFIs.

• The Act defines “credit exposure” to a particular company as:
  • All extensions of credit to a company, including loans, deposits, and lines of credit;
  • All repos, reverse repos, and securities borrowing and lending transactions with a company (to the extent that such transactions create credit exposure for a covered bank holding company (“Covered Company” for domestic bank holding companies or “Covered Entity” for foreign banking organizations);
  • All guarantees, acceptances, and letters of credit issued on behalf of the company;
  • All purchases of, or investments in, securities issued by the company;
  • Counterparty credit exposure to the company in connection with derivative transactions between the Covered Company, or Covered Entity, and the company; and
  • Any other similar transaction that the Fed determines, through regulation, to be a credit exposure under section 165(e).
Credit Exposure Limits for U.S. BHCs

- Section 165(e) directs the Fed to impose single-counterparty credit limits based on the “capital stock and surplus” of a Covered Company.
- Capital Stock and surplus is defined under the Reproposed Rules as: “sum of the [Covered Company’s] total regulatory capital as calculated under the capital adequacy guidelines applicable to that [Covered Company] under Regulation Q . . . and the balance of the [Covered Company’s] allowance for loan and lease losses (“ALLL”) not included in tier 2 capital under the capital adequacy guidelines applicable to that [Covered Company] under Regulation Q.”
- “Aggregate net credit exposure” defined as the sum of all net credit exposures of a Covered Company or Covered Entity to a single counterparty. “Aggregate net credit exposure” of a Covered Company to a single counterparty would be subject to one of three categories of credit exposure limits:
  \[
  \frac{\text{Net Credit Exposure to Counterparty}}{\text{Eligible Capital Base}} \leq \text{Specified \%}
  \]
- Credit exposure limits apply to a Covered Company on a consolidated basis.
Categories

• The proposal becomes more stringent by “category”:
  • Category 1 (Mid-sized BHCs):
    • Would apply to Covered Companies with less than $250 billion in total consolidated assets and less than $10 billion in on-balance-sheet foreign exposures
    • Would be prohibited from maintaining aggregate net credit exposure to an unaffiliated counterparty in excess of 25% of the Covered Company’s total capital stock and surplus
  • Category 2 (Advanced Approaches BHCs):
    • Would apply to any Covered Company that is not a G-SIB with at least $250 billion or more in total consolidated assets or at least $10 billion or more in total on-balance-sheet foreign exposures
    • Would be prohibited from maintaining aggregate net credit exposure to an unaffiliated counterparty that exceeds 25% of the Covered Company’s Tier 1 capital
Categories (cont’d)

• Category 3 (G-SIBs):
  • Would prohibit any Covered Company that is a G-SIB from maintaining aggregate net credit exposure that exceeds
    • 15% of the Major Covered Company’s Tier 1 capital to any “Major Counterparty”
    • 25% of the Major Covered Company’s Tier 1 capital to any other counterparty
Interdependence

• The U.S. government and foreign sovereigns are excluded from the definition of “counterparty”

• A Covered Company’s exposures to a “counterparty” would include both exposures to that particular entity and any exposures to any person with respect to which the counterparty:
  • Owns, controls, or holds at least 25% voting power of a class of voting securities;
  • Owns or controls at least 25% of the total equity; or
  • Consolidates for financial reporting purposes.
Economic Interdependence Among Counterparties

• Where total exposures to a single counterparty exceed 5% of the Covered Company’s eligible capital base (i.e., total regulatory capital plus ALLL or tier 1 capital), the Covered Company would need to add to its exposures to that counterparty all exposures to other counterparties that are “economically interdependent” with the first counterparty.

• Economic interdependence is determined taking into account whether:
  • 50% of one counterparty’s gross receipts or gross expenditures are derived from transactions with the other counterparty;
  • One counterparty has fully or partially guaranteed the exposure of the other counterparty;
  • A significant portion of one counterparty’s production or output is sold to the other counterparty (which cannot be easily replaced by other customers);
Economic Interdependence Among Counterparties (cont’d)

- One counterparty has made a loan to the other counterparty and is relying on repayment of that loan in order to satisfy its obligations to the Covered Company, and the first counterparty does not have another source of income that it can use to satisfy its obligations to the Covered Company;
- It is likely that financial distress of one counterparty would cause difficulties for the other counterparty in terms of full and timely repayment of liabilities; and
- In the event of the common provider’s default, an alternative provider cannot be found (to the extent that both counterparties rely on the same source for the majority of their funding).
Control Relationships

• The proposed rule requires the Covered Company to add to the exposures of an unaffiliated counterparty all exposures to other counterparties that are connected by certain control relationships, evidenced by:
  • Voting agreements;
  • The ability of one counterparty to significantly influence the appointment or dismissal of another counterparty’s administrative, management, or supervisory body, or the fact that a majority of members have been appointed solely as a result of the exercise of the first entity’s voting rights; or
  • The ability of one counterparty to influence significantly senior management or to exercise a controlling influence over the management or policies of another counterparty.
Credit Exposure Limits

- Credit Exposure Limits:
  - No aggregate net credit exposure to any unaffiliated counterparty in excess of 25% of the capital stock and surplus or tier 1 capital, as applicable, of the Covered Company
  - Major Covered Companies prohibited from having aggregate net credit exposure to any Major Counterparty in excess of 15% of the Major Covered Company’s tier 1 capital
  - The limit is based on a Covered Company’s “aggregate net credit exposure” to a counterparty

- Aggregate net credit exposure takes into account credit risk mitigants, such as collateral, guarantees, derivatives, etc. The proposal sets our an approach for calculating the extent of mitigation.

- Special rules are set out to calculate gross credit exposure for securities financing transactions
## Compliance Timeline

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What’s Next?
Recent developments

• There are several developments to watch in the United States:
  • Regulatory concern regarding fintech
  • Continuing discussions regarding regulatory relief for smaller banks
  • Debate regarding the effect of the leverage ratio on the derivatives business
  • The determinations made by FSOC related to nonbank SIFI status
  • The continuing too-big-to-fail dialogue
Derivatives Update

April 12, 2016
Presented By
James Schwartz
Introduction and Overview

• With almost six years having passed since the enactment of Dodd-Frank, the derivatives market is still grappling with the requirements of Title VII
  • Margin requirements not yet phased in – may change economics significantly
  • Differences, both in timing and in substance, between the U.S. regulations and foreign rules
  • Timing differences between CFTC regulations (for swaps) and SEC regulations (for security-based swaps)
Introduction and Overview (cont’d)

Today we will discuss some recent regulatory developments connected to these themes:

