REGULATORY CHANGE IN SECURITIES LENDING: AN UPDATE FOR CLIENTS, PART II

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In the third quarter 2011 installment of our Thought Leadership Series entitled "Regulatory Change in Securities Lending: An Update for Clients", we provided an overview of the global regulatory initiatives with the most potential to impact securities lending. July of 2012 marked the second anniversary of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank or DFA"). While little has been finalized, it is fair to say that 2012 saw an increase in regulatory policy initiatives. In this installment of our series we provide an update on some of the reforms discussed in our prior publication and summarize the major developments that took place in 2012. We hope that you find this year's regulatory discussion helpful as we begin another year that is likely to see additional regulatory change.

WHAT'S NEW

As greater supervisory attention is focused on securities lending across the world there is a commensurate movement to macro-prudential regulation. That is, increasingly regulators are not focusing on securities lending through firm-specific supervision, but are instead transitioning to global rules impacting all market participants. In some cases, such as the on-going work at the Financial Stability Board (FSB), these work streams are specific to securities lending. In other cases, such as the Basel III Accord, securities lending is just one part of broader reform packages that apply across financial institutions.

In addition to global regulatory bodies increasing their attention on securities lending, there are national regulatory reform proposals that may also materially impact the lending market. One example is the single-counterparty credit exposure limits as set forth in regulations proposed by the Federal Reserve Board.

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THE MOST SIGNIFICANT REFORM MEASURES PROPOSED IN 2012 WERE:

FSB Shadow Banking Task Force – Securities Lending and Repo Work Stream.
The FSB's Shadow Banking Task Force has designated securities lending and repurchase transactions as one of five work streams focused on making recommendations on enhanced prudential regulation. The securities lending and repo work stream released an interim report early in 2012 and recently issued a public consultation containing thirteen recommended reforms impacting the securities lending and repo market.

Dodd-Frank 165 – Single-counterparty Credit Exposure Limits.
Section 165 of Dodd-Frank requires the Federal Reserve Board to promulgate enhanced standards for financial institutions with $50 billion or more in total assets. These firms are referred to as "covered companies." Such covered companies cannot have an aggregate net credit exposure to any unaffiliated counterparty that exceeds 25% of the company's consolidated capital stock and surplus (10% when the covered company has $500 billion in assets and is dealing with a counterparty of the same size). Credit exposures are defined to include securities lending transactions. For purposes of Dodd-Frank 165, the borrower default indemnification provided by lending agents is treated as a credit exposure of the agent bank to the borrower of the lending client's securities; and to the extent collateral is used to reduce the agent bank's exposure to the borrower, then the exposure shifts to the collateral issuer.

US Capital and Leverage Reforms Implementing Basel III.
The US banking agencies' have proposed wholesale changes to existing capital regulations that would, over time, replace the US banking book capital regime, and consistent with Basel III, substantially increase capital and procedural requirements with respect to banking institutions subject to the framework. These proposals also include implementation of the Collins amendment under Dodd-Frank.

Revisions to Lending Limits.
Title VI of the Dodd-Frank Act requires that the Office of the Comptroller of the Currency's national bank lending limits regulations be revised to account for credit exposures related to securities lending transactions. The OCC proposed an interim final rule in 2012 implementing this change. Lending limits cap exposures at the bank level while DFA 165 is a consolidated limit applied at the holding company level. Agent banks must comply with both their applicable OCC or state lending limit and DFA 165.

Increasingly regulators are...transitioning to global rules impacting all market participants

KEY POINTS

The Financial Stability Board (FSB) issued a consultative document in November of 2012 making policy recommendations intended to address shadow banking risks in securities lending and repo. These recommendations include proposals to increase transparency, require minimum margins or haircuts, limit risks associated with cash collateral reinvestment, set minimum standards for collateral valuation, establish a repo resolution authority to purchase illiquid collateral, and restrict the reuse and rehypothecation of collateral.

