Impact of Dodd-Frank Act on non-US financial institutions

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In this article, *Richard Schaberg* and *Daniel Meade*, partners at Hogan Lovells, provide an overview of how the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 will impact on non-US financial institutions who do business within the US or with a US person.

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Introduction

In this article, *Richard Schaberg* and *Daniel Meade*, partners at Hogan Lovells, provide an overview of how the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Act) will impact non-US financial institutions who do business within the US or with a US person. The Act was signed into law by US President Obama on 21 July 2010 and puts in place a wide range of reforms to the US financial regulatory system, affecting most aspects of the financial industry.

The Act also introduces a new era for US regulatory oversight of non-US financial institutions that operate within the US.

This article discusses the key issues that non-US financial institutions should consider. For more information on the Act generally, see *Practice note, Road Map to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (www.practicallaw.com/3-502-8479)*.

Investor protection and improved securities regulation

The Act contains provisions which aim to improve investor protection and the regulation of securities. The provisions which affect non-US financial institutions who participate in the US securities markets are described in the section 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 relating to executive compensation. Foreign private issuers (including financial institutions) are exempt from a number of these new corporate governance and executive compensation requirements. The requirements which do not apply include:

- Proxy access.
- Say on pay.
- Say on golden parachutes.
- Disclosure of hedging by officers and directors.
- Disclosure concerning chairman and chief executive officer (CEO) structures.
- Pay for performance disclosures.
- Internal pay equity disclosures.
- Disclosure of CEO and employee pay ratios.

However, foreign private issuers (including financial institutions) are subject to the provisions on corporate governance and executive compensation outlined in the sections below.

Institutional investor disclosure of compensation votes

Institutional investment managers who are subject to section 13(f) of the Securities Exchange Act of 1934 (Exchange Act) are required by the Act to disclose annually how they vote on the new say on pay and say on golden parachutes votes introduced by the Act. This covers managers who exercise investment discretion over $100 million or more in section 13(f) securities, such as exchange-traded (NYSE, AMEX) or NASDAQ-quoted stocks, equity options and warrants, shares of closed-end investment companies, and certain convertible debt securities. Non-US investment managers subject to section 13(f) will also be required to comply with this new reporting requirement.

The say on pay and say on golden parachute votes are non-binding shareholder resolutions required for issuers subject to the US Securities Exchange Commission's (SEC) proxy rules.

Limited discretionary voting by brokers

The Act requires national securities exchanges in the US to prohibit brokers (wherever the broker may be located) 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. However, brokers may continue to vote shares in accordance with specific voting instructions provided by beneficial owners.

Stock exchanges already prohibit discretionary voting by brokers on elections of directors, so the principal effect of this 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 a SEC rule from listing securities of any issuer whose compensation committee is not composed solely of independent directors. However, foreign private issuers are exempt from this independence provision, if they make annual disclosures to their shareholders of the reasons why they do not maintain an independent compensation committee in their annual report.

Compensation committees will also be required to consider independence factors which are being identified by the SEC before engaging any consultants, legal counsel and other advisers hired by the compensation committee. The Act also requires that issuers provide appropriate funding for such advisers. The adviser 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. In turn, the SEC's proposed rule applies to foreign issuers, but leaves in place the exchanges' broad exemption authority.

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:

- Disclosure on incentive compensation payable on the basis of financial information reportable under securities laws.
- Following an accounting restatement triggered by material non-compliance with securities law reporting requirements, the recovery of excess incentive compensation paid erroneously to current and former executive officers. This requirement covers the three year period before the date on which the restatement was required.

The Act does not contain an exemption for foreign private issuers. However, it is possible that the SEC will consider including such an exemption in the rules being adopted by it to implement the clawback provisions. Without an exemption, foreign private issuers will need to put in place a clawback policy.

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 to jointly adopt rules regarding incentive-based compensation arrangements offered by specified financial institutions, including US branches and agencies of non-US banks, and any non-US bank that controls a US insured depository institution. Such financial institutions have assets of $1 billion or more (including, among others, depository institutions, registered broker dealers and other financial institutions determined by the regulators) and offer compensation to their executive officers, employees, directors and principal shareholders. These institutions will be required to disclose all incentive-based compensation arrangements offered by them 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. However, individuals do not need to be named.

