Hogan Lovells

Financial Services Legislative Update

Impact of Dodd-Frank Wall Street Reform and Consumer Protection Act on Non-U.S. companies

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When the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act") was signed into law on July 21, we entered into a new era for U.S. regulatory oversight of non-U.S. based companies that operate within the United States. The Act will have a significant impact not only on the financial services industry, but also on nearly all U.S. public companies because it included new requirements to the securities laws on a range of issues. Importantly, these current developments will also impact many non-U.S. entities who do business within the United States or with U.S. person.

As we noted in our earlier summary of the Act, "*Financial Services Reform Legislation Enacted*", the Act "is not targeted solely at insured depository institutions and their affiliates, but rather at all companies that either do, or may, impact the financial segment of the U.S. economy." Of equal importance are provisions directing U.S. financial and securities regulators to sharpen their international focus and to promote greater cooperation with non-U.S. regulators.

This update highlights these new responsibilities. As noted in our earlier report, we intend to issue additional updates providing in-depth analysis as significant rulemaking initiatives advance and upon the occurrence of other important developments related to the implementation of the Act.

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INVESTOR PROTECTIONS AND IMPROVEMENT TO SECURITIES REGULATION

The portion of the Act concerning investor protections and improvement to the regulation of securities also contains a number of provisions that will affect international participants in U.S. securities markets. Some significant international aspects of this title are discussed below.

CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION

The Act provides shareholders substantially greater power to participate directly in corporate governance and includes a number of required practices and new disclosure requirements applicable to executive compensation. Foreign *private* issuers, which are not subject to many of the SEC's proxy rules applicable to other U.S. and foreign issuers, are exempted from a number of these new corporate governance and executive compensation requirements, such as proxy access, "say on pay", "say on golden parachutes", disclosure of hedging by officers and directors, disclosure concerning Chairman and CEO structures, pay for performance disclosures, internal pay equity disclosures and disclosure of CEO and employee pay ratios. Foreign private issuers are, however, subject to a number of remaining provisions discussed below concerning corporate governance and executive compensation.

Institutional Investor Disclosure of Compensation Votes. The Act requires institutional investment managers subject to Section 13(f) of the Exchange Act to disclose annually how they vote on the new "say on pay" and "say on golden parachutes" votes mandated by the Act. The "say on pay" and "say on golden parachute" votes are nonbinding shareholder resolutions required for issuers subject to the SEC's proxy rules. Foreign investment managers subject to Section 13(f) will also be required to comply with this new reporting requirement.

Limited Discretionary Voting by Brokers. The Act requires national securities exchanges to prohibit brokers from using their own discretion to vote shares of issuers, not beneficially owned by them on certain "significant" matters. These include votes on the election of directors, executive compensation matters, and any other matter determined by the SEC to be significant. Brokers, however, may continue to vote shares in accordance with specific voting instructions provided by the beneficial owners. Because stock exchanges already prohibit discretionary voting by brokers on elections of directors, the principal effect of the new requirement is to extend the prohibition to executive compensation matters, and other matters determined by the SEC to be significant.

Independence of Compensation Committee and its Advisers. In an action that codifies existing practice, national securities exchanges will be prohibited by SEC rule from listing securities of any issuer whose compensation committee is not composed solely of independent directors. Foreign private issuers are exempt from this provision, provided they make annual disclosures to their shareholders of the reasons why they do not maintain an independent compensation committee. Compensation committees also will be required to consider independence factors to be identified by the SEC prior to engaging any

consultants, legal counsel, and other advisers hired by the compensation committee. The Act also requires that issuers provide appropriate funding for such advisors. The advisor independence and funding requirements do not contain specific exemptions for foreign private issuers, although the Act provides the national securities exchanges with broad authority to exempt categories of issuers from those requirements.

Clawback of Compensation Paid "Erroneously." The Act requires SEC adoption of a rule directing stock exchanges to require issuers to have a policy providing for (1) disclosure on incentive compensation payable on the basis of financial information reportable under the securities laws, and (2) the recovery from current or former executive officers, following an accounting restatement triggered by material noncompliance with securities law reporting requirements, of any incentive compensation paid "erroneously" during the three-year period preceding the date on which the restatement was required that exceeds the amount that would have been paid on the basis of the restated financial information. Although the Act does not contain an exemption from this requirement for foreign private issuers, it is possible that the SEC will consider including such an exemption in the rules adopted by it to implement the clawback provisions.

