The Sun Never Sets on Dodd-Frank

April 17, 2012

I. Is Dodd-Frank Light From a City on a Hill?

When Dodd-Frank (more formally, the Wall Street Reform and Consumer Protection Act) was adopted, the legislation was advertised as a legal blueprint that, although proudly stamped "Made in America," would serve as a light of financial safety as to derivatives, bank activities, and like matters for the entire world. The global commercial and financial community was assured that a cooperative, consistent, and rational scheme of regulation would be adopted in financial capitals across the world, from Afghanistan to Zimbabwe, all based closely (maybe even word-for-word!) on translations of Dodd-Frank.

This has not happened. It is not going to happen. It was never going to happen. In fact, the initial proposed version of the regulations implementing the "Volcker Rule" created a wave of public protests—not just from private institutions—but from financial regulators outside the United States.

There are a number of reasons that Dodd-Frank is not a model of international financial regulation:

- First, the haste with which Dodd-Frank was adopted meant that very little consideration could be given even as to its domestic effects, much less as to how it might affect either (i) international (cross-border) commerce and finance or (ii) wholly non-U.S. commerce and finance. [1]

- Second, as much as Dodd-Frank makes life difficult for commercial and banking enterprises in the United States, its impact on non-U.S. enterprises is worse. (While there may be a case for our domestic laws favoring our domestic businesses, at some point we cross a line in our

[1] Various news stories have reported that the legislation, as to which there was virtually no prior study, was ultimately adopted in an all-night drafting session, with enormous changes made at the last minute. *See, e.g.,* http://www.cnbc.com/id/37919120. As I have previously observed, Dodd-Frank is replete with (what I believe to be) errors of various kinds, both conceptual and drafting errors, including quite serious ones. *See, e.g., "What is a Swap?"* (http://www.cadwalader.com/assets/client_friend/041212WhatIsASwap.pdf) (pointing out that the most significant definition in all of Dodd-Frank is impossibly and mistakenly overbroad, and that there appears no way to fix the problem absent corrective legislation).

treatment of non-U.S. enterprises that offends notions of fairness and hinders a global economy.)

- Third, it seems to ignore the legitimate governmental authority of non-U.S. financial regulators to establish rules for their domestic institutions.

II. Some Examples of Cross-Border Issues

Below are a number of aspects of Dodd-Frank that are problematic as a matter of cross-border regulation. (Many are also problematic as a matter of domestic regulation.)

A. Lincoln Amendment. Section 716 of Dodd-Frank generally prohibits banking institutions in the United States from registering as swap dealers. A carve-out is provided that allows U.S. banks to act as swap dealers in interest rates and currencies. No similar carve-out is provided for non-U.S. banks. In the aftermath following the adoption of Dodd-Frank, (now former) Senator Lincoln engaged in a "colloquy" with (now former) Senator Dodd that was roughly to the following effect: "Whoops." In short, everyone agreed that the failure of the Lincoln Amendment to allow domestic branches of offshore banks to deal in interest rates and currencies was a significant mistake, including the author of the amendment. This mistake has not been corrected.

B. Dealer Definition. The definition of "swap dealer" in Dodd-Frank excludes a U.S. bank that enters into interest rate swaps in connection with its grant of a loan, but does not provide the same exemption to non-U.S. banks.

C. Cross-Border Trades. It is generally assumed that for international financial trade to function smoothly, regulated entities in each jurisdiction must be able to trade with regulated entities in other jurisdictions without each being required to register, and be regulated, in the other's jurisdiction. By way of example, Rule 15a-6 under the Securities Exchange Act permits a U.S. SEC-registered broker-dealer to trade with a U.K. FSA-registered broker-dealer without the U.S. broker-dealer registering with the FSA or the U.K. broker-dealer registering with the SEC. Dodd-Frank does not provide any similar exemption for non-U.S. swap dealers. Accordingly, a European or Asian swap dealer that enters into swaps with registered and fully regulated U.S. swap dealers would itself be at risk of having to be registered in the United States. This clearly will negatively impact international trade and is not a precedent that the United States would like to see followed by other governments. That is, it would not be in the interests of the United States if a U.S. swap dealer were required to register, and be regulated by, European authorities simply because the U.S. swap dealer had traded with a European swap dealer.

D. Dealing in non-U.S. Sovereigns By Non-U.S. Banks. The Volcker Rule permits a U.S. bank, operating outside the United States, to be a dealer in U.S. government securities, but does not permit a non-U.S. bank operating in the United States to be a dealer in the securities of its home jurisdiction.

E. Regulation of Non-U.S. Entities that Are Not Banks. Title II of Dodd-Frank presumes to give the United States the power to regulate nonbank financial companies if the U.S. government judges that "financial distress" of such firms could cause a "threat to the financial stability of the United States." One would assume that this power would never be used; if the U.S. economy were in such weak shape that the failure of a foreign company could threaten its financial stability then our problem would be large indeed. Nonetheless, even the assertion of such a power sets a bad precedent – this is not a power that the United States would want other countries to assert against U.S. corporations. In this regard, it should be noted that it is far more likely that the failure of a U.S. corporation could be asserted to injure another country than the opposite.

