# Global Financial Markets Association[1]

## Potential extraterritorial impact of US financial regulatory reform on Asian markets

## 1. INTRODUCTION

This note sets out a summary of U.S. financial regulatory measures that have recently been proposed or are in the implementation process, which may have an extraterritorial impact on non-US markets – particularly Asian markets. These measures are generally mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank Act**), enacted in 2010 by the United States (**U.S.)** Congress in response to the financial crisis that erupted in the prior years.

## 2. DODD-FRANK TITLE VII DERIVATIVES REGULATION

Title VII of the Dodd-Frank Act is directed at the regulation of over-the-counter (**OTC**) derivatives markets, including swaps and security-based swaps (**SBS**)[2]. The broad goals of Title VII are to reduce risk, increase transparency and ensure the integrity of the swap markets. In order to achieve these goals, and similar to regulation under EMIR, the Dodd-Frank Act and related regulation establishes:

1. mandatory clearing and exchange trading for specified OTC swaps;
2. risk mitigation requirements, such as margin and risk management policies; and
3. reporting and other disclosure obligations.

### I. SCOPE

Regulatory obligations under Title VII of the Dodd-Frank Act are generally applicable to U.S. person counterparties to swap transactions, with most requirements imposed on "swap dealers" (**SDs**) and "major swap participants" (**MSPs**)[3]. Broadly speaking, SDs and MSPs are entities whose swap dealing activities exceed certain prescribed levels. However, requirements imposed only on SDs and MSPs may have indirect effects on counterparties that are not SDs or MSPs. For example, certain business conduct standards require SDs and MSPs to determine eligibility

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1 The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit http://www.gfma.org.

2 "Swap" will include swaps and SBS, unless otherwise noted.

3 SD and MSP will include security-based swap dealer (**SBSD**) and major security-based swap participant (**MSBSP**), unless otherwise noted.

of their counterparties to enter into swaps and provide certain risk disclosures to counterparties where applicable. In order to comply with such requirements, SDs and MSPs may ask their counterparties to amend existing swap relationship documentation or establish new agreements.

However, swap market regulation may also reach non-U.S. person market participants under circumstances. The treatment of swaps transactions between U.S. persons and non-U.S. persons, e.g. cross-border swaps, was addressed in Title VII only through general provisions that provided swap regulation under does not apply to swap activity conducted outside the U.S., unless that activity has a "direct and significant connection with activities in, or effect on, commerce of the United States."[4]

In order to provide further context, the Commodity Futures Exchange Commission (**CFTC**) proposed guidance on treatment of cross-border swaps[5], which has not been finalized to date. In the interim, to allow market participants the ability to continue to execute cross-border swap transactions, the CFTC finalized an Exemptive Order which provided relief from certain compliance obligations. However, the order is currently set to expire 12 July 2013, thus creating uncertainty as to what will be required of market participants in the absence of an extension of the order or issuance of final interpretive guidance.

The Securities Exchange Commission (**SEC**) has separately proposed rules on the extraterritorial treatment of SBS[6] through a formal rulemaking process, differing in certain respects from the CFTC's proposed guidance. The SEC's proposal is intended to provide a holistic view of how SBS regulation will be applied in the cross-border context, with comments due 21 August 2013. In light of the significant impact these rules will have on SBS markets, the SEC also reopened comment proposal for many previously proposed SBS regulations.[7]

Both the CFTC and SEC have provided for some form of "substituted compliance", though different in their proposed approaches. Through their respective concepts, the Commissions would give deference, allowing for compliance with foreign regulation under circumstances. The CFTC proposes to take strict "rule by rule" approach, allowing a non-U.S. SD or MSP to comply with specific non-U.S. regulation where parallel Title VII requirements exist and are deemed satisfactory. The SEC alternatively proposes to evaluate the regulatory outcomes of regimes in making comparability determinations. It remains to be seen how final substituted compliance process determinations will be made, given the differences between the CFTC and SEC proposals, as well as the possibility of negotiations between jurisdictions.

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[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 722, 124 Stat. 1376, 1672, 1801 (2010).

[5] Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214, 41,225 (proposed July 12, 2012); Final Exemptive Order Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg 858 (Jan. 7, 2013); Further Proposed Guidance Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 909.

[6] Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, RIN 3235-AL25 (initial release date May 1, 2013).

[7] Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statement Applicable to Security-Based Swaps Proposed Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, RIN 3235-AK74, 3235-AK77, 3235-AK80, 3235-AK79, 3236-AK88, 3235-AK91, 3235-AK93, 3235-AL13, 3235-AL10, 3235-AL05, 3235-AL12 (initial release date May 1, 2013).

## II. REGULATORY OBLIGATIONS UNDER TITLE VII

As the treatment of cross-border swaps under Title VII has not yet been finalized by either the CFTC or the SEC, it is still unclear how regulatory requirements will ultimately affect non-U.S. swaps market participants. However, based on proposed and final rules to date, non-U.S. counterparties (including SDs, MSPs, non-SDs and non-MSPs) may be subject to the following requirements (among others) for swaps entered into with U.S. counterparties:

(a) Swap data reporting – Generally, under CFTC rules, market participants are required to report swap information upon execution (or shortly thereafter) to a swap data repository (**SDR**). The SDR is then responsible for disseminating certain information to the public. The responsibility for reporting to the SDR varies, depending on counterparty status, and whether the transaction is executed on a swap execution facility (**SEF**) or designated contract market (**DCM**). While Title VII requirements are most often triggered by registration as an SD or MSP, all swap counterparties would be responsible for certain reporting requirements, even non-SD/MSPs - so long as one counterparty is considered a U.S. person.

Further, CFTC rules require an SDR to have procedures in place for both parties to a swap to confirm the accuracy of the data that is reported (unless executed on a SEF or DCM). The rule requires the SDR to notify both parties of the data that was submitted and the counterparties to affirm the accuracy of such data or correct any errors. The rule does not address what would happen if one party refuses to give the acknowledgment, however the non-U.S. counterparty could potentially face sanctions if it refuses to correct inaccurately reported swap data.

