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

Part 2: Implementation of Other Key Provisions of Dodd-Frank for Foreign Banks

Scott A. Anenberg
Partner
202 263 3303
sanenberg@mayerbrown.com

Alex Lakatos
Partner
202 263 3312
alakatos@mayerbrown.com

Jeffrey P. Taft
Partner
202 263 3293
jtaft@mayerbrown.com

Thomas J. Delaney
Partner
202 263 3216
tdelaney@mayerbrown.com

Jerome Roche
Partner
202 263 3773
jroche@mayerbrown.com

David Sahr
Partner
212 506 2540 *or* 202 263 3332
dsahr@mayerbrown.com

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Introduction

- Welcome by Sally Miller
- Topics for today's program
  - Systemically Significant Status
  - Orderly Liquidation Authority
  - Capital
  - Extraterritorial Application of Securities Law
  - Investment Adviser Regulation
  - Compensation
  - Other Dodd Frank Developments Affecting Foreign Banks

Systemically Significant Institutions

- Financial crisis demonstrated that certain categories of large financial services firms posed significant risk to the US financial system
- A significant number of these institutions (Lehman, AIG) were not subject to effective comprehensive supervisory oversight by the federal government
- The response of Congress by way of Dodd-Frank was to subject all "systemically significant" institutions - - both banks and nonbanks, domestic and foreign with US operations to FSOC supervision
- FSOC authorized to identify "systemically significant" institutions and for FRB to impose additional supervisory requirements

Systemically Significant Institutions

- Considerations for foreign banks
  - Threshold at which a foreign bank with US operations will be supervised as "systemically significant"
  - Impact of such designation on US and home country operations:
    - Increased capital, liquidity and risk management requirements
      - Potentially more stringent requirements for larger institutions
    - Resolution Plans
    - Credit Exposure Reporting
  - Potential conflict with home country requirements:
    - Section 113(i) – consultation with home country authorities, consideration of comprehensive supervision, national treatment
  - Statute is formulaic in application

Systemically Significant Institutions

- The tail can wag the dog
- Non-US banks and non-US companies that either (i) are BHCs by virtue of their ownership of a US bank, or (ii) are treated as BHCs under the IBA because, for example, they operate a US branch or agency, will be treated as Systemic BHCs under the Dodd-Frank Act <u>if they have at least $50 billion in consolidated assets</u>
- Asset test not limited in statute to the US assets of non-US banks
- Small US branch or subsidiary bank operation of globally active foreign bank could subject that bank to systemic regulation

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Systemically Significant Institutions

- Regulatory developments and what they indicate
- Three significant proposals
  - January 26, 2011 FSOC proposal to establish the criteria for subjecting nonbank financial firms to FRB supervision (comment period closed February 25, 2011)
  - February 11, 2011 FRB proposal to define “Predominantly Engaged in Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company.” (comment period closed March 30, 2011)
  - Proposal to be issued by the FDIC and the FRB to require bank holding companies and foreign banks subject to BHC regulation to develop resolution plans and to file credit exposure reports as required by Section 165(d) of Dodd-Frank. (Federal Register publication pending)

Systemically Significant Institutions

- FRB proposal to define significant bank holding companies:
  - Preference for establishing the same definition for purposes of section 113 and section 165 of Dodd-Frank
    - Calculation based on global assets
  - IIB argued that a global calculation of %50 billion threshold is not appropriate
  - Unlikely to see much variance in adoption of final rule
  - Will institutions with small presence rethink their US footprint?

