Canada Implements Basel III Contingent Capital Requirements
Satish M. Kini and Samuel E. Proctor

On August 16, 2011, the Office of the Superintendent of Financial Institutions Canada (OSFI) became the first banking regulatory authority to issue detailed guidance on its expectations regarding the implementation of the non-viability contingent capital (NVCC) requirements of Basel III. These rules will require all non-common capital instruments to contain features that require them to be converted into common shares if the institution becomes non-viable. The OSFI advisory sets out the NVCC criteria that the capital of Canadian banks, bank holding companies and trust and loan companies (collectively, deposit-taking institutions, or DTIs) must meet for it to qualify as capital for regulatory purposes. While it is still uncertain whether or to what extent the U.S. regulatory authorities will apply the Basel III rules, the OSFI advisory is particularly noteworthy in that its application extends to Canadian banking subsidiaries of non-Canadian banks (including U.S. banks). Thus, given the potential relevance to U.S. financial institutions, it is important to understand and appreciate the Basel III capital rules and the NVCC advisory produced by OSFI. This article provides a basic summary of the NVCC requirements and OSFI's guidelines, in addition to a discussion about some of the concerns and implications of these new rules.

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Book Review

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We thought we were done with financial crisis books (The Big Short, Chain of Blame, Fooling Some of the People All of the Time, The Greatest Trade Ever, Too Big To Fail, No One Would Listen, and even parts of the Financial Crisis Inquiry Commission's massive report on the subprime crisis). Fortunately, most attorneys in private practice witnessed the economic aftermath of the crisis from the sidelines, but nearly everyone knows those who've lost jobs or their financial footing. The uniform theme of recent financial crisis books is that a huge bill has been handed to the public by financial institutions, their shareholders, directors, and executives. But until very recently, there has been very little public reaction.
Navigating the U.S. Living Wills Requirements

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Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) requires large bank holding companies and systemically important nonbank financial companies to prepare plans for their rapid and orderly resolution under the Bankruptcy Code in the event of material financial distress or failure. The recent release of two rules on resolution planning by the FDIC and the Federal Reserve means that the basic contours of the U.S. regulatory framework for resolution plans are now known. In this article, we have focused on how certain aspects of the rules and their implementation by regulators are likely to have a different impact on regional bank holding companies and certain foreign banking organizations, than on other firms subject to the requirements.

Though foreign-headquartered firms subject to the plan requirements may be able to take advantage of the later submission date allowed under the staggered submission process, in light of home country resolution plan requirements many such firms will have to grapple with the U.S. requirements much earlier than such date.

Regional bank holding companies with a small amount of nonbanking assets (under 15% of total assets) also receive some relief under the final rule for resolution plans, because they are allowed to submit “tailored” resolution plans for the bank holding company that focus specifically on the nonbanking operations of the bank holding company. There too, however, the benefits may be illusory as the parent will have to submit a plan under the companion rule for large insured depository institutions, and therefore will ultimately have to provide the same or similar information for both the bank and nonbanking operations of the covered company.

In both cases, dialogue with the regulators in order to assess the applicability and impact of the rule requirements to any particular firm will be critical to navigating the living will requirement in the U.S.

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Background

The requirement that large bank holding companies and systemically important nonbank financial companies prepare plans for their rapid and orderly resolution under the Bankruptcy Code in the event of material financial distress or failure was enacted into law in the U.S. as part of the Dodd-Frank Act on July 21, 2010. The FDIC and the Federal Reserve, acting jointly as required by statute, proposed a rule in April 2011 to implement this resolution plan requirement, and the FDIC has now approved a modified version of the proposed rule, in final form (the “Section 165(d) Rule”).

Separately, and acting alone, the FDIC also adopted an interim final rule that will require insured depository institutions (“IDIs”) with $50 billion or more in total assets to prepare plans for how they could be resolved in the event of failure by the FDIC as receiver under the Federal Deposit Insurance Act (the “IDI Rule”). The Section 165(d) and IDI Rules are intended to work in tandem, both from a process perspective with the regulators and in terms of their substantive requirements, but firms will have to carefully review how those coordinated requirements are met in the plan preparation process.

Many aspects of the rules—such as the requirement that a portion of a firm’s resolution plan be made public, the potentially severe consequences that can follow from the FDIC and the Federal Reserve deeming a plan to be deficient or the IDI Rule’s “least cost resolution” requirement—will be

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3 FDIC and Federal Reserve, Resolution Plans Required (effective November 30, 2011), to be codified at 12 C.F.R. Part 243 and 12 C.F.R. Part 381 [hereinafter Section 165(d) Rule].


5 The Section 165(d) and IDI Rules both require resolution plans to have a public section that consists of an executive summary of the resolution plan that describes the business of the covered company or covered IDI and includes certain specified information “to the extent material to an understanding of the [covered company or covered IDI].” Section 165(d) Rule at 40; IDI Rule § 360.10(f).

6 The Section 165(d) Rule permits the FDIC and the Federal Reserve, as an initial consequence of failure to cure plan deficiencies, to jointly impose on a covered company, or any subsidiary of a covered company, more stringent capital, leverage or liquidity requirements or restrictions on growth, activities or operations. A covered company upon which the foregoing types of requirements and restrictions are imposed faces the further threat of mandated divestitures if it fails, within the first two years following the imposition of such requirements and restrictions, to submit a revised resolution plan that adequately remedies the deficiencies. Section 165(d) Rule at 38–39.

7 The IDI Rule requires that an IDI resolution plan describe how the strategies for separation of the IDI from the parent company’s organization and sale or disposal of the deposit franchise, core business lines and major assets of the IDI can be demonstrated to be the least costly (...continued)
carefully reviewed and analyzed by firms and their advisers in the implementation of the plan requirements.