Several of the proposed disclosures will require fund managers to have an aggregate view of their collateral across all lending and repurchase transactions

- The FSB proposals on transparency recommend collection by regulators of more granular market data on securities lending and repo exposures among large financial institutions. They also propose to establish a working committee to study the feasibility of creating one or more global trade repositories. As an interim step they suggest that national regulators should undertake market surveys and make aggregate information on the securities lending and repo markets available to the public on a regular basis.
- The transparency provisions also include requirements for increased corporate disclosures by global financial institutions including the sources and uses of collateral. In addition, they recommend certain disclosures by fund managers to end investors. Several of the proposed disclosures will require fund managers to have an aggregate view of their collateral across all lending and repurchase transactions whether held bilaterally or by lending agents, tri-party custodians, central counterparties, or clearing firms.
- The FSB recommended that minimum numerical haircuts only apply to securities lending and repurchase transactions where the primary motive is financing. As a result, they propose to exclude securities lending transactions that are collateralized by cash from the application of any numerical floors, provided, the cash is reinvested and is not used to finance the securities being lent. However, securities lending transactions collateralized by securities would be subject to numerical floors on haircuts due to a concern that a non-cash lending transaction could be used to upgrade collateral for a subsequent financing transaction in avoidance of these requirements.
- The proposals address cash collateral investment by suggesting a set of high-level principals with respect to liquidity, capital preservation, consistency with the lender's investment policy, and documentation and review of investment guidelines. They also recommend that specific limits be placed on term to maturity for individual investments, issuer concentration, weighted average maturity and/or weighted average life. They also propose a requirement for ongoing stress testing of reinvestment portfolios.
- The FSB defines the term "re-use" as any use of securities delivered in one transaction to collateralize another transaction. They define "rehypothecation" as the re-use of client securities. The proposals suggest approaches to limit rehypothecation. This along with other regulatory action such as recent European Securities and Markets Authority (ESMA) guidelines on UCIT funds evidence regulators continued effort to reduce the velocity of collateral putting further stress on the supply of eligible collateral for financial market transactions.

On June 12, 2012, US banking regulators released three joint notices of proposed rulemaking ("Capital NPRs") containing proposals to implement the international capital standards commonly called "Basel III," as well as a final joint market risk capital rule implementing the international standards referred to as "Basel II.5," each in a manner aligning with Dodd-Frank Act requirements such as the Collins Amendment. These changes to the US regulatory capital regime will increase the capital costs associated with providing borrower default indemnification.

Proposed regulations implementing Section 165(e) of the Dodd-Frank Act limit the amount of indemnification exposure that agent banks may have to counterparties and collateral issuers. If implemented in its current form, this rule could make borrower default indemnification a limited resource. Specifically, it is estimated that the Section 165(e) proposals could cause securities on loan at US agent banks to decrease by up to 30% to 50% from already reduced post-financial crisis levels, representing $4 to $6billion in total lost revenues.

UPDATES AND WHAT'S NEXT

The following table summarizes some of the major regulatory initiatives, their impact, and what may be the next steps in finalizing each of these reforms.

REGULATORY INITIATIVE	POTENTIAL IMPACT	CURRENT STATUS	NEXT STEPS
VOLCKER RULE	Could negatively impact the ability to maintain collateral accounts and may limit ability of agents to provide indemnification to certain entities.	Proposed regulations were issued in October 2011 to define prohibited proprietary trading and impermissible fund investment/sponsorship activity. In 2012, guidance was issued on conformance activities.	A final rule is expected by mid-2013.
DODD-FRANK 165(e)	Could constrain agents' ability to provide indemnification, limit the ability to accept certain high quality sovereign collateral, and significantly impact the lending market.	Regulations were proposed in January 2012 with comments due in April. The effective date is October 1, 2013 for entities that were covered companies on September 30, 2012. The Federal Reserve has authority to extend the effective date for up to two years.	The Federal Reserve may issue a quantitative impact study and seek to coordinate US requirements with new global counterparty limits being discussed by the Basel Committee prior to reissuing or finalizing the proposed regulations.
BASEL III	May increase the cost to agent banks of providing indemnification.	The US banking agencies are in the process of implementing the Basel III Accord's capital and liquidity requirements. In June 2012, the agencies published three capital proposals.	Final capital rules and proposed liquidity standards are expected in Q2 2013. European implementation of capital directives may slip to 2014.
DODD-FRANK 984	Requires SEC to issue regulations on transparency. Potential increased disclosure. Any broader impacts are currently unknown.	Proposed regulations were required by July 2012. No regulations have been issued.	Proposed regulations expected to be issued before the end of 2013.
FSB SECURITIES LENDING AND REPO WORK STREAM	Increase disclosure requirements, require minimum margins, set guidelines for cash reinvestment and limit rehypothecation.	Consultative document on policy framework issued in November 2012. Comments were due January 14, 2013.	Industry meetings are scheduled in New York at the end of January to discuss proposals. Expected to publish final recommendations in September 2013.