The regulators will also jointly adopt regulations or guidelines prohibiting incentive-based compensation arrangements or features that the regulators determine encourage inappropriate risks by these financial institutions.

Beneficial ownership

When an issuer is subject to SEC rules, the Act contains the provisions set out in the section below which apply to the beneficial ownership of equity securities (that is, major shareholding disclosure rules).

Timeframe for reporting beneficial ownership

The Act authorises the SEC to shorten the deadlines for certain security holders to file reports under sections 13(d) and 16(a) of the Exchange Act. These are the sections which require the reporting of beneficially owned securities.

Section 13(d)

Any SEC rulemaking to shorten the deadline for section 13(d) reporting will apply to all issuer securities registered under the Exchange Act. This includes:

- Securities issued by foreign private investors.
- Securities issued by US private issuers that are held by foreign investors.

Section 16(a)

Securities issued by foreign private issuers are not subject to section 16. This means that SEC rulemaking to shorten the deadline for section 16(a) reporting will not affect directors and officers of foreign private issuers.

However, foreign investors who own 10% or more of a class of equity securities registered under the Exchange Act will be subject to any shortened Section 16(a) deadline. This means that foreign investors should prepare to make disclosure filings more quickly.

Beneficial ownership of equity swaps

The Act also clarifies that a person (including foreign investors) 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 based swaps.

Credit rating agencies

The Act includes a number of provisions that will greatly increase the regulation, accountability and transparency of credit rating agencies (CRAs). The provisions set out in the section below will have a direct impact on foreign private issuers and other non-US financial institutions.

Fair Disclosure exemption repealed

The Act removes an exemption from the SEC's Regulation FD (Fair Disclosure) that has permitted issuers to share material non-public information with CRAs without triggering an issuer public disclosure obligation. For more information on Regulation FD, see *Practice note, Complying with Regulation FD (Fair Disclosure) (www.practicallaw.com/1-383-2635)*.

Expert liability

The Act removes an exemption (contained in rule 436(g) of the Securities Act of 1933 (Securities Act)) for CRAs from potential liability as experts in registration statements and prospectuses filed with the SEC.

The repeal requires CRAs to consent to have their ratings disclosed and to be named in such filings. However, CRAs have indicated they will not provide this consent. Issuers of debt securities can be required by SEC rules to disclose the credit rating associated with their securities, or they provide disclosure of such ratings in offering documents or in documents incorporated by reference into registration statements. Therefore, refusal by the CRAs to give consent effectively prevents issuers from offering and selling many types of debt securities. The SEC has 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. It should be noted though that even before enactment of the Act, there was not any statutory requirement to require ratings be included in securities filings.

Private offers

The Act requires the SEC to revise the private offering safe harbour exemption from Securities Act registration which is frequently relied upon by issuers to raise capital.

One of these revisions requires the SEC to adopt rules within one year of the Act being adopted 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 catch the same persons who are disqualified by rule 262 of the Securities Act from relying on the Regulation A small offering exemption.

Other changes will reduce the number of persons that otherwise might qualify as accredited investors in a Regulation D offering by:

- Amending the $1 million net worth test to exclude the value of an investor's primary residence.
- Authorising the SEC to adjust, at least once every four years, the dollar thresholds for tests of accredited investor status of individuals which are unrelated to the net worth test.

These changes will have an impact on foreign financial institutions offering securities in the US through Regulation D. Underwriters will also be required to conduct "bad actors" diligence in Regulation D offerings (which is similar to what is currently done in Regulation A offerings).

Short selling

The Act prohibits manipulative short selling of securities. It also 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. This includes non-US investment managers.

Foreign investors trading in US securities will need to ensure they do not breach the manipulative short selling rule.

