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FINANCIAL SERVICES

Dodd-Frank for Foreign Financial Institutions

Geared up for change?
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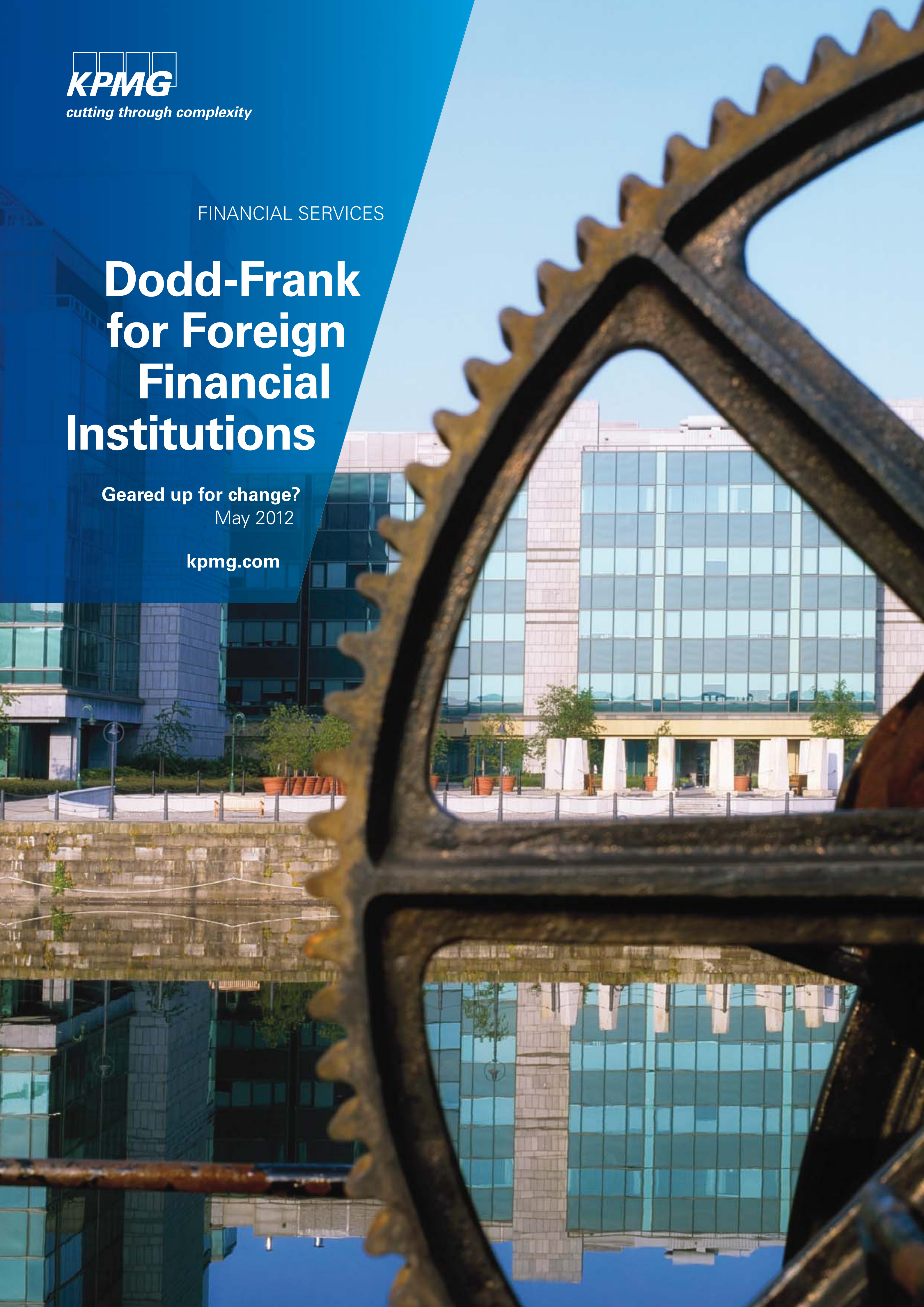


Executive summary

Two years have passed since deliberations began in the United States Congress over legislation which, since becoming law in July 2010, has come to dominate the financial sector landscape in the United States.

