The Effects of the Dodd-Frank Act on Foreign Banks: Where We Are in 2013

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Dodd-Frank and Foreign Banks

• Dodd-Frank was enacted on July 21, 2010 to address the “Lehman shock”—and other “lessons-learned” from the 2008 financial crisis.
• The effect on foreign banking organizations (“FBOs”) was not a focus of Congress during the legislative process.
• Several provisions have extraterritorial consequences (such as the Volcker Rule).
• Much of the “detail” left to the regulators: final regulations are a “work in progress.”
• Much could happen in the coming months that affects FBOs.
Dodd-Frank and Foreign Banks

• The impact of Dodd-Frank on FBOs:
  • Systemic regulation
  • “Living wills”
  • Orderly liquidation authority
  • Regulatory capital
  • The Volcker Rule
  • Derivatives regulation

• Foreign bank activities in the United States
• Dodd-Frank and the global environment
Systemic Regulation: SIFIs

• Dodd-Frank requires enhanced supervision and regulation of “systemically important financial institutions” (“SIFIs”), including banks and nonbank financial companies whose failure would have an adverse effect on the US banking system. SIFIs include:
  • U.S. banks and bank holding companies with US$50 billion or more in assets and:
  • Foreign banking organizations (FBOs) with at least US$50 billion in assets (worldwide test) that directly or indirectly own a U.S. bank; and
  • FBOs with at least US$50 billion in assets (worldwide test) that maintain a U.S. branch or agency.
Systemic Regulation: SIFIs

• The purpose of systemic regulation is to prevent or mitigate risk to U.S. financial stability that could arise from the material distress, failure or ongoing activities of SIFIs.

• The Financial Stability Oversight Council (“FSOC”), a new agency comprised of representatives of the various U.S. regulators, including the Federal Reserve, is charged with the development and oversight of the systemic regulation framework.

• The FSOC must consult with the appropriate foreign regulatory authorities in exercising its systemic oversight authority over FBOs and cross-border activities and markets.
SIFI Prudential Regulation

• The Federal Reserve Board/FSOC is required to establish prudential standards for SIFIs more stringent than those for other financial institutions. (Dodd-Frank § 165).

• FSOC may also recommend heightened standards and safeguards for financial activities and practices if FSOC determines that their scope, size or interconnectedness could create or increase the risk of significant liquidity, credit or other problems (Dodd-Frank § 120).
SIFI Prudential Regulation

• The Federal Reserve Board must establish more stringent prudential standards for:
  • Risk-based capital requirements.
  • Leverage limits.
  • Liquidity requirements
  • Overall risk management requirements.
  • Resolution plan ("living will") and credit exposure report requirements.
  • Concentration limits.
SIFI Prudential Regulation

The Federal Reserve Board may establish more stringent prudential standards for:

- A contingent capital requirement.
- Enhanced public disclosures.
- Short-term debt limits.
- Such other prudential standards as deemed appropriate by the Federal Reserve Board, on its own or based on FSOC’s recommendations.
SIFI Prudential Regulation

• In prescribing or recommending more stringent prudential standards, the Federal Reserve Board and the FSOC must take certain specific factors into consideration.

• Tailored application of prudential standards:
  • The Federal Reserve Board, on its own or on recommendation by the FSOC, may differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors.
  • In other words, this regulatory scheme is not a one-size-fits-all approach.
In addition, the Federal Reserve Board must require the following for SIFIs:

- Risk committees (including BHCs with US$10 billion-US$50 billion in assets) for U.S. publicly traded companies.
- Semi-annual internal stress tests (annually for BHCs with US$10 billion-US$50 billion in assets). Federal Reserve will conduct its own stress tests for BHCs that are SIFIs, and these will be used as key data points for capital plans that such BHCs will need to file.
- Maximum leverage of 15:1 (6.7% leverage ratio) if FSOC determines that the company poses a “grave threat” to U.S. financial stability.
- Inclusion of off-balance-sheet activities in computing capital requirements.
SIFI Prudential Regulation

• If the Federal Reserve Board and FSOC (by 2/3 vote) determine that a SIFI poses a grave threat to U.S. financial stability, they can:
  • limit such company’s ability to acquire or consolidate, or otherwise become affiliated with another SIFI;
  • restrict the company’s ability to offer a financial product;
  • require such company to terminate one or more activities; or
  • impose conditions on the manner in which such company conducts one or more activities (Dodd-Frank §121).
SIFI Prudential Regulation

• The Federal Reserve Board may also require a SIFI to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities, if other measures are deemed to be inadequate.

