

## **How Dodd-Frank and Other New U.S. Laws Affect Non-U.S. Financial Institutions**

The United States increasingly is exercising jurisdiction over non-U.S. financial institutions, even where the activities of those companies take place entirely outside the United States. Given the potentially severe consequences of violations of these laws, it is essential that all non-U.S. financial firms make themselves aware of the extraterritorial affects of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act and the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010.

### ***I. The Dodd-Frank Wall Street Reform and Consumer Protection Act***

It is well understood by non-U.S. headquartered banks, securities broker/dealers, insurance companies, as well as any other non-bank foreign financial companies (“Foreign Financial Firms” or “FFFs”) that the Dodd-Frank Act (“Act”) will substantially impact their U.S. operations going forward. These firms are in many ways treated much the same as domestic financial services firms whose activities are already, or soon will become, subject to additional capital requirements, prudential regulation or general oversight by the Federal Reserve Board (“Fed” or “Board”), the U.S. Securities and Exchange Commission (“SEC”), or the Commodity Futures Trading Commission (“CFTC” and together with the Board and the SEC, “Federal Regulators”).

What is less well understood is how the Act will also impact Foreign Financial Firms’ non-U.S. conduct involving: (i) contact with U.S. investors; (ii) activities in the U.S. financial markets generally; and (iii) non-U.S. “financial” activities if such activities are deemed to have a “substantial impact on the United States financial system.” It will be some time before implementing regulations are finalized and the full scope of the Act’s extraterritorial reach becomes clear. Nevertheless, it is already apparent that there are some areas where Foreign Financial Firms should focus their attention and concern. Properly managing the new compliance risks and potential legal liabilities arising from this sweeping new grant of authority will require consultation with competent U.S. counsel.

## **1. Federal Reserve Supervision of Certain Foreign Nonbank Financial Companies that are Systemically Significant Financial Institutions**

With passage of legislation in the early 1990s to resolve the savings and loan crisis, Congress sought to eliminate the notion that no depository institution is too big or too important to be allowed to fail. With the Fed-coordinated recapitalization of Long Term Capital Management in 1998, and the collapse of brokerage firms and several government-led bailouts of other large financial companies in 2008, it became apparent that even a nonbank financial company (“NBFC”) could in fact be too “interconnected” or “systemically significant” to be allowed to fail.

With the Dodd-Frank Act, Congress is once again attempting to address the “too-big-to-fail” problem. This time around, Congress has established a regime whereby any systemically significant NBFC or large bank holding company (including an FFF) can be identified in advance and then monitored and regulated on a prudential basis by the Board. The objective is to ensure that any institution or product posing a significant systemic risk will be identified upfront. When a “grave” risk is identified, an NBFC can be ordered to cease the risky activities or face forced divestiture of one or more risky subsidiaries or affiliates. Anointed with this auspicious responsibility to identify such risks is a new quasi-regulator, the Financial Stability Oversight Council (“FSOC”).

Given the supervisors’ failure to identify in advance the systemic risks posed by AIG’s activities in the credit default swaps and securities lending markets, it is not surprising that the Act’s principal target is NBFCs, including those FFFs active in U.S. markets and not otherwise subject to effective and comprehensive regulation by a foreign financial regulator. Under the Act, the FSOC can determine that a NBFC shall be supervised by the Board and subjected to higher prudential standards so long as the FSOC first determines that the “material financial distress or failure” of the company, or the company’s “nature, scope, size, scale, concentration, interconnectedness, or mix of activities” could pose a threat to the U.S. financial system. However, the FSOC’s authority to subject NBFCs to Board regulation is limited to those NBFCs that are “predominantly engaged in financial activities” as defined in section 4(k) of the Bank Holding Company Act. Under this standard, a company is considered “predominantly engaged in financial activities” if at least 85 percent of its consolidated annual gross revenues are derived from, or 85 percent of its consolidated assets are related to, activities that are financial in nature.

Section 113(b) of the Dodd-Frank Act also grants the Board authority to supervise certain *foreign* nonbank financial companies (“Foreign NBFC”), which are defined to include companies that are (i) incorporated or organized outside of the United States; and (ii) predominantly engaged in financial activities. The Act gives the Board responsibility for providing more specific guidance on the sorts of foreign financial activities that will render FFFs eligible to be deemed Foreign NBFCs and thus subject to Board oversight. The Act grants the Board specific authority to recommend that the FSOC designate a FFF as a Foreign NBFC upon a finding that material financial distress at the FFF (or the nature, size, scope, or interconnectedness of the FFF) poses a threat to the U.S. financial system. Once designated, the company becomes subject to supervision by the Board and must comply with any prudential, risk based capital requirements and other regulations promulgated by the Board under its new authority.