Over 2,000 pages long, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) focussed on four key objectives:

- Enhance consumer protection
- Increase transparency of the Over The Counter (OTC) derivatives market
- Create a system of oversight in order to minimise risk to the financial system
- Increase capital standards and regulation of big banks

Following on from our initial publication *Dodd-Frank for Foreign Banks*[1], US regulators have been working their way through the Dodd-Frank Act to draft nearly 300 rules – but progress has been much slower than legislators intended, and many rule making deadlines have been missed. However, a body of rules which will set a new paradigm for US financial regulation is beginning to take shape.

As expected, US financial institutions – particularly large bank holding companies (BHCs) , but also securities firms, investment advisers, fund managers, and insurers – face new challenges in the form of increased reporting, enhanced prudential requirements, extended fiduciary commitments and more intensive supervision.

But less expected has been the potential scope of these new rules to impact non-US financial institutions – and indeed other non-financial entities with financial activity linked in any way to the US.

Though all of the Dodd-Frank Act's requirements have the potential to affect non-US headquartered institutions, depending on their location and activities, in this document we have focussed on those likely to have the biggest impact:

Enhanced Consumer Protection agenda – A new, national consumer agency and a renewed focus on fairness – particularly in retail credit – brings a more rigorous and wide ranging approach to conduct rules, as will enhanced requirements for investment advisers and brokers to look out for the best interests of their clients. Banks and advisers need both cultural and operational change to reflect this renewed focus on the customer.

Enhanced Prudential Standards – The largest banks with US operations will be subject to more intensive supervision, capital and risk management standards. Rules to bring foreign banks into scope are still outstanding – but the largest cross border banks – and some other financial institutions including funds and insurers – are likely to be caught.

OTC Derivatives – The Dodd-Frank Act introduces the US requirements to meet G20 rules, which aim to:

- Move derivatives trading onto exchanges;
- Bolster collateral required for trades;
- Maximise the use of central counterparties (who act as both buyer and seller in a trade to centralise and reduce counterparty risk); and
- Increase transparency through more reporting to central repositories.

The challenge for financial institutions is in determining whether, when and where their derivatives trades will be caught by the Dodd-Frank rules and how these might interact with rules developed elsewhere. These are issues still up for debate and clarification.

Swaps Push-Out – The Dodd-Frank Act also introduces additional protection to isolate riskier derivatives trades from core banking activities, by pushing some derivatives out in to separately capitalised entities. But US located foreign banks (including branches) must also comply, adding cost and complexity to funding and entity structures.

The Volcker Rule – This rule prevents banks from trading on their own account and was subject to significant objections from across the industry. As a result, significant change is likely before it is finalised. However, banks with a US presence must watch closely for potential impacts on their business, both at home and abroad.

Adviser registration and reporting – Investment advisers are already facing up to additional reporting and disclosures, as the Dodd-Frank Act removes previously wide exemptions for foreign fund managers with US activities.

Federal Insurance Office – The impact of a new, national body to shape rules for insurers is unclear, but has the potential to harmonise what has – to date – been a patchwork of regulatory regimes.

Additional requirements – Over and above the critical requirements noted above, there are multiple additional provisions in the Dodd-Frank Act of which both financial and non-financial organisations should be aware. These include new rules for remuneration, whistle blowing, and attestation to the source of certain minerals used in supply chains.

Many of the Dodd-Frank Act provisions are scheduled to come into force in 2012, and some requirements are already in place. This paper provides a brief overview of those areas of the Dodd-Frank Act with the potential for significant impacts on non-US headquartered institutions.

Several US institutions are well advanced in their preparations, but outside the US many are only now beginning to appreciate the scale of the potential impact on their business – and the rapidly approaching deadlines for compliance.

1. *Dodd-Frank for Foreign Banks*, KPMG International, October 2010

Next steps...