• As noted above, FSOC may recommend to a federal banking agency heightened prudential standards or safeguards for particular financial activities or practices conducted by any bank holding company or nonbank financial company.
SIFI Prudential Regulation -- FBOs

• In regulating FBO SIFIs, the Federal Reserve Board must give due regard to the principle of national treatment and equality of competitive opportunity, and take into account the extent to which the FBO is subject on a consolidated basis to home country standards that are comparable to U.S. standards.

• In December 2012, the Federal Reserve Board proposed regulations that partially implement the SIFI regulatory requirements of Dodd-Frank §§ 165 and 166 (early remediation) for FBOs.

• These proposals followed by 1 year comparable proposed regulations for domestic (U.S.) SIFIs.
SIFI Prudential Regulation -- FBOs

• Proposed under DFA §§ 165,166 and 167:
  • §165: Prudential regulation requirements for systemically important banks.
  • §166: Early remediation requirements for systemically important banks and financial companies.
  • §167: Prudential requirements for systemically important nonbank financial companies.

• For the most part, the proposed rules are modeled on DFA Section 165/166 rules proposed in December 2011 for domestic bank holding companies.

• Proposals are designed to address systemic risks to the U.S. financial system posed by the U.S. operations of large FBOs and nonbank financial companies.
SIFI Prudential Regulation -- FBOs

• In addition, the proposals represent the Board’s attempt to create a workable framework for the U.S. regulation of systemically important FBOs under the DFA.

• Proposals also reflect other discrete Board concerns:
  • Increased scope/complexity of FBOs’ U.S. nonbank operations.
  • Availability of home country financial resources for U.S. operations of foreign banks and financial companies.
  • Availability of information on U.S. operations of foreign firms.
  • Use of U.S. branch/agency operations to fund home country or offshore activities.

• The Board also took into account national treatment and competitive equality considerations in these proposals.
The proposed regulations would create the following requirements for FBO SIFIs:

- Intermediate holding companies for large U.S. operations.
- Risk-based capital requirements and leverage limits.
- Liquidity requirements.
- Single-counterparty credit limits.
- Risk management requirements.
- Stress testing requirements.
- Debt-to-equity ceiling.
- Early remediation provisions.

These proposals are broadly consistent with the Decembers 2011 proposals applicable to U.S. SIFIs.
Effective Resolution of G-SIFI’s: International Criteria

- FSB’s “Consultative Document on Effective Resolution of Systemically Important Financial Institutions (July 19, 2011). Framework for effective resolution:
  - Strengthened national resolution regimes.
  - Cross-border cooperation arrangements (which may include institution specific resolution arrangements).
  - Improved resolution planning. Each G-SIFI required to have a Recovery and Resolution Plan (“RRP”).
  - Measures to improve obstacles to effective resolution (e.g., insufficient information; intra-group transactions in crisis; need to rely on service providers to carry on critical business lines).
- Second cornerstone to effective regulation of G-SIFIs: need for G-SIFIs to hold additional loss absorption.
Living Wills: U.S. Regime

• Dodd-Frank Act Title II:
  • U.S. regime for effective resolution requires resolution plans or “living wills” for all SIFIs, including FBOs that are SIFIs.
  • Because U.S. “cut-off” for SIFIs is at US$50 billion, many U.S. financial institutions and FBOs that are not G-SIFI’s are covered by the U.S. regime.
  • All SIFIs, including SIFIs that are FBOs, will be required to produce resolution plans, or “living wills,” and reports on credit exposures to other significant financial institutions.
  • Living will requirements for FBOs will differ in some respects from those for U.S. financial institutions, in that the focus is on resolution of U.S. operations of FBOs.
  • SIFI requirements could affect up to approximately 100 foreign banks.
Living Wills: U.S. Regime

• Timetable for FBOs which have less than US$100 billion in total U.S. assets not held in U.S. bank subsidiaries:
  • by December 31, 2013.