**Staggered Initial Submissions**

The proposed Section 165(d) rule would have required all 124 firms estimated to be covered by the rule ("covered companies") to submit their initial resolution plans by a single date. In a key change, and one that the industry broadly supported, the final Section 165(d) and IDI Rules establish three submission dates for initial resolution plans, based on total nonbank asset size:

- July 1, 2012, for covered companies with $250 billion or more in total nonbank assets (and any IDI subsidiaries of such companies that are subject to the IDI Rule);
- July 1, 2013, for covered companies with $100 billion or more, but less than $250 billion, in total nonbank assets (and any IDI subsidiaries of such companies that are subject to the IDI Rule); and
- December 31, 2013, for covered companies with less than $100 billion in total nonbank assets (and any other IDIs that are subject to the IDI Rule and not included in the first two groups).

In each case, for foreign-based covered companies, the measurement of nonbank assets is limited to total U.S. nonbank assets.

Foreign-based covered companies captured by the Section 165(d) Rule because they have total worldwide assets of over $50 billion are obvious beneficiaries of this approach, since the submission date is based solely on U.S. nonbank assets. The term “nonbank assets” is not defined, but we believe it is generally intended to mean assets held outside of an IDI’s consolidation perimeter and that the regulators are likely to treat the assets of uninsured branches of foreign banks as banking assets. The deliberate decision not to define the term means that for those institutions, whether U.S. or foreign, that find themselves close to the line or that have interpretive questions, discussions with the regulators will be possible.

(continued…)

to the Deposit Insurance Fund of all possible methods of resolving the IDI. IDI Rule § 360.10(c)(vii). FDIC staff have indicated that they view this “least cost resolution” requirement to be as much a qualitative as a quantitative assessment.

Most firms subject to resolution plan requirements technically fall into the third group. Importantly though, the FDIC and the Federal Reserve have retained discretion to, with written notice (which must be a joint written notice, in the case of the Section 165(d) Rule), require individual firms to submit their plans earlier or later than provided for by the Rules’ general three-tiered approach.

**Tailored Plans**

The scheme of staggered initial submissions, although helpful, does not in itself address the issue of proportionality, or “one-size-does-not-fit-all,” that was raised by the resolution plan requirements as initially proposed. As a group of major regional bank holding companies commented in response to the proposed Section 165(d) rule, the informational requirements of resolution plans should take into account the significant differences between, for instance, a bank holding company with one large IDI subsidiary and just $51 billion in total assets—in other words, a “barely systemic” institution— and the largest and most complex banking organizations that have substantial nonbank and foreign operations.

In response to this issue, the final Section 165(d) Rule provides a tailored plan option. A firm may elect to submit a tailored plan if it has less than $100 billion in total nonbank assets and its total IDI assets are 85% or more of its total consolidated assets. For a foreign-based covered company to meet the tailored plan requirements, the assets of its U.S. IDIs, branches and agencies must comprise 85% or more of the company’s total U.S. consolidated assets. The resolution plan of a firm that so elects is subject under the Section 165(d) Rule to the same extensive informational requirements as any other covered company, but with respect to most of the requirements, the plan may be limited in scope to nonbanking operations and business lines. So, though a tailored plan must contain strategic analysis and information regarding corporate governance, organizational structure, management information systems and supervisory and regulatory contacts, the tailored plan submitted under the Section 165(d) Rule may limit such analysis and information to nonbanking operations and business lines. By definition for a firm eligible to submit a tailored plan, such operations and business lines will be fairly limited.

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9 See Donna Borak, *Fed Will Differentiate Barely “Systemic” from Truly TBTF*, AMERICAN BANKER, May 6, 2011 (quoting Federal Reserve Chairman Bernanke as saying, “We’re going to be very careful not to have a discrete drop, a discrete change, a discrete difference between $49 billion and $51 billion banks. . . . It will not be the case that community banks, or medium-sized regional banks, or international giants will face the same changes in regulation”).


11 Section 165(d) Rule at 30--31.

12 *Id.*
Impact for Foreign-Based Companies

It is our expectation that different types of financial institutions will benefit differently from the tailored plan option. Foreign banks with no insured depository institution in the U.S. will likely reap the greatest benefits as they will not be subject to the IDI Rule, and the tailored plan, as applied to them, may have fewer informational requirements. This result is a compromise position short of that advocated by foreign banks, who argued that subjecting companies to the Section 165(d) Rule based on their worldwide assets, rather than U.S. assets, was unwarranted by statute and over-inclusive.\(^\text{13}\) The regulators did not modify the test for whether a firm is subject to the rule—so as under the proposed rule, approximately 98 of the estimated 124 covered companies are foreign banks—but they appear to have lessened the burden of being subject to the rule for many foreign firms.

However, the benefits of the later submission date for foreign banks may be illusory as many will be subject to home country resolution plan requirements. To the extent that a home country plan is required to be submitted earlier than December 2013, and will include the foreign bank’s operations and businesses in the U.S., the foreign bank will have to contend with the U.S. resolution plan requirements as part of its home country submission. Foreign banks facing such coordination challenges, including discrepancies in definitions and scope, have been invited by the regulators to discuss their particular situations with the Federal Reserve and the FDIC.

Impact for Large Regional Bank Holding Companies

In addition, it is unclear whether the largest regional bank holding companies will, in practice, gain much from their ability to use the tailored plan option under the Section 165(d) Rule since they will also be subject to the companion IDI Rule with its nearly identical requirements applied at the insured depository institution level. As a result, some regional bank holding companies may find that their overall planning is not reduced. That said, the Section 165(d) Rule’s tailoring concept is still helpful because, combined with the significant flexibility and discretion that the regulators have retained in applying the Rule, it seems likely that even those firms with large IDIs will be able to work with the regulators to customize resolution plans for their business model, size and complexity. For the barely systemic covered companies the tailored plan is likely to be even more helpful as the resolution of the IDI may be viewed as a simpler process for the FDIC.