Asset securitisation

Losses on securitisations of assets, particularly home mortgages, were a major contributing factor to the financial crisis. 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 it is likely some time will pass before the regulatory environment is fully established. The following key measures affect domestic and foreign asset securitisers:

- Credit risk retention. The Act directs the federal banking agencies and the SEC to jointly prescribe rules requiring securitisers to retain 5% of the credit risk of their offerings, except where the offering consists exclusively of qualified residential mortgages. No hedging of the retained credit risk is permitted, although some of that risk may be allocated by regulators to any originator from which the securitiser 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 to be determined by the regulators for assets such as "qualified residential mortgages", auto loans, and commercial loans. On 29 March 2011, the SEC and banking regulators issued a notice of proposed rulemaking regarding risk retention.
- Conflicts of interest. For one year following the closing of a securitisation offering, sponsors and distributors of asset-backed securities will be prohibited (by rules being adopted by the SEC) from engaging (with some exceptions) 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 the SEC to adopt rules about disclosures of asset-backed securities in registered public offerings. The disclosure will include data

disclosure formats and asset-level or loan-level data sufficient to enable investors 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 in 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. However, the SEC has been 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 and managers to private funds

References to advisers in the section below includes investment managers who have discretion over the management of assets.

Extended scope of registration

The Act extends investment adviser registration, record keeping and SEC inspection requirements to advisers to private funds and to other advisers who rely on an exemption from registration for advisers with fewer than 15 clients.

The Act also raises the threshold for SEC registration from $25 million to $100 million of assets under management. Nevertheless, advisers falling below this threshold may still need to register with individual US state regulators. The law requires that these requirements become effective one year from the date of enactment (that is, 21 July 2011), but the SEC, in a letter dated 8 April 2011 to the North American Securities Administrators Association, signified that although rules would likely be complete by 21 July 2011, compliance would likely not be required until the first quarter of 2012.

These changes have the following important implications for non-US investment advisers:

- Any investment adviser who is relying on an exemption from registration because they have less than 15 US clients is now subject to registration with the SEC if it has at least $100 million of US assets under management, regardless of the number of clients in the US. Advisers with US client assets below this threshold may also still be subject to regulation with individual US state securities regulators.
- The principle that an investment fund is a single client for the purposes of the 15 client test has been removed. This means US investors in funds managed by non-US fund managers are considered to be clients of the fund manager for the purposes of determining whether registration is required.

Exemptions

There is an exemption for non-US private advisers. This is an adviser with no place of business in the US, who does not hold themselves out in the US as an investment adviser and has fewer than 15 US clients and less than $25 million of US assets under management (unless a higher threshold is established).

The SEC has also been 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.

Record keeping

The Act significantly expands the types of records that investment advisers with US clients, whether or not SEC 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 those 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 US securities laws. The provisions generally expand the scope of liability, strengthen enforcement powers, and introduce procedural improvements.

Of particular interest to non-US financial institutions is the clarification of the extraterritorial reach of the SEC and the US Department of Justice enforcement authority under section 929P of the Act. The jurisdiction has been expanded or clarified to include,

"conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors"

and

"conduct occurring outside the United States that has a foreseeable effect within the United States."

This extraterritorial jurisdiction is not expanded to grant a private right of action in respect of actions by non-US plaintiffs suing non-US and US defendants for misconduct in connection with securities traded on non-US exchanges. However, the SEC is directed to study the extent to which a private right of action should be expanded, and make recommendations within 18 months of the enactment of the Act.

Systemic risk

Financial stability

Foreign non-bank financial companies

Foreign non-bank financial companies may be subject to new US oversight under the Act. Foreign non-bank financial companies are defined as companies, other than bank holding companies, incorporated or organised in a country other than the US, which are predominantly engaged in financial activities (generally meaning 85% or more of the assets or revenues are derived from financial activities), and conduct financial activities in the US. The Federal Reserve has proposed 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 responsible for identifying and addressing systemic risks posed by large, complex financial companies and certain products and activities. Although the FSOC's mandate relates to preventing harm to the US system, it has the authority to monitor certain international activities. For example, its duties include monitoring international regulatory proposals and it has the authority to obtain information on foreign non-bank financial companies. In relation to gathering information, the FSOC is to co-ordinate, to the extent possible, with the newly-established Office of Financial Research (OFR) (see *Office of Financial Research*) and with the appropriate foreign regulator.