Disclosure by Large Financial Institutions of All Incentive-Based Compensation Arrangements and Prohibition of High-Risk Arrangements. The Act requires the federal banking and finance agencies and the SEC jointly to adopt rules regarding incentive-based compensation arrangements offered by specified financial institutions having assets of $1 billion or more (including, among others, depository institutions, registered broker dealers and other financial institutions determined by the regulators) to their executive officers, employees, directors, and principal shareholders. These institutions will be required to disclose all incentive-based compensation arrangements offered by them (without naming any individuals) in a manner sufficient to determine whether the arrangements either provide "excessive compensation, fees, or benefits" or "could lead to material financial loss" by the institution. The regulators also must jointly adopt regulations or guidelines prohibiting incentive-based compensation arrangements or features that the regulators determine "encourages inappropriate risks" by these financial institutions.

BENEFICIAL OWNERSHIP

The Act also contains a number of provisions applicable to beneficial ownership of equity securities when the issuer is subject to the SEC's rules.

Timeframe for Beneficial Ownership Reporting. The Act authorizes the SEC to shorten the deadlines for certain security holders to file reports under Sections 13(d) and 16(a) of the Exchange Act to report securities beneficially owned by them. Any SEC rulemaking to shorten the deadline for Section 13(d) reporting would apply to all issuer securities registered under the Exchange Act, including securities issued by foreign private issuers, as well as securities issued by non-foreign private issuers that are held by foreign investors. However, because securities issued by foreign private issuers are not subject to Section 16, any SEC rulemaking to shorten the deadline for Section 16(a) reporting would not affect directors and officers of foreign private issuers. Foreign investors, however, that own 10% or more of a

class of equity securities registered under the Exchange Act, would be subject to any shortened Section 16(a) deadline.

Beneficial Ownership of Equity Securities Underlying Swaps. The Act also clarifies that a person will be deemed to beneficially own securities based on a purchase or sale of a security-based swap only to the extent that the SEC, in consultation with other regulators, determines that transactions in the security-based swap are equivalent to direct ownership of the equity securities. This provision will limit, until such time (if any) as the SEC and other regulators determine otherwise, broad interpretations of the beneficial ownership rules to include equity securities that underlie security-based swaps.

CREDIT RATING AGENCIES

The Act includes a number of provisions that will greatly increase the regulation, accountability, and transparency of credit ratings agencies. Certain of these provisions have a direct impact on foreign private issuers and other foreign market participants.

Regulation FD Exemption Repealed. The Act repeals an exemption from the SEC's Regulation FD (Fair Disclosure) that has permitted issuers to share material nonpublic information with credit rating agencies without triggering an issuer public disclosure obligation.

Securities Act Rule 436(b) Repealed. The Act repealed an exemption for credit rating agencies from potential liability as "experts" in registration statements and prospectuses filed the SEC. The repeal requires credit rating agencies to consent to have their ratings disclosed and to be named in such filings, which the rating agencies have indicated they will not provide. Because issuers of debt securities in some cases are required by SEC rules to disclose the credit rating associated with their securities, or typically provide disclosure of such ratings in offering documents or in documents incorporated by reference into registration statements, refusal by the rating agencies effectively prevents issuers from offering and selling many types of debt securities. The SEC recently acted to provide relief for issuers from the immediate effects of the repeal for a six-month period while it considers whether to adopt other forms of relief.

PRIVATE OFFERINGS

The Act requires the SEC to revise the private offering "safe harbor" exemption from Securities Act registration frequently relied upon by issuers to raise capital. One of these revisions will require the SEC to adopt rules within one year that disqualify felons and other "bad actors" from relying on the exemption provided by Rule 506 of Regulation D under the Securities Act . The term "bad actor" is intended to encompass essentially the same persons who are disqualified by Securities Act Rule 262 from relying on the Regulation A small offering exemption. Other changes will reduce the number of persons that otherwise might qualify as an "accredited investor" in a Regulation D offering by (1) amending the $1 million net worth test to exclude the value of an investor's primary residence, and (2) authorizing the SEC to adjust at least once every four years the dollar thresholds for tests of accredited investor status of individuals unrelated to the net worth test.

SHORT SALES

The Act prohibits manipulative short sales of securities and requires the SEC to adopt rules providing for monthly reports of short sales by institutional investment managers subject to Section 13(f) of the Exchange Act.

ASSET SECURITIZATION

Losses on securitizations of assets, particularly home mortgages, were a major contributing factor to the recent financial crisis, and the Act seeks to prevent a recurrence through various measures designed primarily to raise underwriting standards. Many of the measures require joint rulemaking by financial regulators and the SEC, so some time will pass before the regulatory environment is fully established. Prominent among the measures affecting asset securitizers, domestic and foreign, are the following:

Credit Risk Retention. The Act directs the federal banking agencies and the SEC jointly to prescribe rules requiring the securitizers to retain five percent of the credit risk of their offerings, except where the offering consists exclusively of "qualified residential mortgages." No hedging of the retained credit risk will be permitted, although some of that risk may be allocated by regulators to any originator from which the securitizer purchased the assets. Some relief from the credit risk retention requirement will be provided for offerings in which the underwriting and due diligence meet prescribed standards.