DETAILED DISCUSSION

FINANCIAL STABILITY BOARD WORK STREAM ON SECURITIES LENDING AND REPO

The Financial Stability Board (FSB) is the successor to the Financial Stability Forum (FSF). The FSF was established by the G7 Finance Ministers and Central Bank Governors in 1999 to enhance cooperation among national and international supervisory bodies so as to promote stability in the international financial system. In 2009, the G20 reestablished the FSF as the Financial Stability Board expanding its membership and broadening its mandate to promote financial stability, assess vulnerabilities affecting the financial system and identify and oversee action needed to address them, and promote co-ordination and information exchange among authorities responsible for financial stability. The FSB, working through its members, seeks to give momentum to a broad-based multilateral agenda for strengthening financial systems and the stability of international financial markets. The necessary changes proposed by the FSB are enacted by the relevant national regulatory authorities.

Recommendations focus on three general areas: transparency, market structure, and creating more effective regulation

The FSB took initial steps to begin focusing regulator attention on the nuances of securities lending and repo markets last spring when it released a cursory white paper outlining potential reforms that would increase market transparency and reduce systemic risk posed by unregulated market participants. After receiving comments on the paper, the FSB released thirteen concrete policy recommendations in November. These policy recommendations were deemed necessary due to several risks that were identified as relevant to all shadow banking sectors, including securities lending. Those risks are:

– The tendency of secured financing to increase procyclicality of system leverage.

– Collateral fire sales that could create asset valuation spirals.

– The rehypothecation of encumbered assets.

– Interconnectedness resulting from the re-use of collateral.

– Inadequate collateral valuation practices.

The thirteen recommendations focus on three general areas: transparency, market structure, and creating more effective regulation. They run the gamut from mundane and easy to implement to more problematic and operationally difficult. BNY Mellon actively partners with industry association working groups focused on the FSB proposals. Most importantly, the FSB recommended that:

– Regulators engage in a comprehensive and coordinated data collection exercise to evaluate securities lending exposures among large international financial institutions.

– To effectuate new data reporting requirements trade repositories should be created. While these repositories are being established the FSB should require national regulators to participate in market surveys to begin to aggregating data across securities lending markets.

– New public disclosure requirements be enacted, with specific disclosures mandated for securities lending and collateral management activities. The disclosure requirements should draw on reporting requirements for fund managers to end-investors.

– There should be minimum standards for the methodologies that firms use to calculate collateral haircuts. The FSB specifically noted that “in principle, there is a case for introducing a framework of numerical floors on haircuts for securities financing transactions where there is material procyclicality risk. Such floors would work alongside minimum standards for the methodologies that firms use to calculate collateral haircuts.”

There are several components of the proposed rules that are potentially problematic for agent lenders and clients

– Regulatory authorities for non-bank entities that engage in securities lending (including securities lenders and their agents) should implement regulatory regimes meeting the proposed minimum standards for cash collateral reinvestment in their jurisdictions to limit liquidity risks arising from such activities.

– Enhanced regulations affecting the rehypothecation of client assets should be put in place to ensure that appropriate disclosures are provided, assets are not re-hypothecated for the purpose of financing the own-account activities of the intermediary, and only firms' subject to liquidity risk standards are permitted to engage in rehypothecation.