A determination by the FSOC that a Foreign NBFC should be supervised by the Board will involve a weighing the following factors:

- (i) The extent of the leverage of the company;
- (ii) the extent and nature of the company's U.S. related off-balance sheet exposures;
- (iii) the extent and nature of company's relationships with other systemically significant nonbank financial companies and systemically significant bank holding companies;
- (iv) the importance of the company as a source of credit for U.S. households, businesses, and State and local governments, and as a source of liquidity for the U.S. financial system;
- (v) the importance of the company as a source of a credit for low-income, minority or underserved communities in the United States and the impact that failure of the company would have on the availability of credit in these communities;
- (vi) the extent to which assets are managed rather than owned by the company and the extent to which ownership of those assets is diffuse;
- (vii) the nature, size, scale, and interconnectedness of the activities of the company;
- (viii) the extent to which the company is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority;
- (ix) the amount and nature of the company's U.S. financial assets;
- (x) the amount and nature of the liabilities of the company used to fund activities and operations in the United States; and
- (xi) any other risk-related factors that the FSOC deems appropriate.

Needless to say, the FSOC and the Board have been granted substantial discretion under the Act to reach a determination that a particular FFF's financial activities are so significant as to necessitate that it become subject to this special U.S. supervisory regime.

## 2. Extraterritorial Reach of Section 10b of the 1934 Act and *Morrison v. National Australia Bank Ltd.*

In June 2010, while Congress was in the final stages of passing the Act, the U.S. Supreme Court ruled in *Morrison v. National Australia Bank Ltd.* that Section 10b<sup>1</sup> of the Securities Exchange Act of 1934 (“Exchange Act”) does not reach manipulative or deceptive conduct unless such conduct is in connection with (a) the purchase or sale of a security listed on a national exchange, or (b) the purchase or sale of a security in the United States. The decision, in essence, overruled several previous cases holding that a 10b action could be brought in the United States if it was premised on either significant conduct in the United States or an effect on U.S. securities markets. Congress responded immediately to this decision by giving the SEC additional authority to bring actions to enforce the antifraud provisions of the federal securities laws in a manner that rolls back *Morrison*. The Act provides that:

district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of section 17(a) involving: (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

Representative Paul Kanjorski, who authored this language, stated in his floor comments that it was intended to rebut the presumption against territoriality. While most commentators agree that this provision effectively reversed the Supreme Court’s decision in *Morrison*,<sup>2</sup> at least one has questioned whether this provision has indeed extended the application of anti-fraud provisions to outside the United States.<sup>3</sup> While the Act does not affect the application of *Morrison* to private Section 10b actions, it does require the SEC to evaluate whether Congress should restore the conduct and effects tests in private actions to enforce the antifraud provisions of the Exchange Act.

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<sup>1</sup> SEC Rule 10b-5 states that it is unlawful:

for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange: (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 CFR §240.10b-5 (2009).

<sup>2</sup> Bork, *Dodd-Frank Financial Reform Act*, available at <http://www.mondaq.com/unitedstates/article.asp?articleid=108352>.

<sup>3</sup> Conway, George T., *Extraterritoriality After Dodd-Frank*, The Harvard Law School Forum on Corporate Governance and Financial Regulation, available at <http://blogs.law.harvard.edu/corpgov/2010/08/05/extraterritoriality-after-dodd-frank/>

### **3. Foreign Subsidiaries Deemed Covered Financial Institution under the Act's New Special Insolvency Regime**

Title II of the Act subjects certain “financial institutions” to the possibility that they could be subjected to an orderly liquidation pursuant to special resolution authority granted to the Federal Deposit Insurance Corporation under the Act. Section 201 grants the Secretary of the Treasury authority to authorize the FDIC to bring a special emergency proceeding in a federal court in connection with any “financial institution.” The Act defines the term “financial institution” very broadly to include any organization that is incorporated or organized under any provision of federal law or the laws of any State and that is a bank holding company, NBFC or a company engaged in activities that are “financial in nature.” Section 203 of the Act, specifically refers to situations “*in which the largest United States subsidiary ...of a financial company is a broker or dealer ...or in which the largest United States subsidiary of a financial company is an insurance company.*”

Foreign companies that own or control a significantly sized U.S. subsidiary engaged in activities that are financial in nature need to evaluate whether the subsidiary could become subject to the orderly liquidation process provided for by the Act. More importantly, foreign banks should already be consulting with competent U.S. counsel regarding the credit risk management implications of this change in the relevant bankruptcy law and whether any existing secured credit facilities and syndicated loans in which the bank is a participant could face unanticipated losses should the borrower become subject to such a proceeding.