Time is short – and the regulations are complex and still uncertain.

But the changes coming from the Dodd-Frank Act should be considered in conjunction with the major business upheaval you may be grappling with as a result of global regulatory change.

One of the first steps is to understand the potential impacts – both direct and indirect – on your US and foreign activities. Monitoring ongoing developments, and educating key stakeholders on the requirements, allows you to embed the Dodd-Frank Act into the critical strategic and operational changes which are already in progress.

To help you to navigate its implications we simplified our impact analysis inside into 'clusters' for the different types of entity likely to be affected by new rules.

We set out below some of the key steps your institution should be taking now to enable your organisation to be sufficiently prepared for the Dodd-Frank Act.

Actions to take now...

Baseline
Look at your current business and its links to the US, whether through US entities, US based resource, US assets or US counterparties.

Assess impact
Determine which regulatory developments are relevant to your business and the high level impact they may have.

Determine strategy
Review 'grow/maintain/exit' strategies for US linked business in light of regulatory developments here and elsewhere.

Develop target operating model
Determine the organisational and operational infrastructure needed to support your strategy.

Assess readiness and identify gaps
Review new operating model against baseline and determine actions to fill gaps; consider impacts for risk management and broader governance structures.

Prepare high level project plan
Set priorities reflecting timing and cost to implement changes required, identify 'known unknowns'.

Identify interdependencies
Establish links with other internal projects affecting key areas of change.

Monitor developments
Adjust plans accordingly as final rules become known.

Identify 'quick wins' flexibility for further change
Fix known problems now in impacted areas, scope new data requirements but embed flexibility for further change.

Challenges you may face...

Clients have worked with KPMG firms to assess the Act and its possible effects; they have faced a number of challenges. Highlighted below are some of the most significant issues you may find also apply to your business.

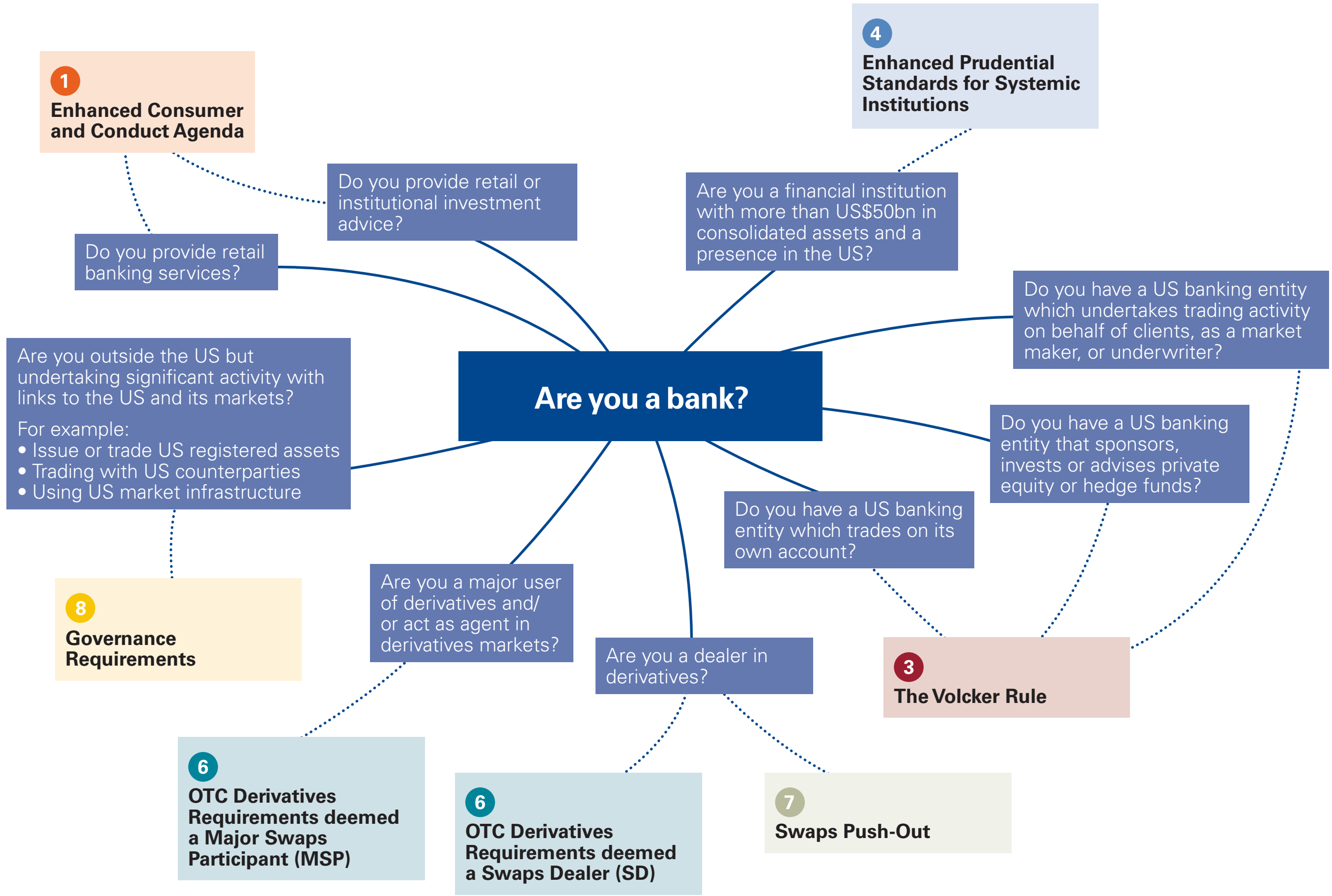
Uncertainty and timing
Though many rules are not yet final, critical areas like OTC derivatives changes are expected to commence this year – compressing implementation timetables for those who do not anticipate the likely outcome by undertaking analysis and planning.