The SEC cross border proposal would require regulatory reporting to a security-based swap SDR for any SBS transaction conducted in the U.S., where one or both direct counterparty is a U.S. person (or where one or both of the counterparties has a U.S. person guarantor), one or both of the counterparties is an SBSD or MSBSP, or the transaction is cleared through a clearing agency with its principal place of business in the U.S. The party responsible for reporting varies depending on counterparty status and relationship.

(b) Swap data recordkeeping – CFTC rules require, each SD and MSP keep full, complete, and systematic records in a readily accessible format for all activities relating to a swap transaction until 5 years after its termination. According to the CFTC's proposed cross-border guidance, registered SDs and MSPs (both U.S. and foreign) would be required to comply with these rules. Further, according to the CFTC's proposed guidance, even non-SD/MSP counterparties are responsible for compliance with recordkeeping requirements to varying degrees, where at least one U.S. person is involved. Thus, in instances where a non-U.S. counterparty falls within CFTC jurisdiction (through transactions with a U.S. person), the non-U.S. counterparty may be required to comply with the applicable requirements.

Per the SEC's proposed cross-border rulemaking, non-U.S. SBSDs would be required to comply with recordkeeping requirements whether transacting with a U.S. or non-U.S. counterparty (absent a substituted compliance determination).

(c) Clearing - The non-U.S. counterparty will be required to clear any swap or SBS that is subject to mandatory clearing, where transactions fall within the scope of the CFTC and SEC's respective jurisdictions (subject to any end-user clearing exemptions). The SEC cross-border proposal would permit SBS subject to mandatory clearing requirements to be cleared through clearinghouses that are not registered with the SEC (or exempt from clearinghouse registration requirements) where a substituted compliance determination has been made – even where underlying counterparties are U.S. persons clearing through non-U.S. person clearing members. Under the CFTC's proposed cross-border guidance, substituted compliance for clearing requirements where swaps involve a "U.S. Person" would not be considered (however, substituted compliance may be available where a foreign branch of a U.S. entity is transacting with a non-U.S. person).

(d) Trade execution – Swaps subject to mandatory clearing that have been made "available to trade" will be required to be executed on a swap execution facility (SEF), security-based swap execution facility (SBSEF) or designated contract market (DCM). The CFTC approved final rules at an Open Meeting on 16 May 2013. The SEC cross-border proposal would allow for counterparties to an SBS transaction that is subject to mandatory trade execution requirements to satisfy obligations by executing on an SBS market that is not registered (or exempt from clearinghouse registration requirements), where there is a substituted compliance finding for that SBS market. Similar to the treatment of clearing requirements, under the CFTC's proposed cross-border guidance, substituted compliance for clearing requirements where swaps involve a "U.S. Person" would not be considered (however, substituted compliance may be available where a foreign branch of a U.S. entity is transacting with a non-U.S. person).

(e) Margin – Margin requirements have not yet been finalized by the CFTC or SEC, but proposals have been released by both Commissions separately (covering non-bank swap entities). The CFTC's proposed rules would require non-bank SDs and MSPs to collect margin from their counterparties on uncleared swaps, including swaps with non-U.S. persons (thus, non-U.S. person counterparties may be required to post margin to registered SD/MSP counterparties). Margin posted is likely to be subject to eligible collateral requirements which may be limited to cash, U.S. Treasury or U.S. Agency debt obligations. In addition, some counterparties that are SDs or MSPs may require their non-U.S. counterparties to establish new collateral agreements.

The SEC's proposed margin requirements would apply only to non-bank SBSDs and MSBSPs. Under the proposal, nonbank SBSDs would be required to collect initial and variation margin for uncleared security-based swaps from each of its counterparties, subject to certain exceptions (i.e., that counterparty is a commercial end-user, if the transaction was entered into prior to the rules effective date, and *potentially*, if the counterparty is another SBSD). Per the SEC's proposed cross-border rulemaking, non-U.S. SBSDs would be required to comply with margin requirements whether with a U.S. or non-U.S. counterparty (absent a substituted compliance determination).

(f) Swap documentation - As with margin requirements, rules imposed directly on SDs/MSPs may indirectly affect non-U.S., non-SD/MSP counterparties. According to the CFTC, in order to comply with certain business conduct standards, SD/MSP counterparties may require their non-U.S. counterparties to establish new swap relationship documentation or amend existing documentation. In particular, U.S.-based SDs or MSPs are likely to require the non-U.S. counterparty to execute the ISDA DF Protocol or similar documentation designed to permit the SD/MSP to satisfy its obligations to make certain disclosures and to give and receive certain representations and undertakings to its counterparties.

The SEC treats documentation rules as entity level requirements, and thus would require a foreign SBSD to comply regardless of whether its counterparty is a U.S. or non-U.S. person (absent a substituted compliance determination). However, a foreign SBSD need comply with external business conduct requirements only with respect to its "U.S. Business", which is defined as any transaction by or on behalf of a U.S. SBSD, wherever entered into, other than a transaction through a foreign branch with a non-U.S. person or another foreign branch.

