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Comparison of Dodd Frank Act and EU Regulatory Reform

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Outline

- OTC derivatives
- Volcker rule and swaps push out rule
- Systemically important institutions
- EU AIFM Directive and U.S. Private Fund Advisers Registration Act
- Other issues

Derivatives - Overview

- Following the financial crisis, the regulation of OTC derivatives has been in sharp focus:
  - initial impetus was in relation to CDS
  - the OTC market generally now faces much greater regulation
- There have been recent detailed regulatory proposals in the U.S. and the EU and other jurisdictions (e.g. Japan)

Derivatives - Overview (cont.)

- September 2009: G-20 Agreement
- Regulatory proposals are focused on four key areas:
  - reducing counterparty risk including strengthening clearing requirements
  - reducing operational risk including greater standardisation and electronic processing
  - increasing transparency including through trade repositories
  - improving market integrity

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act

- Scope:
  - both include very wide definitions including most derivatives
  - in the U.S., FX swaps and forwards may be exempted by regulation
- Regulatory responsibility:
  - in the EU derivative trading continues to be regulated by relevant national regulators
  - CCPs in the EU will also be regulated by national regulators
  - ESMA will have an important role including development of technical standards and overseeing non-EU CCPs
  - Dodd-Frank establishes a bifurcated approach between the CFTC (swaps) and the SEC (security based swaps)

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Non-financial entities:
  - ➢under Dodd-Frank, exemption for non-financial entities which use a swap to hedge or mitigate commercial risk subject to certain conditions
  - ➢EU rules permit non-financials to exclude derivatives which can be objectively viewed as reducing risks directly linked to their commercial activities
  - ➢EU also provides a clearing threshold for non-financials in respect of derivatives not excluded from the clearing obligation

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Clearing requirements:
  - both EU and U.S. require impetus from clearing entities and regulators on which derivatives will be subject to clearing obligation
  - non-discriminatory acceptance for clearing from approved class in both cases
  - EU regulation does not currently require exchange trading for cleared derivatives
- Reporting requirements:
  - reporting requirements to trade repositories are similar
  - in U.S., non-financials must report all swap transactions to repository even if exempt from clearing
  - in EU, non-financials are only required to report to repository if reporting threshold is exceeded
  - EU rules do not currently provide for real time public reporting of derivative transactions but MiFID review envisages post trade reporting requirements for OTC derivatives eligible for central clearing or reported to trade repositories under EMIR

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Trade repositories:
  - similar registration system in U.S. and EU
  - U.S. provisions do not specifically provide for recognition of non-U.S. repositories
  - EU rules do envisage recognition of foreign repositories subject to conditions
  - similar provisions re risk control, disclosure, governance, etc.
- Regulation of CCPs:
  - more detailed cob, organisational and prudential rules in EU. U.S. regulators to produce standards
  - grandfathering of existing CCPs in EU and U.S.
  - both EU and U.S. provide for recognition of foreign clearing systems subject to conditions
  - both provide for minimum capital requirements – currently U.S. proposals are less detailed
  - U.S. regulators may impose shareholding limits
  - no ownership cap in the EU but disclosure of shareholdings and changes in shareholdings required at specified thresholds

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Segregation of collateral requirements:
  - ➢both U.S. and EU contain rules requiring segregation of margin
  - ➢EU rules enable clients of clearing members to require their collateral to be segregated from that of other clients within the CCP
  - ➢in the U.S., in relation to non cleared swaps, counterparties can require segregation of initial margin
  - ➢in relation to cleared swaps, the CFTC is consulting on four alternative approaches to collateral

Derivatives - Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Timing:
  - EU regulation intended to be in force by 2012
  - EU technical standards due to be completed by ESMA by end June 2012
  - most provisions of Dodd-Frank and relevant rules to be effective by July 2011
- Other provisions:
  - Dodd-Frank rules enable CFTC to impose position limits
  - EU rules contain no specific rules on position limits – CCPs may however impose these under their risk management obligations
  - no specific provisions relating to interoperability of CCPs under Dodd-Frank
  - under Dodd-Frank non eligible contract participants (ECPs) must execute trades on an exchange

