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Banking

Federal Reserve Issues Proposed Rulemaking Implementing Basel II Risk-Based Capital Requirements

On March 30, the Board of Governors of the Federal Reserve System (the Federal Reserve), building on an advanced notice of proposed rulemaking issued in August 2003, issued a proposed rulemaking to implement Banking Committee on Banking Supervision (Basel) II risk-based capital requirements in the United States for large, internationally active banking organizations. Notably, the Basel II standards update the Basel standards previously adopted in 1988 (Basel I). The intent of the Basel II standards is to align banking standards around the world to prevent a financial crisis in one part of the world from impacting the larger global banking community. According to the Federal Reserve's press release, the proposed rule would "require the largest internationally active banks to enhance the measurement and management of their risks, including credit risk and operational risk. It would also require these banks to have rigorous processes for assessing overall capital adequacy in relation to their total risk profile and to publicly disclose information regarding their risk profile and capital adequacy." The new rules would be phased-in, requiring a bank to "satisfactorily complete a four-quarter parallel run period, beginning no sooner than January 1, 2008, before operating under the Basel II framework." At the conclusion of a successful parallel run, a "bank would have to progress through three transitional periods, each of at least one year, during which there would be temporary floors on potential declines in risk-based capital requirements." Approval from a bank's primary federal supervisor to move to each transitional floor would be required and, at the conclusion of the transitional period, a bank could move to full Basel II. According to industry estimates, 11 U.S. banks will be required to adopt Basel II and others may voluntarily adopt the capital requirements, likely bringing the U.S. total to 20 institutions.

The other federal banking agencies, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, are also reviewing the Federal Reserve's proposal.
http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060330/default.htm

OTS Sounds Warning on Credit Quality; OCC Focuses on Loan Concentrations

At a speech before the New York Bankers Association (NYBA) on April 6, Office of Thrift Supervision (OTS) Director John Reich expressed concerns about weakening credit quality with some financial institutions. Although the industry has enjoyed record levels of profitability and capital, margins are declining at some institutions. Reich cautioned the bankers that "now is precisely the time to pay attention" to leading indicators that may foreshadow future credit quality concerns. He identified inadequate loan documentation, misaligned loan pricing relative to credit risks, declining underwriting standards, liberalization of loan terms, and increasing reliance on wholesale funding as areas of concern to OTS. Given the tremendous growth in originations the last several years, Reich noted, it is not surprising that volumes are stabilizing. "What concerns us," he observed, "is how some institutions are reacting to this phenomenon. In response, OTS has increased its vigilance and we are digging deeper into loan portfolios," Reich stated, and "paying close attention to the fundamentals, including loan documentation, pricing, loan-to-value ratios, and overall underwriting standards." The speech is available from the OTS website at http://www.ots.treas.gov/.

Comptroller of the Currency John C. Dugan told the same conference of bankers that while concentrations in commercial real estate lending do raise safety and soundness concerns, bank regulators believe they can be safe if they are effectively managed. "Our message is not, 'Cut back on commercial real estate loans.' Instead it is this: 'You can have concentrations in commercial real estate loans, but only if you have the risk management and capital you need to address the increased risk.'" The Comptroller noted that 30 percent of national banks hold commercial real estate loans in amounts exceeding 300 percent of capital and said that nearly all of these institutions are mid-size or community banks. Commercial real estate lending has historically been a volatile business, he noted, adding that it clearly played a role in the banking crisis of the late 1980s and early 1990s. "The degree to which banks participated in the run-up of the commercial real estate market in the early '80s was one of the best predictors of subsequent bank failure," the Comptroller said. "On average, banks that failed had nearly three times as many commercial real estate loans as a percentage of their total assets as banks that did not fail." In the last several years, he said, the OCC has found erosion in some key areas: lengthening maturities, increasing policy exceptions, narrowing spreads, and a lack of independence and quality control in the appraisal process. In addition, the OCC found that risk management practices were not keeping up with the growth in commercial real estate concentrations.

Dugan noted that although it was these recent trends that led regulators to propose new guidance, the proposal is "simply a restatement and amplification of the supervisory guidance that the agencies developed in the wake of widespread bank failures precipitated by commercial real estate lending less than 20 years ago." The proposed guidance provides concentration thresholds that, once crossed, trigger the need for enhanced risk management and capital levels. One threshold is defined as those commercial real estate loans made for construction, land development, or other land that in the aggregate exceed 100 percent of capital. The second threshold applies when all commercial real estate loans made by a bank exceed 300 percent of capital. "Our focus in applying this guidance will be first and foremost on risk management practices," Mr. Dugan said. "To the extent that an institution with a concentration exceeding one of the thresholds has enhanced risk management practices in place, or is moving in that direction, our concern with increased capital is greatly reduced." "In sum, we recognize that commercial real estate lending has been and will continue to be a very good business for banks – all banks – provided that it is effectively managed."