• Margin rules for uncleared swaps
• Cross-border developments and their effects on U.S. counterparties
  • EU-U.S. “Common Approach” to CCPs
  • Status of U.S. cross-border rules, including for margin
  • ISDA 2015 Universal Resolution Stay Protocol and related matters
• Status of SEC rules for security-based swaps and what’s ahead
Background Regarding Margin

• Margin for uncleared swaps was **not** one of the derivatives markets reforms required by the 2009 Pittsburgh G-20 agreement

• Dodd-Frank required regulators to draft rules requiring margin for bilateral swaps that will not be cleared at a clearinghouse (cleared swaps, in contrast, are subject to margin requirements imposed by clearinghouses and their members)

• Margin was added to the agreed G-20 reforms in 2011, when the G-20 requested the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) to develop, for consultation, consistent global standards for margin requirements

• As with the other G-20 reforms, margin requirements, though mandated by international agreement, are being implemented at the level of individual jurisdictions
Background Regarding Margin (cont’d)

• Margin is a significant economic issue that the swap market will need to address in accordance with rules that have only recently become final.
• Based on the BCBS/IOSCO framework, U.S. regulators have finalized rules for swaps that draw heavily on traditional margin practices in the futures market.
• Most significantly, the regulations will require many parties (though not commercial end-users) to provide initial margin, which is intended to account for potential future exposure -- adverse changes in value that may arise during the period of time when a swap or group of swaps is being closed out.
• Initial margin, when required, will be segregated and not subject to rehypothecation or other use – a significant new cost for swap dealers and certain other financial entities.
• It remains to be seen how the market will respond to the margin requirements, and the extent to which products other than OTC swaps (for example, futures) may increasingly be used in place of OTC swaps.
Status of Margin Rules – U.S.

• Last October, the Prudential Regulators issued final rules for swap entities subject to their supervision (essentially swap dealers, major swap participants, security-based swap dealers and major security-based swap participants that are banks)

• In addition, last December, the CFTC adopted final rules to impose margin requirements on uncleared swaps entered into by swap dealers and major swap participants subject to CFTC regulation, referred to as “Covered Swap Entities” or “CSEs”

• The CFTC also adopted an interim final rule to exclude from margin requirements most uncleared swaps that swap entities enter into with commercial end users, financial institutions with $10 billion or less in total assets, and certain other entities
Status of Margin Rules – U.S. (cont’d)

• Both sets of rules have a phased-in compliance schedule beginning in September 2016
• Even though the September phase-in applies only to the largest institutions, it is not clear the market is going to be able to meet the stated timing
Overview of the Final U.S. Rules

• In general, the CFTC’s and Prudential Regulators’ Rules will:
  • Require swap entities, subject to a $50 million threshold, to bilaterally exchange “initial margin” with other swap entities and with a broad range of “financial end users” whose use of uncleared swaps meet a notional amount-based threshold (“material swaps exposure”), all such initial margin to be segregated with a custodian (not affiliated with either counterparty) and generally not subject to rehypothecation or other use by the custodian;
  • Permit the calculation of initial margin by means of either a model-based method or a table-based method;
  • Impose a significantly higher initial margin requirement on uncleared swaps as compared with cleared swaps by requiring that initial margin models use a 10 business day closeout horizon for most uncleared swaps as opposed to a 5 business day horizon for most cleared swaps in order to “incentivize clearing”; and
  • Require swap entities to exchange “variation margin” with swap entities and with a broad range of financial end users (without regard to the existence of material swaps exposure) without any threshold.
Scope of the Final U.S. Rules

• Under both sets of rules, a CSE will not be required to collect or post specified amounts of initial or variation margin for swaps with counterparties that are not Swap Entities or “financial end users” – essentially commercial end-users.

• The final rules contains a “financial end user” definition that lists numerous types of entities, including banks, broker-dealers, investment companies, insurance companies, commodity pools and ERISA plans.

• Expressly excluded from the financial end user definition are sovereign entities (central governments or an agency or department thereof) and multilateral development banks.
Financial End Users with Material Swaps Exposure

- The threshold for determining whether a financial end user has “material swaps exposure” has been increased (as compared with previously proposed rules) under the CFTC’s and Prudential Regulators’ final rules from $3 billion to $8 billion of average daily aggregate notional amount of swaps activity over a 3-month period (determined by reference to the swaps activity of the financial end user and its affiliate(s))
- The higher number is aligned with the BCBS-IOSCO Framework
- This change will reduce the number of entities from which swap entities must post and collect initial margin
- It will also level the playing field between swap entities subject to U.S. rules and those subject to rules of foreign jurisdictions, such as the European Union and Japan, which have also followed the BCBS-IOSCO Framework
Eligible Collateral

• The CFTC’s and Prudential Regulators’ final rules also expand the types of eligible collateral for initial and variation margin in comparison with previous proposals

• Under the final rules, eligible collateral types for Initial Margin include U.S. Treasuries, GSE securities, securities issued by BIS, ECB, IMF and MDBs, publicly traded debt (other than asset-backed securities), publicly-traded equities in certain indices and gold, but not securities issued by the pledgor or its affiliate or banks and similar entities

• Variation Margin may include major currencies (defined in the final rules) in addition to U.S. dollars and the currency of settlement
Eligible Collateral (cont’d)

• In addition, for swaps between a covered swap entity and a financial end user (but not for swaps between swap entities), the final rules permit non-cash collateral eligible to be used for initial margin to serve as variation margin.

• This change from previous proposals is significant for certain financial entities, such as insurance companies, that hold significant reserves of bonds and other securities and commented that the restriction to cash-only variation margin would reduce their investment returns.
Approval of Initial Margin Models

- Both sets of U.S. final rules impose stringent regulatory requirements on initial margin models, including:
  - Written approval of the relevant regulator for use of initial margin models,
  - Demonstration on an ongoing basis that the model satisfies all of the requirements under the rules, and
  - Prior notice to the relevant regulator before making changes to the model or its assumptions.
Eligible Master Netting Agreements (EMNAs)

• The CFTC’s and Prudential Regulators’ final rules permit counterparties to document pre- and post-compliance date swaps as separate portfolios for netting purposes under the same EMNA covered by separate credit support annexes.

• Accordingly, netting portfolios that contain only uncleared swaps entered before the applicable compliance date are not subject to the final rules.

• EMNAs, as under the previous proposals, are subject to a requirement that a swap entity conduct sufficient legal review to conclude with a well-founded basis that among other things, the contract would be found legal, binding, and enforceable under the law of the relevant jurisdiction.

• Although unqualified legal opinions are not required, the legal review must be in writing.
Phased-in Compliance

- The final rules adopt the delayed phase-in schedule announced by BCBS/IOSCO in March 2015, which delays the beginning of implementation of initial margin and variation margin requirements until September 1, 2016.

