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The Dodd-Frank Act: An Operational Response for Non-US Banks

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We are witnessing the dawn of a new age in financial services: the omnipresence of the regulator.

Managing the current frequency and volume of regulatory change within complex systems is a massive challenge for companies – from large, international banks and national banks to funds and other non-bank financial services or quasi-bank entities in the so-called shadow banking sector. Regulators at various levels around the globe are prodding them towards operating within a new infrastructure in which previously private activities, products and entities shift into public exchanges, clearing systems and data warehouses. Enhanced trading and operations transparency and greater frequency and scope of reporting are intended to allow the regulators and market participants to see the whole picture.

Financial markets companies that address these changes effectively will have a clear advantage. This new world order creates opportunities for organisations that are able to create and build integrated governance, risk and compliance (GRC) and operations technology platforms that will make doing business more efficient, more transparent and less risky.

One area of the re-regulation of the financial world that is truly making companies rise to this challenge is the Dodd-Frank Act (DFA). The DFA is having an unexpectedly broad impact on financial markets infrastructure. This legislation affects not only U.S. financial institutions, but also non-financial institution companies and non-U.S. financial institutions and financial service companies – whether they have operations in the U.S. or not.

Tracking and analysing the implementation of this piece of legislation is a formidable task in its own right. In fact, thinking of the DFA as a single law is misguided; this omnibus law encompasses a series of regulations covering a vast array of products, services and types of entities. Furthermore, its implementation requires the promulgation of as many as 350 rules through an array of different regulators and according to different timelines.

Many non-U.S. banks and non-U.S. non-bank financial services entities are only just appreciating the impact the DFA will have on their activities in and – importantly –

outside of the U.S. While some may consider this extraterritorial reach of the legislation to be inappropriate, it is not surprising. As a response to the credit crisis, the DFA was born out of a central perceived failing of the existing regulatory structure: there was no effective way of joining the dots. The DFA approach to bank and financial services supervision is to reconfigure the entire regulatory structure in order to reduce moral hazard, increase the level of regulation in key perceived problem areas, and impose limitations on "high-risk" activities and businesses. Importantly, though, this is all designed with a view to creating a scheme of dynamic systemic regulation through creation of tools to regulate "connectivities" in the global financial markets.

Under the DFA reforms, broadly speaking, the same regulatory bodies remain responsible for financial supervision using many of the same legal and supervisory tools. However, the DFA regime enhances the supervisory and prudential standards, implements more intrusive reporting requirements, and introduces more standards and limitations (or event prohibitions) on more activities. It also focuses and consolidates the consumer regulatory regime. One of the most significant regulatory changes under the DFA – and one which has direct extra-territorial impact outside the U.S. – is that non-bank "systemically important" entities and trading, clearance and settlement facilities are to become regulated.

It is unsurprising that the DFA "systemically important financial institutions" (SIFI) regulatory scheme is directed at an identified group of important financial services firms. However, the new SIFI regulations could also apply to a potentially large group of diverse financial services firms with very different business lines and risk postures. The mere size of a company's U.S. operations will not be the sole factor considered by U.S. regulators assessing systemic significance. Therefore, SIFI designation and regulatory issues for these firms may be harder to predict, but will be more dependent on U.S. views on the possible global ramifications of a non-U.S. organisation's distress or failure.

The DFA also impacts the activities of non-U.S. banks and other companies extra-territorially through measures that regulate specific products and U.S.-originated or U.S.-targeted financial instruments.

The ability of the U.S. to regulate operations of non-U.S. firms, however, may be practically limited to regulation of U.S. operations and coordination with regulators in other jurisdictions with regard to any extra-territorial reach. There remain significant issues for U.S. (and non-U.S.) regulators coordinating internationally to deal with disclosure and underwriting standards, and capital, liquidity, and cross-border recovery and resolution regimes. Even when the regulatory framework begins to take shape, it is likely to be a highly dynamic framework that will be subject to continuing change.

As a further indicator of the inter-connectivities mindset of this new age of the regulator, the DFA creates new "systemic" regulatory authorities. This is consistent with developments in other jurisdictions, such as the newly-formed European Securities and Markets Authority (ESMA) mandated to safeguard the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. Regulators on both sides of the Atlantic thus aim to – dynamically and systemically – regulate financial markets that do not recognise geographic borders, and to coordinate internationally in doing so.

So what should non-U.S. (and U.S.) companies expect in the new regulatory environment?