• The §165(d) standard: a plan “for rapid and orderly resolution in the event of material financial distress or failure” that must discuss:
  • Protection of the insured bank (if any) from risks of affiliates.
  • Ownership structure, assets, liabilities, and contractual obligations.
  • Cross-guarantees, major counterparties, and process for determining pledges of collateral.

• § 165(d) also requires preparation and submission of credit exposure reports (no final regulation yet).
Living Wills: U.S. Regime

• “Rapid and orderly” means a reorganization or liquidation of the SIFI—or for an FBO, of its U.S. operations—that can be accomplished—
  • in a reasonable period of time; and
  • in a way that substantially mitigates risk of serious adverse effects on U.S. financial stability.

• “Material financial distress or failure” means either:
  • losses that would deplete capital without reasonable prospect for recapitalization;
  • assets less than liabilities; or
  • inability to pay obligations in ordinary course of business.
Living Wills: U.S. Regime

• Basic elements of living will:
  • Identifies sources of risk.
  • Explains different stress scenarios.
  • Analyzes possible pre-bankruptcy, private sector solutions.
  • Describes an easily understood and coordinated response to material distress.
  • Describes the institution’s immediate needs in bankruptcy.
  • Describes the rights of different creditors.

• Rules specify content requirements.
• Must be updated annually and when material business changes occur.
Living Wills: FBOs

Consequences for FBOs:

• Resolve U.S. branches/agencies through “ring-fencing.”
• Living wills for FBOs to be coordinated with foreign regulators.
• Fed to take into account and consider:
  • Principle of national treatment.
  • Equality of competitive opportunity
  • Extent to which FBO is subject to home country standards that are comparable to those applied to U.S. financial institutions
• U.S. regulators will consider nature and extent of home country’s crisis management and resolution process in reviewing FBO’s living will.
Living Wills: FBOs

- FBO’s with less than US$100 billion in U.S. assets not held in U.S. bank subsidiaries (and no material U.S. operations outside of U.S. branches, agencies and bank subsidiaries) may submit “tailored” resolution plans limited to U.S. operations. Contents:
  - Information regarding U.S. branches, agencies, subsidiaries, and critical U.S. operations and core U.S. business lines.
  - Mapping of legal entities, interconnections and interdependencies.
  - Detailed explanation of how U.S. operations fit into FBO’s overall resolution plan or contingency planning process.
  - FDIC requires separate living will for each FDIC insured bank subsidiary with US$50 billion or more in assets of an FBO.
Credit Exposure Reports

• Dodd-Frank requires SIFIs to report periodically to U.S. bank regulators, the extent to which:
  • the SIFI has credit exposure to other SIFIs; and
  • other SIFIs have credit exposure to such SIFI.
• For FBOs, these reports will be only with respect to the SIFI’s U.S. operations.
• In writing rules for FBOs (not yet written), Federal Reserve Board to take into account:
  • Principle of national treatment.
  • Equality of competitive opportunity.
  • Extent to which FBO is subject to home country standards that are comparable to those applied to U.S. financial institutions.
Orderly Liquidation Authority ("OLA")

- The FDIC now has the authority to effect an orderly resolution of a “covered financial company” (Title II):
  - Limited to companies organized under U.S. law. (In principle, could include an intermediate U.S. bank holding company for an FBO’s U.S. operations.)
  - Not for FDIC-insured banks (which have their own regime of resolution).
  - Treasury and U.S. regulators must conclude that company’s failure would have serious adverse effects on U.S. financial stability.
  - Governance and conflicts of interest mitigation.
  - No taxpayer funding.
Orderly Liquidation Authority ("OLA")

• Key elements of FDIC orderly liquidation authority ("OLA"):
  • FDIC-centric resolution and claims scheme.
  • Use of bridge companies.
  • Treatment of creditors.
• Congress had Lehman in mind.
  • “The Orderly Liquidation of Lehman Brothers Holdings under the Dodd–Frank Act.”
• OLA process evolving.
• FDIC policy – single point of entry. OLA liquidation activities will generally occur at the top-tier level of a banking organization.
Orderly Liquidation Authority ("OLA")

- Challenges for the FDIC in liquidating large U.S. company with international operations:
  - Treatment of U.S. v. host country activities.
  - Interaction of host country resolution regime with OLA scheme.
  - Cross-border access to information.
  - Treatment of interdependencies—affiliate-facing obligations.
  - Domestic and foreign liquidity sources.