For both large regional bank holding companies and the barely systemic covered companies, later initial submission dates will also mean that those institutions will benefit from the experience gained by the regulators in assessing the resolution plans of the largest, most complex institutions. Indeed, the regulators have indicated that they expect to provide guidance on the resolution plan elements and the structure of the plan submission to firms as they work on their living wills, and that such guidance will be revised and refined for firms with later submission dates based on the experience with the initial set of submissions.

**Discretion and Dialogue**

As is clear from the foregoing, discretion and flexibility are key themes of the resolution plan rules. Some firms will be permitted to submit tailored plans, but the regulators may disallow tailoring in whole or in part even for firms that meet the technical eligibility requirements. Virtually all of the rules’ timing and substantive elements can be varied at the FDIC’s and the Federal Reserve’s discretion, and the rules acknowledge that plans will vary by firm in accordance with variances in capital structure, risk, complexity, financial activities, size and other factors. The iterative nature of the process and comments from regulators suggest that the focus of the regulators will shift over time from the resolvability analysis at the heart of the plans, to the data and informational elements, and eventually to deficiency assessments.

Particularly for the diverse group of firms that compose the third group that will be required to submit plans under the rules, discussion and dialogue with the FDIC and Federal Reserve will thus be crucial. The FDIC releases accompanying the rules make clear that the regulators expect this to occur.\(^{14}\) For firms to produce credible resolution plans, and for those plans to play a meaningful role as a building block in the emerging system of enhanced prudential regulation for systemically important firms, cooperation and follow-through on both sides will be required.

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For more comprehensive information about the Section 165(d) and IDI Rules, see the Davis Polk client publications [Credible Living Wills Under the U.S. Regulatory Framework](http://www.davispolk.com) (September 19, 2011) and [FDIC Releases Joint Notice of Proposed Rulemaking on Resolution Plans and Credit Exposure Reports](http://www.davispolk.com) (April 5, 2011), available at [www.davispolk.com](http://www.davispolk.com).

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\(^{14}\) *See, e.g.,* Section 165(d) Rule at 22 (“*T*he [FDIC and the Federal Reserve] expect the process of submission and review of the initial resolution plan iterations to include an ongoing dialogue with firms.”).
Business Roundtable: Damming the Flow of Dodd-Frank Rulemaking?

Satish M. Kini and Samuel E. Proctor*

On July 22, 2011, the U.S. Court of Appeals for the District of Columbia (the “D.C. Circuit”) found that the Securities and Exchange Commission (“SEC”) acted arbitrarily and capriciously in adopting proxy voting rules, Rule 14a-11. Although the SEC’s adopting release devoted 60 pages to a cost-benefit analysis of this rule, the D.C. Circuit vacated Rule 14a-11 on the basis that the SEC “failed adequately to consider [Rule 14a-11’s] effect upon efficiency, competition, and capital formation.” Business Roundtable v. SEC.¹ In reaching this conclusion, the court sharply criticized the SEC’s efforts, at one point calling them “unutterably mindless.”

Business Roundtable is notable, specifically, for its impact on the SEC’s attempts to amend the proxy access process. More generally, as a rebuke to one of the first SEC rules issued in the wake of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the case may have broader implications. As is well known, the Dodd-Frank Act tasks the SEC and other federal financial regulatory agencies with writing hundreds of rules over the course of several years. Many have speculated that Business Roundtable will delay this already tortured rulemaking process, as agencies re-evaluate the robustness of the analysis needed to support rulemakings and private parties are emboldened to challenge rulemakings in court.

It is to the inquiry of what, if any, impact Business Roundtable will have on the Dodd-Frank rulemaking process that this article is addressed. We first discuss the particulars of Business Roundtable and then review the primary basis for the court’s holding, namely the SEC’s failure to offer analysis in support of Rule 14a-11 sufficient to meet the standards established by the Securities Exchange Act of 1934 (the “Exchange Act”) and Investment Company Act of 1940 (the “Investment Company Act”). Then, this article discusses how

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Business Roundtable should be interpreted – narrowly, as implicating principally the SEC’s rulemakings under its organic statutes, or broadly, with implications for all the federal financial regulatory agencies and others involved in the Dodd-Frank implementation process.

**Background**

A closely divided SEC, by a vote of three Commissioners to two,² adopted Rule 14a-11 in final form in September 2010.³ In general, the rule would have required companies subject to Exchange Act proxy rules and investment companies regulated under the Investment Company Act to include in their proxy materials: (a) information about, and the ability to vote for, a shareholder’s, or group of shareholders’, nominees for director; and (b) shareholder proposals that seek to establish a procedure in the company’s governing documents for the inclusion of one or more shareholder director nominees. The SEC asserted that the rule would yield a variety of benefits, including benefits to “corporate suffrage, the disclosure provided in connection with corporate proxy solicitations, and communication between shareholders in the proxy process.”⁴

The Business Roundtable and the Chamber of Commerce (together, “Petitioners”), two nationally active business associations with corporate members subject to Rule 14a-11, petitioned the D.C. Circuit for review of Rule 14a-11, arguing that the SEC, when promulgating the rule, had failed to consider adequately its “effect upon efficiency, competition, and capital formation,” as specifically required by Section 2(c) of the Investment Company Act and Section 3(f) of the Exchange Act.⁵ According to Petitioners, the SEC’s failure to undertake the required analysis meant that the rule was promulgated in violation of the Administrative Procedure Act and therefore void.

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² The court’s opinion suggests that it was influenced by the dissenting Commissioners’ views. *See* 647 F.3d at 1148 (referencing dissenting Commissioners’ statement and indicating that Commissioners dissented on “empirical” grounds); *see also* Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005) (vacating portions of rule adopted by SEC by a vote of three Commissioners to two).