- Variation margin:
  - Scheduled phase-in on September 1, 2016 where both the covered swap entity combined with all its affiliates and its counterparty combined with all its affiliates have an average daily aggregate notional amount that exceeds $3 trillion.
  - Scheduled phase-in on March 1, 2017 for variation margin for any other covered swap entity with respect to covered swaps with any other counterparty.

- Initial margin: phased-in implementation depending upon swaps average daily aggregate notional amounts of the covered swap entity and its affiliates, and its counterparties and their affiliates, starting from September 1, 2016 (for entities with the largest average daily aggregate notional amount) through September 1, 2020.
Cross-Border Background

• Primary G-20 commitments in relation to swaps, other than margin, derive from the September 2009 meeting in Pittsburgh, at which the G-20 determined that:

  “All standardized OTC derivatives should be traded on exchanges […] cleared through central counterparties […] OTC derivatives contracts should be reported to trade repositories”

• As with margin, for clearing, exchange trading and reporting, the G-20 jurisdictions have been working on parallel, but not identical, reforms that generally resemble each other but differ in their details and timing

• However, the swaps marketplace has historically been profoundly international

• As a result, the question comes to the forefront: which jurisdiction’s rules will apply to which cross-border swaps?

• Also: whose rules should apply to market utilities, such as clearinghouses and trading facilities, who may provide services to clients in multiple jurisdictions?
EU-U.S. “Common Approach” to CCPs

- With respect to cleared swaps, there has been significant progress on international harmonization.
- In February of this year, the European Commissioner for Financial Stability, Financial Services and Capital Markets Union, Jonathan Hill, and CFTC Chairman Timothy Massad announced a “common approach” regarding requirements for central clearing counterparties (CCPs).
- The primary aim of the “common approach” is to permit dually-registered U.S. CCPs (i.e. registered in both the U.S. and EU) to continue to provide services to EU market participants and to permit dually-registered EU CCPs to continue to provide services to U.S. market participants.
Background on “Common Approach”

• Prior to agreeing on the “common approach” with the CFTC, the EU made positive “equivalence” decisions for the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore, Mexico, Canada, South Africa, Switzerland and the Republic of Korea

• The EU also postponed several times its deadline for the recognition of U.S. equivalence in respect of CCPs

• If the EU were to fail to recognize U.S. CCPs, there would come a parade of horribles:
  • U.S. CCPs would not constitute “Qualifying CCPs” for purposes of Basel III risk-weighting
  • European banks would incur prohibitive costs to clear through U.S. CCPs
  • U.S. CCPs would have difficulty in maintaining clearing member relationships with EU firms
  • U.S. CCPs would be ineligible to clear contracts subject to the upcoming EU clearing mandate
Common Approach – Implementation

• In accordance with the “common approach,” the European Commission, adopted an equivalence determination with respect to the CFTC’s requirements for CCPs on March 15, 2016

• In addition, as agreed, on March 16, 2016, the CFTC adopted a substituted compliance determination with respect to many EU requirements for CCPs and streamlined its registration process for EU CCPs
Common Approach – EU Equivalence Determination

• The stated purpose of the EU’s equivalence assessment is to verify that the legal and supervisory arrangements of the U.S. ensure that U.S. CCPs do not expose clearing members and trading venues established in the EU to a higher level of risk than the latter could be exposed to by EU CCPs and, consequently, do not pose unacceptable levels of systemic risk in the EU

• During the recognition process, CFTC-registered U.S. CCPs will continue to benefit from any applicable transitional relief

• Once recognized by the European Securities and Market Authority (ESMA), U.S. CCPs will be able to continue to provide services in the EU, while complying with CFTC requirements
Common Approach – EU Recognition Process

- In order to gain recognition by ESMA, U.S. CCPs must apply to ESMA and confirm that their internal rules and procedures ensure:
  - For clearing members' proprietary positions in exchange traded derivatives, the collection of initial margins that are sufficient to take into account a two-day liquidation period;
  - That initial margin models include measures to mitigate the risk of procyclicality; and
  - The maintenance of 'cover 2' default resources, that is, enough loss absorption capacity to cover a simultaneous failure of a CCP’s two largest members.
Common Approach – EU Recognition Process (cont’d)

• These conditions will not apply with respect to U.S. agricultural commodity derivatives traded and cleared domestically within the United States
  • This carve out is intended to recognize the nexus of these U.S. contracts with the U.S. economy, the importance of these contracts to U.S. farmers and ranchers and the low degree of systemic interconnectedness of these markets with the rest of the financial system

• In addition, the European Commission will soon propose the adoption of an equivalence decision under EMIR to determine that U.S. trading venues are equivalent to regulated markets in the EU, providing a level playing field between EU and U.S. trading venues for the purposes of the MIFID I framework
  • This means that derivatives traded on U.S. exchanges need not be counted toward the clearing threshold for NFC+s
Common Approach – EU Clearing Requirements

• As part of the common approach, the EU recognized that EU market participants might wish to use CFTC-registered U.S. CCPs to satisfy their upcoming central clearing obligations under EMIR

• The first phase of clearing obligations for certain interest rate derivative contracts is scheduled to take effect in Europe on June 21, 2016

• Market participants may continue to clear these contracts in non-recognized CFTC-registered US CCPs until that date

• The European Commission and the CFTC anticipated that CFTC registered CCPs will be in a position to be recognized by that date and that the CFTC would work closely with ESMA to facilitate this process
Common Approach – CFTC Actions

- EMIR requires reciprocity: as a condition to an equivalence determination by the EU with respect to another country’s CCPs, that country’s legal and supervisory regime must include an “effective equivalent system” to recognize EU CCPs
- On the U.S. side, the CFTC on March 16, 2016 made a substituted compliance determination, concluding that many EU requirements are comparable to CFTC requirements
- In addition, as part of the agreed common approach, the CFTC has streamlined the registration process for EU CCPs wishing to register with it
- The CFTC’s substituted compliance determination applies to EU requirements for financial resources, risk management, settlement procedures, and default rules and procedures
Common Approach – CFTC Actions (cont’d)

• This determination will provide a basis for both EU CCPs already registered with the CFTC as derivatives clearing organizations, and those seeking registration, to meet certain CFTC requirements by complying with the corresponding requirements as set forth in EMIR
• The determination is effective immediately upon publication in the Federal Register, which occurred on March 22, 2016
• In addition, as part of the agreed common approach, the CFTC has streamlined the registration process for EU CCPs wishing to register with it
• This will permit EU CCPs to provide services to U.S. clearing members and clients while complying with EU requirements
• In the past, the CFTC has required CCPs located outside of the U.S. but clearing transactions traded on exchanges in the U.S. to comply with all U.S. registration requirements
Common Approach – CFTC Actions (cont’d)