Derivatives - Issues for Cross-border Institutions

- Dodd-Frank will not apply to activities outside the U.S. unless:
  - they have a direct and significant connection with activities in, or effect on, commerce of the U.S. or
  - they contravene such rules or regulations as may be prescribed under the Act necessary or appropriate to prevent the evasion of the relevant provisions of the Act
- Dodd-Frank envisages that swaps may be cleared through foreign clearing houses
- EU draft Regulation:
  - applies to entities with an establishment in the EU
  - envisages CCPs outside the EU subject to specified criteria
- Major cross-border financial institutions are, however, likely to have to consider both sets of rules

Volcker Rule

- Implemented as part of the Dodd-Frank legislation
- Except for certain permitted activities, a “banking entity” cannot engage in proprietary trading or acquire/retain any equity or ownership interest in a hedge fund or private equity fund
- A “non-bank financial company supervised by the Board” that engages in proprietary trading or fund activities will be subject to additional capital requirements and quantitative limits, to be established by rule

Important terms

- "Banking entities" are:
  - bank holding companies (BHCs)
  - non-U.S. entities treated as BHCs
  - insured depository institutions
  - affiliates or subsidiaries of the foregoing

- "Nonbank financial companies supervised by the Board" may engage in proprietary trading but will be subject to rules adopted by the Federal banking agencies, the CFTC, and the SEC relating to:
  - Additional capital requirements
  - Quantitative limits

Important terms (cont.)

- A nonbank financial company is:
  - any company (not including BHCs, exchanges, clearinghouses, swap data repositories) that is "predominantly engaged in financial activities"
    - annual gross revenues derived by the company and all of its subsidiaries from activities that are "financial in nature" and, if applicable, from the ownership or control of one or more insured depository institutions, represent 85% or more of consolidated annual gross revenues of the company
    - consolidated assets of the company and all of its subsidiaries related to activities that are "financial in nature" and, if applicable, from the ownership or control of one or more insured depository institutions, represent 85% or more of the consolidated assets of the company

Important terms (cont.)

- "Supervised by the Board" if systemically significant:
  - test: material financial distress at the company or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company could pose a threat to the financial stability of the U.S.
    - determination based on 2/3 vote of Financial Stability Oversight Council
  - for foreign nonbank financial companies, consideration not limited to U.S. activities and subsidiaries
  - any BHC with total consolidated assets ≥ $50 billion as of January 1, 2010 that participated in the Capital Purchase Program under TARP and ceased to be a BHC will be treated as a NFC supervised by the Board

Important terms (cont.)

- company may establish (or Board may require establishment of) an intermediate holding company for "financial activities" for purposes of Board supervision
- financial activities
  - activities that are financial in nature
  - includes ownership or control of one or more insured depository institutions
  - does not include internal financial activities conducted for the company or any affiliate, including internal treasury, investment, and employee benefit functions
- nonfinancial activities not subject to Board supervision or prudential standards

Important terms (cont.)

- "proprietary trading" defined as engaging as principal for the trading account of the entity in any transaction to acquire or dispose of a security, derivative, contract of sale of a commodity for future delivery, any option on such a security, derivative or contract, or any other security or financial instrument specified by the appropriate federal agencies

- "trading account" means any account used for acquiring or taking positions principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short term price movements, and any other account specified by rule

Important terms (cont.)