- The FDIC has entered into bilateral memoranda of understanding with the UK and Canada to formalize cooperative efforts for the liquidation of large cross-border banks operating in both countries that are parties to the agreement.
Regulatory Capital

• Dodd-Frank requires minimum leverage and risk-based capital requirements for banks, U.S. bank holding companies and nonbank SIFIs (§171 – “Collins Amendment”).
  • The floor is the current capital required of banks. In other words, bank holding companies are not permitted to incur more leverage than banks (addresses concern about overleveraged investment banks)
  • Effectively disqualifies trust preferred and other hybrid capital securities from treatment as Tier 1 primary capital.
• U.S. does not intend to adopt more lax capital standards than Basel III will permit.
Regulatory Capital: Effect on FBOs

• Dodd-Frank has little effect on capital levels for FBOs.
• Federal Reserve continues to look to “capital equivalency” under home country standards for FBOs that establish/maintain U.S. banking operations.
• Foreign bank holding companies with intermediate U.S. bank holding companies:
  • These intermediary holding companies will be required to meet applicable bank holding company capital standards, effective July 21, 2015. In practice, almost all of them meet the standard now.
• The U.S. has just adopted final rules to put into place a new regulatory capital framework for U.S. banks.

• Current U.S. regulatory intentions with respect to Basel II and Basel III implementation:
  • Implementation of 6-year transition period for Basel III requirements: U.S. banking organizations would not be expected to meet fully phased-in Basel III requirements prior to their effective times, but would be expected to (i) take affirmative steps to increase capital levels in order to meet applicable deadlines, and (ii) improve their capital ratios through prudent earnings retention policies.
  • Capital surcharges for systemically important financial firms: coordination with Basel Committee on identification of, and surcharges for, G-SIFIs; and more stringent capital requirements for SIFIs consistent with the requirements of the Dodd-Frank.
**Volcker Rule**

• Named after former Fed Chair Paul Volcker, who promoted the Rule to reduce the risk created by financial institutions taking on risk as a principal investor.

• Not limited to SIFIs or G-SIFIs.

• Basic framework enacted into law: regulators given power to interpret but not to depart from the statute.

• Proposed interagency rules issued in October of 2011 are very complex and have raised many questions. The proposal received over 17,000 comments, including extensive comments from foreign banks, their trade associations and foreign governments.
Volcker Rule

- Basic prohibitions (subject to exceptions) applicable to “banking entities”:
  - No proprietary trading.
  - No investing in or sponsoring covered hedge funds or private equity funds.
Volcker Rule: Banking Entities

- What is a “banking entity”?
  - U.S. banks.
  - Bank holding companies (including FBOs with U.S. bank subsidiaries).
  - FBOs (by virtue of U.S. branches/agencies). Includes parent financial holding companies.
  - Any affiliate of the above entities. Includes insurance and securities affiliates of FBOs.
- Banking entity functioning solely in a trust or fiduciary capacity (trading or investing as trustee on behalf of trust customers) is exempt.
Volcker Rule: Prop Trading

• Prohibition on proprietary trading (“prop trading”):
  • Taking positions as principal in trading account in securities, derivatives, futures, options “or any other security or financial instrument” as provided by rule.
  • “Trading account”: account used to hold positions for short-term resale (presumptively 60 days or less), benefiting from short-term price movements, or to realize short-term arbitrage profits, or that holds assets covered by market risk capital rule.
  • Prohibition is not based on type of instrument: the financial instrument can be held, as long as it is not held for prop trading.
Volcker Rule: Prop Trading

- Permissible financial positions in a trading account:
  - Loans.
  - Commodities.
  - Foreign exchange (but not foreign exchange forwards, which are treated as derivatives).
  - U.S. government and U.S. government agency securities. In current proposal, no comparable exemption for sovereign debt of other countries (heavily criticized by foreign governments and banks).
  - Investments in Small Business Investment Companies (SBICs)
Volcker Rule: Prop Trading

• Permissible transactions:
  • Transactions as agent for customers.
  • Underwriting or market-making activities, to the extent designed not to “exceed the reasonably expected near term demands of clients, customers or counterparties.”
  • Risk mitigating hedging activities.
  • Burden on bank to show compliance with exemptions.