### **4. Non-U.S. Swaps Activities Subject to SEC or CFTC Jurisdiction and Requirement to Register as a Swap Dealer, Major Swap Participant or Swap Execution Facility**

Title 7 of the Act provides a comprehensive grant of regulatory authority to the CFTC and the SEC whereby previously exempt over-the-counter (“OTC”) markets for bilaterally negotiated swap transactions in the U.S. will become subject to mandatory trading and clearing requirements. Title 7 will have a substantial impact on the many foreign financial firms active in the U.S. OTC derivatives markets.

As with pre-existing provisions in the Commodity Exchange Act (“CEA”), the Act exempts from its mandatory licensing and registration regime certain OTC swaps activities conducted outside the U.S. and activities of foreign firms not directed at U.S. markets or U.S. persons. The Act states that it does not apply to swaps-related activities outside the U.S. provided such activities neither (i) have a direct and significant connection with activities in, or effect on, commerce in the U.S., nor (ii) contravene any CFTC rules or regulations designed to prevent the evasion of the Act. However, Title 7 of the Act does contain several provision specifically targeted at FFFs and other provisions that are ambiguous as to their application to foreign firms. For instance, Section 715 of the Act provides the CFTC and SEC with authority to prohibit an entity domiciled in a foreign country from participating in the United States. in any swaps or security-based swap markets if it is determined that the regulation of swaps or security-based swaps markets in the foreign country undermines the

stability of the United States financial system. It remains unclear how the CFTC will exercise this broad grant of discretion.

Likewise, the Act amends Section 4s of the CEA to make it “unlawful for any person to act as a swap dealer unless ... registered ... with the Commission” and “unlawful ... to act as a major swap participant unless ... registered ... with the Commission.” However, it is unclear how these prohibitions apply to FFFs engaged in such activities outside the U.S. because the CFTC is not expressly granted authority over swap dealer desks located in London and other “off-shore” locations, or over foreign domiciled swap dealers and market participants already subject to comparable supervision by a foreign regulator. In contrast, the CFTC is expressly authorized to exempt swap execution facilities from the registration requirements if it finds that they are:

subject to comparable, comprehensive supervision and regulation on a consolidated basis by the SEC, [another Federal Regulator] or “the appropriate governmental authorities in the home country of the facility.

Hopefully, given the CFTC’s authority under the Act to further define the term “swap dealer” and major swap participant,” and its general exemptive authority under section 4c of the CEA; additional clarification as to the extraterritorial scope of these registration requirements will be provided when draft implementing regulation are released by the CFTC and the SEC.

#### **5. Grandfathered Foreign Controlled Unitary Savings Companies may be Required to Conduct their U.S. Activities through an Intermediate U.S. Holding Company**

Section 626 of the Act amends the Home Owners’ Loan Act to provide that if a grandfathered unitary savings and loan holding company conducts activities other than financial activities, the Board may require the company to establish and conduct some or all of these activities through an intermediate holding company. Such an intermediate holding company would be required to register with the Board as a savings and loan holding company established pursuant to regulations of the Board. Also, the Board may require the grandfathered unitary savings and loan holding company to establish an intermediate holding company if the Board determines that such establishment is necessary to (i) appropriately supervise activities determined to be financial activities, or (ii) ensure that supervision by the Board does not extend to outside financial activities. Foreign entities that own or are considering acquiring a grandfathered unitary savings and loan holding companies could be affected by this requirement.

#### **6. Certain Foreign Private Investment Fund Advisers may be Required to Register as Investment Advisers with the U.S. Securities and Exchange Commission**

Section 203(b) of the U.S. Investment Advisers Act of 1940, as amended (the “Advisers Act”), provides certain exemptions from the requirement to register as an investment adviser with the SEC. As written prior to the amendments made by the Dodd-Frank Act, Section 203(b) of the Advisers Act did not distinguish between U.S. and non-U.S. investment advisers. Accordingly, a

non-U.S. adviser seeking to avoid registration as an investment adviser with the SEC typically relied on the primary exemption which generally provided that an adviser having fewer than fifteen (15) clients within a rolling twelve-month period would not have to register. Section 403 of the Act amended the Advisers Act by removing the primary exemption in Section 203(b) and inserting in its place a specific exemption for a “foreign private adviser”, which is defined as an investment adviser that:

- has no place 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 aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment advisor of less than \$25 million (or such higher amount as determined by the SEC); and
- neither holds itself out to the public in the United States as an investment adviser, nor acts as an investment adviser to a registered investment company or a business development company.

The inclusion of language in the definition referring to both “clients” and “investors in the United States in private funds” appears to be intended to prevent an adviser from relying on Rule 203(b)(3)-1 promulgated under the Advisers Act, which generally allows a private fund to be considered a single “client” for purposes of Section 203(b)(3) in determining whether it satisfies the definition of “foreign private adviser”. As such, the clear intention of the “foreign private adviser” definition is to “look through” an investment fund to determine the number of its underlying investors.