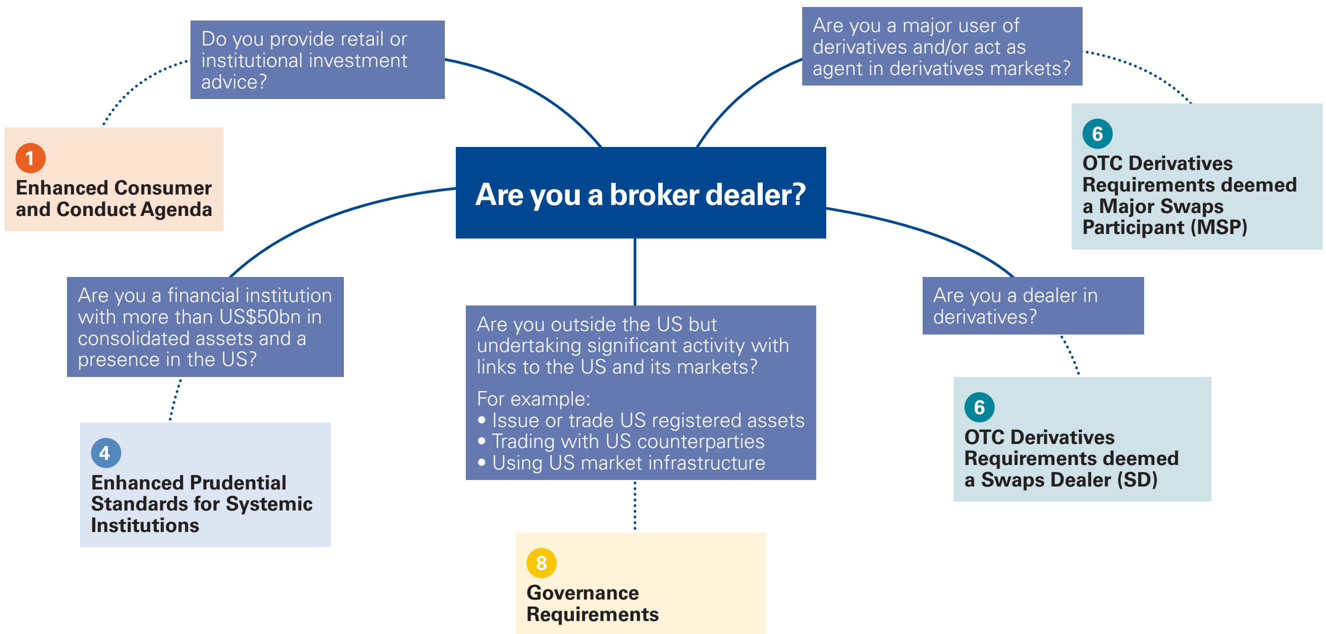
Impacts on entities and organisational structure
Many of the provisions of Dodd-Frank prompt a review of existing legal entities and will likely drive rationalisation or reorganisation. Requirements to conduct derivatives trades from separately capitalised entities will see the creation of new entities. Trading in derivatives must be through entities which are specifically registered for this purpose with the relevant regulators. Changing capital requirements may impact the attractiveness of existing holding companies. Eventual treatment of intra group exposures and transactions may further impact some booking and entity models. Any entity change will necessitate review of changing contractual, governance and reporting requirements for existing and new entities.