Systemically Significant Institutions

- Resolution Plan Proposal
  - Regulation not yet published
  - FDIC Board has approved draft
  - Awaiting parallel action by FRB
- Would apply to systemically significant foreign banks
  - Above $50 billion in assets globally
  - Annual filing (first filing due January 21, 2012)
  - Updated when material changes occur
    - Acquisition, sale, reorganization, discontinuation of a business, bankruptcy of a material entity.
- Potentially complex, expensive, resource-intensive, time-consuming
- Reporting requirements are the minimum; regulators may require more for large, complex companies
- Failure to submit a satisfactory plan can lead to punitive measures up to and including forced divestiture

Systemically Significant Institutions

- Resolution plan definitions
  - Material financial distress
    - Substantial depletion of capital
    - Assets less than obligation to creditors
    - Inability to pay obligations in the normal course of business
    - Various scenarios - - idiosyncratic or wide-spread crisis
  - Core business lines
    - Lines, services and functions that upon failure would result in a material loss of revenue, profit or franchise value
  - Material entity
    - Subsidiary or foreign office significant to activities of a critical operation or core business
  - Critical Operations
    - Operations that upon disruption or failure would result in disruption to the US financial markets

Systemically Significant Institutions

- Resolution plan components
  - Executive summary
  - Strategic analysis
    - Detailed information on how a reorganization or liquidation of US operations under the Bankruptcy Code could be accomplished to mitigate impact on financial stability of the US
    - Identification and mapping of funding, liquidity and capital resources available to material entities, core business lines and critical operations
  - Corporate governance relating to resolution planning
  - Organizational structure
    - Hierarchical list of legal entities
    - Unconsolidated balance sheet
    - Describe material components of liabilities
    - Derivatives activities
    - Hedging strategies
  - Management information systems
  - Interconnectedness and interdependencies
  - Supervisory information

Systemically Significant Institutions

- Resolution Plan Review
  - 60 days following receipt FDIC and FRB determine whether plan satisfies minimum information requirements
  - If informationally incomplete, returned for additional work and resubmission within 30 days, unless provided additional time
  - After review, FDIC and FRB can determine plans are deficient
  - If deficient 90 days to remedy, unless extension is granted
  - Failure to cure deficiencies can result the imposition of more stringent capital, leverage or liquidity requirements or restrictions on growth
  - Two years following the imposition of such restrictions, FRB or FDIC can jointly move to require divestiture of U.S. assets
    - Following consultation with FSOC

Systemically Significant Institutions

- Resolution plan foreign bank considerations
  - Resolution plan requirements generally limited to US operations (subsidiaries, branches and agencies) with the exception of the requirement to map interconnections and interdependencies of core business lines of covered companies
  - Plans must identify the extent of the risks related to foreign operations and strategy for addressing such risks
  - Describe extent to which US resolution strategy is incorporated into parent's overall resolution or contingency planning process
  - Confidential treatment of information submitted to US can be requested but decision is subject to agency determinations

Systemically Significant Institutions

- Credit exposure reporting
  - Quarterly reporting covering the covered company and its subsidiaries to systemically significant companies and their subsidiaries, and vice versa with respect to the following credit exposures:
    - Loans, leases and funded lines of credit
    - Committed but undrawn lines of credit
    - Deposits
    - Repurchase agreements and reverse repurchase agreements
    - Securities borrowing transactions
    - Securities lending transactions
    - Guarantees, acceptances or letters of credit
    - Purchases or investments of securities of systemically significant companies
  - For foreign banking organizations reporting to apply only to US subsidiaries, offices, etc.

Orderly Liquidation Authority

- Resolutions of certain financial companies
  - Orderly liquidation authority (OLA) designed to eliminate "too big to fail"
  - Creates new resolution regime where FDIC appointed as receiver of "financial company" upon determination by US Treasury Secretary
  - FDIC could be appointed as receiver for subsidiaries of financial company under certain circumstances
  - US Bankruptcy Code remains primary resolution authority for financial companies

Orderly Liquidation Authority

- "Financial company" means -
  - Organized or incorporated under federal or state law, and
  - BHC; nonbank financial company supervised by the FRB; company that is "predominantly engaged" in financial activities; or any subsidiary of the foregoing that is predominantly engaged in financial activities
- Possible impact of OLA on foreign banks
  - Financial company would exclude foreign entities, but US subsidiaries of foreign entities could be covered financial companies under OLA
  - Borrowers and counterparties could also be subject to receivership under OLA