Foreign non-bank financial companies may be supervised by the Federal Reserve if the FSOC determines that material financial distress at the foreign non-bank 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 US.

In exercising this authority, the FSOC should co-ordinate with foreign regulators to the extent appropriate.

Enhanced supervision and prudential standards

A non-US financial institution designated by the FSOC as systemically important will be subject to enhanced supervision by the Federal Reserve. This supervision will be similar to the current supervision of bank holding companies (for example, subject to registration and reporting requirements, examination by the Federal Reserve and Federal Reserve enforcement authority), but is required to be more stringent than those that apply to most bank holding companies (for example, higher capital and liquidity requirements, preparation of resolution plans, and other increased prudential standards). The FSOC and the Federal Reserve 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 non-bank 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 US. The FSOC may make recommendations to the Federal Reserve about the prudential standards and reporting and disclosure requirements applicable to non-bank financial companies supervised by the Federal Reserve.

Where the Federal Reserve determines that a grave threat to the stability of the US economy is posed by a bank holding company with assets above $50 billion or by a non-bank financial company designated by the FSOC, it may impose a number of restrictions on that company, including divestiture of subsidiaries or activities. The Federal Reserve may prescribe rules regarding the applicability of this authority to foreign non-bank 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 US standards.

Office of Financial Research

The Act creates the Office of Financial Research (OFR), which will support the FSOC. It will collect information, perform research and develop 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 should co-ordinate with the foreign supervisory authority and should, whenever possible, rely on existing information available from such authority.

Safe harbour

Under the Act, the Federal Reserve will issue regulations on behalf of, and in consultation with, the FSOC. These will set out the criteria for exempting certain types or classes of both US and foreign non-bank financial companies from enhanced supervision by the Federal Reserve.

The Federal Reserve will, in consultation with the FSOC, review the regulations no less frequently than every five years, but no such revision may take effect earlier than two years after final rules are published providing for the revisions.

Access to US financial markets by foreign institutions

When a foreign bank presents a risk to the stability of the US financial system, the Act states that the Federal Reserve may consider, when deciding whether to approve or terminate US operations of the foreign bank, whether the bank's home country has adopted (or has made demonstrable progress towards adopting) an appropriate system of financial regulation to mitigate risks.

International policy co-ordination

The Act calls for co-ordination between US and foreign governmental authorities and financial regulatory entities to protect financial stability and the global economy. It also encourages comprehensive and robust prudential supervision and regulation for all highly leveraged and interconnected financial companies.

Payment, clearing and settlement

The Act gives broad powers 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, (including non-US entities) that provide these services may be identified by the FSOC as designated financial market utilities. This 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 (see *above*) is granted wide authority to seek information and to impose record keeping and reporting requirements in order to assess the systemic importance of both the designated entities and designated activities of financial institutions, including US 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 stabilisation

The Act codifies certain aspects of the emergency stability provided by the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) during the crisis, but puts some additional parameters and reporting requirements on such programmes. The Act amends section 13-3 of the Federal Reserve Act to state that any emergency lending on the part of the Federal Reserve must only be done through widely available programmes such as theTerm Asset-Backed Securities Loan Facility (TALF) and the Capital Purchase Program (CPP) that were set up by the Federal Reserve during the crisis. It cannot be done through one-off loans to particular institutions, such as the loans that were made to AIG. The Act also requires eventual public reporting on the use of such facilities. As was the case during the crisis, such loan programmes could be available to foreign entities engaging in the US markets, depending on the parameters of the programme.

Orderly liquidation

The Act establishes a structure to be used in extreme circumstances to liquidate large failing financial institutions, that is, the type of institution previously deemed "too big to fail". If the Secretary of the Treasury, upon the recommendation of the FSOC, determines that, among other things, "the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States", the following types of financial institution are within scope of the regime:

- Bank holding companies.
- Non-bank financial companies, such as insurance companies and securities broker-dealers.