## 3. DODD-FRANK ENHANCED PRUDENTIAL REQUIREMENTS

Sections 165 and 166 of the Dodd-Frank Act generally require the Federal Reserve to impose enhanced prudential requirements for bank holding companies, including foreign banking organizations with a banking operations in the United States, with total consolidated assets of US$50 billion or more and for nonbank financial companies designated as systemically important by the Financial Stability Oversight Council ("Council"). Under the Dodd-Frank Act, the Federal Reserve has a broad mandate to establish more stringent prudential standards that will include: (i) risk-based capital requirements; (ii) leverage limits; (iii) liquidity requirements; (iv) overall risk management requirements; (v) resolution plan and credit exposure requirements; and (vi) concentration limits. The enhanced prudential standards may also include: (i) contingent capital requirements; (ii) enhanced public disclosures; (iii) short-term debt limits; and (iv) such other prudential standards as the Federal Reserve determines are appropriate. The Dodd-Frank Act also provides that if the Federal Reserve determines that a BHC with total consolidated assets of $50 billion or more poses a "grave danger to the financial stability of the United States," the Federal Reserve, upon affirmative vote of not less than 2/3 of the members of the Council, shall require the subject company to: (i) terminate activities; (ii) impose conditions on the conduct of activities; (iii) limit any expansion; or (iv) dispose of assets or off-balance-sheet items. A foreign banking organization with a US banking presence could conceivably be subject to such action by the Federal Reserve.

On December 20, 2011, the Federal Reserve proposed regulations to implement the enhanced prudential standards mandated by Section 165 and the early remediation requirements mandated by Section 166 of the Dodd-Frank Act with respect to US-based financial institutions. On December 14, 2012, the Federal Reserve issued a separate rule proposal for the implementation of such standards with respect to foreign banking organizations with total global consolidated assets of $10 billion or more and US banking presence and foreign nonbank financial companies designated as systemically important by the Council ("covered foreign institutions") (the "Proposed Enhanced Prudential Requirements"). While the Proposed Enhanced Prudential Requirements for covered foreign institutions are intended to parallel the proposed enhanced prudential requirements for US-based financial institutions, they would impose significant new burdens on covered foreign institutions, and many covered foreign institutions will be forced to restructure their US operations.

The Proposed Enhanced Prudential Requirements are generally designed to ensure the safety and soundness of the US operations of covered foreign institutions and to create a structure that would allow US regulators to promptly intervene to resolve problem covered foreign institutions. The real driver behind the proposed enhanced prudential standards seems to be an increasingly acute concern about the location of an internationally active bank's capital and liquidity and the possibility that such resources, rather than serving as a source of strength for the bank's US operations, will be trapped overseas or deliberately ring-fenced by home country authorities in a crisis. The Federal Reserve appears to be moving away from reliance on the home supervisors of covered foreign institutions and towards imposing structural and other requirements that would help ensure that problem covered foreign institutions are resolved with minimal disruption for the US financial system. Some of these requirements may materially impact the global operations of a covered foreign institution by, for example, requiring liquid assets to be transferred to the United States in compliance with applicable US liquidity requirements or early remediation requirements. In addition, the new rules would substantially increase Federal

Reserve control over US operations of non-US banks and with it, bring increased compliance costs and related burdens.

The Proposed Enhanced Prudential Requirements would require the establishment of an intermediate holding companies ("IHCs") over the US subsidiaries of a covered foreign institution with US assets of $10 billion or more (excluding any assets held by US agencies or branches). In addition, covered foreign institutions would generally be subject to requirements on risk management structure and processes, risk-based capital and leverage, liquidity, stress testing requirements, debt-to-equity limits, and single counterparty credit limits. The Proposed Enhanced Prudential Requirements also provide a set of tools that expand the existing supervisory powers of the Federal Reserve to intervene early upon identification of financial weaknesses or finding of deteriorating management or financial condition of a covered foreign institution that may affect its ability to withstand adverse economic and financial market conditions. The Proposed Enhanced Prudential Requirements contain progressively more stringent requirements on the basis of the amount of consolidated assets of a covered foreign institutions. The progressive application of these requirements is generally presented in the table below.

<table>
<tr><th>Total Consolidated Assets</th><th>Combined US Assets</th><th>Combined US Assets (excluding branches and agencies)</th><th>Applicable Requirements</th></tr>
<tr><td>less than $10 billion</td><td>—</td><td>—</td><td>No new requirements</td></tr>
<tr><td>$10 billion or more, but less than $50 billion</td><td>—</td><td>—</td><td>• Annual capital stress tests under home country regime, broadly consistent with U.S. requirements<br>• US risk committee (if FBO is publicly traded) ("Basic Requirements")</td></tr>
<tr><td rowspan="2">$50 billion or more</td><td rowspan="2">less than $50 billion</td><td>less than $10 billion</td><td>Basic Requirements, plus—<br>• Home country capital standards consistent with Basel standards<br>• Single-counterparty credit limits<br>• Annual internal liquidity stress tests<br>• §166 early remediation (triggered on discretionary basis) (together with Basic Requirements, "Transitional Requirements")</td></tr>
<tr><td>$10 billion or more</td><td>Transitional Requirements, plus—<br>• Intermediate holding company for all U.S. operations other than branch and agency network<br>• IHC subject to:<br>– US bank holding company capital requirements<br>– Single-counterparty credit limits<br>– §165(i) annual "company-run" capital stress tests</td></tr>
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|---|---|---|---|
| | $50 billion or more | less than $10 billion | Transitional Requirements, *plus*—<br>• US risk committee (whether or not FBO is publicly traded)<br>• US chief risk officer<br>• Information requirements on results of annual capital stress tests under home country regime<br>• §166 early remediation (triggered automatically)<br>• US branch and agency network and IHC, if any, subject to:<br>– monthly liquidity stress tests<br>– local liquidity buffer requirement<br>– contingency funding plan (together with Transitional Requirements, "***Full Requirements***") |
| | | $10 billion or more | Full Requirements, *plus*—<br>• Intermediate holding company for all U.S. operations other than branch and agency network<br>• IHC subject to:<br>– US bank holding company capital requirements<br>– Single-counterparty credit limits<br>– §165(i) annual "company-run" capital stress tests<br>• If IHC total consolidated assets = $50 billion or more, IHC also subject to:<br>– Regulation Y "capital plan" rule<br>– §165(i) annual supervisory and semi-annual "company-run" capital stress tests |

## I. Living Wills

As noted above, the enhanced prudential requirements of the Dodd-Frank Act include a resolution plan requirement. The resolution plan requirements were implemented separately from the bulk of the other enhanced prudential requirements. On November 1, 2011, the Federal Deposit Insurance Corporation ("FDIC") and the Federal Reserve published a final rule to require "covered companies" to submit a resolution plan, or "living will," providing for the "rapid and orderly resolution" of the company under Title 11 of the United States Code (the "Bankruptcy Code") in the event it experiences material financial distress. "Covered companies" include foreign banking organizations with US banking presence and $50 billion or more in total worldwide consolidated assets and foreign nonbank financial companies designated as systemically important by the Council ("foreign covered companies").

