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Post-Election Changes and Their Impact on the Financial Services Industry: The Seven Deadly Sins

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During his first term, President Obama began an ambitious path of reforming the U.S. financial system with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Over two years later, however, many financial regulators are struggling to finalize many key rulemakings, including items such as the regulation of systemically important financial institutions and many foundational aspects of derivatives market reform. Nearly two-thirds of the rulemakings required by Dodd-Frank have not yet been finalized.

The re-election of President Obama for a second term has provided some certainty in the political players and that the Dodd-Frank Act will remain largely intact. With that certainty, Dodd-Frank Act implementation will continue to move forward apace, allowing the Obama Administration to more freely pursue and complete the controversial aspects of its financial services regulatory agenda. Financial regulators will also be encouraged to take up additional rulemakings outside of the Dodd-Frank Act, such as those required by the Jumpstart Our Business Startups Act. Discussed below are the impending, high-stakes regulations that will have a significant impact on the financial services industry – the "Seven Deadly Sins."

1. Designation of Systemically Important Financial Institutions

The Financial Stability Oversight Council (the "FSOC"), which is composed of the heads of the major financial regulatory agencies and several other nonvoting federal and state officials, is well underway with its chief mandate to designate certain nonbank financial companies as systemically important financial institutions ("SIFIs") for heightened supervision by the Federal Reserve. However, several major questions regarding the regulation of SIFIs remain unanswered, creating significant uncertainty.

Under the Dodd-Frank Act, the Federal Reserve has not yet finalized its proposed rule on the definition of "nonbank financial company," which defines the pool of companies from which a SIFI may be designated. Additionally, the Federal Reserve has not yet finalized the heightened standards applicable to designated SIFIs. SIFIs will most likely face restrictions on paying dividends, repurchasing common stock or other securities, or engaging in transactions that could affect capital. SIFIs will also most likely be subject to certain lending concentration limits, which may force a SIFI to restructure its current lines of business. Counterparties, shareholders, and creditors of potential SIFIs are also likely to be impacted by heightened SIFI regulation. As a result, SIFI designations will have enormous consequences for the entire marketplace, and not just a designated SIFI.

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2. Derivatives Reform

The Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") have made substantial progress in establishing the new, comprehensive over-the-counter derivatives market regulatory regime. Despite their efforts, however, some of the fundamental questions relating to derivatives reform remain unanswered. With potentially onerous registration, compliance, and reporting obligations becoming effective in early 2013, the list of open questions is particularly troublesome.

High on the list of unresolved issues is the Proposed Interpretive Guidance on the Cross-Border Application of the Swaps Provisions of the Dodd-Frank Act (the "Cross-Border Guidance"). The Cross-Border Guidance is intended to clarify who must comply with the U.S. derivatives regulatory regime, what those obligations may be, and if "substituted compliance" will allow a foreign participant to comply with domestic, rather than U.S., regulation.

Although the Cross-Border Guidance addresses some of these issues, there are significant concerns about the extent to which foreign entities will need to comply with U.S. derivatives regulation. Given this uncertainty, many firms have decided to reduce their trading volume with U.S. counterparties to avoid triggering required compliance with U.S. derivatives regulation. The CFTC has signaled a willingness to sit down with international regulators to revisit the Cross-Border Guidance and harmonize its proposal with the expectations of the international marketplace, but it also plans to release a finalized version of the Cross-Border Guidance within the next several weeks.

3. The Volcker Rule

On November 7, 2011, the Treasury Department, the Federal Reserve, the Federal Deposit Insurance Corporation, and the SEC proposed a rule to implement the "Volcker Rule," which prohibits banks from engaging in proprietary trading and ownership or sponsorship of a hedge or private equity fund. Regulators are continuing to receive comments on the Volcker Rule and have specified that compliance with the final rule will be required by July 21, 2014. Many banks are consequently spinning-off their proprietary trading desks to separate capitalized affiliates, resulting in a shift in counterparties from banks to hedge funds and changing the associated risk analysis.

Recent high-profile trading losses stemming from hedging practices have reignited Congressional interest in the issue. Democratic members of the Senate are urging for the swift completion of the Volcker Rule, but a key dispute over the definition of "market making" and the ability to invest in outside investment vehicles, such as hedge funds, has emerged between the banking regulators and the SEC. Complicating these tensions are competing "ringfencing" proposals being debated in the United Kingdom and in the European Union, which would legally separate retail banking divisions from certain risky proprietary trades.

4. The Foreign Account Tax Compliance Act

Global financial institutions are also grappling with implementation of the Foreign Account Tax Compliance Act ("FATCA"), which becomes effective in 2013. FATCA requires detailed disclosure of a U.S. person's bank account held by a foreign financial institution (a "FFI"). Non-financial foreign entities ("NFFEs") must also report their "substantial U.S. owners" to their withholding agents or certify that no U.S. ownership exists. Failure to comply with these reporting obligations would result in a 30% withholding tax on payments made to an account held by an FFI or NFFE.