A copy of the entire speech may be found at http://www.occ.treas.gov/ftp/release/2006-45a.pdf

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Broker Dealer

NASD Adopts Form NMA

The Securities and Exchange Commission has approved, effective immediately, an NASD rule change to adopt Form NMA and make technical changes to its Rule 1013, membership application. Form NMA,

attached to the rule filing with the SEC, must be filed as part of an NASD membership application. The form lists the items required under Rule 1013, and sets forth how the requirements of each item are to be satisfied. Several matters are specified in Form NMA as mandatory, and others are left for the applicant to determine whether they are required. Form NMA clarifies and makes uniform a requirement that the applicant file a Security Sales Activity Statement—listing its prior securities activities and undertaking not to engage in any securities business while the application is pending.
http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_016168.pdf

NASD Proposes to Expand Coverage of Fair Price Rule

NASD has filed a rule proposal with the Securities and Exchange Commission to expand the coverage of Rule 2440 and IM-2440 to include all securities, whether listed or unlisted. Rule 2440 requires a member firm to buy from and sell to customers, as principal, at a fair price and as agent to charge a fair commission or service charge. IM-2440, the source of the 5 percent mark-up or mark-down rule, would now apply to transactions in listed and unlisted securities. Heretofore, NASD took the position that charging excessive compensation violated NASD Rule 2110. That rule required a member firm to observe high standards of commercial honor and just and equitable principles of trade. According to NASD, this proposal would expand and clarify a firm's obligation to charge fair commissions and mark-ups or mark-downs.
http://a257.g.akamaitech.net/7/257/2442/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-4822.pdf

NYSE Proposes to Expand Cross Margining

The New York Stock Exchange has filed a rule proposal with the Securities and Exchange Commission to expand cross margining, now called portfolio margining, under Rule 431(g). It would cover all margin eligible securities, listed options, over-the-counter derivatives and U.S. security futures. If a member firm or an affiliate is a futures commission merchant, member of a board of trade and a member of a futures clearing organization for the subject products, it would include in portfolio margin related products to options on exchange traded funds, index warrants and underlying instruments. To engage in portfolio margin activities the member firm must establish a comprehensive, written risk analysis methodology. This must be approved by the NYSE and submitted to the SEC prior to implementation. Among other things, the methodology must include procedures and guidelines for (a) obtaining and reviewing documents relating to a customer's corporate and financial position, (b) reviewing and approving credit limits for a customer, (c) monitoring credit risk exposure on both an end-of-day and intra-day basis, (d) stress testing of portfolio margin accounts, (e) internal audit review of this methodology on a regular basis, (f) managing the impact of credit extended in portfolio margining, (g) management response when credit limits have been exceeded, and (h) determining the need to collect more margin. An approved theoretical pricing method that is to be used in connection with portfolio margining is a stress testing of net positions at various levels of gain or loss by each customer. Previously only the Options Clearing Corporation stress test was permitted. The proposal would permit applicants to develop a testing of their own, subject to NYSE approval. Portfolio margin is only available to broker-dealers registered with the SEC, members of a national futures exchange or anyone else who maintains a minimum equity in the account of $5 million. Guaranties and equity in other accounts cannot be used to meet the $5 million minimum equity. A specific margin account or sub-account must be identified for the customer to use for portfolio margin. Margin deficits or falling below the $5 million minimum equity must be cured within three days and cannot be cured by the broker-dealer taking a charge to its net capital. During the three-day cure period no new positions can be taken on other than to hedge existing positions. One business day from the call, the deficit or call must be included as a charge to the firm's net capital. Three business days after the call, no trading is permitted in the portfolio margin account, and the firm must liquidate positions to bring the account into compliance. Portfolio margin cannot exceed 10 times the firm's net capital. If it exceeds that amount, the firm must give immediate written notice to the NYSE and the SEC. Day trading is not permitted in a portfolio margin account. In addition, the NYSE will require delivery to, and

acknowledgement in writing by, a customer of a written statement setting forth 21 specified risks of engaging in portfolio margining.
http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/E6-5019.pdf

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United Kingdom Developments

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FSA Consults on Rule Changes Which Would Allow London-Listed Hedge Funds

As part of a review of the Listing Rules for Investment Entities, the Financial Services Authority (FSA) is consulting on a number of far-reaching changes. In a Consultation Paper released on March 30, the FSA proposed changes to the rules for investment entities which are designed to replace its current detailed rules with a more principles-based approach to determining eligibility for listing and ongoing requirements. One consequence to which the FSA drew attention, is the fact that the proposed rules would enable funds employing a wider range of investment strategies, including those currently utilized by some hedge funds, to list in the UK for the first time.

A related rule change proposal would give greater freedom of investment to investment trusts. For the first time, they would be allowed to sell short and to invest in derivatives. In addition the rule preventing investment trusts allocating more than 15% of their portfolio to a single asset would also be deleted.