• EU CCPs seeking CFTC registration must still complete the customary Form DCO

• However, with respect to questions and information requirements in areas where compliance with the EMIR framework is substituted for compliance with the CFTC’s own regulations, the EU CCP may evidence its compliance with the EMIR framework in lieu of its compliance with the CFTC’s regulations

• Instead of submitting the exhibits required under the CFTC Form DCO regulation, an EU CCP applicant for registration may use existing materials that it has submitted to its national competent authority for its EMIR authorization to demonstrate compliance with the EMIR provisions for which substituted compliance is available
Status of U.S. Cross-Border Rules

• CFTC issued cross-border “guidance” in July of 2013
  • Addresses which substantive rules apply to which swaps and which counterparties
  • “Guidance,” not rules, but generally treated as rules

• SEC has not yet issued comprehensive final rules or guidance
  • In general, the SEC is far behind the CFTC in finalizing and implementing its rules
  • The SEC has not yet finalized its proposed rules regarding which substantive rules apply to swaps involving which counterparties
  • However, the SEC has provided certain targeted cross-border rules
Status of U.S. Cross-Border Rules (cont’d)

• Particular rules regarding margin:
  • Prudential banking regulators have provided final rules regarding margin for cross-border transactions
    • Prudential regulators include the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency
    • Prudential regulators’ margin rules govern swap dealers that are banks subject to U.S. regulation
  • CFTC has proposed rules regarding margin for cross-border transactions but has not yet finalized them
  • No final SEC margin rules yet, or rules regarding the cross-border application of margin rules
CFTC Cross-Border Guidance

- Divides substantive CFTC regulatory requirements into “Transaction-Level” and “Entity-Level” requirements
- Entity-Level requirements include capital adequacy, chief compliance officer, risk management, and most swap data recordkeeping and swap data repository reporting
- In relation to Entity-Level Requirements, for non-U.S. swap dealers, the CFTC has generally shown broad deference (through substituted compliance determinations) to rules of other jurisdictions
- Transaction-Level Requirements consist of Category A Transaction-Level Requirements (which include clearing, trade execution, swap trading relationship documentation, and real-time public reporting) and Category B Transaction-Level Requirements (the CFTC’s external business conduct standards)
CFTC Cross-Border Guidance (cont’d)

- Transaction-Level requirements – like a continuum:
  - At one end of the spectrum, Transaction-Level requirements apply to swaps involving
    - A CFTC-registered swap dealer (whether or not a U.S. Person) acting through a U.S. branch or
    - A U.S. Person other than a swap dealer.
  - At the other end of the spectrum, Transaction-Level requirements do not apply (unless one party is a swap dealer acting through a U.S. branch or a U.S. Person) to swaps involving a party that is not a U.S. Person and not otherwise linked to the U.S. as a “guaranteed affiliate” or an “affiliate conduit”
  - With respect to swaps that do not fall at either end of the spectrum, such as swaps involving a CFTC-registered swap dealer acting through a non-U.S. branch, a substituted compliance determination is possible in relation to many Transaction-Level requirements
CFTC Cross-Border Guidance (cont’d)

• Basic idea of substituted compliance is that a market participant may substitute compliance with a local non-U.S. rule for compliance with a U.S. rule

• In order for a market participant to comply with non-U.S. rules instead of U.S. rules, the relevant U.S. regulator must determine that the analogous foreign rules are sufficiently comprehensive and comparable to its own rules

• Tension between a requirement-by-requirement approach to substituted compliance and a “holistic” or “outcome based approach”
CFTC Substituted Compliance Determinations

• Notwithstanding the recent determination with respect to EU CCPs, the CFTC has announced few substituted compliance determinations to date, and, other than that recent determination, none since the end of 2013:
  • On December 20, 2013, the CFTC announced comparability determinations for various entity-level requirements for Australia, Canada, the EU, Hong Kong, Japan and Switzerland
  • However, with respect to transaction-level requirements, the CFTC’s comparability determinations were limited to a few provisions for Japan and the EU
  • No substituted compliance determinations yet with respect to mandatory clearing or trade execution
SEC Cross-Border Rules

• The SEC released proposed (and not yet finalized) rules regarding the cross-border application of its substantive rules in May, 2013
  • Although the details are different, there is a similar pattern, or continuum, as in the CFTC’s cross-border guidance

• In addition, in May, 2014, the SEC released final rules regarding which security-based swaps count toward the security-based swap dealer de minimis registration thresholds
  • Rules include definition of U.S. Person

• In February of this year, the SEC also recently released additional set of final rules clarifying that certain SBS arranged, negotiated or executed by personnel within the U.S. will count toward the de minimis thresholds
Harmonization and the CFTC’s Guidance

• The CFTCs’ cross-border guidance appears to contain features that, from the perspective of a non-U.S. regulator, might well complicate attempts at harmonization

• Under the cross-border guidance, many of the CFTC’s substantive rules, including for mandatory clearing and trade (SEF) execution, will apply to any swap involving a U.S. Person (as defined)
  • However, in a transaction between, for example, New York head office of a U.S. swap dealer and the German head office of a German swap dealer, the EU’s rules should presumably apply to the same extent the U.S. rules do
  • If the EU were to take a position parallel to that of the CFTC and require the application of the EU’s rules to a transaction involving an EU swap dealer, the transaction would be governed by both U.S. and EU rules
  • Any material differences between these two sets of rules could be a significant issue for the parties to such a transaction and, by extension, for the swaps market as a whole
Harmonization and the CFTC’s Guidance (cont’d)

- Another feature of the CFTC’s cross-border guidance that could frustrate a reciprocal approach is the CFTC’s stance regarding swaps with non-U.S. Persons located within the U.S.
- The CFTC has taken the view that the U.S. branch of a non-U.S. swap dealer would be subject to Transaction-Level requirements, including clearing and SEF execution, because of the CFTC’s strong interest in regulating dealing activities occurring within the United States.
- However, the CFTC did not recognize an equally strong interest of non-U.S. regulators in regulating the dealing activities of branches of U.S. swap dealers located in their jurisdictions.
Harmonization and the CFTC’s Guidance (cont’d)

- With respect to transactions entered into by U.S. swap dealers acting through non-U.S. branches, the CFTC stated that, if such branches faced a U.S. Person (other than the foreign branch of another U.S. swap dealer) in a swap, then the CFTC’s own Transaction-Level Requirements would apply.

- Once again, if a foreign regulator were to take a position parallel to that of the CFTC, requiring that the branches of swap dealers within its geographical jurisdiction adhere to the foreign regulator’s rules, then a transaction could be governed by both U.S. and non-U.S. rules.