• Certain prudential restrictions (discussed below) apply to trading activity that meets these exemptions.
Volcker Rule: Prop Trading

- Full exemption for regulated insurance companies that are affiliates of “banking entities.”
- Prop trading only for the insurance company’s own general account.
- Trading by an insurance company for a specific account (where customer and not insurance company bears the risk) may be deemed to be on behalf of the customer—and therefore permitted.
Volcker Rule: Prop Trading for FBOs

- Trade executed by FBO or its affiliate “wholly outside” the U.S. is exempt. Conditions for exemption:
  - The FBO must be a QFBO—i.e., majority of its business and banking activities outside the U.S. and must not be controlled by a banking entity organized under U.S. law.
  - “Banking entity” engaged in the trade must not be organized under U.S. law.
  - No counterparty to the trade is a U.S. resident.
  - No personnel directly involved in the trade are located in the U.S. (other than back office and mere administrative personnel).
  - Transaction must be executed “wholly outside” the U.S.
  - The entity conducting the trade must be in compliance with currently applicable FBO regulations for its activities.
Volcker Rule: Prop Trading for FBOs

- Concerns for FBOs:
  - Prohibition does apply to U.S. branches/agencies, U.S. bank subsidiaries and U.S. affiliates of FBO.
  - Use of U.S. execution facilities may possibly take the exemption away (U.S. exchange). Heavy focus of industry comments.
  - FBOs’ U.S. offices or affiliates cannot be involved as broker/intermediary to facilitate the trade.
  - The exemption is conditional on adherence by FBOs with certain safety and soundness standards, called “Prudential Backstops,” which are discussed below.
Volcker Rule: Funds

• A “banking entity” may not as principal acquire or retain ownership in or sponsor a “covered fund.”

• Hedge/private fund investment/sponsorship
  • Investment: acquisition of equity, partnership or other ownership interest (including, possibly, debt with equity-like characteristics).
  • Sponsorship: GP/equivalent; management selection/control; name-sharing.
Volcker Rule: Covered Funds

• What is a “covered fund”? 
  • Any fund that avoids SEC registration as an investment company because it is offered privately and owned either by (i) 100 persons or fewer or (ii) only by “qualified purchasers” (generally high net worth individuals holding at least US$5 million in investments and institutional investors). Excludes publicly traded funds, such as mutual funds and other funds not subject to registration pursuant to other registration exemptions. 
  • Commodity pool as defined in the Commodity Exchange Act. 
  • Non-U.S. funds that would be exempt from SEC registration by reason of either of the two exemptions above if they were organized or offered under U.S. law. 
  • Other similar funds as determined by the regulators.
Volcker Rule: Customer Fund Exemption

• “Customer Fund” exemption:
  • Sponsorship and management of, and investment in, fund organized/offered by a banking entity in connection with its offering of trust, fiduciary, commodity trading or investment advisory services to its customers:
    • Investment may not exceed 3% of the fund (carried interest doesn’t count). Seed capital for first year (with possible extensions) may exceed 3%.
    • Investments in such covered funds can’t exceed 3% of the banking entity’s Tier 1 capital.
    • Banking entity may not share its name with the “customer fund.”
    • Several other conditions must be observed.
Volcker Rule: Other Fund Exemptions

- Investments in a “covered fund” for certain risk-mitigating hedging purposes.
- Unclear whether there will be a blanket exemption for investments in private equity and hedge funds by regulated insurance companies affiliated with banking entities.
- Treatment of venture capital and similar funds is unknown at this time.
- Will investment by insurance company for a customer’s specific account be permissible because not as “principal” investment?
Volcker Rule: Non-U.S. Funds Exemption

• Investment in covered fund by an FBO or its affiliate “solely outside” the U.S. is exempt. Conditions:
  • As with Prop Trading foreign exemption, the FBO must be a QFBO and must comply with currently applicable FBO regulations for its investment.
  • Neither the fund nor the banking entity that sponsors, offers or controls the fund may be organized under U.S. law.
  • No affiliate/employee involved in the offer/sale of an interest in the fund may be incorporated or physically located in the U.S.
  • No interest in the fund may be offered/sold to U.S. residents: in other words, no co-investment with U.S. investors.
  • The exemption is conditional on adherence by the FBO with certain safety and soundness standards, called “Prudential Backstops,” which are discussed below.
Volcker Rule: “Fund of Funds Exemption”

• A “covered fund” that is exempt as a “customer fund” may invest in other funds. The second and third tier funds, etc., are themselves exempt, without regard to any other Volcker Rule exemption.