Orderly Liquidation Authority

- Powers of receiver generally modeled after FDIA with certain changes to conform to US Bankruptcy Code
  - FDIC regulations clarifying claims process and statutory requirements
  - FDIC issued legal opinions to address preference and true sale issues pending rulemaking
- Some key points to consider
  - Repudiation of contracts
  - Treatment of QFCs/protected contracts
  - Use of bridge financial companies

Orderly Liquidation Authority

- Cross-border insolvencies
  - Difficult to have an orderly liquidation of a large interconnected multi-national financial services firm without some coordination amongst regulators and insolvency regimes
  - Study on international coordination in bankruptcy process required by OLA

Capital Provisions of Dodd-Frank – Overview

- Move to strengthen capital requirements post-crisis
- Reflected throughout Dodd-Frank and BCBS actions
- Key D-F provisions
  - Collins Amendment (§171)
  - Requirement for FHCs to be well-capitalized (§ 606)
  - Higher capital for SIFI's (§§115(b), 165(b))
- Other key developments
  - Basel 2.5 and Basel 3
  - Global SIFI's
  - Stress tests

Capital Provisions of Dodd-Frank – Overview (cont'd)

- Challenges for foreign banks
  - Impact of US requirements on US banking operations
  - Extraterritorial application of US requirements to global bank
  - Home country requirements
  - Global implementation/coordination
  - Evolving standards
  - Regulator/market expectations

Collins Amendment (§171)

- Named for Senator Susan Collins, Republican from Maine
- Not particularly well-drafted and lots of interpretational issues
- Requires US bank regulators to establish minimum leverage and risk-based capital requirements for insured depositories, their holding companies, and systemic nonbank financial companies
- Holding company standards can’t be lower than existing bank-level requirements
- New standards can’t be lower than July 21, 2010 requirements

Collins Amendment

- 2 key issues for foreign banks
  - Treatment of intermediate US holding companies/SR 01-1
  - Applicability to global bank
- Treatment of intermediate US bank holding companies
  - Relevant only for foreign banks that control US bank subsidiaries (not only branches/agencies) through a US bank holding company
  - Generally, US bank holding company subsidiaries of foreign banks subject to same leverage and risk-based capital requirements as “domestic” US bank holding companies
  - But since 2001, FRB policy has been to exempt those intermediate bank holding companies if parent foreign bank qualified as FHC

Collins Amendment

  - Collins Amendment eliminates that exemption and gives those intermediate US bank holding companies of foreign bank FHCs 5 years (July 21, 2015) to meet US capital requirements at the US holding company level
  - Also calls for a GAO study of the issue due January 2013
  - Potential impact demonstrated by Barclay's recently reported reorganization of its US operations
- Applicability to global bank
  - IIB was successful in amending Collins to include a specific carve-out for non-US parents of US bank holding companies

Collins Amendment

- But December 2010 US interagency "capital floor" proposal threatened to undermine that exemption
  - Designed to implement Collins Amendment provision requiring that US risk-based capital standards (such as Basel II-Advanced for core banks) can't be less than "generally applicable" risk-based standards (Basel I)
    - So replaces Basel II 3-year transitional sliding scale tied to Basel I with a permanent floor tied to 100% of Basel I
    - Controversial in its own right
  - But also requested comment on whether/how Collins Amendment's mandated Basel I capital floor should be applied in evaluating a foreign bank's capital as part of the application process (e.g., FHC qualification, bank and nonbank acquisitions)
    - Statutory approval standards require FRB to determine that foreign bank capital is "equivalent" or "comparable" to capital that would be required for US bank