Conflicts of Interest. Sponsors and distributors of asset-backed securities will be prohibited by rules to be adopted by the SEC from engaging (with some exceptions), for one year following the closing of a securitization offering, in any transaction "that would involve or result in any material conflict of interest" with an investor in the offering.

Expanded Disclosures. The Act requires that the disclosures of asset-backed securities in registered public offerings include, in accordance with rules to be adopted by the SEC, data disclosure formats and asset-level or loan-level data sufficient to enable investors both to compare this information with data regarding other securities in similar types of asset classes and to perform their own independent due diligence.

Elimination of Exemptions. The Act has deleted the exemption from Securities Act registration provided by Section 4(5) of the Securities Act for mortgage-backed securities meeting specified requirements. The Act also excludes asset-backed securities from the classes of securities of an issuer for which the duty to file SEC reports under Section 15(d) of the Exchange Act is suspended for any fiscal year in which the issuer had fewer than 300 record holders of the class at the beginning of the year. The SEC, however, was granted authority to adopt rules indicating the terms and conditions under which suspension or termination of the reporting obligation regarding such classes will be permitted.

INVESTMENT ADVISERS TO PRIVATE FUNDS

The Act extends investment adviser registration, as well as record-keeping and SEC inspection requirements, to advisers to private funds and to other advisers who previously relied on an exemption from registration for advisers with fewer than 15 clients. It also raises the threshold for SEC registration from $25 million to $100 million of assets under management. Advisers falling below this threshold must register with U.S. state regulators, unless federal registration is required. These requirements will become effective one year from the date of enactment, with earlier registration expressly permitted.

These changes have several important implications for non-U.S. investment advisers. First, any investment adviser previously relying on an exemption from registration for having less than 15 U.S. clients is now subject to registration with the SEC if it has at least $100 million of U.S. assets under management, regardless of the number of clients in the U.S. Advisers with U.S. client assets below this threshold may be subject to regulation with U.S. state securities regulators. Additionally, the principle that an investment fund is a single client for purposes of this 15-client test has been removed, so that U.S. investors in funds managed by off-shore fund managers are considered to be clients of the fund manager for purposes of determining whether registration is required.

The following types of investment advisers, among others, will be exempt from registration under the Act, in most cases subject to SEC rulemaking defining the scope of the exemption:

- U.S.-based advisers to venture capital funds (but not private equity funds);
- U.S.-based small private fund advisers (advisers whose only clients are private funds and who have U.S. investor assets of less than $150 million); and
- Foreign private advisers (advisers with no place of business in the United States, who do not hold themselves out in the United States as investment advisers, and have fewer than 15 U.S. clients and less than $25 million of U.S. assets under management (unless a higher threshold is established)).

The SEC was granted authority to adopt rules providing for registration and examination procedures for "mid-sized private funds" (a term the Act does not define) to reflect the level of systemic risk posed by such funds.

The Act significantly expands the types of records that investment advisers with U.S. clients, whether or not registered, will need to maintain. Although these records will be subject to SEC inspection as part of the federal government’s new efforts to monitor systemic risk, they generally will be exempt from public disclosure under the Freedom of Information Act (FOIA). The Act generally protects from FOIA disclosure records relating to investment and trading strategies, analytical or research methodologies, trading data, computer hardware and software concerning intellectual property, and other information determined by the SEC to be proprietary.

ENFORCEMENT

The Act contains numerous provisions that will enhance the ability of the SEC and private parties to enforce U.S. securities laws. The provisions generally will expand the scope of liability, strengthen enforcement powers, and introduce procedural improvements.

Expansion of Liability

- Market manipulation. The Act expands the reach of the anti-manipulation provisions of Section 9 of the Exchange Act beyond securities registered on a national securities exchange to encompass any security other than a government security.

- Aiding and abetting. The Act supplements the SEC's longstanding authority under the Exchange Act to bring actions against parties who aid and abet securities law violations by vesting the SEC with the same authority under the Securities Act, the Investment Company Act and the Investment Advisers Act. The Act also makes it possible for the SEC (but not private parties) to base such actions on conduct that was knowing or reckless.

- Control persons. The Act makes it clear that the SEC has the authority, which formerly was believed to be vested solely in private parties, to bring actions based on "control person" liability under Section 20(a) of the Exchange Act.