⁴ *Id.*

The D.C. Circuit granted Petitioners’ request for review, concurred with their arguments and vacated the rule. The court, in an opinion penned by Judge Douglas Ginsburg, held that the SEC’s analysis of the economic ramifications of the rule did not meet the burden imposed by Sections 2(c) and 3(f). The court took the SEC to task for having: “inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.”6 In sum, the court vacated Rule 14a-11 because the SEC fell far short of its “statutory obligation to determine as best it can the economic implications” of the rule.7

Implications of the Case: The Narrow View

One way to view Business Roundtable is as a decision dictated by what the D.C. Circuit labeled as the “unique” standard imposed under the SEC’s organic statutes (the Exchange Act and the Investment Company Act). According to the D.C. Circuit, these statutes specifically require the SEC to “apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation.”8 This economic impact standard imposes a higher statutory burden on the SEC, without which the court arguably would not have vacated the rule. Indeed, as the court noted in Business Roundtable, this was not the first case in which the SEC had been found deficient in its analysis under these statutory standards – and, perhaps, it was the court’s sense that the SEC was a recidivist offender that triggered its sharp language.9

Viewed this way, Business Roundtable may, as a legal matter, be of limited precedential value for rulemakings under other statutory regimes. In the absence of a provision in an agency’s organic statute that requires heightened economic analysis similar to that necessitated

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6 647 F.3d at 1148-49.
7 Id. at 1148.
8 Id.
9 On previous occasions, the D.C. Circuit has vacated SEC rulemaking because of the SEC’s failure to assess adequately economic effects of its rule. See American Equity Investment Life Insurance Company v. SEC, 613 F.3d 166 (D.C. Cir. 2010); Chamber of Commerce, supra. The court made several references to these prior holdings in the Business Roundtable opinion.
by Sections 2(c) and 3(f), it may be difficult to regard *Business Roundtable* as offering principles that deserve broader application.

Even taking this “narrow” view, however, the D.C. Circuit’s opinion could well have significant implications for the SEC and others. According to a Congressional Research Service report, the SEC is either authorized or required to issue at least 97 new regulations under the Dodd-Frank Act.\(^\text{10}\) Many of these new rules will be adopted under the Exchange Act and Investment Company Act and, therefore, will need to satisfy the economic impact standard set forth in *Business Roundtable*.

The Commodity Futures Trading Commission (“CFTC”), which, like the SEC, is charged with significant rulemaking authority under Dodd-Frank, also is required to apply a heightened economic analysis to its rulemakings. Specifically, the Commodity Exchange Act, the CFTC’s organic statute, requires the CFTC to assess five broad cost-and-benefit factors in rulemakings, including protection of market participants and the public and “efficiency, competitiveness, and financial integrity of futures markets.”\(^\text{11}\) That standard appears highly similar to what is required of the SEC by the Exchange Act. As a consequence, *Business Roundtable* has caused disquiet among some CFTC Commissioners, who have commented openly that the agency’s rulemaking process may be vulnerable to the same challenges as the SEC’s Rule 14a-11.\(^\text{12}\)

Another agency likely to be affected by *Business Roundtable* is the newly formed and highly controversial Consumer Financial Protection Bureau (“CFPB”). The CFPB was created by the Dodd-Frank Act and entrusted with rulemaking (and other) authority over an array of consumer financial protection laws, including the Truth in Lending Act, the Equal Credit Opportunity Act and Truth in Savings Act. In crafting rules, the CFPB must undertake a multi-pronged analysis, with specific reference to a variety of cost-and-benefit factors. First, the agency is instructed to consider (a) the costs and benefits of its rulemaking to both consumer and


regulated entities, including the potential reduction in access to consumer financial products by consumers, (b) the impact of its rules on depository institutions with assets of less than $10 billion and (c) the effects of rules on rural consumers.\(^{13}\) The analysis does not stop there, however. The Dodd-Frank Act also requires the CFPB to consider the possible impact of its rules on small business. Specifically, in any rulemaking, the CFPB must consider “\textit{any} projected increase in the cost of credit” for small business, as well as describe “\textit{any} significant alternatives to the proposed rule” that accomplish the rule’s objectives and minimize the increase in cost of credit for small business.\(^{14}\)

That level of analysis – to consider \textit{any} potential alternatives to a rule and \textit{any} new costs of credit for small business – is only required of three agencies: the CFPB, the Environmental Protection Agency, and the Occupational Health and Safety Administration. This exacting standard, on top of an already multi-factor cost-benefit analysis, would seem to be an even higher hurdle than the SEC’s heightened economic impact standard under the Exchange Act.

Thus, even if one takes a narrow view of \textit{Business Roundtable}, the case’s potential impact seems significant. This case would seem to require heightened economic analysis from at least the SEC, CFTC and CFPB, agencies that are charged by the Dodd-Frank Act with issuing more than 150 new rules establishing new standards and requirements for derivatives trading, securities markets and disclosures and consumer financial protection.\(^{15}\) \textit{Business Roundtable} suggests that, at a minimum, these three agencies will need to conduct searching analyses of the costs and benefits of their proposed rules and ensure that their rules can be justified on various economic grounds. That level of analysis will be time-consuming, costly and highly difficult for agencies to undertake. For these agencies, as one commentator noted, \textit{Business Roundtable}

\(^{13}\) Dodd-Frank Act § 1022.

\(^{14}\) Dodd-Frank Act § 1100G (emphasis added).

