THE ONGOING OFFSHORE IMPACT OF THE U.S. DODD-FRANK ACT

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What led the United States to the 2008 Financial Crisis?

- Risk exposure (credit risk default swaps)
- Capital (insufficient buffers to check against leverage)
- Lack of transparency (no monitored market for hedge funds, fund advisers, credit default swaps)
- Systemic risk (interconnectedness)
- Executive compensation (compensation molds conduct – in this case, excessive risk-taking)

The 2008 U.S. Financial Crisis – The Reckoning

> 8 million U.S. jobs lost and many individuals' personal savings wiped out

> Housing prices dropped 50% in some markets

> 488 U.S. banks failed from 2008 to 2013 (in 5 years prior, only 10 U.S. banks failed)

> Total assets of failed U.S. banks since 2008 amounts to nearly US$6 billion

> Pace of U.S. bank failures slowing down to pre-2008 levels

> U.S. bank regulatory authorities, however, continue to worry about troubled non-U.S. banks

The 2008 U.S. Financial Crisis – The Reckoning (Continued)

- Crisis resulted in a change in political party control at the White House and Congress received a populist mandate to clean up U.S. finance.
- Dodd-Frank Wall Street Reform Act of 2010 – passed July 1, 2010 ("DFA").
- What indirect effects have resulted following passage of DFA?

The 2008 U.S. Financial Crisis – The Reckoning (Continued)

- The United States is culturally in an era of re-regulation and "responsible finance." Unprecedented financial regulation, regulatory enforcement and financial litigation has ensued.
  - SAC Capital Advisors pleads guilty to insider trading and pays a record US$1.2 billion penalty – first large Wall Street firm since 1980's to confess to criminal conduct (Nov. 2013).
  - Wegelin Bank pleads guilty to U.S. tax evasion (Jan. 2013).
  - Hundreds of failed bank D&Os being sued by FDIC.
  - Scores of money center bank settlements.
  - Large consultants being investigated. (Deloitte Financial Advisory Services; Promontory)

Too Big to Jail?

> "The pendulum has swung too far back the other way…I think we should be entering a serious era of institutional accountability, not just personal responsibility."

- Preet Bharara,
  U.S. Attorney for the Southern District of New York (Nov. 5, 2013)

DFA HIGHLIGHTS

> New Consumer Protection Agency and Whistleblower Program

- New Consumer Financial Protection Bureau is created, housed at the Federal Reserve, with the authority to ensure U.S. consumers get clear, accurate information when shopping for mortgages, credit cards and other financial products, and to police against hidden fees, abusive terms and unfair and deceptive practices.
- Authority to enforce regulations for banks and credit unions with assets of over US$10 billion and all mortgage-related businesses (lenders, services, mortgage brokers and foreclosure scam operators), payday lenders and student lenders – plus non-financial firms that are large, such as debt collectors and consumer reporting agencies.
- SEC has created a program to encourage people to report securities violations, creating reward of up to 30% of funds recovered.

DFA HIGHLIGHTS (Continued)

> Looking out for the Next Big Problem

- Financial Stability Oversight Council (FSOC) – identifies and addresses “systemic risks” posed by SIFIs – large, complex financial companies.
- Made up of 10 federal regulatory agencies, an independent member and 5 nonvoting members (insurance industry and state regulators).
- Council is chaired by the Treasury Secretary, and includes the Federal Reserve, SEC, CFTC, OCC, FDIC, FHFA, NCUA and CFPB.
- Authorizes that a nonbanking financial company be regulated by the Fed if FSOC believes the non-bank firm poses “systemic risks.” Capital, leverage, liquidity and risk management rules imposed on those non-financial firms.
- New capital and leverage requirements to make it more costly to get too big – end TBTF (?)

DFA HIGHLIGHTS (Continued)

> Volcker Rule

- Federal Reserve has published implementing proposed Volcker Rule regulations for banks, their affiliates and holding companies to prohibit proprietary trading, investment in and sponsorship of hedge funds and private equity funds and to limit relationships with hedge funds and private equity funds.

DFA HIGHLIGHTS (Continued)

> Hedge fund and asset manager regulation

- Ends "shadow" financial system by requiring most hedge funds and fund advisors to register with the SEC as investment advisers and provide information about their trades and portfolios necessary to assess systemic risk.
- Raises the assets threshold for federal regulation of investment advisers from US$40 million to US$100 million, meaning U.S. states have significant role to enforce registration of investment advisers and funds with AUM under US$100 million.
- SEC given authority to impose fiduciary duty on stock brokers who give investment advice – advice must be in the best interest of customer.