Strengthened Enforcement Powers

- Wider jurisdiction of federal courts. The Act reduces the impact of the Supreme Court's recent decision in *Morrison v. National Australia Bank* that limited the reach of the securities antifraud provisions to transactions that occurred only in the United States. The Act does so by permitting the SEC (but not private parties) to bring actions under the antifraud provisions regarding transactions that either occurred outside the United States or involved only foreign persons if (1) conduct that occurred within the United States constituted significant steps in furtherance of a violation, or (2) conduct that occurred outside the United States had a foreseeable substantial effect within the United States with respect to a violation.

- Sharing Privileged Information with Other Authorities. The SEC and the Public Company Accounting Oversight Board ("PCAOB") will not be deemed to waive privilege by sharing information with, among others, foreign authorities. In addition, the SEC cannot be compelled to disclose privileged information obtained from foreign securities or law enforcement authorities.

- Broader power to impose civil money penalties. The Act now permits the SEC to impose monetary penalties in cease and desist proceedings against any person.

- Extended range of collateral bars. The Act broadens the SEC's ability to impose collateral bars under the Exchange Act and the Investment Advisers Act by allowing the SEC to impose bars against association with any broker-dealer, investment adviser, transfer agent, or credit rating

agency, rather than only against association with entities regulated under the securities law provisions that were violated.

- Expansion of whistleblower protections. Whistleblowers who provide original information in SEC enforcement actions that results in sanctions exceeding $1 million will be entitled under the Act to compensation based on a percentage of the amount received, and will have a private right of action against employers who retaliate against them.

Foreign Accounting Firms

- Production of Documents. Foreign public accounting firms that provide material services upon which domestic registered public accounting firms rely must (i) produce its work papers and other documents that the SEC and the PCAOB may request and (ii) be subject to the jurisdiction of U.S. courts for purposes of enforcement of any such request.

- Agent for Service. If a foreign public accounting firm performs work for a domestic registered public accounting firm, the foreign firm must furnish an irrevocable consent and power of attorney that designates the domestic firm as an agent for services of any request by the SEC or PCAOB.

SYSTEMIC RISK

FINANCIAL STABILITY

Foreign Nonbank Financial Companies Subject to Certain Oversight. The Act grants certain oversight to the U.S. authorities over foreign nonbank financial companies, which are defined as companies, other than bank holding companies, incorporated or organized in a country other than the U.S. and which are predominantly engaged in financial activities, including through a branch in the U.S. The Federal Reserve is to issue rules for determining whether a company is predominantly engaged in financial activities.

Financial Stability Oversight Council. The Act creates a Financial Stability Oversight Council ("FSOC"), which is charged with identifying and addressing systemic risks posed by large, complex financial companies and certain products and activities. While the FSOC's mandate relates to preventing harm to the U.S. system, it has the authority to monitor certain international activities. For instance, its duties include monitoring international regulatory proposals, and it has the authority to obtain information on foreign nonbank financial companies. With respect to gathering information, to the extent possible, the FSOC is to work in coordination with the newly-established Office of Financial Research ("OFR"), discussed below, and with the appropriate foreign regulator. To the extent possible, the FSOC is to rely on information already collected by that regulator.

Foreign nonbank financial companies may be supervised by the Federal Reserve if the FSOC determines that material financial distress at the foreign nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities, could pose a threat to the financial stability of the U.S.

In exercising this authority, the FSOC is to coordinate with foreign regulators to the extent appropriate.

Enhanced Supervision and Prudential Standards. The FSOC may make recommendations to the Federal Reserve concerning the prudential standards and reporting and disclosure requirements applicable to nonbank financial companies supervised by the Federal Reserve. With regard to foreign nonbank financial companies, the FSOC must "give due regard to the principle of national treatment and equality of competitive opportunity" and take into account the extent to which the foreign nonbank financial company or foreign-based bank holding company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the U.S.

Where the Federal Reserve determines that a grave threat to the stability of the U.S. economy is posed by a bank holding company with assets above $50 billion or by a nonbank financial company, it may impose a number of restrictions on such company. The Federal Reserve may prescribe rules regarding the applicability of this authority to foreign nonbank financial companies and foreign-based bank holding companies. In doing so, it must take into account the extent to which the foreign company is subject on a consolidated basis to home country supervision standards that are comparable to U.S. standards.

Office of Financial Research. The Act creates the OFR, which is tasked with supporting the FSOC by collecting information, performing research, and developing tools for risk management and monitoring. As part of its duties, the OFR may collect information on financial companies that are regulated by a foreign supervisory authority. Before requiring the submission of any report from such a company, the OFR shall coordinate with the foreign supervisory authority and shall, whenever possible, rely on existing information available from such authority.