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FATCA will usher in some of the most sweeping and expensive regulatory changes in tax compliance in recent history. To comply with these new reporting requirements, FFIs and NFFEs will need to significantly overhaul their technology, develop new protocols for account management and servicing, and be prepared for periodic audits from U.S. withholding agents. Given these substantial requirements, the Internal Revenue Service ("IRS") has recently pushed back the effective date for many FATCA obligations, such as due diligence requirements for existing account holders.

Opportunities exist for relaxing compliance with FATCA, but FFIs need to start collaborating with their home regulators now to receive this special treatment. Certain FFIs with home regulators that are considered "FATCA partners" may streamline their FATCA obligations and disclose the required information to their home regulators pursuant to an intergovernmental agreement between the United States and a FATCA partner. The IRS's recently released Model Intergovernmental Agreement will serve as the basis for future intergovernmental agreements.

5. Money Market Mutual Fund Reform

For over two years, leadership at the SEC debated systemic reform of the money market mutual fund ("MMMF") industry. Reform options included requiring MMMFs to adopt a floating net asset value or maintain capital buffers coupled with redemption restrictions to avoid "breaking the buck" in a future financial crisis. Facing stiff opposition from other commissioners, SEC Chairman Mary Schapiro announced August 22, 2012 that the SEC would not put forward its MMMF reform proposal for public comment.

Citing Chairman Schapiro's announcement and its unprecedented expansive authority, the FSOC has now announced proposed recommendations on MMMF reform. Currently, the reform options include requiring MMMFs to adopt a floating NAV or requiring the adoption of capital buffers coupled with delayed redemptions or additional investment restrictions and disclosure requirements. Outside of these proposals, the FSOC could also designate one or several MMMFs as SIFIs or decide to restrict MMMFs on a systemwide basis as a "payment, clearing, or settlement" activity. It could even decide to act through the Federal Reserve and impose restrictions on banking relationships with MMMFs.

The upcoming retirement of Chairman Schapiro also complicates the path of MMMF reform. Currently, only Commissioner and future Chairman Elisse Walter is expected to support the FSOC's proposed recommendations. This means that at least two other Commissioners would also need to accept the FSOC's proposed recommendations in order to move forward with MMMF reform. If a proposed recommendation is not accepted, the FSOC would presumably proceed with MMMF reform through its other statutory powers, such as SIFI designation.

With several options to choose from and little oversight of its actions, the FSOC will be a major player in future MMMF reform. However, it is possible that the SEC could make a strong case for reasserting its jurisdiction over the future of MMMF reform. That move would represent a compromise between concerns about the accountability of the FSOC and an acknowledgment that the SEC will remain committed to thorough MMMF reform.

6. The Fiduciary Duty Rules

In October 2010, the Department of Labor released a proposed rule to update the definition of the term "fiduciary" under the Employee Retirement Income Security Act ("ERISA"), which would subject a broad range of the financial services industry, including independent broker-dealers and registered investment advisers, to substantial liability under the "best interest" ERISA fiduciary standards. The

rule was subsequently withdrawn, but the Department of Labor has now indicated that a revised draft of the rule will be issued in 2013.

At the same time, the SEC may also decide to pursue harmonization of the fiduciary standards of registered investment advisers and broker-dealers. Section 913 of the Dodd-Frank Act allows for the SEC to propose new rules, as appropriate, to govern the fiduciary duties of registered investment advisers and broker-dealers, and a study pursuant to that section recommended a uniform standard. In late 2012, several special interest groups heavily lobbied Congress and the SEC for the application of a uniform fiduciary standard, and Chairman Schapiro recently indicated that a proposal may be issued in 2013. However, with Chairman Schapiro's departure in December 2012, this controversial rulemaking may be stalled until a new SEC Chairman is confirmed.

Broker-dealers and registered investment advisers need to be prepared to counter significant new challenges to their business operations. Congressional and regulatory outreach will be crucial in defining the scope and applicability of each proposal.

7. Financial Transaction Tax

U.S. policymakers have been debating the highly controversial imposition of a financial transaction tax ("FTT") on equity, debt, and derivatives transactions. France officially introduced an FTT in early August and over ten members of the European Union recently agreed to implement their own FTT beginning in 2013. In the U.S., multiple bills on this subject have been introduced and could gain traction in light of the current fiscal constraints and in the context of tax reform. International policymakers, especially in the European Union, may be willing to impose an FTT for the same reasons.

The imposition of an FTT in the United States may severely impact trading operations in the most active markets of the world. Regardless, given the current political climate, it is possible that a hastily-introduced FTT or other tax that does not consider the current tax burdens of multinational financial institutions gains momentum.

Next Steps

Looking forward, the Obama Administration has a full regulatory agenda that will have dramatic effects on the financial services industry. Congress is expected to continue exercising its oversight over these rulemakings, but there is no guarantee that Congress will prevent financial regulators from committing one of the Seven Deadly Sins on its own. The only way for the financial services industry to shape the rules and mitigate their impact is to get and stay engaged with the regulators, Congress, and, if necessary, the courts.

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