– An appropriate expert group on client asset protection should examine possible harmonization of client asset rules with respect to rehypothecation, taking account of the systemic risk implications of the legal, operational, and economic character of rehypothecation.

– Minimum regulatory standards for collateral valuation and management for all securities lending market participants be adopted.

– The costs and benefits of proposals to introduce central clearing counterparties, or CCPs, into securities lending markets be evaluated, especially in cases where important funding providers in the repo market are currently not participating in existing CCPs.

SINGLE-COUNTERPARTY CREDIT EXPOSURE LIMITS

In January 2012, the Federal Reserve proposed quantitative restrictions on the "interconnectivity" of large financial institutions. Comments were due in April and the rulemaking is yet to be finalized. As noted earlier, aggregate credit exposures between firms with more than $50 billion in assets are capped at 25% of consolidated capital stock and surplus. Firms with more than $500 billion in total assets, termed "major covered companies", cannot have aggregate exposures to one another that exceed 10%. Importantly, the proposed rules aggregate all subsidiaries for these calculations. Subsidiaries are determined by ownership of 25% or more of the total equity of the company, power to vote 25% or more of voting securities, or if the subsidiary is consolidated for financial reporting purposes. Credit exposures are defined broadly and include all securities finance transactions. For an in-depth discussion of how securities lending exposures are calculated for purposes of the limit and its potential impact, please refer to our recent Thought Leadership piece, which is available on BNYMellon.com entitled "Securities Lending – Impact of Regulatory Initiatives on Borrower Default Indemnification."

There are several components of the proposed rules that are potentially problematic for agent lenders and clients. If enacted as released, the requirements would:

– Overstate credit exposures associated with securities lending and similar activities as a result of the credit exposure calculation methodology required to be used;

– Fail to treat and exempt exposures to high-credit quality foreign sovereigns in the same manner as the US Government; and

– Rely upon a definition of "control" for purposes of aggregating affiliates of covered companies and counterparties that may be difficult for market participants to identify and track.

The proposed rule's treatment of securities lending transactions appears loosely based on the collateral-haircut approach found in the Federal Reserve's Regulation Y. Credit exposures resulting from a securities lending transaction would be:

– The market value of the securities lent, increased by an amount based on standard Regulation Y supervisory haircuts; less

– The market value of collateral received, reduced by the Regulation Y standard supervisory haircuts.

The proposed rule would include an additional adjustment for cross-currency transactions and would allow limited netting under bilateral netting agreements.

Many of the comments submitted in response to the proposed regulations focused on the following concerns:

- **Lack of risk sensitivity –** Both the proposed rule and the Regulation Y standard supervisory haircut approach use highly-conservative volatility haircuts. The proposed haircuts are absolute—i.e., no credit is given for correlation between the securities on loan and the collateral received. Both equity loans and equity collateral generally are given a 15% haircut. Cash on deposit applied as collateral is given a zero haircut. Banks active in securities lending do not typically use the collateral haircut approach, and have, instead, developed more risk sensitive calculations utilizing simple VaR methodologies. Precluding the use of more risk sensitive measurements will, by definition, overstate exposures and potentially restrict the ability of agent lenders to provide borrower default indemnification.
- **Inappropriate holding period –** The proposed rule assumes a 10-day holding period to unwind securities lending transactions. Regulation Y, including the standard supervisory haircut method from which the proposed rule's haircut table is taken, assumes a five day holding period for securities lending transactions, and permits bank holding companies to adjust the standard supervisory haircuts accordingly.
- **Lack of recognition of netting –** While the proposed rule includes language regarding permissible netting for securities lending transactions, one potential reading suggests that the provision, as drafted, provides very limited opportunities to net transactions, perhaps limited to netting individual CUSIPS within a netting set. Additionally, it does not appear to recognize the legal enforceability of commonly used netting agreements. Regulation Y, under the simple VaR methodology, more appropriately recognizes the netting applicable in measuring credit exposure to a counterparty.
- **Lack of recognition of correlation –** The proposed rule provides no recognition of the correlation effect between securities lent and collateral received.
- **Inclusion of Foreign Sovereign Securities –** Sovereign entities are generally included as covered counterparties, but the US government is exempted. Given the prevalence of high-quality foreign sovereign securities as collateral in securities lending transactions, their inclusion may restrict the ability of agent banks to accept these securities as collateral for their indemnified clients. Exposure limits to a sovereign country include exposure to any of its agencies, instrumentalities and political subdivisions. In addition, where the currency of the securities on loan does not match the currency of the securities received as collateral, an additional 8% "haircut" is applied to the transaction.