Safe Harbor. Under the Act, the Federal Reserve is to issue regulations on behalf of, and in consultation with, the FSOC setting forth the criteria for exempting certain types or classes of both U.S. and foreign nonbank financial companies from supervision by the Federal Reserve. The Federal Reserve shall, in consultation with the FSOC, review the regulations not less frequently than every five years, but no such revisions may take effect earlier than two years after final rules are published providing for the revisions.

Access to U.S. Financial Market by Foreign Institutions. The Act states that, in deciding whether to approve or terminate U.S. operations of a foreign banking organization, the Federal Reserve may consider, for a foreign bank that presents a risk to the stability of the U.S. financial system, whether the bank's home country has adopted, or made demonstrable progress toward adopting, an appropriate system of financial regulation to mitigate such risk.

International policy coordination. The Act calls for coordination between U.S. and foreign governmental authorities and financial regulatory entities to protect financial stability and the global economy, and to encourage comprehensive and robust prudential supervision and regulation for all highly leveraged and interconnected financial companies.

PAYMENT, CLEARING AND SETTLEMENT

The Act provides broad authority to the Federal Reserve and the other federal financial regulatory agencies to designate and regulate payment, clearing and settlement activities that are deemed systemically important by the FSOC. Entities that provide these services may be identified by the FSOC as designated financial market utilities, which will subject them to enhanced oversight and enforcement. The Federal Reserve is directed to consult with both the FSOC and the appropriate supervisory agency to make such designations.

The FSOC is granted wide latitude to seek information and to impose recordkeeping and reporting requirements in order to assess systemic importance of both the designated entities and designated activities of financial institutions, including U.S. branches and agencies of foreign banks. The information may be shared with other regulators, including state and international regulators and supervisors. Enforcement is to be carried out by the primary federal regulator, but in cases of emergency, the Federal Reserve, after consulting with that regulator, may act unilaterally.

EMERGENCY STABILIZATION

The Federal Reserve, in consultation with the Treasury, is to establish regulations regarding emergency lending. Activities authorized by such programs are to be used to make loans to promote liquidity, subject to new collateral requirements, but may not be used to assist a single or specific entity. The names of the entities receiving assistance do not have to be made public immediately. Any loan or other financial assistance extended under this program must be reported to the Congressional committees that have jurisdiction over the Federal Reserve.

Further, emergency programs will be subject to audit by the Government Accountability Office at the Comptroller General's discretion. The information contained in the audit report must include the identity of each business, individual, entity or foreign central bank that receives assistance. The initial report is confidential, but it may ultimately be released to the public one year after the termination date of the credit facility, and the Federal Reserve is to provide Internet access to the audit report six months later.

ORDERLY LIQUIDATION

The Act establishes a structure to be used in extreme circumstances to liquidate large failing financial institutions — the type of institution previously deemed "too big to fail." Covered entities include bank holding companies, nonbank financial companies such as insurance companies and securities broker-dealers, and their financial subsidiaries, if any of these are deemed to be systemically important. This new authority is not expected to be used except in extreme cases where an orderly dissolution of the troubled institution is necessary to preserve U.S. financial stability.

Current U.S. bankruptcy law will remain the presumptive system under which such liquidation would occur, unless Treasury finds that a financial company is in distress and the new liquidation authority should be used instead. The FDIC would be appointed as receiver and charged with winding down the troubled company. In such cases, financial contracts subject to "qualified financial contract" rights include, among others, foreign exchange currency options, foreign futures commodity contracts, qualified foreign government securities repurchase agreements and foreign exchange swap agreements. The Act prohibits the transfer of qualified financial contracts to foreign banks and foreign-organized financial institutions.

Where the FDIC has been appointed receiver, the Act requires that the FDIC coordinate with foreign financial authorities where the financial company has assets or operations outside the U.S. The Act requires, within one year after the date of enactment, a study focused on international coordination of the orderly liquidation of financial companies under U.S. bankruptcy law. The study must include (i) the extent to which international coordination exists, (ii) current mechanisms and structures for international coordination and (iii) the barriers to effective international coordination. Additionally, Treasury must report to Congress the basis for any systemic risk determination and any potential international ramifications of resolution under applicable insolvency laws.

BANKING REGULATION

REGULATORY AGENCY RESTRUCTURING

The Act makes many changes to the current structure of U.S. regulation of financial institutions and their holding companies and extends federal regulatory authority to nonbank financial companies that the Federal Reserve designates as "systemically important financial companies." The Act eliminates the Office of Thrift Supervision, and requires its merger with the OCC. It does not, however, change the federal regulator for foreign branches and agencies.