- In addition, with respect to such Transaction-Level requirements, the CFTC has stated that, even if a non-U.S. branch of a U.S. swap dealer were facing a non-U.S. Person in a swap, then substituted compliance would apply.
Harmonization and CFTC Advisory 13-69

• Taking the CFTC’s view of its authority one step further, the CFTC in November 2013 issued a “Staff Advisory” regarding swaps “arranged, negotiated or executed, or executed by personnel or agents of the non-US SD located in the United States”

• In the advisory, the CFTC took the position that, because of its supervisory interest in swap dealing activities within the United States, even where a swap is between a non-U.S. branch of a non-U.S. swap dealer and another non-U.S. Person, the CFTC’s Transaction-Level Requirements will apply to the swap if it is “arranged, negotiated, or executed by personnel or agents of the non-U.S. swap dealer located in the United States.”

• It appeared that the CFTC would require counterparties to a swap to comply with certain transaction level requirements even if both were foreign and entered into a swap through non-U.S. offices, if one entity employed U.S.-based front office personnel or agents in relation to the swap
Harmonization and CFTC Advisory 13-69 (cont’d)

• However, a series of no-action letters have granted relief, currently extended until September 30, 2016 (or any prior date of CFTC action), to non-U.S. swap dealers failing to comply with the Transaction-Level Requirements in relation to swaps with any non-U.S. person

• In addition, the CFTC has issued a request for comment on “whether the Commission should adopt” the advisory “as Commission policy, in whole or in part”

• Recent comments by CFTC Chairman Massad appear to indicate that the CFTC is determining how to amend the advisory
Margin – Cross-Border Application

- Prudential Regulators’ final margin rules contain provisions governing the cross-border application of the margin rules
- CFTC has proposed a separate rulemaking, not yet finalized, to address cross-border application of its margin rules
• Under Prudential Regulators margin rules, margin rules do not apply to any foreign non-cleared swap or foreign non-cleared security-based swap of a foreign covered swap entity
• A foreign covered swap entity is any covered swap entity that is not:
  • An entity organized under the laws of the United States or any State, including a U.S. branch, agency, or subsidiary of a foreign bank;
  • A branch or office of an entity organized under the laws of the United States or any State; or
  • An entity that is a subsidiary of an entity that is organized under the laws of the United States or any State.
Prudential Regulator Cross-Border Rules for Margin (cont’d)

- A foreign non-cleared swap (or security-based swap) is any transaction in which neither the counterparty to the foreign covered swap entity nor any party that provides a guarantee of either party’s obligations under the non-cleared swap or non-cleared security-based swap is:
  - An entity organized under the laws of the United States or any State (including a U.S. branch, agency, or subsidiary of a foreign bank) or a natural person who is a resident of the United States;
  - A branch or office of an entity organized under the laws of the United States or any State; or
  - A swap entity that is a subsidiary of an entity that is organized under the laws of the United States or any State.
Prudential Regulator Cross-Border Rules for Margin (cont’d)

• Substituted compliance may apply only if
  • The covered swap entity’s obligations under the non-cleared swap or non-cleared security-based swap do not have a guarantee from:
    • An entity organized under the laws of the United States or any State (other than a U.S. branch or agency of a foreign bank) or a natural person who is a resident of the United States; or
    • A branch or office of an entity organized under the laws of the United States or any State; and
  • The covered swap entity is:
    • A foreign covered swap entity;
    • A U.S. branch or agency of a foreign bank; or
    • An entity that is not organized under the laws of the United States or any State and is a subsidiary of a depository institution, Edge corporation, or agreement corporation.
Prudential Regulator Cross-Border Rules for Margin (cont’d)

• In determining whether to make a substituted compliance determination, the prudential regulators will consider whether the requirements of such foreign regulatory framework for non-cleared swaps applicable to such covered swap entities are
  • Comparable to the otherwise applicable requirements of the prudential regulators margin rules and
  • Appropriate for the safe and sound operation of the covered swap entity, taking into account the risks associated with non-cleared swaps and non-cleared security-based swaps
Prudential Regulator Cross-Border Rules for Margin (cont’d)

• A covered swap entity satisfies its requirement to post initial margin by posting to its counterparty initial margin in accordance with the initial margin that its counterparty is required to collect under a foreign regulatory framework, provided the prudential regulators have made a substituted compliance determination for that framework, and the counterparty’s obligations under the non-cleared swap or non-cleared security-based swap do not have a guarantee from:
  • An entity organized under the laws of the United States or any State (including a U.S. branch, agency, or subsidiary of a foreign bank) or a natural person who is a resident of the United States or
  • A branch or office of an entity organized under the laws of the United States or any State.
CFTC Cross-Border Application Proposal

- CFTC’s proposed rules for cross-border application of margin rules contain intriguing disparities from the CFTC’s cross-border guidance
  - Increased scope for potential substituted compliance determinations
  - Narrowing definition of “U.S. Person”
  - Narrowing definition of “guarantee”
- These changes may indicate that the CFTC may be willing to step back from certain problematic aspects of its cross-border guidance
- Increased scope for potential substituted compliance determinations
  - Under CFTC’s cross-border guidance, transactions between a non-U.S. dealer and a U.S. person are subject to the CFTC’s rules (although substituted compliance may apply to transactions between the non-U.S. dealer and the foreign branch of U.S. swap dealer)
  - However, under the proposed cross-border rules applicable to margin requirements, substituted compliance could apply to transactions between a non-U.S. swap dealer and most U.S. persons (other than U.S. swap dealers)
CFTC Cross-Border Application Proposal (cont’d)

• The CFTC is proposing to make element-by-element determinations, including, but not limited to, 11 elements, as to comparability, and could make substituted compliance determinations for some, but not all, of a foreign jurisdiction’s margin requirements.

• Narrowed definition of “U.S. Person” for purposes of margin requirements
  • Deletion of “includes, but is not limited to” at beginning of definition
    • Provides greater legal certainty
  • Deletion of investment vehicles majority-owned by U.S. persons

• Narrowed definition of “guarantee”
  • Guarantee is defined specifically as an arrangement in which a party to a swap has a right of recourse against a U.S. person to receive or otherwise collect payments from the U.S. person in connection with the non-U.S. person counterparty’s payment obligations under the swap
  • Narrower definition than in cross-border guidance
ISDA Resolution Stay Protocols

• As of today, there are two such protocols:
  • ISDA 2014 Resolution Stay Protocol; and
  • ISDA 2015 Universal Resolution Stay Protocol

• Primary difference is scope of product coverage – the new “universal” protocol covers not only transactions under ISDA Master Agreements, but also securities financing transactions
  • “Securities financing transactions” include repurchase transactions and securities lending transactions

• New protocol supersedes previous one for parties who adhered to previous protocol

• Protocols are contractual solutions to questions relating to the cross-border application of special resolution regimes

• Protocols are intended to address issue of banks being “too big to fail” and to give regulators time to facilitate an orderly resolution of a troubled bank
ISDA Resolution Stay Protocols (cont’d)

• Regulations are widely expected to be proposed in the near future that will apply to a broader range of market participants requirements similar to those contained in the protocols
• Timing for proposed rules: supposed to be last quarter
• Proposed regulations are expected to require regulated institutions to include in their contracts with unregulated counterparties provisions similar to those contained in the protocols
• New regulations (like 2015 protocol) are expected to apply to derivatives, repurchase transactions and securities lending transactions – and may even be broader
• Both protocols were developed by a group of ISDA member institutions in coordination with the Financial Stability Board
ISDA Resolution Stay Protocols (cont’d)

• Address the fundamental concern is that a close-out of derivatives/repo/sec lending transactions by a large institution could destabilize markets and make resolution of the institution difficult.