Multiple impacts on core business processes
Strategic decisions to change the nature or structure of your business may be needed as a result of the Dodd-Frank Act. Planning for change will highlight the scale and scope of upheaval for your core business processes from front to back, as well as the risk and control frameworks which sit around these. Short timelines and the scale of change put at risk key controls and clarity over processes and their governance.

Conflict and inconsistency
The Dodd-Frank Act will have multiple overlaps with regulatory changes in other jurisdictions in which you operate. Mapping both the inter-dependencies and the inconsistencies with these other requirements is daunting. Regulatory expertise, business knowledge, and change management leadership must come together and sit across individual initiatives in order to feed in new rules and requirements as they emerge – after assessing and prioritising their impact. Avoiding fragmentation can help to drive a coherent and efficient change process, minimising cost and disruption to the business and highlighting areas of opportunity.

What you may be subject to…





Are you an insurer?

- Are you a major user of derivatives?
  - 6 **OTC Derivatives Requirements deemed a Major Swaps Participant (MSP)**
- Are you a financial institution with more than US$50bn in consolidated assets and a presence in the US?
  - 4 **Enhanced Prudential Standards for Systemic Institutions**
- Do you provide insurance products in the US?
  - 5 **Federal Insurance Office pronouncements**

Are you an investment manager/advisor?

- Are you a financial institution with more than US$50bn in consolidated assets and a presence in the US?
  - 4 **Enhanced Prudential Standards for Systemic Institutions**
- Are you owned/sponsored by a bank with US links?
  - 3 **The Volcker Rule**
- Are you outside the US but undertaking significant activity with links to the US and its markets?
  For example:
  - Issue or trade US registered assets
  - Trading with US counterparties
  - Using US market infrastructure
  - 8 **Governance Requirements**
- Do you advise private funds?
  - 1 **Enhanced Consumer and Conduct Agenda**
  - 2 **Advisor Registration and Form PF Fund Reporting**
- Are you a major user of derivatives?
  - 6 **OTC Derivatives Requirements as a Major Swaps Participant (MSP)**

Are you a non-financial institution with significant US links?

- Are you a major user of derivatives?
  - 6 **OTC Derivatives Requirements deemed a Major Swaps Participant (MSP)**
- Are you outside the US but undertaking significant activity with links to the US and its markets?
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Implications for foreign financial institutions