EXPANSION LIMITATIONS

The Act limits combination activity by the largest financial institutions, which are defined to include foreign banks and companies that are treated as bank holding companies for purposes of the Act.

CAPITAL REQUIREMENTS

The Act extends the leverage capital requirements and risk-based capital requirements currently applicable to insured depository institutions to U.S. bank holding companies owned or controlled by foreign banking organizations (but not to the foreign banking organizations themselves). These risk-based capital requirements will serve as a floor for the capital requirements to be established by the Federal Reserve. One effect of this limitation is to eliminate trust preferred securities and other hybrid capital instruments from Tier 1 capital treatment. These provisions are subject to various grandfathering and transition rules. The effective date for any U.S. bank holding company subsidiaries of foreign banking organizations is 5 years after the date of enactment.

DERIVATIVES REGULATION

The Act creates a new regulatory framework to cover participants and products in the U.S. over-the-counter derivatives market. Most derivative products traded in the U.S. will now be required to be traded on exchanges and routed through clearinghouses, and certain customized swaps that can still be traded over-the-counter will need to be reported. The Act also requires that capital, margin, reporting, recordkeeping and business conduct rules be written for firms that deal in derivatives, and requires banks in the U.S. to spin off the riskiest derivatives trading operations into separate affiliates (the so-called “Volcker” rule).

REGULATORS

The Act divides primary regulatory authority between the CFTC and the SEC. Differentiating between “swaps” and “security-based swaps,” the Act gives the CFTC authority over swaps, swap dealers and major swap participants, and SEC authority over security-based swaps, security-based swap dealers and major security-based swap participants. The CFTC and SEC will have enforcement authority as to these particular jurisdictions, while the prudential regulators of banks and branches or agencies of foreign banks (such as the Federal Reserve and OCC) will have exclusive authority to enforce capital and margin requirements. Derivatives that have characteristics of both swaps and security-based swaps will be subject to both CFTC and SEC jurisdiction (For purposes of this summary, except where we discuss the differential regulatory coverage, we will collectively refer to all such securities, dealers and participants as swaps, swap dealers, and major swap participants, respectively.)

Of critical importance to non-U.S. entities, if either CFTC or the SEC determines that the regulation of swaps or security-based swaps in a foreign country undermines the stability of the U.S. financial system, then either regulator, in consultation with the U.S. Treasury, may prohibit an entity domiciled in that foreign country from participating in the U.S. in any security-based swaps.

Banks will be permitted to have operations in interest-rate swaps, foreign-exchange swaps, and gold and silver swaps among others. However, trading in derivatives such as agriculture commodities, most metals, and energy swaps will need to be conducted through affiliates. Banks and other regulated entities will continue to be subject to regulation by their prudential regulator.

Specified banking products are carved out from CFTC and SEC jurisdiction (and consequently, the swap definitions). These include bank deposit accounts, including CDs; banker’s acceptances; bank-issued letters of credit; bank debit accounts linked to credit cards; bank-issued loans; and loan participations in bank (or affiliate) loans other than those sold to a broker or dealer.

While credit default swaps, interest rate swaps, and total return swaps on a range of asset categories are covered by the Act, many transactions are excluded and thus not covered by the Act. These include certain sales of a nonfinancial commodities and securities that are intended to be physically settled.

Foreign exchange swaps and forwards are considered swaps subject to CFTC jurisdiction, unless Treasury determines that they should not be regulated as swaps and are not structured to evade the Act. If Treasury determines to exclude foreign exchange swaps and forwards, the parties to those transactions will be subject to business conduct standards, and the transactions will need to be reported to a swap data repository or the CFTC. Regardless of any determination by the Treasury, the CFTC will retain jurisdiction over retail foreign exchange transactions.

DEALERS AND MARKET PARTICIPANTS

Under the Act, all swap dealers and security-based swap dealers will be required to register with the CFTC and SEC, respectively, and all major swap participants and major security-based swap participants must register with the CFTC and the SEC, respectively.

A swap dealer includes any person that:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties in the ordinary course of its business for its own account; or
- engages in any activity causing the person to be commonly known in the trade as a dealer or market-maker in swaps.

A security-based swap dealer is defined similarly, except the definition refers to "security-based swaps" rather than "swaps." A dealer does not include persons that enter into security-based swaps individually or in a fiduciary capacity, and not as part of their regular business. Also, a bank is not considered a "swap dealer" as a result of entering into a swap with a customer in connection with originating a loan to the customer. This exception does not apply to the definition of "security-based swap dealer."

