

Implementation of the Dodd-Frank Act – Implications for Foreign Banking Organizations

Part 1: OTC Derivatives Regulation and the Volcker Rule

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Introduction

- Welcome by Sally Miller
- Numerous DF (Dodd Frank) regulations still in process of being developed
- Many key issues still require answers
- Continuing involvement of Congress
- Importance of industry comment and input
- Today's principal topics
 - OTC Derivatives Dealer Registration and Regulation
 - Push Out of Derivatives Activities
 - Volcker Rule

OTC Derivatives

- Title VII – Wall Street Transparency and Accountability Act of 2010
- Feverish activity by CFTC and SEC to issue regulations because of statutory deadlines
- Five principal issues facing foreign banks
 - Which entities must register as swap dealers?
 - What will be the extraterritorial impact?
 - What effect will the substantive requirements have on the affected business lines?
 - What is timing for compliance?
 - What will be the impact of the push-out?

Swap Definitions

- “Swap” is broadly defined by DF and includes interest rate swaps, currency swaps, commodity swaps, equity swaps and credit derivatives.
 - Exemptions include futures, forwards on nonfinancial commodities and options on securities
 - Treasury to determine if FX swaps and forwards should be exempt
- “Security-based swap” is defined to include any swap based on a narrow-based security index or on a single security or loan
- Proposed regulations further defining swaps and security-based swaps not yet issued

Who Must Register?

- Swap/Securities-Swap Dealer
 - Hold out as a dealer, act as market maker, regularly enter into swaps with counterparties as ordinary course of business for its own account, or commonly known as a dealer/market maker
 - CFTC proposal: “any person accommodating demand for swaps from other parties and entering into swaps in response to interest expressed by others.”
- Regulations have been proposed but are not yet final
 - Some differences in approach between CFTC and SEC

Who Must Register?

- Major swap participants
 - Not a swap dealer but maintains “substantial net position in swaps” (excluding those positions held primarily for hedging commercial risk) or meets other criteria
 - Most banks more likely to be covered by dealer definition; CFTC expects only a handful of entities will be MSPs
- Firms engaged in both swap and security-based swap activities will register with both CFTC and SEC

Who Must Register?

- Exemptions

- Enter into swaps for own account but not as part of regular business
- As proposed, de minimis quantity of swaps (less than \$100 million notional amount over last 12 months plus other conditions)
- Does not include acting as agent
- Swaps entered into by insured depository institution in connection with originating a loan to that customer
 - Not available to uninsured branches and agencies of foreign banks or to their non-US offices
 - IIB seeking similar treatment

Extraterritorial Impact

- CFTC requirements will apply to non-US activities that “have a direct and significant connection” with activities or commerce in the US or constitute evasion of rules
- SEC requirements will not apply to transactions outside US jurisdiction, unless evasion is occurring
 - “US jurisdiction” means use of “means and instrumentalities of interstate commerce” such as telephone, mail or e-mail
- CFTC proposed released:
 - “A person outside the US who engages in swap dealing activities and regularly enters into swaps with U.S. persons would likely be required to register as a swap dealer.”

Foreign Bank Proposed Structures To Minimize Extraterritoriality

- Foreign bank register as principal
 - Regulators defer in some respects to home country regulation (capital, margin)
 - Treat transactions between non-US counterparties as exempt
- Registered US office or affiliate acting as agent for foreign bank
 - Foreign bank as principal does not register
- Registered US office or affiliate acting as principal with back-to-back transactions with head office
 - Possible role of US office could be undermined by push-out
- CFTC/SEC still reviewing these proposals

Registration Issues for Foreign Banks

- Which parts of the group will be swap dealers or MSPs?
 - US branch or agency?
 - US nonbank affiliate?
 - Head office or other non-US offices?
 - Non-US affiliate?