Action…	This means…	Challenges to consider…	Questions you should ask…
1 **Enhanced Consumer and Conduct Agenda**	• You will be subject to the rules issued by the new **Consumer Financial Protection Bureau (CFPB)** which has a more intrusive approach to conduct, better resources and can impose criminal penalties. • There will be a cap on the fees you can earn for the provision of debit and credit card interchange services. • You will be required to retain 5 percent for securitisations issued ('skin in the game'). • Potential enhancements and greater harmonisation of fiduciary standards for investment advisers and broker dealers.	• The current focus of the CFPB is on fairness in retail credit, but its agenda is likely to widen. • Improving customer experience is a key issue globally, but requirements are likely to vary locally. • Securitisation requirements may be relaxed, eg. exemption of qualified residential mortgages. • Extent of fiduciary change could impact investor choice and raise compliance risk and cost.	• Have you established accountability for monitoring CFPB pronouncements? • How will you assess the impact of emerging requirements on products and customers? • How will new fiduciary standards affect existing compliance policies and procedures?
2 **Advisor Registration and Form PF Fund Reporting**	• You need to register with the SEC and/or CFTC depending on the assets you advise on, driving additional data submission and new compliance requirements. • Significantly reduced exemption for foreign private advisors. • Exempt advisors must still provide additional reporting. • You need to file 'Form PF' if you advise on funds with AUM of more than US$150m, with more reporting for larger funds – a periodic filing to collect information on systemic risk.	• Considerable room for interpretation of definitions in assessing qualification for reporting thresholds. • Regulatory AUM calculation and the use of leverage can result in more AUM and therefore more disclosure requirements. • Rigorous internal certification frameworks are needed. • Reporting for large hedge funds by June 2012, remaining funds by December 2012.	• Do you have the necessary data to deliver much more extensive reporting? • Do you have the necessary in-house compliance functions and are these effective? • Have you identified the funds and products which are relevant to determining your reporting requirements?
3 **The Volcker Rule**	• US headquartered or resident banking entities must cease proprietary trading in all US affiliates. • You will be required to meet extensive compliance monitoring and reporting requirements to verify to regulators that you are not undertaking proprietary trading. • The rules may extend to non-US affiliates if there is any connection to the US. • You cannot have ownership above a 3% de minimis in private equity or hedge funds. • You are prohibited from marketing non-US funds to US clients or by US based sales people. • Activities 'wholly outside the US' by non-US headquartered banks are exempt from the rule. • US mutual funds are exempt from the rules, however similar funds outside the US are not. • The rule becomes effective from 21 July 2012. Banks must then show 'good faith' efforts towards compliance, but are allowed the two years until 21 July 2012 to fully conform.	• Rule not yet final and may be subject to significant change. • Definition of 'wholly outside US' to exempt foreign banking activity requires more clarification. • Uncertain whether ownership/ sponsor rules will apply to entire banking group or only to US entity. • Not clear what is required to show 'good faith' efforts to be compliant. • Clarity over the definition of proprietary trading versus other allowable activities like market making is challenging. • Reporting against metrics may be required before the final conformance deadline. • The two year conformance period may not be extended if rules are delayed.	• Which entities are covered by the rule? • Which activities or investments/sponsorships might be covered, by the rule? • What options are available to you (modification, cessation, offshore, alternative distribution channels)? • Do you have the data and processes to report against proposed compliance metrics in all impacted entities?
4 **Enhanced Prudential Standards for Systemic Institutions**	• The new **Financial Stability Oversight Council (FSOC)** will monitor macroprudential risks in the US, including the ability to designate financial institutions as systemic. • You could be deemed systemic if you are: – a bank or non-bank financial institution – US or Foreign institution with US operations – have consolidated assets of US$50 billion or more. • There are more rigorous risk based capital and liquidity requirements, leverage limits, and restrictive single counterparty credit limits for large Bank Holding Companies (BHCs) (>US$50bn in consolidated assets) and Non-Bank Holding Companies (**NBHCs** – see below) designated as systemic by the FSOC (together 'covered companies'). • These 'covered companies' and medium BHCs (assets between US$10–US$50bn) need enhanced risk management standards and stress tests, and are subject to a new 'early remediation framework' with four levels of supervisory action up to and including resolution. • **NBHCs** may be designated as systemic if you cross any one of five additional thresholds based on the size of your derivatives exposure and your leverage – large hedge funds, asset managers, Financial Market Utilities (FMU) and insurers are most likely to be caught. You may be deemed a SIFI after two further stages of analysis, leading to additional capital, reporting and supervision requirements.	• Federal Reserve rules for non-US headquartered institutions are still outstanding – which may reduce requirements in light of reliance on home state regulation. • RRPs prepared for home-country regulators may not be wholly relied upon by US regulators, resulting in duplication and additional effort. • New capital rules are already in place, with phased implementation for the remaining proposals including expected announcements on the approach to Basel 3 implementation and implementation of systemic surcharges by 2014. • A list of potential non-bank SIFIs is expected from the FSOC by the end of 2012. • A potential systemic designation could affect plans for US expansion.	• Are you a SIFI? If so, how will your prudential requirements change? • What are your new funding and capital requirements – how will you meet these? • Is your existing entity structure optimal in light of systemic requirements? • Have you started an RRP – in the US or elsewhere? Do you have a process to continually update this and link it to RRPs elsewhere? • Is your current risk governance and supporting risk management sufficient to deliver new accountabilities, including enhanced stress testing? • As a non-bank SIFI, have you assessed yourself against the FSOC criteria and considered your ability to demonstrate effective risk management and governance to mitigate a systemic designation?
5 **Federal Insurance Office pronouncements**	• You will have to respond to information requests from the **Federal Insurance Office (FIO)**. • The FIO does not currently have rule making powers to oversee the insurance industry. • The FIO study into the insurance industry is overdue.	• The FIO study has not yet been issued, so significant uncertainty over its approach and reach remains.	• Are you monitoring ongoing developments to ensure adequate time to assess, consult and implement as new proposals come out?