- hedge funds or private equity funds includes entities that would be subject to registration under the Investment Company Act but for Section 3(c)(1) (fewer than 100 owners) or for Section 3(c)(7) (those offered only to "qualified purchasers")

- sponsoring a hedge fund or a private equity fund includes controlling the fund (by virtue of being a general partner or a managing member, or through board control), or sharing a name with the fund

De Minimis Investments

- A banking entity may make and retain an investment in a fund that the banking entity organises and offers; provided, that:
  - it seeks unaffiliated investors for the fund
  - within one year of a fund's start date, the banking entity's investments shall not exceed more than 3% of the total ownership interests in such fund
  - the aggregate of investments in all such funds does not exceed 3% of the banking entity's Tier 1 capital
- The one year period can be extended by up to 2 more years upon application to the Board

Permitted Activities

- Transactions in U.S. government securities (including securities of the GSEs)
- Transactions in connection with 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 in connection with a banking entity’s individual or aggregate positions, contracts or holdings
- Customer transactions
- The purchase or sale of securities and derivatives by a regulated insurance company engaged in the insurance business, subject to state insurance regulation and federal safety and soundness review

Permitted Activities (cont.)

- Certain proprietary trading that occurs solely outside of the U.S. by a banking entity that is not directly or indirectly controlled by a banking entity organised under the laws of the U.S.
- The acquisition or retention of an ownership interest or the sponsorship of a fund by a banking entity solely outside of the U.S. if interests in the fund are not offered or sold to a U.S. resident and the banking entity is not directly or indirectly controlled by a banking entity organised in the U.S.
- All other activities deemed appropriate by the applicable oversight agencies that would promote the safety and soundness of the banking entity

Permitted Activities (cont.)

- Organising and offering a private equity or hedge fund, if the banking entity (*the "fiduciary" exception*):
  - provides bona fide trust, fiduciary, or investment advisory services
  - provides trust or related services and offers interests in the fund only in connection with providing such services and only to bank customers
  - does not acquire or retain an interest in the funds except for de minimis investments (see above)
  - observes certain limitations on transactions between it and the fund
  - does not guarantee the obligations or performance of the fund

Limitations on Permitted Activities

- No transaction, class of transactions, or activity may be deemed a permitted activity if it would:
  - involve a "material conflict of interest" (to be defined by rule) between the banking entity and its clients, customers, or counterparties
  - result, directly or indirectly, in a material exposure by the banking entity to "high-risk assets" or "high-risk trading strategies" (to be defined by rule)
  - pose a threat to the safety and soundness of the banking entity
  - pose a threat to the financial stability of the U.S.

Permitted Fund Services

- A banking entity may provide prime brokerage services to a sponsored fund if :
  - the provision of such services complies with other applicable restrictions of the regulations
  - the CEO (or equivalent officer) of the banking entity certifies annually to such compliance
  - the Board determines that the transaction is consistent with the safe operation and sound condition of the banking entity

Limitations on Relationships with Funds

- A banking entity that serves as an investment manager, investment adviser or sponsor to a fund or that organises and offers interests in a fund may not enter into "covered transactions", nor may its affiliates
- Covered transactions – transactions such as extension of credit, issuance of a guarantee, purchase of an asset, etc., which could be used to effectively transfer to the fund the benefit of the bank's access to the federal "safety net" i.e. lower cost insured deposits and access to the discount window
- For non-bank financial companies supervised by the Board, who carry out such notes in relation to funds, additional capital requirements or other restrictions will be specified by rule

Phase-In Period

- Generally, these provisions shall take effect on the earlier of:
  - 12 months after the date of the issuance of the final rules
  - two years after the date of enactment of the Act
- Bank entities and nonbank financial companies will have two years after the effective date (or two years after the date on which the entity becomes subject to Federal Reserve supervision as a bank entity or a nonbank financial company) to bring their activities into compliance
- This phase-in period may be extended by the Federal Reserve for one year at a time, with extensions not to exceed an aggregate of three years
- However, the Federal Reserve may extend the period in order to permit compliance with a contractual obligation that was in effect on May 1, 2010, in connection with illiquid funds

Milestones

Anticipated Effects

- Generally, for market:
  - proprietary trading limitations (including derivatives activities)
    - will remove certain participants from the market
      - will that impact liquidity? will hedge funds replace banks?
    - how will banks distinguish between market making and risk mitigating trades and proprietary trades?
  - passive investments in funds
    - impacts banks that are sponsors or LPs
    - impacts the private equity market as a whole
  - activities involving funds will be subject to Section 23A/B Federal Reserve Act
  - banks and non-banks also may be subject to additional capital requirements

