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ALERT MEMORANDUM

Final TLAC Rule: Effect on U.S. GSIB Debt

December 15, 2016

Today, the Federal Reserve issued its final TLAC rule that, among other things, requires the holding companies for U.S. GSIBs (Covered BHCs) to maintain significant amounts of external long-term debt having specific terms (eLTD).[1]

While the rule largely adopts the eLTD criteria outlined in the proposed TLAC rule,[2] in a significant departure from U.S. capital markets practice, the rule introduces a 30-day cure period for non-payment of interest and principal prior to acceleration of eLTD.

The rule also provides for grandfathering of Covered BHC debt issued prior to December 31, 2016 that meets certain criteria, which will allow significant amounts of existing debt to qualify as eLTD. The Federal Reserve asserts this grandfathering will reduce the estimated aggregate eLTD shortfall for the eight Covered BHCs from approximately $120 billion to approximately $70 billion.[3]

This memorandum enumerates the eLTD requirements, discusses the potential effect of the rule on some common provisions currently included in some Covered BHC debt and describes the scope of the grandfathering.

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For more information on the global implementation of the TLAC standard, visit www.clearygottlieb.com/TLAC

[1] The final rule is available at: https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20161215a1.pdf. For more information regarding the rule release, see: https://www.federalreserve.gov/newsevents/press/bcreg/20151030a.htm.

[2] The TLAC proposal is available at: https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-29740.pdf.

[3] The eight Covered BHCs are Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street and Wells Fargo.

eLTD Eligibility Requirements

The rule largely retains the eligibility requirements for eLTD from the proposed rule, with some modifications. Specifically, eLTD is debt that:

1. Is issued by the Covered BHC and fully paid-in;
2. Is unsecured, is not guaranteed by the Covered BHC or any of its subsidiaries and is not subject to any other arrangement that legally or economically enhances its seniority;
3. Has a maturity of one year or more from the issuance date;
4. Is governed by U.S. law; and
5. Is "plain vanilla," which means that it:
   - Does not provide a contractual right to accelerate payment of principal or interest, other than a right that is exercisable:
     - on one or more designated dates, or
     - in the event of (i) insolvency or (ii) nonpayment of principal or interest that continues for at least 30 days;
   - Does not include credit-sensitive features;[4]
   - Is not a structured note, the definition of which is essentially unchanged from the proposed rule; and
   - Is not convertible into or exchangeable for equity of the Covered BHC.

How the Rule Addresses (or Fails to Address) Key Issues

The rule provides helpful clarifications for some of the questions raised by the proposed rule, but ambiguity remains in several key areas.

— **Acceleration upon Covenant Breach**. Acceleration rights based on a covenant breach are prohibited in eLTD (apart from outstanding long-term debt that has been grandfathered).

— **Cure Period for Payment Defaults**. The rule introduces a requirement that eLTD provide a 30-day cure period prior to acceleration for nonpayment of principal or interest. Although a cure period for interest payments is consistent with current market practice, any cure period for nonpayment of principal is off-market and could have material pricing implications for Covered BHC issuers.

— **Authority to Disqualify Otherwise Eligible LTD**. The rule includes a new anti-evasion provision that would permit the Federal Reserve to order a Covered BHC to exclude from eLTD any instrument that the Federal Reserve deems to include features that would significantly impair the ability of the instrument to absorb losses.

— **Structured Notes**.

- Structured notes, including principal-protected notes, will not qualify as eLTD.

[4] The rule includes as an example of a credit-sensitive feature an interest rate that resets periodically based on the credit quality of the Covered BHC issuer. By contrast, the rule clarifies that interest rates that adjust based on other criteria, such as market interest rates, are acceptable.

- Instruments that are non-dollar denominated or are floating rate notes with interest payments linked to an interest rate index such as LIBOR are not deemed structured notes based solely on these features.
- There is no indication in the rule that inclusion of an issuer call would cause an instrument to be deemed a structured note. Indeed, eLTD may be redeemed pursuant to an issuer call without prior approval of the Federal Reserve so long as the redemption would not cause the Covered BHC issuer to fall below its eLTD or TLAC requirements.

— **Put Rights**. Otherwise qualifying eLTD may give the holder a put right exercisable on a fixed date, but its maturity will be deemed to be the first date on which the put right may be exercised. Long-term debt with a "survivor put" feature would be treated as having matured on the date of issuance, and therefore disqualified from eLTD.

— **Convertible and Exchangeable Notes**. Convertible and exchangeable debt instruments are excluded from eLTD because they are deemed to contain an embedded stock call option that the Federal Reserve views as inconsistent with "plain vanilla" debt securities.

— **Trust Preferred Securities (TruPS)**. TruPS and their underlying subordinated debt issuances will not qualify as eLTD (and are not grandfathered), even if the instruments otherwise qualify as Tier 2 capital.

Grandfathering for Debt Issued Before December 31, 2016

Under the rule's grandfathering provision, long-term debt issued by a Covered BHC prior to December 31, 2016 will be considered eLTD, even if the debt contains otherwise impermissible acceleration provisions or is governed by the law of a non-U.S. jurisdiction. This will allow a significant portion of existing Covered BHC debt to count toward eLTD and TLAC requirements. However, structured notes, convertible and exchangeable notes, TruPS and debt containing a "survivor put" will <u>not</u> qualify for grandfathering. In light of this expansive grandfathering, the rule has discarded the proposed phase-in of the TLAC requirements and instead establishes January 1, 2019 as the effective date for the TLAC and eLTD requirements.

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