Collins Amendment

- Traditionally, FRB found equivalency if foreign bank operating under Basel I or II and accepted the capital ratios computed by foreign bank under home country standards even if differed in some respects from US versions of Basel I and II
- But because (i) Collins establishes Basel I as mandatory floor for US core banks under Basel II, and (ii) other Basel II countries' practices vary with respect to establishment of floors, FRB asked whether US Collins-type Basel I floor should be applied to foreign banks operating under Basel II when assessing their capital as part of application process
- Comment period closed February 28
- IIB and several foreign banks/trade associations filed comment letters strongly opposing application of Basel I floor to foreign banks

Other Dodd-Frank Capital Provisions

- Requires FHCs to be well-capitalized and well-managed at FHC not just bank subsidiary level (§606)
  - Likely to be interpreted to apply to foreign bank parent, but already the case under existing FRB regulations for foreign banks with US branches or agencies
- Authorizes FSOC to recommend and requires FRB to apply higher regulatory capital requirements to SIFI's (§§115(b), 165(b))
  - Potentially includes all foreign banks with global assets of $50 billion or more
  - IIB-added language requiring due regard for national treatment and equal competitive opportunity, and consideration of home country requirements

Dodd-Frank Implications for US Implementation of Basel II/III

- Basel II only for largest US ("core") banks
  - No US banks have yet even entered the transitional floor period
- Dodd-Frank creates significant complications for US implementation of Basel III
  - Collins Amendment floors
  - Collins Amendment's treatment of hybrid capital
  - §939A ban on use of credit ratings
  - Hundreds of other regulations

Dodd-Frank Implications for US Implementation of Basel II/III

- And lots of issues beyond Dodd-Frank
  - Opportunity to revisit controversial aspects (e.g., MSR's, DTA's and trade finance)
  - Whether and to what extent Basel III will be applied to vast majority of US banks not even subject to Basel II
  - Need to achieve consensus among 3 different agencies
  - Congressional oversight

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Questions

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

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Extraterritorial Application of US Anti-Securities Fraud Laws

- Exchange Act Section 10(b) and Rule 10b-5 thereunder
  - Silent as to extraterritorial reach
- Pre-*Morrison* Rule
  - Conduct and effects test
    - Whether the wrongful conduct occurred in the United States
    - Whether the wrongful conduct had a substantial effect in the United States or upon United States citizens
    - An admixture or combination of the two

Extraterritorial Application of US Anti-Securities Fraud Laws

- *Morrison v. National Australia Bank*
  - "F-cubed" case: Foreign plaintiffs, issuer and exchange
  - Amicus participation
    - Governments: Australia, France, UK, Switzerland
    - Trade Associations, including IIB
  - Important victory for non-US issuers and non-US governments
    - Section 10(b) of the Exchange Act applies "purchase or sale of a security listed on an American stock exchange", and
    - "the purchase or sale of any other security in the United States"

Extraterritorial Application of US Anti-Securities Fraud Laws

- Dodd-Frank Act, Section 929
  - Enacted shortly after *Morrison*
  - Restored SEC jurisdiction in cases under Exchange Act Section 10(b)
    - US conduct that constitutes "significant steps" in furtherance of the violation
    - Conduct outside US that has a "foreseeable substantial effect" within the US

Extraterritorial Application of US Anti-Securities Fraud Laws

- Dodd-Frank Act, Section 929Y: SEC Study
  - Legislatively overrule *Morrison*?
  - Congress asked about the extent to which private rights of action under the Exchange Act should be applied extraterritorially, including:
    - the scope of such a private right of action;
    - implications on international comity;
    - the economic costs and benefits; and
    - whether a narrower extraterritorial standard should be adopted.