The resolution plan requirements would result in increased regulatory burden and would further expand the extraterritorially regulatory scrutiny exercised by US regulators over non-US operations of both US-based and foreign covered companies. The resolution plans are primarily designed to help ensure rapid and orderly resolution of covered companies but most likely would be used as an additional tool that the US regulators would use to oversee and regulate covered companies.

A resolution plan would have to include a strategic analysis containing the following elements:

- Description of the key assumptions.
- Specific actions to facilitate rapid and orderly resolution of material entities, critical operations, and core business lines.
- Description of funding, liquidity, and capital needs mapped to critical operations and core business lines.
- Strategy for maintaining the funding for the covered company and its material entities.
- Strategy in the event of failure of a material entity (other than entities with less than $50 billion in total assets, which are not resolved under the Bankruptcy Code), critical operation, or a core business line, including specific actions to mitigate the effect of such failure on the financial stability of the United States.
- Strategy to help ensure that bank subsidiaries of a covered company are protected from risks arising out of its nonbank activities.
- Specification of the time periods expected to be needed for the successful execution of each material step of the resolution plan.
- Description of any potential material weaknesses or impediments to effective an timely execution of the resolution plan and discussion of any actions to remedy or mitigate such weaknesses or impediments, including the timeline for such remedial actions.
- Description of the processes used to: (i) determine current market values and marketability of material asset holdings, core business lines, and critical operations; (ii) assess the feasibility and timeliness of plans for any divestitures, sales, restructurings, recapitalizations or other similar actions contemplated by the covered company's living will and the impact of such actions on the value, funding, and operations of the covered company.

A resolution plan would also include a description of the covered company corporate governance structure related to resolution planning, organizational structure and related information, description of key management information systems, identification and mapping of interconnections and interdependencies, certain supervisory and regulatory information, and contact information

The resolution plan must be submitted by the top-tier covered company. It must contain, however, information regarding all direct and indirect subsidiaries of the covered company. Any company in which the covered company owns, or holds with power to vote, 25 percent or more of any class of voting securities is deemed to be a subsidiary of the covered company. A covered company that is domiciled in the United States would be required to provide information with regard to both its U.S. operations and its foreign operations. A foreign covered company, would generally be required to provide information regarding its U.S. operations (including US subsidiaries, US branches, critical operations and core business lines conducted in whole or material part in the US), an explanation of how resolution planning for its U.S. operations is integrated into the foreign-based covered company’s overall resolution planning process and information regarding the interconnections and interdependencies among its U.S. operations and its foreign-based operations.

A foreign covered company may also be able to submit a "tailored resolution plan" if: (i) it has less than $100 billion in total US nonbank assets; and (ii) the assets of the US insured depository institution subsidiaries, US branches, and US agencies of the covered foreign company comprise 85 percent or more of the foreign company's total US consolidated assets. The information required under a tailored plan is generally limited to information regarding the nonbanking operations of the company and the interconnections between the bank and nonbank operations of the company, rather than its entire operations.

Among other things, the living wills rule provides that if a covered company submits a resolution plan that the agencies deem not to be credible, it will have 90 days to revise and resubmit its resolution plan. If a covered company fails to submit a revised resolution plan within the specified time period, or the revised resolution plan does not remedy the deficiencies identified in the agencies' written notice, the agencies may subject the covered company to more stringent capital, leverage or liquidity requirements, or impose restrictions on its growth, activities or operations. Failure to remedy deficiencies within two years following the imposition of such requirements or restrictions could lead to an order by the regulators to divest assets or operations as necessary to facilitate orderly resolution.

Following the submission of an initial living will, covered companies will be required to update their living will annually on the anniversary of the initial submission.[8] The Federal Reserve and the FDIC will have the authority to require an update within a reasonable amount of time and may require on a case-by-case basis more frequent submissions of living wills. A covered company must also submit a notice no later than 45 days after any event or change in condition or circumstances that may have reasonably foreseeable material effect on the resolution of the covered company.

## II. The Volcker Rule

Section 619 of the Dodd-Frank Act amended the US Bank Holding Company Act (the "BHCA") to generally prohibits covered banking entities from conducting proprietary trading and from sponsoring or acquiring an interest in a hedge fund or a private equity fund. This amendment is commonly known as the "Volcker Rule." The BHCA and the Volcker Rule generally apply extraterritorially to any foreign banking organization that has banking operations in the United States. In other words, foreign banking organizations that conduct banking operations in the United States would be covered banking entities under the Volcker Rule.

The Federal Reserve, the FDIC, the Office of the Comptroller of the Currency, U.S. Securities and Exchange Commission ("SEC"), and the U.S. Commodity Exchange Commission ("CFTC") are authorized to issue rules implementing the Volcker Rule with respect to covered banking

[8] Covered companies will be required to submit an initial living will on a staggered schedule depending on the size of their nonbank assets. Covered companies with $250 billion or more in total nonbank assets had to submit their initial living will by July 1, 2012. Covered companies with $100 billion or more in total nonbank assets must submit their initial living will by July 1, 2013. All other covered companies must submit their initial living will by December 31, 2013. For purposes of these thresholds, foreign covered companies must count only US nonbank assets.

entities they supervise. Proposed regulations ("the Proposed Regulations") were issued by these agencies in 2011, but have yet to be finalized.[9]

Proprietary Trading Prohibition

Under the Volcker Rule "proprietary trading" is statutorily defined as engaging as a principal for the trading account of a banking entity in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate federal banking agencies, the SEC and the CFTC may determine by rule.