Prudential Requirements for Swap Dealers

- Registered banks are subject to capital and margin requirements of their US banking regulator
 - In case of foreign banks, Fed may defer to home country capital requirements if adequate, with respect to branches or agencies or non-US offices
- Non-bank swap dealers subject to CFTC/SEC prudential requirements
- Regulations have not yet been proposed

CFTC Requirements Applicable to All Swap Dealers

- All regulations still in proposed form
- Registration procedure
 - FCM model
- Reporting
 - Real time reporting
 - Reporting to swap data repositories
- Recordkeeping
- Position limits
- Anti-manipulation

CFTC Requirements Applicable to All Swap Dealers

- Business conduct rules
 - Disclosures
 - Treatment of special entities
- Conflicts of interest
- Chief Compliance Officer/Risk Management
- Documentation requirements
 - Relationship documentation requirements
 - Confirmation requirements

Clearing and Execution Requirements

- Clearing orgs and CFTC/SEC to determine swaps subject to mandatory clearing
- Exemption for swaps entered into prior to implementation of clearing requirement so long as reported to data repository
- Commercial end user may opt out of clearing
- Swaps subject to mandatory clearing also subject to mandatory execution if there is an available trading facility (exchange or swap execution facility)

Margin Requirements

- Cleared and uncleared swaps require margin
- Only FCMs may hold margin for cleared swaps
- Margin for non-cleared swaps must be segregated with a third party custodian
- Commercial end users to be exempt from margin for uncleared swaps

Timing Issues

- Statutory effective date including registration: July 15, 2011
- CFTC proposed advance applications for registration starting April 15, 2011
- CFTC and SEC have acknowledged deadlines are unrealistic
- CFTC Chairman Gensler has laid out a broad schedule intended to complete issuance of final regulations this year but acknowledges they will run into the fall
- Has also recognized need to give affected entities adequate time to comply with new requirements

Push-Out of Swap Activities

- Push-out may impact US branch or agency as well as US bank subsidiary
 - Registered swap dealer may not obtain advances from Fed discount window or other “federal assistance” (FDIC insurance)
 - Exclusion for certain swap activities of FDIC insured depository institutions
 - Hopefully not effective until July 2013 plus insured depository institutions get up to three year transition period
 - Possible impact on non-US offices?

Push-Out of Swap Activities

- Safe harbor exemption for insured depository institutions
 - Because of conference committee oversight, not available to branches and agencies of foreign banks
 - Senator Lincoln colloquy recognizes this as an oversight
 - If no clarifying amendment to DF, US uninsured branches and agencies that are “swap dealers” will need to push out all swap activities to an affiliate or give up access to the Fed discount window
 - IIB is seeking legislative/regulatory relief
 - NB: Volcker Rule prohibits “proprietary trading” in derivatives

Push-Out of Swap Activities

- Swaps and activities eligible for the safe harbor exemption for insured depository institutions
 - Interest rate and currency swaps
 - Other swaps based on instruments that banks can invest in directly such as precious metals, investment securities
 - CDS that are cleared
 - Bonafide hedging directly related to the bank's activities
- Swaps that are not eligible
 - Swaps based on commodities or equities that are not eligible for investment by a bank
 - CDS that are not subject to clearing

Steps to be taken now to prepare for implementation of new derivatives requirements

- Identify entities/offices that could be subject to swap dealer registration
- Explore whether any exemptions might be available
- Begin to analyze impact of proposed substantive requirements on the business
- Consider whether any restructuring options are available that might mitigate the impact on your bank
- Actively engage in public comment process directly or through associations

Questions

- If you'd like to ask a question, please use the Q&A panel on the right side of your screen.

Volcker Rule

- Section 619 of DF will prohibit (i) “proprietary trading” in derivatives, securities and other instruments and (ii) sponsoring or investing in private equity and hedge funds
- Many issues of definitions and scope; regulations are expected to be proposed in the summer
- Financial Stability Oversight Council (FSOC) issued study in January but left open many questions
- Final regulations to be effective July 2012, “conformance period” until July 2014, and additional extensions beyond that date may be sought from the Federal Reserve

Volcker Rule – Prohibition on Proprietary Trading

- Proprietary trading defined as “engaging as a principal for the trading account...in any transaction to purchase or sell...any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such [instrument],or any other security or financial instrument designated by [the US regulators].”
- Applies to any “banking entity” including “affiliates”
- “Trading account” includes any account used “principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements).”