\(^{15}\) CRS Rulemaking Study, \textit{supra} (tallying the rulemakings required of the three cited agencies).
imposes “an extraordinarily difficult burden,” making rulemaking highly difficult and susceptible to legal challenge.\textsuperscript{16}

Evidence of the present and forthcoming difficulties faced by these agencies may be found in the SEC’s ongoing rulemaking regarding conflict minerals, mandated by Section 1502 of the Dodd-Frank Act. Under the SEC’s proposed rules, securities issuers that use certain minerals for functionality or production would need to disclose whether these minerals originated in the Democratic Republic of the Congo or an adjoining country. If so, that issuer would need to describe in a report the measures it has taken to exercise due diligence regarding the source and chain of custody of the minerals. Further, any such issuer would be required to certify that it obtained an independent audit of its report.\textsuperscript{17} The SEC’s proposal suggested the total paperwork compliance cost would be $71 million, an estimate hotly disputed by the National Association of Manufacturers, which put the cost at $9 to $16 billion. The Chamber of Commerce, evidently emboldened by \textit{Business Roundtable}, has threatened to sue. The SEC’s rulemaking is now significantly behind schedule.\textsuperscript{18}

\textbf{Implications of the Case: The Broad View}

Many commentators are not convinced that the narrow view of \textit{Business Roundtable} is correct. They read the decision more broadly to impose on \textit{all} agencies an “affirmative obligation to determine the economic implications of a proposed rule.”\textsuperscript{19} In this view, even though the D.C. Circuit’s holding was predicated on the heightened economic impact standards specific to the SEC’s organic statutes, the court was sending a clear signal to all regulatory agencies of the need to undertake a rigorous analysis of economic and other effects of rulemakings and to expect that this analysis will be subject to close judicial scrutiny.

\begin{itemize}

\item \textsuperscript{17} \textit{Conflict Minerals}, 75 Fed. Reg. 80,948 (Dec. 23, 2010).


\item \textsuperscript{19} BNA’s Banking Report, \textit{Court Vacates SEC’s Proxy Access Rule, Cites Failure to Address Economic Impact} (July 26, 2011).
\end{itemize}
Viewed this way, the D.C. Circuit’s decision puts the “entire” Dodd-Frank implementation process “at heavy risk.”20 According to commentators who hold this view, Business Roundtable applies with equal force to all the regulatory agencies and renders all Dodd-Frank rulemakings “completely attackable.”21 In addition, taking this broad view, Business Roundtable requires a searching analysis of not just economic factors related to an agency rulemaking but also other factors and considerations raised by commenters during the rulemaking process.

Whether or not the broad view is justified as a legal matter, anecdotal evidence suggests it is justified as a practical matter. Indeed, from informal conversations we have had with several senior agency staff, we believe they are carefully considering Business Roundtable in their ongoing Dodd-Frank Act rulemaking. As a result, we theorize that the effects of the D.C. Circuit holding may include:

- **Conservative Positioning by Agencies.** The federal regulatory agencies charged with Dodd-Frank implementation may generally take less controversial positions in rulemakings. To the extent that these agencies are able to take positions that are non-controversial and require less “empirical” justification, they may do so regardless of an agency’s underlying policy preference. To some affected parties, in some situations, this may be a desired outcome but, given the many conflicting and confusing provisions of the Dodd-Frank Act, there are likely to be situations in which agency timidity is not desirable. Indeed, for some market participants, having an agency definitively resolve a controversial question one way or another is preferable to the agency taking a “safe” position that does little to resolve uncertainty.

- **More Extensive Consideration of Comments.** In Business Roundtable, the D.C. Circuit took the SEC to task for failing to “adequately address” comments, even those that some legal scholars deemed “entirely speculative.”22 As result, agencies are likely to be more solicitous of comments and to give more explicit consideration of comments in a

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20 Donna Borak, *Court Ruling Offers Path to Challenge Dodd-Frank*, American Banker (Aug. 2, 2011) (“‘The entire Dodd-Frank implementation is at heavy risk because if any of these rules are challenged by the courts, they won’t survive,’ said Hal Scott, Nomura Professor and Director of the Program on International Financial Systems at Harvard Law School”).

21 Id. (“Rules put out by other federal agencies will be ‘completely attackable’ under this decision, Scott said.”).

22 647 F.3d at 1152; accord J. Robert Brown, *supra*. 
rulemaking process. Agencies are less likely to be able simply to disregard unpersuasive evidence and arguments but will need to document why evidence and arguments presented by commenters need not alter an agency’s approach in a rulemaking.

- **Delay.** More careful consideration of comments in rulemaking is likely to be viewed by many as a positive development. Forcing the agencies to be explicit about why they reject one approach but adopt another is a desired outcome. But, a significant downside likely will be further delay – agency rulemakings to implement the Dodd-Frank Act already are significantly behind schedule, and the process is likely to be delayed even further if the federal regulatory agencies believe that they need to devote additional time to “papering the record.”

- **Less Rulemaking.** Agencies are likely to avoid rulemakings in areas where Dodd-Frank authorizes, but does not command, that new rules be issued. The agencies are more likely to act through guidance, no-action relief and examination and supervisory channels. For example, some have speculated that the recent decision of the Financial Stability Oversight Council (the “FSOC”) to issue interpretive guidance on its process for designating nonbank systemically important financial companies under Title I of the Dodd Frank Act reflects a concern by the FSOC that it lacks the authority to promulgate legally binding rules and could face litigation if it were to proceed with rulemaking.23 The result is guidance that, as a matter of law, may not require notice-and-comment to be changed. Such results may be less than desirable for many, for which the legal certainty of -- and opportunity to comment on -- rulemaking is preferred.

- **More Litigation.** The D.C. Circuit, many believe, has opened the door to further litigation. There seems little doubt that the court’s ruling in *Business Roundtable* will embolden others to challenge rules that they cannot change in the notice-and-comment process.

**Conclusion**

*Business Roundtable* seems likely to affect significantly the Dodd-Frank implementation process. If viewed narrowly, the decision will affect three key agencies – the SEC, CFTC and CFPB – and likely require them to undertake more rigorous economic analysis in their rulemakings. That effect already seems evidenced by agency actions; for example, the SEC’s conflicts minerals proposal, as discussed above, is bogged down in part over disputes regarding

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costs and economic burdens, and the CFTC seems to be taking steps to increase the robustness of its cost-benefit analysis.\textsuperscript{24}

The implications of the case also could be broader – affecting other agencies and their consideration of not only economic but also other factors in the rulemaking process. If so, the Dodd-Frank rulemaking process, already tortured and slow-moving, will become even more sluggish. For some, this will be a positive outcome. For others, including market participants for which finality and legal certainty are beneficial, the increased delay will be a negative outcome.