DFA HIGHLIGHTS (Continued)

- Executive compensation and corporate governance
  - Provides shareholders of public companies with a "say on pay" and corporate affairs with a non-binding vote on executive compensation and golden parachutes.
  - U.S. bank regulatory authorities issue their own guidance on executive compensation expectations.
- Credit rating agency oversight
  - Provides new rules for transparency and accountability for credit rating agencies to protect investors and businesses.
  - Creates an Office of Credit Ratings at the SEC with its own compliance staff.

DFA HIGHLIGHTS (Continued)

- Requires nationally recognized statistical ratings organizations to disclose their methodologies, use of third parties' due diligence and their ratings track records.
- Investors can now sue a rating agency for a "knowing or reckless failure to conduct a reasonable investigation of the facts" or obtain analysis from an independent source.

So what is the offshore impact of the DFA?

> INVESTMENT MANAGER REGISTRATION – FOREIGN PRIVATE ADVISER EXEMPTION (Title IV of the DFA)

- On June 22, 2011, the SEC adopted final rules to implement Title IV of the DFA.
- Many offshore investment advisers ("IAs") previously exempt from registration under the Investment Advisers Act of 1940 are required to register with the SEC or state authority, depending on the amount of AUM they advise.
- The most relevant exemption to registration for foreign IAs under the new rules is the "foreign private adviser exemption."

So what is the offshore impact of the DFA? (Continued)

> Foreign private adviser is an IA that: (i) has no "place of business" in the United States; (ii) has fewer than 15 clients and investors in the United States in private funds advised by the adviser; (iii) has less than US$25 million in AUM attributable to such permissible U.S. clients; and (iv) neither holds itself out to the public in the U.S. as an investment adviser nor advises mutual funds.

So what is the offshore impact of the DFA? (Continued)

> "Place of business" of an IA is (i) an office at which the adviser regularly provides investment advisory services, solicits, meets with or otherwise communicates with clients; and (ii) any other location that is held out to the general public as a location at which the adviser conducts such activities. The SEC clarified that an office at which an adviser regularly communicates with its clients, whether U.S. or non-U.S., qualifies as a "place of business."

So what is the offshore impact of the DFA? (Continued)

- "Client." The new rules provide a safe harbor for purposes of counting clients of a foreign private adviser. A foreign private adviser may deem the following to be a single "client": a natural person, including their relatives if they maintain the same principal residence, and accounts and trusts for such natural person and family that are the only primary beneficiaries to a trust instrument.

So what is the offshore impact of the DFA? (Continued)

> INVESTMENT MANAGER REGISTRATION – FAMILY OFFICE EXEMPTION (TITLE IV of the DFA)

- Another relevant exemption for offshore funds is the SEC's final rule exempting "family offices" from IA registration. Before DFA, most family offices were not required to register with the SEC because of the now repealed, long-standing "fewer than 15 clients" exemption.
- The final rule defines "family office" as an entity that: (i) has no clients other than family clients; (ii) is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and (iii) does not hold itself out to the public as an IA. An adviser controlled by employees who are not family members would not qualify as a family office under the rule.

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So what is the offshore impact of the DFA?
(Continued)

1. Family Client

"Family client" means (i) current and former family members; (ii) current key employees of the family office (and, in some circumstances, former key employees); (iii) charities funded exclusively by family clients; (iv) estates of current and former family members or key employees of the family office (and, in some circumstances, of former key employees); (v) irrevocable trusts existing for the sole current benefit of family clients or, if both family clients and charitable and nonprofit organizations are the sole current beneficiaries, trusts funded solely by family clients; (vi) revocable trusts in which one or more other family clients are the sole grantors; (vii) trusts solely funded and controlled by key employees; and (viii) companies wholly owned and operated for the sole benefit of one or more family clients.

So what is the offshore impact of the DFA? (Continued)

2. Family Members

"Family members" means all lineal descendants (including by adoption, stepchildren, foster children, and in some cases, legal guardianship) of a common ancestor (who may be living or deceased), as well as current and former spouses or spousal equivalents of those descendants, provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.

So what is the offshore impact of the DFA? (Continued)

3. Key Employees

"Key employees" means the following individuals (including any such individual's spouse or spousal equivalent): (i) executive officers, directors, trustees, general partners or persons serving in a similar capacity for the family office or its affiliated family office; and (ii) any other employee of the family office or its affiliated family office (other than a clerical or secretarial employee) who, in connection with his or her regular duties, has participated in the investment activities of the family office or affiliated family office or similar functions or duties for the entity for at least 12 months.