Volcker Rule – Definition of Banking Entity

- Any FDIC-insured depository institution
- Any company that controls such an institution
- Any foreign bank (and any parent FBO) with a US branch or agency or a US insured depository institution subsidiary
- Any affiliate or subsidiary of the above
- Applies to all of these entities on a global basis
- Does not apply to a foreign bank that does not have a US branch or agency or a US depository institution subsidiary and that is not otherwise affiliated with a “banking entity.”

Volcker Rule – Permitted Activities Exempt from Prohibition on Proprietary Trading

- In connection with market making and designed not to exceed near term demands of clients
- Hedging relating to the banking entity's positions
- Transactions on behalf of customers
- US Government securities
- Activities engaged in “solely” outside the US pursuant to sections 4(c)(9) /4(c)(13)of the BHCA
- Regulated insurance company investment activities

Volcker Rule – Proprietary Trading – FSOC Study

- Close down traditional prop desks
- Asset-Liability Management activities should be permitted
- Recommends development of metrics to identify by asset class prohibited trading that may be taking place in context of other “permitted activities”
- “Robust” monitoring and compliance systems to be put in place to identify trading
- CEO public attestation of effective compliance regime
- No discussion of offshore exemption

Volcker Rule – Proprietary Trading – Foreign Bank Issues

- Investment/ALM activities
- Market making/Customer transactions
- Potential burdens of regulatory compliance structure/use of metrics/CEO attestation
- Scope of offshore exemption - - IIB seeking clarification

Volcker Rule – Ban on Sponsoring and Investing in Private Funds

- Applies to “banking entity” including “affiliates”
- Definition of “private equity fund” and “hedge fund”
 - Any “issuer” exempt from registration under the Investment Company Act of 1940 under sections 3(c)(1) or 3(c)(7) and any “similar fund”
 - Potential broad scope of definition
 - Non-US regulated funds
 - Legislative history urges exemptions for corporate vehicles, joint ventures, venture capital funds
 - IIB seeking narrowing of scope

Volcker Rule – Permitted Activities Exempt From the Ban on Sponsoring and Investing in Private Funds

- Organizing and offering funds under the bona fide fiduciary exemption. Conditions include:
 - In connection with providing trust, fiduciary, or investment advice to customers
 - 3 percent de minimis investment limit in the fund after one year
 - 3 percent Tier 1 capital limit in aggregate
 - No 23A covered transactions and no guarantee of fund
 - No sharing of name
 - Limits on employee investments
- SBIC

Volcker Rule – Permitted Activities Exempt From the Ban on Sponsoring and Investing in Private Funds

- Investment in or sponsorship of a private fund under sections 4(c)(9)/4(c)(13) of the BHCA “solely” outside of the US
 - No interest may be offered or sold to a US resident
 - Exemption not available to any banking entity controlled by a US banking entity
 - Definition of “solely”

Volcker Rule – Transactions with Private Funds

- Volcker also prohibits any covered transaction as defined in section 23A between a banking entity/affiliate and any private fund advised or sponsored by a banking entity or its affiliate
- Arms length requirements of 23B also apply
- For example, a US branch or agency may not lend to or purchase an asset from a private fund advised by an affiliate

Volcker Rule – Ban on Sponsoring and Investing in Private Funds – Foreign Bank Issues

- Scope of offshore exemption
- Impact on non-US funds relying on 3(c)(1) or 3(c)(7) for any US investors
- IIB seeking clarification

Volcker Rule – Ban on Sponsoring and Investing in Private Funds – FSOC Recommendations

- Recognizes 3(c)(1) and 3(c)(7) tests may pick up wide range of funds or vehicles not intended to be covered
 - Suggests venture capital funds should not be covered
 - Suggests joint ventures and other corporate vehicles used by banking entities should be exempt
 - Status of securitization and similar vehicles
- On the other hand, suggests that regulators should not permit “evasion” by “similar funds” that technically may not need to rely on 3(c)(1) or 3(c)(7)
- Did not address many comments such as Canadian banks’ letter about impact on non-US regulated funds

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