Largely restating the statutory provisions of the Volcker Rule, the Proposed Regulations define "proprietary trading" to mean acting in a principal capacity by a banking entity for its *trading account* in any purchase or sale of a *covered financial position*. The Proposed Regulations then further clarify the meaning of a "covered financial position" and a "trading account." The Proposed Regulations define the term "trading account" broadly and the exemptions from the general prohibition on proprietary trading narrowly. Moreover, the Proposed Regulations interpret the meaning of the term "covered financial position" broadly to include even derivative instruments that are not subject to regulation by the SEC or the CFTC.

The Volcker Rule provides that the prohibition on proprietary trading does not apply to purchases and sales of covered positions if: (i) the covered banking entity is not directly or indirectly controlled by a banking entity organized in the United States; (ii) the transaction complies with Section 4(c)(9) or (13) of the BHCA; and (iii) the transaction occurs solely outside the United States (the "Foreign Bank Exemption"). The Proposed Regulations interpret the statutory provisions in a way that significantly narrows the Foreign Bank Exemption and expands the extraterritorial application of the proprietary trading prohibitions.

Under the Proposed Regulations, a transaction will only occur "outside the United States" if: (i) the covered banking entity is not organized under the laws of the United States; (ii) no party to the transaction is a resident of the United States; (iii) no personnel of the covered banking entity directly involved in the transaction are physically located in the United States (excluding any strictly ministerial or administrative functions); and (iv) the transaction is wholly executed outside the United States. To satisfy the statutory requirement that the exempted transaction comply with Section 4(c)(9) or (13) of the BHCA, the Proposed Regulations would also require each non-U.S. banking entity to meet certain tests that require that most of its assets and revenues are generated outside the United States.

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[9] The statutory effective date of the Volcker Rule was July 21, 2012. However, the Dodd-Frank Act provides for a transition period of two years, until July 21, 2014, during which covered banking entities should come into compliance with the requirements of the Rule (the "Conformance Period"). On April 19, 2012, the Federal Reserve Board issued a policy statement clarifying that covered banking entities will have the full two-year Conformance Period provided by the statute to fully conform their activities and investments, unless the Federal Reserve extends the Conformance Period. The policy statement further indicates that during the Conformance Period covered banking entities will be expected to engage in good-faith efforts appropriate for their activities and investments, that will result in the conformance of all of their activities and investments to the requirements of the Volcker Rule by no later than the end of the Conformance Period.

Most significantly, under the Proposed Regulations a transaction would not be deemed to have occurred solely outside the United States if a party to the transaction is a resident of the United States. Under the Proposed Regulations, it appears that every covered banking entity that intends to transact as a principal with residents of the United States (*e.g.*, in a dealer or underwriting capacity) would have to establish an extensive internal compliance program and controls, and/or otherwise comply with the requirements of potentially applicable exemptions. Proprietary transactions with U.S. residents would be prohibited even if conducted by an affiliate from a non-U.S. location.

The Volcker Rule also contains exemptions for, among other things, hedging, market making, and underwriting activities. These exemptions are also defined narrowly, however. In addition, the Proposed Regulations impose very burdensome compliance program, quantitative reporting and recordkeeping requirements for a covered entity to be able to engage in permitted proprietary trading activities. Under the Proposed Regulations, these compliance requirements most likely would apply, not only to the U.S. operations of covered entities, but also to any affiliate worldwide wishing to effect financial transactions with U.S. residents.

Fund Investments and Sponsorship Prohibition

The Volcker Rule generally prohibits "sponsoring" or acquiring any equity, partnership, or other "ownership interest" in a "hedge fund" or a "private equity fund." The Proposed Regulations clarify the statutory prohibitions and definitions by, among other things: (i) clarifying which funds will be "covered funds" subject to the prohibition; (ii) defining "ownership interest" and "sponsor;" and (iii) detailing the exceptions for (a) covered funds organized and offered by a covered banking entity with a *de minimis* investment not exceeding 3% and (b) sponsoring or investing in covered funds solely outside the United States.

The Proposed Regulations interpret the statutory exceptions from the general prohibition on investing and sponsorship of private equity and hedge funds narrowly. Most significant for non-US covered banking entities is the statutory exemption for sponsoring or investing in covered funds solely outside the United States. The Proposed Regulations do little to address the narrow scope of this exception. Under the Proposed Regulations, the exception requires that: (i) the covered banking entity is not directly or indirectly controlled by a banking entity organized under U.S. federal or state law; (ii) the activity is conducted pursuant to Section 4(c)(9) (exempting "shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States") or Section 4(c)(13) (exempting "shares of, or activities conducted by, any company which does no business in the United States except as an incident to its international or foreign business") of the BHCA; and (iii) no ownership interest in the covered fund is offered for sale or sold to a resident of the United States; and (iv) the activity occurs solely outside the United States. Thus, the ability of non-US covered entities to sponsor, establish, control or invest in funds that have US investors will be severely constrained, irrespective of the place of organization of such funds.

## III. Dodd-Frank Section 716 Push Out

Section 716 of the Dodd Frank Act is commonly referred to as the "swaps push-out rule." The section generally prohibits "federal assistance" to be provided to "swap entities." Federal assistance is generally defined as the use of any Federal Reserve credit facility or discount window, or receiving Federal Deposit Insurance Corporation (FDIC) insurance or guarantees.

Thus, US banks and US branches of foreign banks that are generally eligible and receive federal assistance must "push out" swap trading activities to affiliated swap entities.