• Apart from the broader product coverage of the 2015 protocol, the substance of the two protocols is largely similar.

• In the U.S., concerns are addressed by Title II of Dodd-Frank (“Orderly Liquidation Authority”), which imposes a limited stay on termination rights against U.S. banks.

• There are similar provisions in other countries to likewise restrict termination rights against banks.
ISDA Resolution Stay Protocols (cont’d)

• However, the cross-border application of such special resolution regimes is not wholly clear
  • What if U.S. bank in resolution faces counterparty in another jurisdiction? Is counterparty bound by Dodd-Frank’s special resolution provisions?
  • Similarly, what if non-U.S. bank faces a counterparty in the U.S? Is U.S. counterparty bound by the bank’s home country resolution procedures?
ISDA 2015 Universal Resolution Stay Protocol

• Under both protocols, adhering parties opt into accepting the special resolution regimes that may apply to their counterparties
  • Such resolution regimes typically stay or override certain default rights that would otherwise arise when a bank enters into insolvency, resolution or similar proceedings
  • In addition, adhering parties opt into contractual stays on certain cross-default rights that would otherwise apply in the context of insolvency proceedings and that are similar to some of the types of stays contained in certain statutory resolution regimes
• The Protocol was intended to apply only to the 21 largest banks and their affiliates
• As of last week, there were 211 adhering parties, mainly large banks and their affiliates
• Many market participants (e.g., fiduciaries such as asset managers) would have potential legal issues if they voluntarily gave up or agreed to delays in exercising their termination rights
Accordingly, regulators will likely impose the contents of the protocol on many market participants by regulation in the near future, by means of requiring banks to add similar provisions to their trading agreements.

Such laws or regulations have already been proposed or adopted in many European countries.

ISDA has stated that it expects to release a protocol to facilitate compliance with the expected regulations.

There will likely be two different forms of the protocol, one for regulated entities and one for buy-side firms.
ISDA 2015 Universal Resolution Stay Protocol (cont’d)

- Section 1 – Opt-in to Special Resolution Regimes
  - Provides generally that if one adhering party is subject to a special resolution regime, then the other adhering party may exercise default rights under a “Covered Agreement” or related credit support arrangement only to the extent it would be able to do so under such special resolution regime
- Covered Agreements include both ISDA Master Agreements and numerous forms of repurchase and securities lending agreements
- Also provides that transfers of Covered Agreements and related credit support arrangements will be effective to the same extent as such a transfer would be effective under the relevant special resolution regime
ISDA 2015 Universal Resolution Stay Protocol (cont’d)

- Section 1 – Opt-in to Special Resolution Regimes
- Contains similar provisions that may apply if
  - An affiliate of an adhering party (not the adhering party itself) becomes subject to a special resolution regime or
  - A credit support arrangement runs to the benefit of an affiliate of a party to a Covered Agreement
ISDA 2015 Universal Resolution Stay Protocol (cont’d)

• Definition of “Special Resolution Regime” includes
  • Identified resolution regimes of France, Germany, Japan, Switzerland, the UK and the U.S. and
  • “Protocol-eligible Regimes,” which are defined to include:
    • The resolution regimes of states that are members of the FSB (examples: Argentina, Russia and Saudi Arabia), but only if such resolution regimes incorporate certain protections for creditors
      • No discrimination based on nationality, location or domicile of creditors or jurisdiction where they may be paid
      • Limitations on length and nature of stay that may restrict creditors’ rights; and
    • Any other jurisdiction that is the jurisdiction of organization of the ultimate parent entity within a banking group that has been designated by the Financial Stability Board as a “global systemically important bank”
ISDA 2015 Universal Resolution Stay Protocol (cont’d)

• Section 2 – Limitation on Exercise of Default Rights in U.S. Insolvency Proceedings
• Restricts default rights that would otherwise arise if an affiliate of an adhering party, not the party itself, becomes subject to insolvency proceedings
• Intended to support a “single point of entry”-style resolution of a parent entity of a financial group, a resolution with only the top-tier parent company entering proceedings
Status of SEC Rules

• Few SEC rules are currently both technically in effect and operative
• SEC seems to want to take a less piecemeal approach than the CFTC has taken
• There is a contingent nature to the effectiveness of many rules
  • Many rules will go into effect when other rules are finalized or other events occur
  • Generally, to date, those conditions have not been met
• Broad no-action relief extends to February 2017
Status of SEC Rules (cont’d)

• Among the SEC rules that have been proposed but not yet finalized are the following:
  • Cross-border rules, including rules stating which substantive SEC requirements would apply to which security-based swap transactions and which market participants
  • Business conduct standards for security-based swap dealers and major security-based swap participants
  • Margin rules for uncleared swaps
  • Applications by security-based swap dealers and major security-based swap participants for statutorily disqualified associated persons to be involved in effecting security-based swaps
Status of SEC Rules (cont’d)

• Among the SEC rules that have been finalized are the following:
  • Registration process for security-based swap dealers and major security-based swap participants (most recent – released in August of last year)
  • Certain cross-border rules, relating to, among other things, which security-based swap transactions need to be counted toward the SBSD registration thresholds
  • Security–based swap data repository registration, duties and core principles
  • Reporting and Dissemination of security-based swap information
Status of SEC Rules (cont’d)

• SEC Chair Mary Jo White (speech on February 19):
  • “We will continue in 2016 to complete the remaining mandates. Of particular focus and priority will be to finalize the remaining security-based swap rules required of the SEC by Title VII of the Dodd-Frank Act, a goal supported by all of the Commissioners, so that the new regulatory regime can become operational… Next in line will be to finalize the substantive requirements for security-based swap dealers – in particular, the rules governing their business conduct and the requirements for their capital, margin, and asset segregation.”