The rules are expected to be finalized, with some significant changes, during 2013. It is likely that prior to finalization the Federal Reserve will conduct analysis on the potential ramifications of the limits, including how they may impact the securities lending market.

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The Proposed Rule provides no recognition of the correlation effect between securities lent and collateral received

The Collins Amendment is a uniquely American creation that will further complicate capital management at US banking institutions

US CAPITAL AND LEVERAGE REFORMS IMPLEMENTING BASEL III

On June 7, 2012, the Federal Reserve Board approved for publication three notices of proposed rulemaking to implement the capital components of the Basel III Accord. In their totality, the three proposals will result in significant changes to current capital regulation, a proliferation of capital ratios that bank holding companies must meet, and potential changes to how firms conduct their funding operations and businesses.

The proposed rules would alter and revise the components of capital, introduce the application of a common equity Tier 1 requirement, revise existing Basel I-based capital rules to include a more risk sensitive risk-weighting framework, create a new Standardized Approach for assigning risk weightings that will now be considered the "generally applicable rules for all US banks, and make significant alterations to existing Advanced Approach requirements. Also, the proposals would enshrine the requirements of Section 171 of Dodd-Frank (the so-called "Collins Amendment"). The Collins Amendment is a uniquely American creation that will further complicate capital management at US banking institutions. The provision mandates that the largest bank holding companies use the higher of the generally applicable capital charge (i.e., that is applicable to all US banks) and the charge applicable under the advanced approaches. Although, the determination of which method is controlling is done on an aggregate basis, it appears that the method that would produce the largest capital charge for indemnified securities lending transactions would be the charge calculated under the "standardized" method, a direct result of the Collins Amendment. This method employs a collateral haircut approach similar to that under the proposed Dodd-Frank Section 165(e) rules discussed earlier for securities lending transactions and other counterparty transactions, as opposed to the simple VaR or other internal models that would reflect correlations. The Standardized Approach also would, to some extent, negate the value of netting arrangements. These changes increase the denominator in the required regulatory capital ratios and thereby will significantly increase capital required to provide borrower default indemnification.

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The Basel III changes, as conceived internationally and proposed in the United States, will result in higher capital ratio requirements for all banks. In addition to the already higher limits of capital that the proposals envision, the Basel Committee and the FSB have also announced plans for an additional capital surcharge applicable to global systemically important banks (G-SIBs), a group that includes most large securities lending agent banks. According to a report published by Fitch Ratings, the then-29 identified G-SIBs would require an additional 23% more capital, or $566 billion, over current reserve levels in order to satisfy new capital requirements.

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Beyond these new capital reforms, the proposals would also implement a supplementary leverage ratio that is intended to ensure banks maintain a base level of liquidity. The supplementary leverage ratio expands upon the existing US leverage concept by broadening the denominator to ensure inclusion of certain off-balance sheet items. The supplemental ratio is not yet fully developed, and in particular its treatment of borrower default indemnification provided in agency lending transactions is still under consideration by international regulators. For this reason, the US banking agencies have proposed, in the interim, to exclude exposures from current off-balance sheet securities lending borrower default indemnifications and continue to include principal lending transactions carried as an asset on the balance sheet, consistent with the measure of exposure used in the agencies' current leverage calculation. However, they will consider modifying this approach in the future based on the results of ongoing observations by the Basel Committee and further international discussions.

BNY Mellon and other agent banks have met with regulators to assert that indemnification should be included in the supplementary leverage ratio, if at all, only to the extent that the indemnification exposure exceeds the collateral coverage (the "current exposure"). The regulators have expressed some support for the current

exposure approach, but as indicated earlier, the ultimate result is not certain. If current exposure is the final approach, the supplementary leverage ratio should have little impact on securities lending programs. If, on the other hand, the full amount of the indemnification exposure were to be included in the supplementary leverage ratio, it could substantially curtail indemnification programs.