Extraterritorial Application of US Anti-Securities Fraud Laws

- Dodd-Frank Act, Section 929Y: SEC Study
  - Comment letters
    - Trade associations: IIB along with MEDEF, BDI, Economiesuisse, SBA, EBF; SIFMA; Clearing House & ABA Securities Association; many others
    - Governments: Australia, UK, France, Germany, EC, Switzerland

Extraterritorial Application of US Anti-Securities Fraud Laws

- Dodd-Frank Act, Section 929Y: SEC Study
  - Key Points raised by comment letters:
    - Harmful to comity and affront to sovereignty of other nations
    - Unnecessary to have private right of action
    - Detrimental to US interests
    - Legitimate skepticism about efficacy of plaintiffs’ class actions

Extraterritorial Application of US Anti-Securities Fraud Laws

- Post *Morrison* issues/cases
  - Transactions on non-US markets ordered or originated in the United States
  - Transactions on non-US markets of securities that also are US listed
  - Transactions of US-listed ADRs
  - Private transactions of swaps that reference non-US securities
  - Private placements of stocks listed on pink sheets

Extraterritorial Application of US Anti-Securities Fraud Laws

- Next steps
  - SEC study
  - Possible Congressional action
  - Amicus briefs

US Investment Adviser Regulation

- Absent an exemption, any person using US jurisdictional means to provide securities advice for compensation would be subject to registration as an investment adviser with the SEC (or one of the US states)
- The "private adviser exemption" is useful to advisers with a limited number of advised clients
  - This will *likely* no longer be available after July 20, 2011 (but see SEC letter to NASAA dated April 8, 2011)
  - Instead, the Dodd-Frank Act imposes several new and more restrictive exemptions

US Investment Adviser Regulation (continued)

- Dodd-Frank Act exempts from registration "foreign private advisers"
- To qualify an adviser must:
  - have no place of business in the US
  - have, in total, no more than 14 US person clients and US person investors in private funds that it advises;
  - have aggregate assets under management attributable to the foregoing US persons of less than $25 million (or a higher amount set by the SEC); and
  - not hold itself out to the public in the US as an investment adviser or act as an investment adviser to a registered investment company or an electing business development company

US Investment Adviser Regulation (continued)

- Dodd-Frank Act exempts from registration advisers to small private funds
- Unlike some other provisions added by the Dodd-Frank Act, this exemption is not self-executing and requires implementing regulations from the SEC
- However, the statute does provide a basic framework under which an adviser seeking to rely on this exemption must:
  - advise only private funds; and
  - have assets under management "in the United States" of less than $150 million

US Investment Adviser Regulation (continued)

- Neither Dodd-Frank Act nor the proposed rules amend the “bank” exclusion from registration
- For many years, US branches and agencies have relied on the “bank” exclusion to the same extent as domestic banks based on statutory reading and SEC precedents in other areas like the Exchange Act
- Accordingly, any US branches or agencies that may have been relying on the private adviser exemption may be unaffected by Dodd Frank if they conclude they qualify for the bank exclusion

Interstate Branching

- Expands *de novo* interstate branching authority
  - Eliminates requirement that state expressly "opt-in" to *de novo* branching
  - Agencies authorized to approve applications for *de novo* interstate branches if under the law of the state in which the branch is to be located, bank chartered by that state would be permitted to establish the branch
  - Permits *de novo* interstate branching by non-US banks, which are permitted to branch outside of their "home" states to the same extent as domestic banks
  - Changes were effective on July 22, 2010

Affiliate Transactions under 23A/B

- Key changes
  - Expands the definition of “affiliate” to cover investment funds where bank or affiliate acts as investment advisor
  - Expands definition of “covered transaction” to include -
    - Securities borrowing or lending transactions with an affiliate, and all derivatives transactions with an affiliate, to extent there is credit exposure
  - Subjects repurchase agreements to the collateral requirements of Section 23A
  - Credit transactions must be collateralized at all times, rather than just at the time of the transaction

Affiliate Transactions under 23A/B

- Other changes
  - FRB to issue regulations or interpretations regarding the manner in which netting agreements should be taken into account in determining the amount of a covered transaction
  - Scales back FRB's unilateral authority to issue exemptions
  - Interpretations must be issued jointly by FRB and bank's primary regulator
  - Additional restrictions imposed by Volcker Rule
- Changes to Section 23A/B are effective in July 2012