The FSA emphasized that appropriate protections for investors would be maintained through revised and enhanced disclosure requirements.
http://www.fsa.gov.uk/pubs/cp/cp06_04.pdf

FSA Consults on Share Disclosure Rules

The Financial Services Authority (FSA) announced on March 30 that it is consulting on whether to abolish the current requirement on a person building a stake in a company to disclose his share holding to the issuer as soon as it reaches 3%. As part of the implementation of the EU Transparency Directive, the FSA is considering raising the disclosure threshold to 5%. The FSA's proposals would also weaken the current disclosure regime for larger holdings. At present shareholders must notify the issuer at each 1% step above 3%. The proposed rules provide for disclosure in 5% steps to 30%, with 50% and 75% as the next disclosure levels.

The FSA also announced that while it was asking for market participants' views on the desirability of establishing a disclosure regime for holdings of derivatives such us contracts for differences, it was not minded to expand share holding disclosure wholesale to apply to derivatives positions as well. This approach contrasts with the UK Takeover Panel, which in mid-2005 amended its rules to require just such disclosure.
http://www.fsa.gov.uk/pages/Library/Policy/CP/2006/06_04.shtml

FSA Announces Changes to its Supervisory Approach

The Financial Services Authority (FSA) has announced certain changes to its risk based supervisory approach as part of its continuing program of making the FSA "easier to do business with." The changes relate to the FSA's "ARROW" framework. ARROW sets out the parameters for the manner in which the FSA risk assesses and supervises the firms it regulates; the way it manages its relationship with those firms; and its standards of service for communications. The changes, which took effect on April 1, include: (1) a revised risk assessment model ("ARROW II") designed to allow supervisors more accurately to reflect their assessment of risk in individual firms; (2) better communication with firms as to FSA's risk assessment of them; and (3) improved training and guidance for supervisors, as well as streamlined internal processes.
http://www.fsa.gov.uk/pubs/other/letter_changes.pdf

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Litigation

Subject Matter Jurisdiction Lacking Under Conduct and Effects Test

Plaintiffs filed a federal securities law class action against numerous defendants arising out of the precipitous decline in the price at which securities of Yukos Oil Company traded, including the trading of its American Depositary Receipts in the United States. Among other things, plaintiffs alleged that defendants issued materially misleading public statements that failed to disclose the risks or pertinent details of Yukos' tax strategy. In dismissing claims by two of the plaintiffs on the ground that it lacked subject matter jurisdiction, the court noted that the transactions at issue were "predominantly foreign" in that (i) only insubstantial wrongful conduct occurred in the United States; and (ii) the effect of the alleged wrongdoing on United States citizens was insignificant. The court further held that it had subject matter jurisdiction over the claims of a third plaintiff and, while dismissing certain of those claims with leave to replead, it held that other claims had been sufficiently stated. (*In re Yukos Oil Company Securities Litigation*, 2006 WL 800736 (S.D.N.Y. Mar. 30, 2006))

Failure to Allege Injury Separate from Predicate Acts Supports Dismissal of RICO Claims

Plaintiff alleged claims under the Racketeer Influenced and Corrupt Organizations Act against a bank and one of its officers arising out of the officer's creation of fictitious loans and forgery of checks. In granting defendants' motion to dismiss, the court noted that the complaint failed to plead an investment injury or an injury resulting from the use or investment of the proceeds of any alleged racketeering activity. Because plaintiff's alleged injuries were a direct result of defendants' predicate acts of fraud and forgery, her complaint failed to state claims actionable under RICO. (*Berhow v. The Peoples Bank*, 2006 WL 839527 (S.D. Miss. Mar. 28, 2006))

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CFTC

CFTC and SEC Propose Framework for Trading Futures on Debt Security Index Contracts

The Commodity Futures Trading Commission and the Securities and Exchange Commission have jointly proposed rules to authorize trading of futures contracts based on corporate and other non-exempt debt securities and on narrow based debt indices. Security futures on debt securities and narrow-based debt indices could be traded on futures exchanges and securities exchanges subject to regulation by both the CFTC and SEC. In addition, the proposed rules would exclude from the definition of "narrow-based security index" debt securities indices that satisfy prescribed criteria. Debt securities indices that satisfy these criteria, i.e., broad-based indices, would not be a security future and could trade on futures exchanges subject to the exclusive jurisdiction of the CFTC. Specifically, the index must be composed solely of debt securities and each index component must have a total remaining principal amount of at least $250,000,000. The debt securities index also must be comprised of more than nine securities issued by more than nine non-affiliated issuers. The securities of any issuer cannot comprise more than 30 percent of the index's weighting and the securities of any five non-affiliated issuers cannot comprise more than 60 percent of the index's weighting. Finally, each issuer must either (a) be required to file reports pursuant to section 13 or 15(d) of the Exchange Act; (b) have a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more; (c) have outstanding securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion; or (d) be a government of a foreign country or a political subdivision of a foreign country.

Comments on the proposed rules should be received by the respective Commissions within 30 days of their publication in the Federal Register. The two Commissions expect to adopt final rules by June 30, 2006.
http://cftc.gov/files/opa/opajointproposedrules.pdf

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