The push out rule does not apply, however, with respect to certain swap activities of US insured depository institutions. US branches of foreign banks are generally not "insured depository institutions" and, accordingly, are not eligible for this exemption. Thus, US branches of foreign banks would have to push out all of their swap activities if they want to retain Federal discount window access. This discriminatory treatment against foreign banks probably resulted from a drafting oversight. It is doubtful, however, that a legislative amendment would be adopted to remedy the situation prior to the effective date of the push out rule in July 2013.

## 4. DODD-FRANK AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") eliminated the private adviser registration exemption from the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and, consequently, will likely affect most foreign (non-U.S.) investment advisers seeking U.S. clients and investors.

As an overview, any entity meeting the definition of an "investment adviser" that uses U.S. jurisdictional means in connection with an advisory business must register as an investment adviser with the U.S. Securities and Exchange Commission (the "SEC") or an appropriate state authority under the Advisers Act, unless such entity qualifies for an exemption from registration. The Advisers Act defines an "investment adviser" as any person who:

- engages in the business;
- of providing advice to others or issuing reports or analyses regarding securities;
- for compensation.

When determining whether a person qualifies as an investment adviser, the SEC analyzes all relevant facts and circumstances and generally takes an expansive view of what satisfies each prong. As noted above, an adviser that otherwise meets the definition of an investment adviser under the Advisers Act may avoid registration or comply with less burdensome requirements if the adviser qualifies for an exemption.

The Dodd-Frank Act overhauled adviser registration exemptions by eliminating the private adviser exemption and creating two new exemptions: the foreign private adviser exemption and the private fund adviser exemption.

*Foreign private adviser exemption* – The foreign private adviser exemption is available to any investment adviser who:

- has no place of business in the United States;
- has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;
- has less than $25 million in aggregate assets under management attributable to clients in the United States and U.S. investors in private funds[10] advised by the investment adviser; and
- does not hold itself out generally to the public in the United States as an investment adviser.

Although many expected that the SEC would use its authority to increase the less-than-$25 million threshold for the foreign private adviser exemption, the SEC left the $25 million threshold intact. Consequently, the foreign private adviser exemption is likely too narrow of an exemption for most foreign advisers.

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[10] A "private fund" is defined as a fund that would otherwise have been an investment company under the Investment Company Act of 1940, as amended, but for the exemptions provided by Sections 3(c)(1) and 3(c)(7), the "less than 100 owners" and "qualified purchasers only" investment company exemptions, respectively.

*Private fund adviser exemption* – The private fund adviser exemption is available for any adviser to one or more private funds (and solely to such private funds) if the adviser's assets under management in the United States attributable to the advised private funds are, in the aggregate, less than $150 million. The private fund adviser exemption is available to an adviser with its principal office and place of business located outside the United States so long as all of the adviser's U.S. clients are private funds (even if the adviser has non-U.S. clients who are not private funds).

With respect to advisers with a principal office and place of business located outside the United States, the SEC clarified that an adviser need only count assets it manages from a place of business in the United States towards the $150 million threshold. (On the other hand, a U.S.-based adviser must count all private fund assets it manages, regardless of where the management takes place.) For avoidance of a doubt, only securities portfolios for which a foreign adviser provides "continuous and regular supervisory or management services" from a U.S. place of business must be counted as "assets under management in the United States" for purposes of determining whether the private fund adviser exemption is available.

If a foreign adviser qualifies for and elects to use the private fund adviser exemption such foreign adviser would be exempt from provisions of the Advisers Act and related rules that apply to "registered" advisers. Although exempt from registration, an adviser availing itself of the private fund adviser exemption—an exempt reporting adviser ("**ERA**")—is required to meet certain recordkeeping and reporting requirements and subject itself to SEC examination for cause. Most notably, an ERA would have to complete and regularly update select portions of Part 1A of Form ADV (the form currently used by investment advisers to register with the SEC). Part 1A of Form ADV requires an ERA to disclose certain information about its business and owners, including the following: basic identification information; business activities; financial industry affiliations; control persons (if any); disciplinary history of the ERA and all advisory affiliates[11]; information regarding the ERA's direct and indirect owners and executive officers; and the amount of private fund assets under management. Thus, while the private fund adviser exemption is broader than the foreign private adviser exemption, foreign advisers should note that the private fund adviser exemption is conditional upon annual reporting to the SEC and the possibility of for cause SEC examination.

**As a result of the Dodd-Frank Act amendments to the Advisers Act and rules thereunder, many foreign (non-U.S.) advisers may have to register in the United States or report as ERAs or alter their business model. Please contact us should you have further questions regarding registration requirements and exemptions in the United States under the Advisers Act**.

**Private Placements of Securities and the JOBS Act**

Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act"), which was enacted on April 5, 2012, directs the SEC to amend Rule 506 of Regulation D ("Rule 506") and Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"), to eliminate the prohibition on general solicitation in transactions effected under those rules. On August 29, 2012, the SEC proposed amendments—which have not yet been officially adopted—that

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[11] Advisory affiliates are: (i) all current employees (besides those performing clerical, administrative, support or similar functions); (ii) all officers, partners or directors; and (iii) all persons directly or indirectly controlling the adviser or controlled by the adviser.

eliminate the current ban on general solicitation in transactions made pursuant to Rule 506 and Rule 144A.

