Discussion Paper EFMLG Meeting, Dublin 22 March 2011
(Miki Prokop, ING)

<u>Extraterritorial effects of Dodd-Frank Act on the EU domiciled banks.</u>

Introduction

Dodd-Frank Act aims at full-fledged reform of the US financial sector; it states that its key objective is

> "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ''too big to fail'', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes".

There are questions how Dodd-Frank Act affects EU-domiciled banks. Two distinct issues are presented here: (i) Title VII requirements and EU domiciled banks and (ii) extraterritorial expansion of the US private liability regime.

Case 1: Title VII requirements (swaps) and EU domiciled banks

1.1. Territorial scope of Dodd-Frank Act

The extraterritorial scope of Dodd-Frank Act may seem at the first blush to be limited. Under Section 722 of Dodd-Frank Act, the regulation of swaps under Commodities Exchange Act as amended by Dodd-Frank Act

> "shall not apply to activities outside the United States unless those activities (1) have a <u>direct and significant connection with activities in, or effect on, commerce of the United States</u>; or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the <u>evasion</u> of any provision of [Commodities Exchange Act enacted by Dodd-Frank Act]."

Under Section 772 of Dodd-Frank Act, the regulation of security-based swaps under Securities Exchange Act as amended by Dodd-Frank Act

> "shall [not] apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of any provision of [Securities Exchange Act as amended by Dodd-Frank Act].'

However the questions remain as to application of these rules on various obligations under Dodd-Frank Act.

1.2. Registration and organizational requirements

CFTC has provided for some guidance in proposed rules on the Registration of Swap Dealers and Major Swap Participants[1] where it states that

> “a person whose swap dealing activity has no connection or effect of any kind, direct or indirect, whether through affiliates or otherwise, to U.S. commerce would not be required to register as a swap dealer. […] The Commission generally would not require a person to register as a swap dealer if their only connection to the U.S. was that the person uses a U.S.-registered swap execution facility, designated clearing organization or designated contract market in connection with their swap dealing activities, or reports swaps to a U.S.-registered swap data repository. On the other hand, a person outside the U.S. who engages in swap dealing activities and regularly enters into swaps with U.S. persons would likely be required to register as a swap dealer.”

CFTC also consults

> “what level of swap dealing activity outside the U.S. would qualify as having a direct and significant connection with activities in or effect on commerce of the U.S., thereby requiring a person outside the U.S. to register as an [Swap Dealer]. In particular, in view of the global nature of the swap markets and the ability to transfer swap-related risks within affiliated groups, [CFTC consults] when swap dealing activity with or by non-U.S. affiliates of U.S. persons has a ‘direct and significant connection with activities in, or effect on’ U.S.”

The swap dealer[2] and major swap dealer[3] registration requirements are also bound with the organizational requirements (capital, margining, risk management etc.) which come along with such registration. Falling within such registration and organizational requirements may expose EU-domiciled banks to a double regulation (home and US). Question also remains how these rules will apply in cases when transactions are entered through an US branch of EU-domiciled bank or between EU-domiciled bank and its US affiliate.

1.3. Transactional requirements of Dodd-Frank Act

Dodd-Frank Act introduces several transactional requirements for swaps – in particular swap reporting requirements, transaction recordkeeping, collateral segregation requirements and mandatory organized trading and clearing requirements.

Again the situations in which an EU-domiciled bank should comply with transactional requirements are not completely clear. This applies to

---

[1] 75 Fed. Reg. 71379

[2] Defined by Dodd-Frank Act as “any person who (i) holds itself out as a dealer in swaps, (ii) makes a market in swaps, (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.”

[3] Defined by Dodd-Frank Act to include: persons whose swap positions exceed thresholds established for the “effective monitoring, management, and oversight of entities that are systemically significant or can significantly impact the financial system of the United States” or whose “outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets”

transactions which are entered directly with the US counterparties but also with US affiliates of EU-domiciled bank or transactions entered via its US branch. In addition, in absence of information on mutual recognition of trade repositories, multilateral trading facilities and clearing houses there is a potential conflict between EMIR, MiFID and Dodd-Frank Act.

Case 2: Extraterritorial expansion of the U.S. private liability regime

Dodd-Frank empowers SEC to conduct a study to determine the extent to which private rights of action under the antifraud provisions of the Securities and Exchange Act are to be extended to cover

> (1) conduct within the United States that constitutes a significant step in the furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; and
> (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

This clearly establishes strong extraterritorial effects of Securities and Exchange Act and exposes investment services providers to US litigation, including class-action law suits. Same conduct may be therefore subject to two litigations, one in the country where a securities transaction occurs and one in the US.