• Commissioner Kara M. Stein (speech on February 19):
  • “I think the first order of business is to finish the remaining rules under Title VII of the Dodd-Frank Act of 2010. The security-based swap market is global, with counterparties located around the world… The large market remains largely unregulated until we complete our Title VII rules. We made some progress last year and earlier this year, with the adoption of the final rules regarding the registration of security-based swap dealers and major security-based swap participants. But, many rules remain outstanding… I look forward to the staff’s recommendations in all of these areas. Hopefully, we will have the final rules in place by this time next year.”
Questions?

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• Because of the generality of this presentation, 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.
A FinTech Discussion: An Overview of Select U.S. Legal Issues

Sean Ruff

April 12, 2016
What Is FinTech?

What is FinTech?
- FinTech is a term to describe the intersection between finance and technology
- It often refers to technical innovation being applied to a traditional financial service, or it may refer to innovative financial services offerings that disrupt the existing financial services market

Why is it important?
- It is one of the fastest growing segments of the financial services marketplace
- A number of factors are driving FinTech growth, including:
  - The expansion of digital connectivity
  - The economic downturn and financial institutions turning to technology as a way of improving their processes while reducing costs
  - The new regulations and the penalties associated with getting it wrong creating a demand for managing compliance and reducing risk
Money Transmission
Quick Recap – Money Transmission

• What is money transmission?
  – General framework for analyzing business models that may implicate money transmission regulation

<table>
<thead>
<tr>
<th>Control Funds?</th>
<th>YES</th>
<th>NO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Intermediary?</td>
<td>YES</td>
<td>NO</td>
</tr>
</tbody>
</table>

• State money transmission law?

• Federal Money Services Business law?
The Online Money Transmitter

The online money transmitter facilitates the transmission of funds between individuals, between businesses and between individuals and businesses. To do so, the online money transmitter acts as a financial intermediary by taking control of funds that are received from senders and intended for a designated recipient.

• **Discussion Questions**
  – Is this activity subject to regulation under state money transmission laws?
  – Okay, so if licensing is required, what are the highlights of that process?
  – Post licensing, what about compliance, exams, etc.?
  – What about exemptions or carve-outs? Money transmission regulation can’t be as broad as it appears. There must be “beta” exemptions, right?
The New “Payment Processor” – Part 1

• New Processor Inc. (the “Processor”) is a payment services provider that enables a Merchant to accept payments that are initiated with payment cards (credit, debit, etc.) for goods and services sold by that Merchant to its Customers (“transaction proceeds”).

  – Unlike traditional payment processors that only handle data and do not handle or control settlement funds, the Processor receives settlement funds into a Processor owned and controlled bank account and then settles directly to the Merchant.

  – In order to provide payment processing services to Merchant, the Processor has entered into a contract with the Merchant that appoints the Processor as Merchant’s limited agent for the sole purpose of receiving transaction proceeds on behalf of Merchant.

  – In addition, the contract affirms that the Processor’s receipt of transaction proceeds satisfies the Customer’s obligation to the Merchant.

• Discussion Questions

  – Is the processor providing a service to the merchant or some other entity?

  – Do transaction proceeds settle to the processor’s own account prior to merchant settlement?
In this scenario, the Processor, while otherwise acting identically to the scenario set forth on Part 1, is not expressly appointed as an agent of the Merchant. Rather, the agreement that exists between the Processor and the Merchant and, to the extent applicable, any agreement between the Processor and the Customers, are vague as to the extent that the Processor is acting on behalf of the Merchant and Customers.

**Additional Discussion Questions**
- Who are the parties to the transaction?
- Is the processor providing a service to the merchant or some other entity?
The New “Payment Processor” – Part 3

Does the Processor hold or control funds?

- In this scenario, the Processor, while otherwise acting identically to the scenario set forth on Part 1, neither holds nor controls funds. Rather, the Processor is partnered with a bank and the bank holds and controls all funds before settling such funds directly to the Merchant.

- **Additional Discussion Questions**
  - As between the Processor and Bank, what are distinct responsibilities of both?
  - Are the funds actually being held in an “FBO” account owned and controlled by Processor?
  - Is the Processor holding itself out as a money transmitter?
The "Innovator"

• The Innovator has a new idea to handle a legacy payments process better, faster and cheaper. But ... the Innovator is a financial intermediary that will receive customer funds and may not be otherwise exempt from licensing.

• The Innovator needs to move to market fast and needs alternatives while it figures out its own licensing strategy.

• Discussion Questions
  – Would a relationship with a bank help?
    • A partnership?
    • An agency relationship?
  – What can an incumbent money transmitter licensee offer?
    • An agency relationship?
    – Can we “rent” a money transmission license?
    • What about a partnership?
Alternative Lending Platforms
What Is Alternative Lending?

- Alternative lending covers a wide range of Internet-based lending arrangements
  - The borrowers may be individuals, small businesses or institutions
  - The lenders/investors may be individuals, banks, institutions, securitization vehicles, etc.
- Alternative lending includes peer-to-peer (“P2P”) lending
- Alternative lending is also viewed as “debt crowdfunding”—that is, funding through debt rather than equity investments
What Laws and Regulations Apply?

- Federal and state banking laws and regulations
- Federal and state securities laws and regulations
- Consumer protection laws and regulations
- Privacy laws
Overview of Lending Laws & Regulations

• Alternative lending activities may be regulated under state lender licensing laws
  – Non-bank consumer lenders may be subject to licensing obligations in a majority of states
  – Non-bank commercial lenders may be subject to licensing obligations in a minority of states
• State licensing regimes for non-bank lenders require extensive disclosures in the licensing application
  – Such disclosures may include financial statements, management/organizational information and background checks (and fingerprinting) for control persons
• Licensees will be subject to minimum net worth and surety bond requirements, and to examination by state licensing authorities and restrictions on owners/control persons
• Non-bank lenders are generally subject to state rate restrictions (i.e., usury laws)
Overview of Lending Laws & Regulations

• Bank partnerships may avoid state licensing obligations and rate restrictions
  – Federal law authorizes federally insured banks to charge interest authorized by the state in which they are located without regard to usury laws of other states (i.e., to “export” rate rules from their home state)
    ▪ The ability of non-banks to rely on a partner bank’s rate exportation has been called into question in Madden and CashCall
  – Bank partners that originate consumer loans will have compliance obligations under consumer protection laws, discussed below

• Platform operators, independently or through their bank partnership, may have Bank Secrecy Act (“BSA”)/anti-money laundering (“AML”) obligations
  – Such obligations may include customer identification, screening, reporting and/or recordkeeping
Overview of Lending Laws & Regulations