This power is not expected to be used except in extreme cases where an orderly dissolution of the troubled institution is necessary to preserve US financial stability and by its terms only applies to institutions organised in the US, but could possibly apply to US subsidiaries of foreign parent organisations.

Other aspects of the orderly liquidation authority will impact on non-US financial institutions including:

- Brief restrictions on the transfer of qualified financial contracts to a counterparty that has been placed under the orderly liquidation regime. A qualified financial contract includes foreign exchange currency options, foreign futures commodity contracts, qualified foreign government securities repurchase agreements and foreign exchange swap agreements.
- Co-ordination of the FDIC with foreign financial authorities when a financial institution has assets or operations outside the US.
- A study on international co-ordination of the orderly liquidation of financial companies under US bankruptcy law.

Banking regulation

Regulatory agency restructuring

The Act makes many changes to the current structure of regulating US financial institutions and their holding companies. It also extends federal regulatory authority to those non-bank financial companies that the FSOC designates as systemically important financial companies. The Office of Thrift Supervision (OTS) will merge with the Office of the Comptroller of the Currency (OCC).

However, for most foreign financial institutions its US federal regulators will not change.

Expansion limitations

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

Capital requirements

The Act extends the leverage capital requirements and risk-based capital requirements currently applicable to insured depositary institutions to US bank holding companies owned or controlled by foreign banking organisations (but not to the foreign banking organisations themselves). Therefore, foreign banks that own US insured depository institutions through an intermediate holding company will need to adequately capitalise the intermediate holding company, rather than past practice of relying on the parent's capital. 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 US bank holding company subsidiaries of foreign banking organisations is five years after the date of the Act's enactment.

Derivatives regulation

The Act creates a new regulatory framework to cover participants and products in the US over-the-counter (OTC) derivatives market. Most derivative products traded in the US will have to be traded on exchanges and routed through clearing houses. Certain customised swaps that can still be traded OTC will need to be reported. The Act also requires that capital, margin, reporting, record keeping and business conduct rules be drafted for firms that deal in derivatives. It also requires banks in the US to "spin off" the riskiest derivatives trading operations into separate affiliates (the so-called Lincoln push-out rule).

Regulators

The Act divides primary regulatory authority between the US Commodity Futures Trading Commission (CFTC) and the SEC by differentiating between swaps and security-based swaps. The Act gives the CFTC authority over swaps, swap dealers and major swap participants The SEC has 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 the 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 the purposes of this article, except where the differential regulatory coverage is mentioned, references to all such securities, dealers and participants are to swaps, swap dealers, and major swap participants.)
If either the CFTC or the SEC determines that the regulation of swaps or security-based swaps in a foreign country undermines the stability of the US financial system, then either regulator, in consultation with the US Treasury, may prohibit an entity domiciled in that foreign country from participating in the US in any security-based swaps. This is obviously of critical importance to non-US entities.

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

Foreign exchange swaps and forwards are considered swaps subject to CFTC jurisdiction, unless the Treasury determines that they should not be regulated as swaps and are not structured to evade the Act. If the Treasury decides 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. On 29 April 2011, the Treasury issued a notice of proposed determination for exempt foreign exchange swaps and forwards. 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 the SEC. Likewise, all major swap participants and major security-based swap participants must register with the CFTC and the SEC. 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.
- 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 in a similar way, 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. 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 a security-based swap dealer.

A major swap participant is any non-dealer that falls within one of the following categories:

- That maintains a substantial position in swaps for any major swap category determined by the CFTC, but excluding positions:
  - held for hedging or mitigating commercial risk; or
  - maintained by an employee benefit plan under the Employee Retirement Income Security Act of 1974 (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 US banking system or financial markets.
- 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 in a similar way, 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" to ensure 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 US.

The Act also expands the definitions in the Commodity Exchange Act of 1936 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 organisation.

If a swap product is not accepted for clearing by any derivatives clearing organisation, 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 organisation will 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 authorised to adopt rules to make swaps transaction, volume and pricing data publicly available. This is to enhance price discovery.