• This “fund of funds” exemption isn’t available to a fund that is not a “customer fund” but controlled by an FBO based on the non-U.S. fund exemption. Each “subsidiary” fund would need to be analyzed on its own circumstances for the availability of an exemption.
Volcker Rule: Foreign Funds

• Special concerns affecting FBOs:
  • If FBO controls a fund, whether public or private (for example, by being the general partner or controlling the board of directors), the fund’s investments are attributed to the FBO for U.S. bank regulatory purposes. This is true even with a fund that is exempt as a non-U.S. fund.
  • Under these circumstances, existing prohibitions (that pre-date the Volcker Rule) on FBOs on investments in U.S. companies continue to apply. For example, FBOs can’t own 5% or more of company engaged in business in the U.S. except pursuant to an available exemption. See, e.g., Regulation K, 211.23(f).
Volcker Rule: 23A and 23B Restrictions

• Federal Reserve Act Section 23A regulates “covered transactions” (namely, extensions of credit and assets purchases) by U.S. banks with their affiliates. Section 23B requires any transactions by a U.S. bank with affiliates to be on market terms.

• As seen below, the Volcker Rule extends Section 23A and 23B to relationships between any “banking entity” (including an FBO and its affiliates) and certain “covered funds.”
Volcker Rule: Super 23A and Super 23B

• Section 23A under the Volcker Rule (“Super 23A”).
  • If a banking entity (including an FBO), relying on the “customer fund” exemption, serves as an investment adviser or manager to or sponsor of a “covered fund,” or organizes and offers interests in a “covered fund,” neither the banking entity nor an affiliate may buy assets from or make loans to the fund.

• Section 23B under the Volcker Rule (“Super 23B”).
  • A banking entity (including an FBO and its affiliates) is subject to the market terms and other restrictions of Section 23B in respect of any transactions with such a “covered fund.”

• Prime brokerage services for such a covered fund are permitted, but subject to Section 23B.
Volcker Rule: 23A and 23B Restrictions

• Issues for FBOs:
  • Under proposed regulations: Super 23A and 23B would apply to transactions by an FBO with any covered fund, even if the non-U.S. exemption applies, if the FBO or its affiliates sponsor, advise or manage the fund. This is not dictated by the statute and has been criticized.
  • Raises serious extraterritorial questions.
  • Super 23A and 23B restrictions do not apply to mere investment by an FBO in an exempt non-U.S. fund not sponsored, advised or managed by the FBO.
Volcker Rule: Prudential Backstops

• A banking entity cannot use an exemption if the activities or investments would:
  • Involve or would result in a material conflict of interest.
  • Result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies.
  • Pose a threat to the safety and soundness of a banking entity.
  • Pose a threat to the financial stability of the United States.

• The regulatory “solution”:
  • Conflicts management requirements (disclosures, information barriers).
  • Prohibitions of certain transactions posing “material conflicts.”
  • Requirements extend to customers and counterparties.
Volcker Rule: Prudential Backstops

Problems for FBOs:

• The “prudential backstops” could result in a loss of the “solely outside the U.S.” exemptions for investment in non-U.S. “covered funds” and prop trading.

• This raises serious question about extraterritorial effect of Dodd-Frank.
  • How would U.S. bank regulators assess the “prudential backstops” for such non-U.S. activities?
  • How would FBOs comply?