European Equivalents of Volcker Rule

- In UK, Independent Commission on Banking Call for Evidence in September 2010

- In UK, various legislative developments regarding activities/ soundness of financial institutions

UK Financial Sector Stability Developments

- Special Resolution Regime – created powers for UK authorities to transfer all or part of a failing bank's business to a private sector purchaser or to a publicly-controlled "bridge" bank or to take the bank into temporary public ownership
- Bank insolvency regime and bank administration regime
- Bank recovery and resolution plans ("living wills")
- Investment banks – special administration regime

European Equivalents of Volcker Rule

- Currently no European-level equivalent to Volcker Rule
- European Commission communication in October 2010 relating to crisis management in the financial sectors and describing certain measures under consideration, such as equivalents of the UK's SRR and living wills
- Possible European legislative proposals spring 2011

Lincoln Provision - Swaps Push-out Rule

- No “Federal assistance” may be provided to any “swaps entity” with respect to any swap, security-based swap, or other activity of the swaps entity

- Clarifies that insured depository institutions may have affiliates that are swaps entities, so long as the institution is supervised by the Federal Reserve and complies with certain provisions applicable to dealings between affiliates under sections 23A/23B of FRA

Key Terms

- Federal assistance:
  - the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility
  - FDIC insurance
  - guarantees
  - in any case, for the purpose of
    - making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity
    - purchasing the assets of any swaps entity
    - guaranteeing any loan or debt issuance of any swaps entity
    - entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity

Key Terms (cont.)

- Swaps entity:
  - only swap dealers and major swap participants registered under the Commodity Exchange Act or Securities Exchange Act (excludes exchanges and clearing houses)
  - excludes insured depository institutions that are major swap participants

Exceptions to Prohibition

- Prohibition on Federal assistance does not apply to insured depository institutions that limit their swap activities to:
  - hedging and other similar risk mitigating activities directly related to the insured depository institution's activities
  - acting as a swaps entity for swaps involving rates or reference assets that are permissible for investment by national banks
    - CDS is permissible only if centrally cleared
- Insured depository institutions still must comply with proprietary trading ban under the Volcker Rule

Effective Date and Transition Period

- Prohibition takes effect 2 years after effective date of the Act
- To the extent an insured depository institution would be subject to the prohibition, the applicable Federal banking agency (in consultation with the CFTC and SEC) shall permit the institution up to 24 months to divest the swaps entity or cease the prohibited activities
  - may extend transition period up to 1 year
- Prohibition only applies to swaps entered into <u>after</u> the end of the <u>transition period</u>

Implications for Foreign Financial Institutions

- On its face, the exceptions for insured depository institutions do not apply to noninsured U.S. branches and agencies of foreign banks
- Colloquy related to § 716 between Senator Lincoln and Senator Dodd may explain Congressional intent regarding the treatment of uninsured U.S. branches and agencies of foreign banks
- Colloquy states that:
  - there was a significant and clearly unintended oversight with regard to the treatment of uninsured U.S. branches and agencies of foreign banks
  - under the U.S. policy of national treatment, uninsured U.S. branches and agencies of foreign banks are authorised to engage in the same activities as insured depository institutions
  - it was not intended to force U.S. branches and agencies of foreign banks to push-out all their swap activities
  - U.S. branches and agencies of foreign banks should be treated the same as insured depository institutions under § 716, including the safe harbour language

Anti-Avoidance

- Council may prohibit Federal assistance to swaps entities on an institution-by-institution basis upon a 2/3 vote
- Basis for determination – When other provisions established by Dodd-Frank Act are insufficient to effectively mitigate systemic risk and protect taxpayers

G-20 – Systemically Important Financial Institutions

- G-20 meeting in Seoul endorsed FSB's proposals to reduce "moral hazard risks" posed by SIFIs and address the "too big to fail" issue
- SIFIs should have loss absorbency capital commensurate with system-wide losses that would be occasioned by their failure
- Initial focus on global SIFIs (GSIFIs):
  - FSB and national authorities to draw up list of GSIFIs by mid 2011
- GSIFIs to be required to have greater capacity to absorb losses than under proposed Basel III minimum standards
- More intensive and effective supervisory oversight
- BCBS to produce report on additional loss absorption capacity of GSIFIs by mid 2011

G-20 – Systemically Important Financial Institutions (cont.)