The CFTC will be required to ensure that trading on non-US 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 derivatives requirements

Bank push-out

Under the Act, the US 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, as long as the depository institution is part of a holding company structure supervised by the Federal Reserve. The prohibition also does 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. Banks are not allowed to act as a swaps entity for certain CDSs. Banks with activities subject to the federal assistance prohibition have up to 24 months to divest the swaps entity or cease the activities.

In addition, the restrictions on affiliate transactions under sections 23A and 23B of the Federal Reserve Act are significantly broadened to include swap transactions within the scope of covered transactions.

Board approval and record keeping

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 e-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. For swap dealers and major swap participants that are banks, the prudential regulators, in consultation with the CFTC, will together impose capital and margin requirements.

For more information about the impact of the Act concerning derivatives regulation and non-US financial institutions, see *Practice note, Road Map to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010: Swaps and Derivatives (www.practicallaw.com/3-502-8479)*.

Insurance regulation

Federal Insurance Office

The Act establishes a new office inside the Department of the Treasury called the Federal Insurance Office (FIO). This will act as the co-ordinating office for federal agencies concerning prudential aspects of international insurance issues. The FIO will represent the US in the International Association of Insurance Supervisors (IAIS) and will assist the Treasury in negotiations regarding international insurance agreements.

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 authorised to identify any insurer or affiliate that should be regulated as a non-bank financial company under Federal Reserve supervision.

The FIO will determine whether US state insurance rules are pre-empted by international insurance agreements, but will have limited pre-emption power where state insurance laws conflict with international insurance agreements. The FIO director is authorised to intervene when US state insurance requirements would result in less favourable treatment for a non-US insurer headquartered outside the US.

US 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. Any decision is subject to public notice and comment. Congress must also be made aware of any inconsistencies between international agreements and US state law.

The FIO must submit to Congress a study and report on how to modernise and improve the system of insurance regulation in the US, including international co-ordination of insurance regulation, before January 2012. The report is to examine the impact that developments in the regulation of insurance in non-US jurisdictions might have on the potential federal regulation of insurance and on the international competitiveness of US insurance companies if they were to be subject to federal regulation.

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

Non-admitted insurance

US states cannot prohibit the placement of insurance from a non-admitted insurer domiciled outside the US, if that insurer is listed on the Quarterly Listing of Alien Insurers maintained by the National Association of Insurance Commissioners (NAIC) International Insurers Department.

Reinsurance

The FIO has to send to Congress a report on the US and global reinsurance market by 30 September 2012. The report will describe the breadth of the market and the role played by the market in supporting insurance in the US.

Consumer protection

The Act creates a new Bureau of Consumer Financial Protection (Bureau), which will be an independent bureau situated within the Federal Reserve Board. It will inherit most of the existing authority to write and enforce financial consumer protection rules currently existing in the federal banking agencies. It will also exercise new federal authority over financial consumer protection with regard to non-bank financial institutions.

Enforcement authority

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

Remittance transfers

The Act amends the Electronic Funds Transfer Act to specifically provide for the regulation of remittance transfers. This includes 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.

Next steps

With passage of the Act, attention turns to the various regulatory agencies such as the Federal Reserve, FDIC, SEC, CFTC, and the new FSOC and the fact that the Act requires over 200 new rulemakings. The one-year anniversary of enactment, 21 July 2011, is an important milestone. It marks the transfer date of authorities being transferred to the consumer bureau and the authorities of the OTS being transferred mostly to the OCC.

However, Congress continues to play an important role in the implementation of the Act. Through its oversight function and hearings, Congress is paying close attention to the implementation of the Act by the regulatory agencies. In addition, the budgets of agencies such as the SEC and CFTC are part of the budget debate currently being waged in the Congress. Opponents of the Act, many of whom are part of the new Republican majority in the House of Representatives, are working to reduce the appropriations to some of the agencies that actually need increased budgets in order to fully carry out their new tasks. Whether or not agencies that are implementing the Act will be starved of funding will continue to be one of the most important next steps regarding the Act in the US Congress.

Authors

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