\textsuperscript{24} Borak, \textit{supra} note (“In May, the [CFTC’s] general counsel and chief economist issued a memo spelling out guidelines for cost-benefit analyses. The memo and other efforts to slow down the Dodd-Frank rules drew rare praise from the agency’s internal watchdog, which said the [CFTC] “has taken proactive steps to address concerns.””)
Canada Implements Basel III Contingent Capital Requirements

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On August 16, 2011, the Office of the Superintendent of Financial Institutions Canada (OSFI) became the first banking regulatory authority to issue detailed guidance on its expectations regarding the implementation of the non-viability contingent capital (NVCC) requirements of Basel III. These rules will require all non-common capital instruments to contain features that require them to be converted into common shares if the institution becomes non-viable. The OSFI advisory sets out the NVCC criteria that the capital of Canadian banks, bank holding companies and trust and loan companies (collectively, deposit-taking institutions, or DTIs) must meet for it to qualify as capital for regulatory purposes. While it is still uncertain whether or to what extent the U.S. regulatory authorities will apply the Basel III rules, the OSFI advisory is particularly noteworthy in that its application extends to Canadian banking subsidiaries of non-Canadian banks (including U.S. banks). Thus, given the potential relevance to U.S. financial institutions, it is important to understand and appreciate the Basel III capital rules and the NVCC advisory produced by OSFI. This article provides a basic summary of the NVCC requirements and OSFI’s guidelines, in addition to a discussion about some of the concerns and implications of these new rules.

Basel III NVCC Requirements

On January 13, 2011, in an annex to the Basel III rules text that was published in December 2010, the Basel Committee on Banking Supervision outlined the minimum requirements to ensure loss absorbency at the point of non-viability. The rules require that all non-common capital instruments (generally preferred shares and subordinated debt) issued by an internationally active bank contain features that require these instruments to convert into common equity tier 1 capital if the bank becomes non-viable.

These provisions are meant to protect the public from paying for bailouts of failing banks before investors fully absorb bank losses. According to the rules, the NVCC requirements would be triggered by a decision from a relevant authority that either a write-off of the non-common capital instrument is announced or an effect that is tantamount to a write-off is announced.

1 The Australian Prudential Regulation Authority (APRA) recently became the second international regulator to provide comments on the NVCC requirements. Australian Prudential Regulation Authority, “Discussion Paper: Implementing Basel III capital reforms in Australia” (September 6, 2011). See pages 18 and 19 specifically for a discussion of the implementation of the NVCC requirements.


3 For example, in a recent speech at the International Monetary Conference, Treasury Secretary Tim Geithner advocated for a requirement that the largest firms (e.g., the firms whose failure could cause the greatest damage to the economy) hold more capital relative to risk than smaller institutions, in the form of a common equity surcharge, as opposed to implementing contingent capital instruments. “Remarks by Treasury Secretary Tim Geithner to the International Monetary Conference” (June 6, 2011), online: U.S. Department of the Treasury <http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx>.


5 Although the Basel III rules apply only to internationally active banks, OSFI has determined to apply the NVCC requirements to all DTIs incorporated in Canada.
capital instrument or a public sector injection of capital (a bailout) is necessary because the bank in question would otherwise become non-viable. In either case, the triggering of the NVCC requirements would mean that before public funds are injected to save a bank from failure, all non-common capital instruments must either be written off or be immediately exchanged into common equity capital to absorb the losses. This will shift the costs of bank failure first and foremost onto the shoulders of investors, rather than depositors and taxpayers, because the write-off/conversion must occur before any public money is used to bail out the bank. Any publicly owned capital issued for a bailout would therefore be protected from being diluted by the newly converted common equity capital. Under Basel III, all non-common capital instruments issued after January 1, 2013, must include NVCC features. Non-common capital instruments without NVCC features will be phased out according to the timeline detailed in annex 4 to Basel III.

OSFI Advisory Providing Additional Guidance on NVCC Requirements

In its August 2011 advisory, referred to above, OSFI set out 10 principles governing the inclusion of NVCC instruments in regulatory capital and described the process under which OSFI will assess whether such instruments qualify as additional tier 1 or tier 2 capital that meets the NVCC requirements. In addition, the advisory outlines some of the criteria to be considered by the Superintendent prior to triggering conversion.

Among the principles set out in the advisory is that the contractual terms of all qualifying non-common capital instruments must include a clause requiring full and permanent conversion into common shares on the occurrence of a trigger event. In addition, each capital instrument must contain clauses that include, at a minimum, the following two trigger events:

1. The Superintendent publicly announcing that the DTI has been advised in writing that the Superintendent is of the opinion that the DTI has ceased or is about to cease to be viable, and that after the conversion of all contingent instruments and taking into account any other factors or circumstances that are considered relevant or appropriate, it is reasonably likely that the viability of the DTI will be restored or maintained; and

2. A federal or provincial government in Canada publicly announcing that the DTI has accepted or agreed to accept a capital injection without which the Superintendent would have determined the DTI to be non-viable.

Although the Basel III NVCC requirements provide each country with discretion to require all non-common capital instruments to either be written off or be exchanged into common shares upon a trigger event, OSFI determined that a conversion to common shares was more consistent with traditional insolvency consequences and therefore will not permit a write-off of the capital instrument.6

Other principles emanating from the OSFI advisory are that the conversion terms of the new NVCC instruments must reflect the market value of the common equity of the bank before the date of the trigger event and that the conversion method must also put a limit or a cap on the number of shares issued upon a trigger event. Furthermore, the method of the conversion should

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6 By contrast, APRA will allow the flexibility to write off the instrument rather than requiring it to be converted into common shares, supra note 1.
take into account priorities in an insolvency. Former debtholders should receive economic entitlements greater than those given to former preferred shareholders; former preferred shareholders should receive economic entitlements greater than those given to pre-existing common shareholders; and common shareholders will have their ownership interest substantially diluted. The issuing DTI must also ensure that there are no impediments to conversion, so that the conversion will be automatic and immediate, and the DTI must make all commercially reasonable efforts to ensure that the conversion is not an event of default under any other contract entered into by the DTI. In addition, the issuing DTI must provide procedures or mechanisms for dealing with the issuance of common shares to persons who are prohibited from owning shares in the bank.