Affiliate Transactions under 23A/B

- Applicability to foreign banks
  - Changes will apply to US branches and agencies of foreign banks to the extent that an affiliate is subject to affiliate transaction restrictions under the FRB's Regulation W

Concentration Limits

- Prohibits mergers if total consolidated liabilities of resulting financial company exceed 10% of aggregate consolidated liabilities of all financial companies
- “Financial companies” include non-US bank that has a US branch, agency, or bank subsidiary
- For foreign-based companies, liabilities determined on basis of total risk-weighted assets of US operations calculated under applicable risk-based capital rules
  - Would require estimation of risk-weighted assets and regulatory capital of US operations

Concentration Limits

- FSOC study issued in Jan. 2011
  - Discusses several practical implementation issues and recommends changes
  - Study highlights potential unequal treatment of acquisitions by US-based firms and foreign-based firms
  - FRB required to issue proposed regulation by September 2011 to implement concentration limits

Executive Compensation

- SEC. 956. aimed at incentive based pay that is deemed to be excessive or could lead to material financial loss
- 9 month post enactment deadline
- Joint agency proposal soon to be published for comment
- Covers branches of foreign banks with $1 billion in U.S. assets
  - Based on U.S. assets
- Institutions with $50 billion or more in consolidated assets subject to more stringent requirements
  - Executive officers (President, CEO, Chairman, CFO, COO, CIO, CLO, GC, Chief Risk Officer, Business Line Head)
    - Deferral of at least 50% of annual incentive based compensation for no less than 3 years
    - Must reflect actual losses
  - Additional limitations imposed on employees that present particular risk exposure

    Determined by board of directors

    Directed at traders

Credit Risk Retention

- The Dodd-Frank Act
  - Directs specified agencies to require risk retention generally at a level of not less than 5% of the credit risk of the securitized assets and to specify the permitted forms and minimum duration of the retention
  - Contemplates several important exceptions that either eliminate any retention requirement or permit regulators to specify lower or different retention requirements
- The agencies jointly issued a proposal at the end of March 2011
  - Proposing release is nearly 400 pages
  - Comments are requested by June 10, 2011

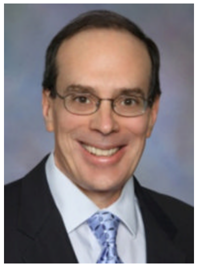
Credit Risk Retention (continued)

- Effectiveness:
  - + 1 year for RMBS
  - + 2 years for all other ABS
- FRB Study: Different requirements for different assets
- FSOC study: Platitudes
- Most important issues
  - What percentage will apply to what assets?
  - What will definition of “qualified residential mortgage” be? Will it be narrow and conservative or broader?
  - What forms of retention will be permitted, and how will this affect accounting treatment?
  - Will securitizers/originators be able to finance their retained interest?
- Interplay with EU requirements for US subs of EU regulated entities and EU investors in US issuer offerings

Questions

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

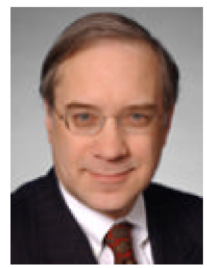
Presented By:



Scott A. Anenberg
Partner
Washington, DC
202 263 3303
sanenberg@mayerbrown.com

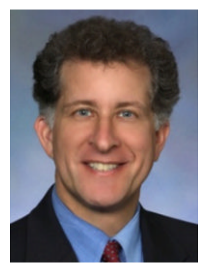
Jerome Roche
Partner
Washington, DC
202 263 3773
jroche@mayerbrown.com

Thomas J. Delaney
Partner
Washington, DC
202 263 3216
tdelaney@mayerbrown.com



David Sahr
Partner
Washington, DC and New York, NY
202 263 3332 (DC)
212 506 2540 (NY)
dsahr@mayerbrown.com

Alex Lakatos
Partner
Washington, DC
202 263 3312
alakatos@mayerbrown.com



Jeffrey P. Taft
Washington, DC
Partner
202 263 3293
jtaft@mayerbrown.com

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