So what is the offshore impact of the DFA? (Continued)

> **VOLCKER RULE – Section 619 of the DFA**

- The Volcker Rule amended the U.S. Bank Holding Company Act of 1956 by generally prohibiting banks (**including non-U.S. banks**) and their subsidiaries from engaging in proprietary trading (the "**Proprietary Trading Prohibition**") and certain covered fund activities (the "**Covered Fund Restrictions**") unless those activities are conducted solely outside the United States (the "**SOTUS Exemption**").
- The final rule (the "**Final Rule**") implementing the Volcker Rule and delineating the parameters of the SOTUS Exemption has not yet been finalized by the Federal Reserve. A published proposed rule (the "**Proposed Rule**"), however, which provides guidance on the interpretation of the Volcker Rule, was published on October 11, 2011.

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So what is the offshore impact of the DFA? (Continued)

> **VOLCKER RULE – Section 619 of the DFA (Continued)**

- U.S. Treasury Secretary Jacob J. Lew expects the Final Rule to be promulgated prior to the end of 2013, although we have heard Federal Reserve staff identify January 2014 as the aspirational date to complete a final regulation implementing the Volcker Rule.

- The Proposed Rule generally prohibits a covered banking entity from engaging in **proprietary trading**. Proprietary trading is defined as engaging as principal for the trading account of the covered banking entity in any purchase or sale of one or more covered financial positions; provided, however, that *proprietary trading does not include acting solely as agent, broker or custodian for an unaffiliated third party* (emphasis added).

So what is the offshore impact of the DFA? (Continued)

> **VOLCKER RULE – Section 619 of the DFA (Continued)**

- The "solely outside the United States" or SOTUS exemption to the Volcker Rule as currently drafted provides that a purchase or sale is deemed to have occurred solely outside the United States if all the following fact-sensitive conditions are satisfied:
  - (i) the covered banking entity conducting the purchase or sale is not organized under the laws of the United States or of one or more States;
  - (ii) no party to the purchase or sale is a resident of the United States;
  - (iii) no personnel of the covered banking entity who is directly involved in the purchase or sale is physically located in the United States; and
  - (iv) the purchase or sale is executed wholly outside of the United States.

So what is the offshore impact of the DFA? (Continued)

> **PROPOSED FBO RULES – IMPOSITION OF INTERMEDIATE HOLDING COMPANIES**

- December 14, 2012 – Federal Reserve issued proposed regulations that would implement the enhanced prudential standards of Section 165 and 166 of the DFA to the U.S. operations of certain foreign banking organizations (FBOs).
- Material revision of the regulatory oversight of FBOs in the United States.
- Could encourage FBOs to operate in the U.S. through branches and agencies rather than subsidiaries; increase regulatory costs; and discourage non-bank U.S. operations of FBOs.
- In many ways, the proposed FBO rules signal an "on the record" acknowledgment by the Federal Reserve that it does not welcome FBOs to the same degree it did in the 70s, 80s and most of the 90s.

So what is the offshore impact of the DFA? (Continued)

> **Proposed FBO rules:**

- If FBO has between US$10 billion to US$50 billion in global assets (regardless of U.S. holdings), it will be required to maintain a U.S. risk committee and meet home country stress test requirements that are broadly consistent with U.S. stress test requirements – this will have some impact on offshore supervisory stress-test protocols.
- If FBO has more than US$50 billion in global assets plus at least US$10 billion or more in U.S. assets, the FBO will be required to establish a U.S. IHC, regardless of whether the FBO controls a U.S. bank.
- That IHC will be required to meet same capital and leverage requirements of U.S. BHCs.
- Purpose of the IHC is to "ring-fence" the U.S. operations of an FBO in case the FBO fails outside the United States.
- Final rules pending – 2014?

So what is the offshore impact of the DFA? (Continued)

> **CAPITAL REQUIREMENTS**

- Generally, the DFA imposes new, tougher regulatory capital requirements on banks.
- Under Collins Amendments, U.S. regulatory discretion is limited in adopting Basel III Capital requirements.
- July 9, 2013: FDIC issues “interim final rule” adopting Basel III capital requirements.
- Becomes effective January 1, 2014 for large U.S. banks and January 1, 2015 for smaller ones.
- Foreign Banks in LatAm and Caribbean should review how this new rule might indirectly affect them.

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So what is the offshore impact of the DFA? (Continued)

- Large banks may use their own mathematical models to risk-weight their non-U.S. correspondent bank credits.
- Smaller banks, however, will need to apply new risk weights depending upon country risk classification assigned by rules.
- See Table 2 to 12 C.F.R. § 324.32 (“Risk Weights for Exposures to Foreign Banks”)
- Risk Weights can range from 20% to as high as 150%, depending on country, which could make certain correspondent bank loans impractical commercially.

THANK YOU