• Volcker Rule will require that each FBO adopt a compliance program to assure that its trading and fund-related activities comply with the Rule.
Volcker Rule: Compliance Program

• The compliance program must include the following elements:
  • Internal policies and procedures to document, describe and monitor the activity.
  • Internal controls reasonably designed to monitor and identify potential noncompliance.
  • Management framework that clearly delineates compliance responsibility and accountability.
  • Independent testing for the effectiveness of compliance.
  • Training for trading personnel and managers to implement the program.
  • Recordkeeping sufficient to document compliance.
Volcker Rule: Deadlines

- Compliance program is more extensive if banking entity has more than $1 billion in trading assets or invests in or sponsors funds with aggregate assets of $1 billion or more.
- Banking entities generally will have until July 21, 2014, to bring activities into compliance (without an extension). During this “compliance period,” banking entities must engage in “good faith” efforts towards compliance, which would include the establishment of a compliance plan.
  - Federal Reserve may grant up to three (3) one-year conditional extensions.
  - Federal Reserve may grant a single extension, not to exceed five (5) years, for illiquid funds owned or obligated as of May 1, 2010.
Volcker Rule: Action Plan for FBOs

- Analyze and monitor all prop trading to determine whether “solely outside the U.S.” exemption applies.
- Analyze and monitor all investments in hedge and private equity funds to determine whether non-U.S. exemption applies.
- Establish compliance program (required in any event by Volcker rule) to meet Volcker Rule requirements.
- Establish “conformance plan”: how bank will implement Volcker Rule and be in compliance by July 21, 2014.
- Consider including “regulatory opt-out” provisions in hedge fund and private equity fund subscription agreements.
- How will U.S. regulators enforce non-U.S. aspects of Volcker rule? As practical matter, most likely to become an issue in connection with applications for expanded activities in the U.S.
Derivatives Regulation

• Lincoln Amendment/Swaps “Push-Out”:
  • Section 716 of the Dodd-Frank Act prohibits the provision of federal assistance to swaps entities, including swap dealers, security-based swap dealers, major swap participants and major security-based swap participants.
  • Expressly excluded from the prohibitions of Section 716, however, are insured depository institutions (“IDIs”) that are major swap participants and major security-based swap participants.
  • In what has generally been regarded as a drafting error, Section 716 does not apply these exclusions and the transition period to uninsured U.S. branches and agencies of foreign banks.
  • The Lincoln Amendment becomes effective today, July 16, 2013.
Derivatives Regulation

• Lincoln Amendment/Swaps “Push-Out.”
  • In June, the Federal Reserve Board issued an interim final rule that accords foreign banks’ uninsured U.S. branches and agencies parity with U.S. IDIs for purposes of the swaps push-out rule in Section 716.
  • In addition, uninsured state and Federal branches and agencies may apply to the Federal Reserve Board or the Office of the Comptroller of the Currency, respectively, for a transition period of up to 24 months (with the possibility of an additional year) in which to conform their swaps activities to those permitted to IDIs under Section 716.
Derivatives Regulation

• Cross-Border Derivatives Regulation
  • The absence of a definitive cross-border derivatives regulatory framework that is accepted internationally is a major gap in the regulatory implementation of Title VII.
  • The CFTC and the SEC released proposed guidance on the regulation of cross-border swaps and security-based swaps activities in June 2012 and May 2013, respectively. Both proposals have generated significant interest and discussion, especially the CFTC proposal, which is viewed as less accommodative to the interests of foreign than the SEC proposal.
Derivatives Regulation

• Cross-Border Derivatives Regulation
  • On July 11, the CFTC and the European Commission (“EC”) announced a “Path Forward” regarding their joint understandings on a package of measures for how to approach cross-border derivatives.
    • In general, the Path Forward is premised on the view that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulation and enforcement regimes.
    • It is hoped that in light of the progress made on international cooperative regulatory efforts, CFTC – and perhaps SEC -- action to further address the cross-border regulation issue may be forthcoming later in 2013.
FBO Access to U.S. Markets

• U.S. Offices of FBOs
  • For an FBO that presents a risk to the stability of the U.S. financial system, the Federal Reserve must take into account, in considering application to establish a U.S. branch or agency, whether the home country has adopted, or made demonstrable progress toward adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk (Dodd-Frank Act §173).
  • The Federal Reserve can terminate a U.S. office of a foreign bank if the home country of the foreign bank that presents that risk has not adopted or made demonstrable progress towards adopting such a system.
  • SEC has similar regulatory powers for U.S broker-dealer affiliates of an FBO.
FBO Access to U.S. Markets