OSFI has also indicated that in the case of a DTI that is a subsidiary of a non-Canadian financial institution that is subject to Basel III’s capital adequacy requirements, the NVCC instruments that the DTI issues must be convertible into shares in the DTI and not in the parent or affiliate without the prior consent of OSFI. In addition, the trigger events must not occur at the discretion of a non-Canadian regulator or be based on non-Canadian events applicable to the affiliate. If the DTI has a non-Canadian subsidiary subject to Basel III requirements, the DTI may include the NVCC issued by non-Canadian subsidiaries in its consolidated regulatory capital to the extent allowed by the Basel III rules. NVCC instruments issued by non-Canadian subsidiaries must contain triggers that are equivalent to those specified by OSFI. OSFI will activate those triggers only after consulting with the host authority if the subsidiary is non-viable or if the parent is non-viable as a result of an injection of capital or similar support into the subsidiary. In triggering conversion, OSFI will be informed by its interactions with the Financial Institutions Supervisory Committee, as well as by the Minister of Finance. Other public sector interventions will likely need to be used in tandem with NVCC measures.

**Benefits and Concerns**

As with any new regulatory requirements, there are both supporters and critics of the new Basel III rules. Proponents of the NVCC requirements argue that contingent capital should strengthen market discipline, in light of the serious concern resulting from the recent financial crisis over the implicit government support that the markets and rating agencies ascribe to systemically important financial institutions. Given this support, banks are able to raise funds more cheaply than competitors that do not benefit from an implicit government guarantee. This creates a moral hazard because creditors have no incentive to insist on strong risk management if they can expect to receive a hundred cents on the dollar by virtue of the government’s stepping in to bail out the troubled bank. Such proponents theorize that mandatory conversion features will force the holders of subordinated debt and preferred shares to insist on stronger risk management practices, which should reduce the moral hazard. If there is a perception that a bank does not have strong risk management, investors will require a risk premium in the form of a higher yield

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7 The Financial Institutions Supervisory Committee (or FISC, as it is commonly referred to) was created in 1987 under section 18(1) of the Office of the Superintendent of Financial Institutions Act (Canada). Its membership includes the Superintendent at OSFI, the Governor of the Bank of Canada, the Chairperson of the Canada Deposit Insurance Corporation and the Deputy Minister of Finance.

8 The OSFI advisory does not specify examples of public sector interventions, but the most likely example would be a government investment in shares of the troubled institution.
to purchase securities of the bank, thereby creating market discipline for the bank to strengthen its risk management.

Critics of the NVCC requirements, however, are chiefly concerned that the capital markets do not have the depth to absorb this new form of capital and that finding investors to invest in such instruments will prove challenging. For example, fixed-income investors may be unable or unwilling to purchase such instruments if they could end up holding common shares in the bank – particularly if the instruments are not eligible for inclusion in bond indices – since the investors are essentially being required to assume equity downside risk without the potential upside of equity investments. In any event, investors will likely require a significantly higher interest or dividend coupon to compensate for the fact that such instruments contain mandatory conversion features. Given that banks in Canada and the United States raise billions of dollars in capital each year, there is a concern that adding additional uncertainties may cause investors to become more reluctant to make investments in banks, which would actually weaken the stability of the financial institutions sector as opposed to strengthening it. Moreover, banks that are not actually on the eve of insolvency (but that may be experiencing some financial difficulties) may find it especially difficult to raise common share equity since the holders of that new capital would effectively be facing significant dilution. This concern becomes amplified significantly if hedge funds or others try to “game” the system. The unintended consequence could be that such struggling banks may end up experiencing even greater financial difficulties (which could eventually lead to insolvency) resulting from the potential inability to raise capital on reasonable terms.9

**Potential for Exemptive Relief in the United States**

As mentioned earlier, it is still unclear whether or to what extent, the U.S. regulatory authorities will apply the Basel III rules. For example, the final Basel III rules contain the possibility that the new requirements will not apply if

1. the governing jurisdiction of the bank has laws that (i) require such tier 1 and tier 2 instruments to be written off upon such event, or (ii) otherwise require these instruments to fully absorb losses before taxpayers are exposed to loss;

2. a peer group review confirms that the jurisdiction conforms with clause (1); and

3. the relevant regulator and issuing bank disclose in future issuance documents that these instruments are subject to loss under clause (1).

Many believe that these provisions were inserted at the request of officials from the United States on the basis that the provisions of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) and other regulatory changes made in the United States will

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9 When asked whether there is a sufficient market for contingent capital instruments, OSFI Superintendent Julie Dickson remarked that if need be, investment banks will find a way to sell the NVCC securities. Said Dickson: “A sufficient investor base will be a function of the ultimate design, ratings, and other items. Financial institutions have shown an uncanny ability to design instruments for their own use that have found broad market acceptance.” “Too-Big-to-Fail and Embedded Contingent Capital: Remarks by Superintendent Julie Dickson, Office of the Superintendent of Financial Institutions Canada (OSFI) to the Financial Services Invitational Forum” (May 6, 2010).
satisfy the requirement. However, to our knowledge, no peer group has been created to conduct the assessment, and it is unclear whether the Dodd-Frank Act will satisfy the requirements of (1). Even if the exemptive relief is not available, it is possible that U.S. regulatory authorities will not fully adopt Basel III, which is not legally binding on any country. However, until more clarity is available on the potential applicability of the NVCC requirements, U.S. banks will need to continue to monitor these developments closely.