Much like the Dodd-Frank Section 165(e) counterparty exposure limit proposal, the US capital proposals while directionally sensible may increase capital costs for banks involved in securities lending. The proposed capital rules would:

– Prohibit banks from using the simple VaR or internal modeling methods under the Standardized Approach to calculate exposures arising from securities lending;

– Diverge from the Basel III Accord by requiring all exposures to securities firms to be treated as corporate exposures;

– Mandate that banks assume a 20 business day holding period if the total number of trades within a netting set exceeds 5,000 at any time during a quarter; and

– Increase capital charges in the event of margin disputes.

As to the first issue, firms actively involved in securities lending typically use the simple VaR methodology for risk management purposes. These models have evolved over the years and possess several features that make them well suited to measuring credit exposures resulting from securities lending transactions, including risk sensitivity, appropriate assumed liquidation periods, and recognition of netting and correlation effects within netting sets. Even during the unusual volatility of the recent financial crisis, the simple VaR methodology performed appropriately. The model-based framework demonstrated a superior ability to measure the actual risks associated with securities lending transactions.

Approved models and their comprehensive nature leads to less blunt and more risk-sensitive outputs

Why did a models-based approach perform admirably, even during times of crisis? In short, banks active in the securities lending market have spent years developing the features of these approved models and their comprehensive nature leads to less blunt and more risk-sensitive outputs. For instance, the use of models allows firms to account for risk mitigation (i.e., correlation benefits), diversification and the shorter duration of most loans.

For reasons that are unclear, the US banking agencies are proposing to raise the risk-weighting for exposures to securities firms to 100%. This is despite the fact that the text of Basel III expressly permits exposures to securities firms to be the same as exposures to other depository institutions – that is, subject to a 20% risk weighting – if certain criteria are met.

The proposals dictate that if two or more margin disputes concerning a single netting set exist over a consecutive two-quarter period, the agent bank must use a holding period assumption that is at least twice the minimum assumption otherwise applicable to the netting set. This requirement is problematic and seems to many in the securities lending industry to be unnecessary. Most disputes are settled according to the contractual provisions of individual securities lending agreements. That is, it is difficult to conceptualize a "margin dispute" that would materially affect the risk of a netting set and require a commensurate increase in risk-based capital. Unlike derivative transactions, margin disputes rarely occur in securities lending due to readily available market prices for loaned securities and collateral.

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Agent lenders, including BNY Mellon, clients, and others have been discussing these concerns with the regulators since the proposals were released. We suspect that the capital reforms may be finalized later in 2013. It is anticipated that when the rules are finalized the agencies will include provisions to synchronize them with the phased-in implementation schedule announced by the Basel Committee in 2010.

The amendments to the lending limits may pose more issues for these programs at national banks, as well as banks chartered in the many states that largely adopt OCC limitations in their own state laws

REVISIONS TO LENDING LIMITS

Section 610 of the Dodd-Frank Act upends existing national bank lending limits requirements by, for the first time, expressly requiring the inclusion of securities lending and borrowing transactions as well as derivative transactions in the definition of "loans and extensions of credit." The OCC has proposed an interim final rule implementing this provision; however, it is not completely clear how the proposal applies to borrower default indemnification. Assuming indemnified agency lending would be treated in the same manner as principal securities lending, an agent bank may use either an approved internal models-based approach or a standardized "non-model method" to calculate credit exposure arising under the transaction for purposes of the limits. To the extent cash is taken as collateral, treatment of indemnified securities lending programs may not be affected depending on the approach taken. As the industry migrates to other types of collateral, however, the amendments to the lending limits may pose more issues for these programs at national banks, as well as banks chartered in the many states that largely adopt OCC limitations in their own state laws. The interim final rule became effective July 21, 2012, with a temporary exception for extensions of credit arising from derivative or securities financing transactions prior to January 1, 2013.

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02/2013

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