A major swap participant is any non-dealer:

- that maintains a substantial position in swaps for any major swap category determined by the CFTC, but excluding positions (1) held for hedging or mitigating commercial risk or (2) maintained by an employee benefit plan under ERISA for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;
- whose outstanding swaps create substantial counterparty exposure that could have an adverse systemic effect on the stability of the U.S. banking system or financial markets; or

- that is a financial entity that maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC, is highly leveraged relative to the amount of capital it holds and is not subject to capital requirements of a Federal banking agency.

As with the "dealer" definitions above, a major security-based swap participant is defined similarly, except that the definition refers to "security-based swaps" in the place of "swaps" and the SEC in place of CFTC.

The CFTC and SEC are required to define "substantial position" such that it will be "prudent for the effective monitoring, management and oversight" of entities that are systemically important or can significantly impact the financial system of the United States.

The Act also expands the definitions in the Commodity Exchange Act of "futures commission merchant," "introducing broker," "commodity pool" and "commodity pool operator," such that more entities, including some swaps market participants that are otherwise treated as swap dealers or major swap participants, will be required to register with the CFTC in these categories.

CLEARING, TRADING AND REPORTING SWAPS

The CFTC or SEC will review each swap product, or class of swap product, and determine whether it should be required to be cleared. If the SEC or CFTC determines that it should be cleared, then a swap product must be cleared through a derivatives clearing organization.

If a swap product is not accepted for clearing by any derivatives clearing organization, it must be reported to a swap product data repository or, if there is no swap product data repository that would accept the swap product, to the CFTC or SEC. Any individual or entity in a swap product transaction that is not accepted by a derivatives clearing organization would be required to provide the CFTC or SEC with reports regarding the swap products held by the individual or entity.

Swap execution facilities will be required to make public timely information on price, trading volume and other trading data on swaps. The CFTC and SEC are also authorized to adopt rules to make swaps transaction, volume and pricing data publicly available to enhance price discovery.

The CFTC will be required to ensure that trading on non-U.S. foreign boards of trade in the same commodity will be subject to comparable limits and that CFTC imposed limits will not cause price discovery in the commodity to shift to trading on the foreign boards of trade.

OTHER NEW REQUIREMENTS

Bank Push-Out. Under the Act, the U.S. government is prohibited from providing financial assistance to any swap-based entity. This prohibition does not apply to an insured depository institution with a swap entity affiliate, so long as the depository institution is part of a holding company structure supervised by the Federal Reserve. The prohibition also would not apply to any insured depository institution that limits its swap product activities to hedging and similar risk mitigating activities directly related to the insured

depository institutions activities. Bank-permissible activities do not include acting as a swaps entity for certain credit default swaps. Banks with activities subject to the federal assistance prohibition have up to 24 months to divest the swaps entity or cease the activities.

Additionally, the restrictions on affiliate transactions under Federal Reserve Act Sections 23A and 23B are significantly broadened to include swap transactions within the scope of “covered transactions.”

Board Approval and Recordkeeping. Any public company that seeks to use an exemption from clearing a swap or executing a swap through a securities exchange, or swap executing facility must receive approval from an appropriate committee of the company’s board of directors.

All swap participants are required to maintain daily trading and related records of swaps (including cash or forward transactions). Recorded communications must also be maintained; these include electronic mail, instant messages and telephone calls; daily trading records for each customer or counterparty; and a complete audit trail for conducting comprehensive and accurate trade reconstructions.

Capital and Margin. At least annually, the CFTC, in consultation with the prudential regulators, must impose capital and margin requirements for swap dealers and major swap participants. As to swap dealers and major swap participants that are banks, the prudential regulators, in consultation with the CFTC, will together impose capital and margin requirements.

INSURANCE REGULATION

FEDERAL INSURANCE OFFICE

The Act establishes a new office inside the Department of the Treasury, the Federal Insurance Office (FIO), which will serve as the coordinating office for Federal agencies regarding prudential aspects of international insurance issues. FIO will represent the U.S. in the International Association of Insurance Supervisors, and will assist the Treasury in negotiations regarding international insurance agreements. The FIO is to consult with the individual U.S. states regarding prudential matters of international significance.

The FIO is not a primary federal regulator, but it has subpoena power and is charged with collecting and making available to the public non-confidential information about the insurance industry. The FIO will also monitor the industry for systemic risk and it is authorized to identify any insurer or affiliate that should be regulated as a nonbank financial company under Federal Reserve supervision. The FIO Director serves as a nonvoting member of the FSOC and will administer the Terrorism Risk Insurance Program.