- Resolution Frameworks:
  - all jurisdictions should have a resolution framework in place to facilitate rapid resolution of a failing institution
  - depositors should be able to continue to access their deposits
  - authorities must have power to transfer and sell viable parts of the entity
- Internationally active institutions:
  - sharing and co-operation agreements
  - elimination of laws protecting domestic creditors at expense of foreign creditors
  - for GSIFIs, co-operation agreement between home and host authorities
- FSB to draw up criteria for assessing resolvability of SIFIs by March 2011

Dodd-Frank – Systemically Important Institutions

- Federal Reserve will have oversight of systemically important non-bank institutions
- Bank holding companies with total consolidated assets equal to or greater than U.S.$50bn are automatically considered systemically important
  - could include non-U.S. institutions
- Financial Stability Oversight Council can also designate institutions that are systemically important
  - could include non-U.S. institutions
- Systemically significant entities will be subject to increased requirements in certain areas including:
  - capital requirements
  - credit exposure limits
  - recovery and resolution plans / living wills
  - limitation on acquisitions

EU AIFM Directive

- Approved by EU Parliament on 11 November 2010
- Likely to be implemented by all EEA member states by early 2013
- Many implementing measures yet to be drafted
- Will apply to:
  - all EU alternative investment fund managers (AIFMs) managing any AIF
  - all non-EU AIFMs managing an EU AIF or marketing any AIF in the EU
- A fund manager regulated by its home member state is exempt if its assets under management do not exceed €100m
- AIFMs must be authorised before they can provide management services to EU or non-EU AIFs unless an exemption applies

EU AIFM Directive (cont.)

- Additional capital and operational requirements
- Transparency and disclosure requirements
- EU AIFMs will be able to market EU AIFs to professional investors across the EU under a marketing passport
- Subject to notification and certain conditions, from 2015 the passport is extended to EU AIFMs marketing non-EU AIFs across the EU
- From 2015, a non-EU AIFM can obtain a marketing passport and obtain the same market access as an EU AIFM:
  - must be prior authorisation from competent authority of ‘member state of reference’
  - other conditions must be satisfied

Dodd-Frank – Private Fund Advisers Registration Act 2010

- Dodd-Frank Act eliminated private advisor exemption from registration under Investment Advisers Act 1940
- New exemptions for:
  - foreign private advisers
  - advisers to venture capital funds
  - advisers to private funds with less than U.S.$150m in assets under management in the U.S.
  - family offices
- SEC to define the exemptions
- SEC published draft rules in November 2010

Dodd-Frank – Private Fund Advisers Registration Act 2010 (cont.)

- Adviser with principal office and place of business outside the U.S. will qualify for private fund adviser exemption if:
  - it has no U.S. person(s) as a client except for one or more qualifying private funds and
  - all assets managed from a place of business in the U.S. are solely attributable to private fund assets the total value of which is less than U.S.$150m

Dodd-Frank – Private Fund Advisers Registration Act 2010 (cont.)

- Foreign private adviser exemption applies to any foreign private adviser that:
  - has no place of business in the U.S.
  - has fewer than 15 clients and investors in the U.S. in private funds advised by it
  - has aggregate assets under management attributable to clients in the U.S. (and investors in private funds advised by it) of less than U.S.$25m
  - does not hold itself out generally to the public in the U.S. as an investment adviser or act as an adviser to a registered investment company or business development company

Other Issues

- Regulation of credit rating agencies
- Reliance on credit ratings (including in capital framework)
- Regulatory capital
- Corporate governance / executive compensation
- Bank levies

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