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BOOK REVIEW:
RECKLESS ENDANGERMENT
by Gretchen Morgenson and Joshua Rosner

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We thought we were done with financial crisis books (The Big Short, Chain of Blame, Fooling Some of the People All of the Time, The Greatest Trade Ever, Too Big To Fail, No One Would Listen, and even parts of the Financial Crisis Inquiry Commission’s massive report on the subprime crisis). Fortunately, most attorneys in private practice witnessed the economic aftermath of the crisis from the sidelines, but nearly everyone knows those who’ve lost jobs or their financial footing. The uniform theme of recent financial crisis books is that a huge bill has been handed to the public by financial institutions, their shareholders, directors, and executives. But until very recently, there has been very little public reaction.

The relatively muted response to the financial meltdown by the unemployed, underemployed, involuntarily downsized and foreclosed-upon is a bit of a mystery, and the initial lack of public reaction made financial crisis literature seem more academic than vital. So we thought we’d read enough.

Then the Occupy Wall Street movement started in lower Manhattan, and started spreading to other cities. If it continues and develops into a broad-based, noisy and unpredictable public reaction to the financial meltdown, it makes sense to refocus on the roots and causes of the crisis. So we returned to the financial crisis bookshelf, reaching for Gretchen Morgenson and Joshua Rosner's massive "Reckless Endangerment," which examines the role of Fannie Mae and Freddie Mac in the days leading up to the housing meltdown.

The authors, veterans of the financial and journalism worlds, did their homework. Gretchen Morgenson, assistant business editor of the New York Times, has worked as a broker and as a journalist for several leading finance magazines. Rosner is a financial
analyst who’d previously been with Oppenheimer & Co. Their book is packed with data, figures, quotes, emails, and off-the-record comments from ostensibly reputable sources. It's well written and actually gripping at times, with a compelling cast of outsized characters and an intricate web of relationships, secrets and unacknowledged agendas. That's the good part.

The principal downside to Reckless Endangerment is that, rather than documenting and describing events and consequences, Morgenson and Rosner struggle mightily almost from the first page to convince readers of the corrupt culture of the GSEs. The book doesn't stop attacking long enough to let readers connect the dots and reach their own conclusions about these agencies -- it jams the authors' opinions down readers' throats. In their attempt to vilify the executives who ran the GSEs, the politicians who supported them, and the finance company executives who cozied up to them to advance their business agendas, the authors cross over the line from documenting the role of the GSEs to trumpeting their maliciousness. If Morgenson and Rosner were prosecutors determined to bring Fan and Fred's executives to justice, Reckless Endangerment could serve as “Exhibit 1.” While not heaping the entire blame on the GSEs, they find them at the rotten heart of the disintegrating mortgage industry. Fannie Mae, in particular, is cast as the poster child for bad corporate behavior.

Morgenson and Rosner cut Fannie no slack for its activities even before the accounting nightmare that brought investor and Congressional scrutiny to the agencies in the late 1990s. Early on, they suggest that Fannie’s efforts in the early 1990s to increase minority lending were mostly an attempt to keep potential adversaries, like ACORN and National Council of La Raza, at bay. Moreover, the authors claim Fannie was not satisfied with merely muting potential critics and low-income housing advocates -- they see Fannie’s adoption of lax underwriting standards as a deliberate attempt to convert aspiring homeowners into fuel for the engine that grew the GSEs.

At times, Reckless Endangerment reads not as a narrative deconstructing GSE history for the last 20 years, but as a playbook for how the agencies (and more specifically,
their executives and those in their political and commercial orbit) bent two of the most prominent institutions of the US economy to their own ends.

In Morgenson and Rosner’s view, no Fannie Mae program is untainted with self-interest. *Reckless Endangerment* lays out a virtual conspiracy with participants ranging from nonprofits and businesses to the well-funded Fannie Mae Foundation. Fannie’s establishment of local partnership offices around the country is described as a thinly veiled effort to sink roots into communities so local and national politicians would view Fannie as a constituent. Fannie created employment opportunities for these politicians or their families to increase their sense of obligation. Local business owners with no apparent connection to housing were invited to join Fannie advisory boards in an effort by Fannie to buy or flatter their way into their good graces. These efforts are viewed by the authors as a patronage system by which Jim Johnson, Fannie’s CEO from 1991-98, tried to bulletproof Fannie "and his position atop it." If these actions had any positive effect at all on promoting housing opportunity, you wouldn’t know it from reading this book.

Even Fannie’s explicitly charitable efforts were part of its empire-building and patronage system according to Morgenson and Rosner. They claim the Fannie Mae Foundation allowed Fannie to move millions of dollars in advertising expense off its books and thereby improve its profit picture. More damningly, they maintain that the Foundation disguised a system of kickbacks to community groups and other nonprofits in exchange for their support for maintaining Fannie’s tax exempt status.

Even Fannie’s research journals were deliberately biased in its favor. Fannie’s housing research was ultimately undertaken to "defend the status quo," say Morgenson and Rosner, and rarely broached the subject of the true cost of the implied government guarantee of their programs.

The GSEs’ influence did not stop with local community groups, potential Congressional adversaries and scholars, either. The authors say that official reports unfavorable to the
GSEs were often leaked to them in advance, giving them an opportunity to roll out their take-no-prisoners lobbying machines. *Reckless* views pre-crisis Fannie and Freddie as all-seeing, all-knowing and all-powerful actors in the public policy arena.

*Reckless Endangerment* is a long and readable book that makes a case for the possibility that, over two decades, Fannie Mae and Freddie Mac engaged in a relentless effort to build empires and enrich their executives and favored patrons. Morgenson and Rosner give the GSEs rough treatment in their book, but the denouement of the GSEs has proven far rougher.