*Private Placements in the United States* – U.S. federal securities laws prohibit offerings of securities unless they are registered with the SEC or qualify for an exemption from registration. While U.S. public offerings must be registered under the Securities Act, private placements of securities are exempt from registration. As used herein, a "private placement" means an offer or sale of securities that is made in reliance on Section 4(2) of the Securities Act or one of the safe harbors under that section, namely Rule 144A, Rule 506 and Regulation S, which provide exemptions from the registration requirements applicable to public offerings.[12] Whereas Rule 144A provides a safe harbor for resales to U.S. persons that qualify as qualified institutional buyers ("QIBs"), Rule 506 provides a safe harbor for offers and sales of securities to persons that qualify as accredited investors and Regulation S provides a safe harbor for offers and sales of securities made outside the U.S. While Rule 144A, Rule 506 and Regulation S each have their own set of requirements, the proposed SEC amendments, if adopted, would affect the following requirements:

- General Solicitation – a private placement made pursuant to Rule 506 or Rule 144A must not involve any "general solicitation" under Rule 502(c) of Regulation D. "General solicitation" includes: (i) advertisements, articles, notices, press releases or other publications in any U.S. newspaper, magazine or similar media (including the internet); (ii) broadcasts over U.S. television or radio (including the internet); and (iii) any seminar or meeting in the U.S. whose attendees have been invited by any general solicitation or advertisement; and

- Directed Selling Efforts – Activities which are conducted outside the United States as part of a Regulation S offering will not result in a general solicitation in the United States as long as they are conducted in a manner reasonably designed to avoid broad dissemination of information about the offering in the United States. Directed selling efforts are activities that could reasonably be expected, or are intended, to condition the market in the United States with respect to the securities being offered outside the United States.

*JOBS Act Elimination of the Ban on General Solicitation* – On August 29, 2012, the SEC proposed amendments to Rule 506 and Rule 144A that would remove the ban on general solicitation for private placements effected under Rule 506 and Rule 144A provided that the issuers take reasonable steps to verify that all purchasers of securities are accredited investors for private placements made pursuant to Rule 506 or QIBs for private placements made pursuant to Rule 144A.

If the proposed SEC amendments are adopted, private placements could be made via general solicitation or advertising so long as the issuer reasonably believes that all purchasers are accredited investors or QIBs, depending on the safe harbor used by the issuer. Additionally, the elimination of the ban on general solicitation would facilitate off-shore (non-U.S.) Regulation S offerings made concurrently with a Rule 506 or Rule 144A (domestic) offering since general

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[12] Please note that Regulation D has three separate exemptions from registration. This memorandum assumes that a private placement would be made pursuant to Rule 506 of Regulation D, which permits an issuer to raise an unlimited amount of capital so long as certain requirements are met (most notably the accredited investor and general solicitation requirements).

solicitation or advertising in the United States for the domestic offering would not constitute prohibited "directed selling efforts" for the purposes of Regulation S because Regulation S offerings are not considered integrated with concurrent domestic offerings. Consequently, the proposed SEC amendments to Rule 506 and Rule 144A would provide greater clarity on what information can be provided to the public for private placements and greater transparency to investors since it will be easier to compare private placement issuers with the increased availability of sales materials. Additionally, smaller issuers with favorable track records will likely benefit from the opportunity to easily market future private placements.

**Please note, however, that the proposed SEC amendments pursuant to the JOBS Act have not been formally adopted by the SEC as of April 11, 2013 and, consequently, the ban on general solicitation or advertising in connection with private placements in the United States remains in effect**.

## 5. THE FOREIGN ACCOUNT TAX COMPLIANCE PROVISIONS OF THE US HIRING INCENTIVES TO RESTORE EMPLOYMENT ACT OF 2010 (FATCA)

**The US federal tax advice contained in this note is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties under US federal, state or local tax laws and is not intended or written to be used, and cannot be used, for the purpose of promoting, marketing or recommending to another party any transaction or matter addressed herein.**

### i. General

The Foreign Account Tax Compliance provisions of the US Hiring Incentives to Restore Employment Act of 2010 (known as "**FATCA**") implement a new reporting and withholding regime intended to encourage non-US financial institutions to report income earned and assets held by US persons outside the United States. This is achieved by imposing a 30% withholding tax on certain payments made to "foreign financial institutions" or "**FFI**s" unless they agree to provide information about their customers and investors to the US Internal Revenue Service (the "**IRS**") or otherwise establish that they are exempt from withholding under FATCA. FFIs that enter into this agreement with the IRS (an "**FFI Agreement**") are referred to as "**Participating FFIs**" and those that do not, and are not otherwise exempt from withholding under FATCA, as "**Non-Participating FFIs**". Under FATCA, the United States is effectively exercising jurisdiction over situations that have little or no real US nexus by imposing a coercive tax on non-complying institutions and by making it difficult for non-complying institutions to do business with complying ones.

There are two relevant definitions for what constitutes a financial institution for purposes of FATCA. The first is contained in the Treasury Regulations issued under FATCA on 17 January 2013 (the "**FATCA Regulations**") and the other is contained in agreements that the United States is entering into with certain other governments regarding the application of FATCA to entities in those jurisdictions (Intergovernmental Agreements or "**IGAs**"). When an entity is operating in an IGA jurisdiction, it is subject to the definition contained in the relevant IGA, otherwise the entity is subject to the definition contained in the FATCA Regulations.

FFIs generally include entities that (i) take deposits in the course of a banking business, (ii) hold financial assets of others as a substantial part of their business, (iii) are "Investment Entities", (iv) are insurance companies that issue cash value insurance contracts, annuity contracts, or debt or equity instruments linked to US assets, (v) are holding companies and treasury centers[13] that are members of groups that include other financial institutions or (vi) are holding companies or treasury centers that are formed in connected with or availed of by investment funds. The term "Investment Entity" includes entities that (i) primarily engage in trading, portfolio management, or investing, administering, or managing funds, or certain financial assets on behalf of customers,[14] (ii) entities that primarily engage in investing, reinvesting or trading certain financial

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13 Generally, a treasury center is an entity that primarily engages in investment, hedging or financing transactions with or for members of its group for purposes of managing the risk of interest rate changes, price changes, currency fluctuations or the working capital of a member of its group or for purposes of acting as a finance vehicle for a member of its group.

14 An entity is treated as primarily conducting the business of managing funds, money or financial assets on behalf of customers if the entity's gross income attributable to such activities is equal to or greater than 50% of the

assets and are managed by other investment entities and (iii) entities that function or hold themselves out as funds or similar investment vehicles.