Action…	This means…	Challenges to consider…	Questions you should ask…
6 **OTC Derivatives Requirements**	Any transaction sourced, executed, booked or settled in the US or through a US-based financial institution will, under current proposals, be subject to new requirements for OTC derivatives under the Dodd-Frank Act. These include: • Classification of major buyers and sellers in US derivatives markets as either a Major Swaps Participant (MSP) or Swaps Dealer (SD), which requires registration with regulators and brings these parties fully in scope for the derivatives rules set out below. • Designation as an MSP or SD by comparing derivatives activity to thresholds set by the regulators, excluding qualifying FX and commercial hedging activity as well as swaps between majority owned affiliates. • Swaps deemed eligible by regulators must be cleared through a central counterparty. • Eligible trades must be executed through a Designated Contract Market (DCM) or Swaps Execution Facility (SEF). • Additional capital and collateral requirements for both cleared and non-cleared trades, with tighter rules to protect customer assets. • Rapid reporting of all derivatives trades to a Swaps Data Repository (SDR). • Positions in certain commodities will be subject to quantitative limits. • Requirements are split between the CFTC and the SEC (and sometimes jointly regulated) depending upon the nature of the swap and its underlying asset. **Major Swaps Participant (MSP)** • You may be deemed an MSP if you maintain 'substantial' positions in any of the major swaps categories. • In practice, these requirements are likely to apply primarily to asset managers, hedge funds, insurers and some large corporates. • An MSP must register with the CFTC and/or the SEC. • If you meet the threshold you will be subject to the clearing requirements above, including additional risk management, reporting and record keeping. • If you do not exceed the threshold you will be subject to higher collateral requirements for uncleared trades. **Swap Dealer (SD)** • You will be required to register with the Commodity Futures Trading Commission (CFTC) and/or the Securities Exchange Commission (SEC) if you: – hold yourself out as a dealer in swaps or make a market as a dealer in swaps – regularly enter into swaps with counterparties as an ordinary course of business for own account, or – engage in any activity causing you to be commonly known as a dealer or market maker in swaps. • If you meet the criteria you will be subject to the clearing requirements above, including additional risk management, reporting and record keeping. • You must register as a Futures Commissions Merchant (FCM) to provide clearing services for clients.	**Rule making** • Rules are not yet final. In particular, capital and collateral requirements for cleared and uncleared trades are outstanding, as are many SEC rules. • US rules may be inconsistent with rules written elsewhere. • Implementation is likely to be in advance of other regions. • Further clarification is needed on extraterritorial reach, eg. US counterparty, asset, client, that might bring the activity into scope. • Extent of reliance on foreign OTC regimes for activities undertaken outside US but touching US markets is unclear. **Registration and implementation** • Multiple entities may need registration for multiple functions (Broker Dealer, Swaps Dealer, Futures Commission Merchant). • Offshore entities must aggregate trading across all affiliates when assessing thresholds. Any activity in US boundaries would bring the aggregated total in scope. • Registration of bank branches may force registration of entire bank. • Customers may need novation to new entities depending on changes to entity structure, booking models and registration strategies. **Ongoing change** • There will be a higher capital cost on both the legacy book and future business with uncleared trades. • There are significant technology challenges, including meeting near real-time reporting requirements and managing more frequent and extensive collateral movements.	