The FIO will determine whether U.S. state insurance rules are pre-empted by international insurance agreements, but will have limited preemption power where state insurance laws conflict with international insurance agreements. The Director is authorized to intervene when U.S. state insurance requirements would result in less favorable treatment for a non-U.S. insurer headquartered outside the United States. U.S. state insurance officials must be notified in advance of any potential international inconsistencies and potential Federal action to pre-empt the state's insurance regime, and any decision is subject to public notice and comment. The Congress must be made aware of any inconsistencies between international agreements and U.S. state law.

No later than January 2012, the FIO must submit to Congress an study and report on how to modernize and improve the system of insurance regulation in the US, including international coordination of insurance regulation. The report is to examine the impact that developments in the regulation of insurance in non-U.S. jurisdictions might have on the potential Federal regulation of insurance and on the international competitiveness of U.S. insurance companies if they were to be subjected to Federal regulation.

Treasury and the United State Trade Representative are jointly authorized to negotiate and enter into covered agreements on insurance after consulting with the Congress. Agreements take effect 90 days after they are submitted to the Congress for review, but they are not subject to ratification by the Congress.

NONADMITTED INSURANCE

U.S. states cannot prohibit the placement of insurance from a nonadmitted insurer domiciled outside the United States, if that insurer is listed on the Quarterly Listing of Alien Insurers maintained by the NAIC International Insurers Department. The Act requires a GAO study of the nonadmitted insurance market due 30 months after the effective date of the subtitle, which is a year after enactment of the bill.

REINSURANCE

FIO is directed to send to Congress a report on the U.S. and global reinsurance market by September 30, 2012, describing the breadth of the market and the role played by the market in supporting insurance in the U.S.

No state may deny credit for reinsurance to any reinsurers domiciled in an NAIC-accredited state, or in a state which has substantially similar requirements to those which are necessary to be NAIC accredited, which recognizes credit for reinsurance ceded risk. Solvency of the reinsurer is governed by its state of domicile. The Act also preempts extraterritorial application of state laws and regulations to reinsurers, except for those governing taxes and assessments on income.

CONSUMER PROTECTIONS

The Act creates a new Bureau of Consumer Financial Protection, housed in the Federal Reserve, but with independent, wide-ranging authority.

ENFORCEMENT AUTHORITY

The Bureau is granted investigatory authority, either independently or in conjunction with another governmental entity, and is granted subpoena power. The Bureau may serve civil investigative demands and enforcement petitions upon any person inside or outside the U.S. In addition, the Bureau may transmit evidence of criminal action to the U.S. attorney general with respect to both domestic and foreign persons.

REGULATORY IMPROVEMENTS

The Act amends the Electronic Funds Transfer Act to specifically provide for the regulation of remittance transfers, including transfer disclosures, cancellation and refund policies and error resolution. The Act also addresses receipt disclosures for remittance transfers to countries that do not permit the sender of a remittance transfer to know the amount of currency to be received by the transfer recipient.

OTHER CHANGES

INTERNATIONAL SOVEREIGN ASSISTANCE AND RESOURCES

The Act requires that Treasury instruct the U.S. Executive Director of the International Monetary Fund to review proposed loans to any country whose public debt exceeds its GDP, and to oppose those loans if it appears that the loan is unlikely to be repaid. Treasury is also directed to report annually to Congress on the likelihood of repayment for loans that are approved for such nations.

CONFLICT MINERALS

The Act contains a provision expressing the sense of the Congress that the exploitation and trade of minerals in the Democratic Republic of the Congo “is helping to finance conflict characterized by extreme levels of violence.” The provision requires that the SEC promulgate regulations requiring annual disclosures of the use of conflict minerals originating from the Democratic Republic of the Congo or an adjoining country. Reports are also required of the U.S. Department of State and the U.S. Department of Commerce. These requirements remain in force until at least July 2015. [pages 851-856]

DISCLOSURE OF PAYMENTS BY RESOURCE EXTRACTION ISSUERS

The SEC must issue final rules no later than April 22, 2011, requiring each resource extraction issuer to include in its annual report information relating to payments made to a foreign government or to the U.S. Federal government for the purpose of the commercial development of oil, natural gas, or minerals.

WHAT COMES NEXT

Congressional enactment of financial services reform legislation is a first step in the process of reform in the U.S. Now it is up to the regulatory agencies to begin the laborious process of writing regulations to implement the law and to research and write the many reports and studies required by the Act. Much of that process will involve interaction with regulatory counterparts around the world, monitoring their efforts and trying to anticipate and eliminate conflicting rules that will disrupt the capital markets.

We will continue to monitor and report on these developments. For more information on the matters discussed in this update, or to have this publication sent to additional colleagues, please contact us.

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