• U.S. Offices of FBOs
  • Various Federal Reserve Board FBO approval orders have addressed financial stability factors. See Bank of Communications Co. (April 2011); Hana Financial Group (January 2012); Bank of China (May 2012).
  • Capital One Financial Corp. (Federal Reserve Board order February 14, 2012) sheds more light on the elements and mechanics of the financial stability analysis for U.S. banks.
  • In the ICBC order approving acquisition of control of U.S. bank subsidiary of Bank of East Asia (May 2012), the Federal Reserve Board observes that a proposal that involves an acquisition of less than US$2 billion in assets or results in a firm with less than US$25 billion in assets in the U.S. may be presumed not to raise financial stability concerns for the U.S. banking system in the absence of other factors (e.g., increase in interconnectedness, complexity, cross border activities, or other risk factors).
Foreign Bank Access to U.S. Markets

- Incentive Compensation
  - June 2010 guidance based on September 2009 FSB Principles for Sound Compensation Practices: Incentive compensation needs to be appropriately balanced so as not to encourage imprudent risk-taking; risk management and internal controls should support balanced incentive compensation arrangements; and incentive compensation programs should be supported by strong corporate governance.
  - Incentive compensation policies for U.S. operations of FBOs should be coordinated with FBO’s group-wide policies developed in accordance with home country supervisor.
  - In April 2011, banking agencies proposed rules for the reporting to regulators of incentive compensation arrangements, and prohibition of “improper” incentive compensation arrangements,” that would apply to U.S. operations of FBOs with US$1 billion or more of U.S. assets (Dodd-Frank § 956).
Foreign Bank Access to U.S. Markets

- Foreign Bank Interstate Branching

  - Dodd-Frank Act allows national banks and state insured banks to establish *de novo* branches outside of their home state if the target state allows *de novo* branching for its own state-chartered banks within such state (Dodd-Frank Act §613). Bank must be “well capitalized” and “well managed” (Dodd-Frank §607).

  - FBOs may establish *de novo* branches and agencies outside of their home states if the establishment of such branch or agency would be allowed for a national bank (for a federal branch or agency) or a state bank (for state branch or agency). To qualify, FBO must have capital that would be “equivalent” (under home country standards) to a “well capitalized” U.S. bank holding company, and its U.S. operations must have at least a composite satisfactory rating (*i.e.*, be “well managed”).
Dodd-Frank and the Global Environment

- Key Issues for Global Supervisors and FBOs:
  - “Extraterritorial” impact of Dodd-Frank – general and specific.
  - Capital – cooperation at the BCBS level and apparent understanding in principle among BCBS members that Basel III will be consistently applied (albeit on differing timelines).
  - Systemic resolution: mutual recognition of the goals, and need for coordination, of cross-border resolutions but no real agreement on the hard details of such coordination.
Dodd-Frank and the Global Environment

• Key Issues for Global Supervisors and FBOs.
  • Volcker Rule – no meaningful coordination is apparent as of yet.
  • OTC derivatives regulation:
    • Dodd-Frank §752 broadly requires the SEC and CFTC to “consult and coordinate” with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation (including fees) of swaps/security-based swaps activities and participants.
    • U.S.- international consultations have been ongoing through CPSS, IOSCO and IOSCO Task Force, the FSB’s ODWG, and the ODRF.
Dodd-Frank and the Global Environment

- Key Issues for Global Supervisors and FBOs.
  - OTC derivatives regulation
    - Ongoing regulatory dialogue with EC and ESMA concerning differences between DFA Title VII and EMIR and MiFID/MiFIR.
    - FSB Report in October 2010 on regulation of OTC derivatives which was endorsed by the G-20 leaders in November 2010.
    - But, uneven progress in implementation of 2009 G-20 leaders’ commitments regarding (i) standardized trading and clearance of derivatives by end-2012; (ii) reporting of OTC derivatives contracts to trade repositories; and (iii) higher capital requirements for non-centrally cleared trades.
  - Registration and regulation extraterritoriality issues still remain to be resolved. The CFTC-EC “Path Forward” (discussed above) may facilitate further progress in this area.
Dodd-Frank and the Global Environment

• FBO response strategies that could result from the Dodd-Frank Act:
  • “Debank” in the U.S.
  • Cease, downsize or “offshore” affected U.S. activities.
  • Restructure U.S. activities or operations to minimize adverse impacts of the Dodd-Frank Act.
  • Many FBOs are actively considering alternative courses of action but are taking a “wait and see” approach pending the adoption of final U.S. regulations.