### ii. FATCA Regulations

Under the FATCA Regulations, withholding agents will be required to withhold 30% on certain US source payments made to Non-Participating FFIs, certain other non-US entities ("**NFFEs**") that do not provide information regarding whether their direct and indirect owners are US persons and certain customers or investors that refuse to provide certain identifying information or waive the benefit of applicable customer privacy laws that would prevent reporting to the IRS ("**recalcitrant account holders**"). Withholding is not limited to amounts that are beneficially owned by US persons or amounts otherwise subject to withholding under the general US withholding tax regime. Rather, the purpose is to impose a financial penalty on any Non-Participating FFI that receives payments from sources in the United States for its own account or for the account of its customers.

The 30% withholding tax generally will apply, (i) beginning in 2014, to any US source payment of interest, dividends, rents, salaries, and other fixed or determinable annual or periodical gains, profits, and income ("**US Source FDAP Income**"), and (ii) beginning in 2017, to gross proceeds from the sale or disposition of property of a type that can produce US source interest or dividends (collectively, with US Source FDAP Income, "**Withholdable Payments**").[15] Payments made on and the proceeds from the disposition of indebtedness and other obligations[16] outstanding on 1 January 2014 are generally excluded from the definition of Withholdable Payments. In order to be exempt from withholding under FATCA, an entity that is an FFI and that is not in an IGA jurisdiction will either need to meet one of the exceptions for being subject to FATCA withholding or will be required enter into an FFI Agreement.

Under an FFI Agreement, a Participating FFI generally must: (i) comply with specified due diligence and documentation requirements to identify accounts ("**US Accounts**") that are held by certain US persons ("**Specified US Persons**")[17] or by non-US entities with one or more owners that are Specified US Persons and whose ownership exceeds certain thresholds ("**US Owned Foreign Entities**"); (ii) report annually certain information to the IRS with respect to US Accounts maintained by the Participating FFI; (iii) comply with requests from the IRS for additional information with respect to any US Account maintained by the Participating FFI; (iv) seek appropriate waivers of any applicable customer privacy law that prevents reporting to the IRS in respect of US Accounts under the FFI agreement, and if such waivers are not obtained within a reasonable period, to close the relevant US Account; (v) withhold tax on Withholdable Payments and certain non-US source payments made by the Participating FFI as

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entity's gross income during the shorter of the three-year period ending on 31 December of the year preceding the year in which the determination is made and the period during which it has been in existence.

15 In general, payments made to FFIs with respect to swaps will not be treated as Withholdable Payments; rather, these payments may be subject to withholding under the rules related to foreign passthru payments, as described below.

16 For these purposes, an obligation generally includes, among other financial transactions, a derivatives transaction entered into between counterparties under an ISDA Master Agreement that is evidenced by a confirmation.

17 The follow categories of US persons are excluded from the definition of "Specified US Person": certain publicly traded corporations and their subsidiaries, tax exempt organizations, charitable trusts, federal, state and local governments, banks, real estate investment trusts, regulated investment companies and common trust funds.

principal ("**foreign passthru payments**") to account holders that are Non-Participating FFIs, non-complaint NFFEs or recalcitrant account holders; and (vi) comply with certain verification obligations.

The manner in which foreign passthru payments will be subject to FATCA withholding has not yet been determined by the IRS. The FATCA Regulations anticipate that withholding on such payments would begin no earlier than 1 January 2017. Payments made on and the proceeds from the disposition of indebtedness and other obligations that cannot produce US source income that are outstanding on 1 January 2014, or if later, the date that is six months after the date on which the Treasury Regulations defining the term "foreign passthru payment" are published will not be subject to withholding under the foreign passthru payment regime.

### iii. Intergovernmental Agreements

The United States and several other governments have entered into IGAs and the US Department of Treasury is in negotiations with a number of other jurisdictions.[18] While there are some variations among the IGAs, the IGAs generally follow two models, the "Model I IGA" and the "Model II IGA."

Most FFIs that are acting in Model I IGA jurisdictions will not be required to enter into an FFI agreement with the IRS in order to receive payments free of FATCA withholding; rather, FFIs that are acting in these jurisdictions will be required to obtain information regarding their accountholders and report such information to the local government. These Model I IGA jurisdictions have agreed, in turn, to report such information to the IRS. FFIs resident in Model I IGA jurisdictions that comply with the revised diligence and reporting obligations set forth in the IGA will be treated as deemed-compliant FFIs, and will be able to receive payments free of FATCA withholding. While these FFIs generally will still be required to withhold or provide information to allow another payor to withhold on Withholdable Payments (i.e. those form U.S. sources), as described above, the IGA does not require the FFI to withhold on gross proceeds from the sale or disposition of property of a type that can produce US source interest or dividends or foreign passthru payments. The United States and the Model I IGA jurisdictions have instead agreed to work together to develop an alternative approach to achieve the policy objectives of gross proceeds and foreign passthru payment withholding.

FFIs that are acting in Model II IGA jurisdictions generally are directed to enter into FFI agreements with the IRS, and will be subject to the same rules as FFIs in jurisdictions without an IGA.

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18 Currently, (i) Denmark, Ireland, Mexico, Switzerland and the United Kingdom have entered into IGAs, (ii) Germany, Italy, Norway and Spain have initialed IGAs, (iii) Canada, Finland, France, Guernsey, Isle of Man, Japan, Jersey and the Netherlands have announced that they are in the process of finalizing negotiations, (iv) Argentina, Australia, Belgium, Cayman Islands, Cyprus, Estonia, Hungary, Israel, Republic of Korea, Liechtenstein, Malaysia, Malta, New Zealand, Singapore, Slovak Republic and Sweden have announced that they are in dialogue, and (v) Bermuda, Brazil, British Virgin Islands, Chile, Czech Republic, Gibraltar, India, Lebanon, Luxembourg, Romania, Russia, Seychelles, Slovenia, South Africa and St. Maarten have announced that they are exploring options.