**Business Model considerations:** • What is the ROE impact of proposed changes? • What is your current booking model – are there offshore options? • Is your current entity structure optimal in light of the costs and additional reporting and compliance requirements for swaps entities? • Will any of your entities act as an FCM? • Which CCPs (known in the US as Derivatives Clearing Organisations (DCO)) will you be a member of as an FCM? • If not an FCM, which of these will you use to access clearing? • What are the impacts on current hedging and netting strategies of any changes to booking or entity structures? • What is the level of trading with affiliates where your US entity currently has a minority stake and how will these affect your threshold calculations? • How will customers react to changes in the entity they transact with? **Operational considerations:** • What changes are needed to your technology, contractual and operational practices as a result of clearing requirements? • Can your systems cope with more frequent margining, reporting and monitoring against clearing eligibility and limits? • Are existing risk management and reporting arrangements in all potential swaps entities adequate to meet regulatory requirements? • How will you monitor your derivatives activity relative to the thresholds? Can you demonstrate the links defined by the regulators in order to classify commercial risks as hedging?
7 **Swaps Push-Out**	• Applies to you if you are a bank (or branch) with US Federal Deposit Insurance Corporation (FDIC) or access to the Fed discount window. • You will be required to segregate your derivatives business into a separately capitalised legal entity. • The push-out rule excludes hedging, FX, interest rates, some CDS and commodities business for most institutions (but see *Issues to be resolved*).	• The wording of the Act does not allow foreign bank branches to access the exemptions. This is a technical error, but one which may or may not be corrected. • Registered swaps companies may be required to file audited financial statements.	• Which current positions and future activity must novate to a new entity? • What will be the capital and liquidity requirements of a standalone swaps entity? • How will you ensure the new entity has an adequate risk, reporting and governance capability? • Will existing customers deal with a separate entity with stand alone funding and credit rating?
8 **Governance Requirements**	• Dodd-Frank includes requirements to enhance the quality of governance, including remuneration disclosures, non-binding votes for shareholders (a 'say on pay') and clawback provisions. • It introduces requirements for all public companies to be subject to new whistle blowing procedures with substantial financial incentives. • Due diligence and disclosure for conflict minerals: – companies must disclose whether they manufacture products containing 'conflict minerals' mined from the designated countries – the rules apply to private or foreign corporations that operate in the supply chain of a publicly listed US customer no matter how little they use – while they do not have SEC reporting obligations, many may need to provide documentation to their customers.	• Forcing data and aligning governance and compensation practices to meet new requirements may be both complex and disruptive. • SEC to consider a higher payment for whistleblowers who report internally first – allows companies the opportunity to investigate potential misconduct and self-report to authorities. • Companies must be able to trace and report on materials used in their supply chain and conduct due diligence on the origin of the minerals. • Complying with the due diligence requirements of the provision is unclear.	• Do you have the necessary data and process to produce new remuneration disclosures? • Have you assessed current compliance programs to ensure you promote a culture of compliance, with adequate internal whistleblowing procedures to raise concerns? • Do you operate in mines – and therefore adhere to US health and safety standards? • Do the company's Board and compensation structures align with enhanced requirements?

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