- *Madden v. Midland Funding, LLC, No. 14-2131-cv (2d Cir. 2015)*
- Facts:
  - Plaintiff, a New York resident, opened a credit card account with Bank of America, N.A. (“BOA”) in 2005, which later transferred the account to FIA Card Services, N.A. (“FIA”)
  - Around the time of transfer, the terms of Plaintiff’s account were amended by Plaintiff’s receipt of a Delaware law-governed “Change in Terms” document
  - In 2008, FIA determined Plaintiff’s debt was uncollectable, and sold the debt to Defendants
  - In November 2010, Defendants sent Plaintiff a letter seeking to collect payment on her debt, stating that an annual interest rate of 27% applied
Overview of Lending Laws & Regulations

• *Madden v. Midland Funding, LLC*, No. 14-2131-cv. (2d Cir. 2015)

• Procedure:
  – Plaintiff filed suit in 2011, alleging that Defendants:
    ▪ Engaged in abusive and unfair debt collection practices in violation of the Fair Debt Collection Practices Act (“FDCPA”)
    ▪ Charged a usurious rate of interest in violation of New York law, which caps interest at 25% per year
  – Defendants argue that Plaintiff’s claims fail because:
    ▪ The FDCPA and usury claims are based on state-law violations against a national bank’s assignees, and are therefore preempted by the National Bank Act (“NBA”)
    ▪ The Change in Terms specifies Delaware law, under which the interest rate charged is allowed
  – The District Court found in favor of the Defendants and the Plaintiff appealed
Overview of Lending Laws & Regulations

• *Madden v. Midland Funding, LLC*, No. 14-2131-cv. (2d Cir. 2015)

• Holding:
  – The Second Circuit reversed the District Court’s holding regarding the NBA preemption, vacated the District Court’s judgment and denial of class certification, and remanded the issue as to whether Delaware law applies because it was not addressed by the District Court.

• Rationale:
  – Though the NBA may preempt state usury law with respect to national banks, thereby allowing FIA, located in Delaware, to charge interest rates that would be usurious under New York law, the NBA preemption does not extend to Defendants as FIA’s assignees.
  – The U.S. Supreme Court has suggested that the NBA preemption may extend to “non-national banks acting as the ‘equivalent to national banks with respect to powers exercised under federal law,’” e.g., subsidiaries or agents of national banks.
  – Unlike subsidiaries or agents, the Defendants were not acting on behalf of a national bank but were only acting on behalf of themselves as owners of the debt.
  – In addition, the Second Circuit asserted that application of state laws would not “significantly” interfere with either national bank’s ability to exercise its powers under the NBA.
Overview of Lending Laws & Regulations

• Consumer lending activities are subject to a range of consumer protection laws, including laws enforced by the Consumer Financial Protection Bureau (“CFPB”)
  – The CFPB has aggressively enforced consumer protection laws against banks and non-banks, with potential for significant civil money penalties

• Consumer protection laws include
  – The federal Truth in Lending Act, which imposes disclosure requirements on lenders and creates substantive rights for borrowers
  – Federal fair lending laws, including the Equal Credit Opportunity Act, which prohibit discrimination in credit transactions (consumer or business credit)
    ▪ Also, the U.S. Supreme Court’s recent holding in Inclusive Communities regarding disparate treatment
  – Federal and state debt collection practices laws, which regulate the conduct of debt collectors
  – Federal and state privacy laws, which may regulate use and disclosure of consumer data
  – The UDAAP/UDAP authority of the CFPB, Federal Trade Commission (“FTC”) and/or state attorneys general
Digital Wallets and Prepaid
Mobile Wallet Forecast

• Mobile in-store payments are still only a drop in the bucket
  – Only $3.8 million in 2014 (415 Research)

• But the forecast is still bullish
  – Mobile in-store payments forecasted to be approaching $50 billion by 2020 (415 Research)

• And the real promise of mobile payments is not just as an alternative transaction channel . . .
The Promise of Mobile Wallets

Old Model

New Model

Coupon

Real-Time

Buy Now
Mobile Wallets—New Developments

The chicken-and-egg problem is beginning to be solved—companies are beginning to make infrastructure investments that will foster mobile payments adoption.

EMV Card Readers
- Complements tokenization and encryption technologies

• Host Card Emulation (“HCE”)
  - Cloud storage of card credentials

• Bluetooth Low Energy (“BLE”)
  - Promise of in-store location tools

• Biometrics
  - Pay by selfie, by voice, by fingerprint
Regulators and Digital Wallets

All of these government actors have published guidance, notices or reports relating to digital payments.
The CFPB is very interested in engaging with companies and innovators regarding mobile payments

- Project Catalyst
- Office Hours
- No-Action Letter Process
- Informal Discussion
Digital Wallets and Regulatory Concerns

• Given that no regulation or guidance has been issued that is specifically applicable to digital wallets or mobile payments, regulators and companies must adapt regulations written with legacy payments in mind to new payments systems
• Sometimes the analysis is straightforward, sometimes it is not

• Regulatory Issues
  – Durbin Rule
  – Prepaid Access
  – Unfair, deceptive or abusive acts or practices
    • Disclosures
    • Contracting
    • Privacy and Security
  – Proposed Prepaid Rule
FinTech/Bank Partnerships
FinTech/Bank Partnerships

• FinTech/Bank partnerships can be a win/win
  – FinTech companies have the opportunity to leverage the strengths of bank partners
    • Quick to market strategies for FinTech companies
    • The bank’s experience with risk and regulations
    • The bank’s relationship with its customers
  – Allows banks the opportunity to leverage the strengths of FinTech partners
    • Avoidance of old legacy IT/operating structures that inhibit innovation
    • Pinpointed focus on a narrow band of customer needs
    • FinTech partners have relationships with customers outside of the traditional bank footprint

• Strategic Partnership Structures
  – Bank remains the hub of the consumer or small business financial relationship
    • Agent structures
    • Partnership structures
Bank Oversight of FinTech Partners

• **Compliance Responsibilities**
  – A banking partner is generally responsible for ensuring that products/services offered are compliant with applicable law
  – A bank must not abdicate its compliance responsibilities
    • Shared compliance responsibilities
    • Completely outsourced compliance responsibilities
  – Bank control of products/services

• **Recent Developments**
  – FDIC and marketplace lending
  – OCC and bank partnerships
  – FinCEN and AML/BSA oversight
FinTech Partner Due Diligence

- Select Legal/Regulatory Due Diligence Areas of Critical Concern
  - Licensing/registration
    - State and federal money transmission licensing/registration
    - State and federal virtual/crypto-currency licensing/registration
    - State lending licensing
      - State debt collection/servicing licenses
      - State broker licenses
  - Consumer protection
    - UDAP or UDAAP
    - CFPB proposed rule on short-term and other high-cost loans
    - CFPB proposed rule on prepaid products
  - AML/BSA/OFAC