In summary, if a non-U.S. investment fund sponsor or manager can satisfy all of the components of the definition of a “foreign private adviser”, then it will be exempt from the requirement to register as an investment adviser with the SEC. However, the inability to satisfy all any component will require a non-U.S. firm to register. This is particularly important because the jurisdiction of the investment fund’s organization or registered office is immaterial with respect to the application of the exemption – it can be a U.S. fund or an offshore fund.

## ***II. Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010***

### **Non-U.S. Financial Institutions can be Deprived of Access to the U.S. Financial System under the new Iran Sanctions Law**

On July 1, President Obama signed into law the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (the “Act”). This Act significantly expands the list of activities that can subject non-U.S. financial institutions to potential U.S. sanctions. Foreign banks and financial institutions that engage in transactions with Iranian banks, companies or individuals

that have been designated by the U.S. Government as assisting in Iran's efforts to obtain weapons of mass destruction or Iran's support for organizations the U.S. Government has designated as terrorists can be denied access to the U.S. financial system through new restrictions placed on correspondent accounts in the United States.

Section 104(c) of the Act requires the Treasury Department to adopt regulations that prohibit or impose strict conditions on the opening or maintaining in the United States of a correspondent account or a payable-through account for foreign financial institutions that engage in any of the following transactions:

- (i) "Facilitating" efforts of the Government of Iran to acquire or develop weapons of mass destruction or delivery systems for weapons of mass destruction;
- (ii) "Facilitating" efforts of the Government of Iran to provide support for organizations designated by the U.S. Government as terrorist organizations;
- (iii) "Facilitating" activities of persons subject to financial sanctions pursuant to UN Security Council resolutions;
- (iv) Engaging in money laundering to carry out any of the preceding activities;
- (v) "Facilitating" efforts by the Central Bank of Iran or any other Iranian financial institution to carry out any of the preceding activities;
- (vi) "Facilitating" transactions of Iran's Revolutionary Guard Corps ("IRGC"); and
- (vii) "Facilitating" transactions of a financial institution whose property in the U.S. is "blocked" because of its support for Iran's proliferation of weapons of mass destruction or support for terrorism.

A U.S. financial institution that violates these regulations is subject to penalties. A foreign financial institution that "causes" a U.S. financial institution to violate these regulations is likewise subject to penalties, including fines and prison sentences.<sup>4</sup>

The U.S. Treasury Department's Office of Foreign Assets Control ("OFAC") has designated a number of Iranian banks under its sanctions programs relating to weapons of mass destruction or terrorism programs, including: Bank Saderat, Bank Sepah, Bank Mellat, Bank Melli, Persia International Bank, Bank Kargoshaee, Future Bank (Bahrain), Export Development Bank of Iran, and the Post Bank of Iran. OFAC has not yet designated the Central Bank of Iran, though it remains a possibility. Under Section 104(c) of the bill, a non-U.S. financial institution becomes subject to sanctions if it "facilitates" transactions on behalf of any of these listed banks. The term "facilitation" is broadly interpreted by OFAC and other U.S. enforcement authorities. Thus, any

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<sup>4</sup> This potential liability is explicitly provided for in Section 104(c)(3) of the Act. In like manner, non-U.S. banks could become subject to massive penalties if they engage in any of the activities identified in Section 104(c) of the bill.

transaction by a non-U.S. financial institution with one of the listed banks could lead to the closing of all of its correspondent and payable-through accounts in the United States and also render it subject to investigation and possible U.S. penalties.

The new law greatly increases the power of U.S. authorities to take severe action against non-U.S. institutions that are viewed as thwarting U.S. sanctions policies against Iran. Even before its enactment, the United States had shown its willingness to impose heavy monetary penalties on foreign financial institutions. In the recent past, U.S. enforcement authorities have imposed massive penalties against Lloyds TSB, Credit Suisse and ABN AMRO (now the Royal Bank of Scotland). These banks were subjected to penalties in the hundreds of millions of dollars for activities undertaken entirely outside of the United States. Specifically, the non-U.S. branches of these banks were accused of “stripping” information about the Iranian source of funds routed to or through the U.S. financial system. In each case, the penalties were imposed because the non-U.S. banks “prevented” U.S. financial institutions from fulfilling their obligations under U.S. regulations to properly screen the funds transfers. Barclays was similarly fined almost \$300 million under a deferred prosecution agreement in August 2010. In the future, such non-U.S. institutions could not only face fines but the ruinous consequences of being barred from access to the U.S. financial markets, even if none of their activities with the proscribed Iranian entities touched the United States in any way.

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