The DFA, in parallel with reforms in Europe, will unfold as a programme of more consolidated horizontal and vertical regulation and supervision. There will be a greater insistence on comprehensive and transparent risk management and mitigation activities. A strong emphasis on corporate governance and accountability, as well as on capital and liquidity resources and buffers will accompany the new risk management regime. Supervisory attention will focus on credit and counterparty exposures and concentrations. Under the DFA and parallel European regulations, we will witness a gradual and incremental application of new regulatory standards, limitations and supervisory activities to a broad range of regulated banking and other (currently non-regulated and non-bank) firms.

Nevertheless, it is helpful that, while the regulators will have to "learn" how to supervise in the new environment, they will rely on established regulatory and supervisory practices, policies, and procedures. For companies aiming to comply with the new rules, this all translates into a need for early assessment and planning, plus attentive and incremental adjustment of existing operational systems and procedures through regulatory reform risk assessment, regulatory tracking and analysis, and project management.

So, what is a company supposed to do? And how can it not just survive, but thrive, in the new environment?

The new regulatory environment under the DFA and parallel European reforms requires an organised response. Companies must first assess and understand the key qualitative features of the new environment:

- more intensive enterprise-level regulation and supervision with emphasis on adequate capital/liquidity, adequate management information systems (MIS) and risk management systems, policies and procedures, adequate corporate governance and oversight, credit and counterparty exposures and concentrations;
- collection, synthesis and production of new and potentially large amounts of data;
- possible limitations on activities, especially those viewed as presenting higher levels of institution-specific or systemic risk; and
- new and powerful early-action regulatory and supervisory authority

Working with its advisors, a company should devise a plan and a system to stay on top of regulatory changes. This will likely involve examining existing and available operating models, products and services. A number of firms, new technology platforms, and new and enhanced GRC software solutions (such as Protiviti's Governance Portal, which is augmented by Morrison & Foerster's FrankNDodd[1] database and tracking system) are developing to assist companies in addressing the demands of the new regulatory environment. External legal advisors may work with company counsel, compliance and operations departments and business people to assist in identifying the impact of regulatory changes on the company's activities, business lines, and products. They may also help in developing plans of action (including timelines and cost). This will require performing a review of business lines and identifying key operations.

GRC software solutions may be configured for a specific business to bring together compliance and governance technology with real-time DFA-related and other regulatory updates and guidance. These tools help companies determine the status of regulatory developments and changes, assess regulatory risk, assign accountability and track the status of implementation efforts, show evidence of compliance, and demonstrate effective risk management practices to regulators, customers and stakeholders.

Substantively, the DFA and parallel European reforms will also require a review of an organisation's capital structure and the sources of capital and funding to ensure that the means are available to obtain more.

Since a hallmark of the DFA and parallel European reforms is greater frequency and scope of transparency and reporting, companies are well-advised to commence building up their data collection and information infrastructure. Non-bank service companies who will soon come under the new DFA and European regulatory regimes and financial institutions that will soon be subject to enhanced supervision and regulation should review and strengthen MIS and data collection systems now.

The reformed reporting regime will have a particular emphasis on assessing systemic "interconnections" evidenced by financial exposures to geographic markets, business segments and markets, and individual and central counterparties. Data collection systems will need to pay close attention to credit and operational exposure concentrations. Therefore, companies should work with their advisors to review the sufficiency of enterprise-level risk management systems, focusing on the collection, consolidation and analysis of risk exposure data and the robustness of stress-testing models and programmes and their compliance with current regulatory expectations.

It is important for companies to bear in mind that because the regulators will also be "learning" how to supervise in the new environment, they will rely on established policies and practices. Organisations should work with advisors to build on what already exists (i.e. existing enterprise risk management activities and systems, MIS, prudential data systems, and risk management committees), reviewing the sufficiency of existing governance, risk and compliance systems. Part of the planning for compliance under the DFA and parallel European reforms should be to leverage and integrate the deliverables that will be required under the new regime.

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[1] FrankNDodd is a trade name of Morrison & Foerster LLP.

Amidst these operational challenges lies opportunity. Organisations that coordinate responses among business, risk management, finance and treasury, IT and operations functions can rebuild and even enhance profitability. By taking steps now in anticipation of the new era of regulatory oversight, non-US banks and non-bank financial services entities will be better equipped to tackle the weight of regulatory changes facing them under the DFA and its European counterparts.

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