F. Scope of U.S. Jurisdiction. Under Section 722 of Dodd-Frank, the U.S. government purports to have the authority to regulate non-U.S. activities that have a "direct and significant connection with activities in" or "effect on commerce of" the United States. The exercise of the power is not dependent upon there being any misconduct; *e.g.*, the assertion of authority is not dependent upon there being, for example, fraudulent conduct or price conspiracies. It simply depends upon the non-U.S. activity having an effect on the United States. Unlike the power to regulate non-U.S. non-banks, it is not so clear that this power would not be used. For example, in the various hearings on the international reach of Dodd-Frank, the CFTC seemed to hold open the possibility that it could regulate two non-U.S. entities trading (in a non-criminal manner) in a "commodity" (such as a physical asset, like oil) that is important to the United States. Again, this is an assertion of authority that we in the United States would resent it if another country were to assert as to economic activity in the United States, and our assertion of such an authority is not be a precedent that we would want followed.

G. Holding Collateral. Any collateral held in connection with a swap must be held by a "futures commission merchant" registered with the U.S. CFTC: for example, an entity such as MF Global, the recently failed FCM as to which over a billion dollars are still unaccounted for. In the hearings as to the failure of MF Global, representatives of the CFTC testified that the CFTC does not have any examiners inspecting the custody arrangements of registered FCMs. Therefore, as a non-U.S. entity (or non-U.S. regulator), one wonders: is it better to have my collateral held at a major European or Asian bank or is it better to have my collateral held at a U.S. FCM whose custody arrangements are not inspected by the U.S. regulators? Many non-U.S. entities would prefer that their collateral be held by a regulated bank. Unfortunately, this is not permitted under the U.S. rules.

H. Buy U.S. Bonds. Cash collateral held at CFTC-registered FCMs may be invested in bonds issued by the U.S. government and states, cities and towns and other governmental entities located in the United States, but not in obligations of governmental entities outside the United States. This seems neither fair, if we expect U.S. regulation to establish a model for non-U.S. entities, nor does it seem prudent. *The New York Times*, for example, has reported that many local governmental entities in the United States are in serious financial trouble; and yet the obligations of these entities are permissible investments for FCMs, while national sovereign debt of other countries, including G-8 countries, is not.

I. Capital Regulation. The capital of swap dealers in the United States will be regulated by the CFTC, despite the fact that the CFTC has acknowledged that it does not have the financial expertise to oversee the use of financial models. To deal with this lack of expertise, the CFTC has said that it will permit the use of financial models by entities whose capital requirements are overseen by the U.S. banking regulators (which does have the relevant expertise). However, all subsidiaries and affiliates of non-U.S. banks must comply with the capital requirements of the CFTC (without models), which will likely subject them to a significant competitive disadvantage as against the non-bank subsidiaries of U.S. bank holding companies.

J. Organizational Structure. Dodd-Frank requires that the compliance officer of a swap dealer with responsibility for compliance with the rules under the U.S. Commodity Exchange Act report directly either to the governing board of the swap dealer or to its chief executive officer. Most of the non-U.S. entities that will be required to register as swap dealers under Dodd-Frank will be major non-U.S. banks. These banks generally will be of a type that do business in many different countries and are subject to many laws in each country. The Board and CEO of these banks bear some responsibility for these many laws (which include some important ones, like banking regulation, financial reporting, AML, paying taxes), not to mention responsibility for business issues, such as raising capital and other strategic issues. Is it good policy to require that the individual responsible for compliance with a single U.S. law must have a direct reporting line to the Board/CEO? Is that a sensible measure of the significance of this law?

K. Register Now, Tell You the Regulations Later. The CFTC seems to be inclined to require non-U.S. banks to register with the CFTC before the CFTC decides whether, or to what extent, trades of the non-U.S. banks with non-U.S. persons will be regulated by the CFTC. This manner of conducting regulation seems wrong, as a matter of basic equity. (The SEC does not appear to intend to proceed in this manner.)

III. Conclusion

The purpose of this memorandum is to describe a few, certainly not all, of the provisions of Dodd-Frank that are inequitable in their treatment of non-U.S. institutions doing business in the United States, and that the United States ought not to wish to establish as precedent for global financial regulation. Further, many of the provisions described in this memorandum are significantly flawed, even as applied to U.S. financial institutions.

Nonetheless, there are steps that non-U.S. institutions, and non-U.S. regulators, should take as various provisions of Dodd-Frank come near effect. First, there is benefit in commenting to the various U.S. regulators on the rules. Clearly, the comments of non-U.S. regulators and institutions on the Volcker Rules caused a rethinking of the proposed implementing regulations. While many problems of Dodd-Frank require corrective legislation, there is also much that the regulators can do. For example, the decision of the SEC to delay the implementation of its swap dealer registration requirements until there has been a determination of the extra-territorial application of the rules seems the right decision; and one that the CFTC could follow.

Beyond that, non-U.S. institutions must consider their obligations to comply with these provisions of Dodd-Frank that will directly affect them, regardless of whether those provisions appear appropriate. The most significant provisions in this regard are the Volcker Rule (limiting proprietary trading by banks, as well as relationships between banks and private funds); swaps regulation; and the regulation of advisers that manage funds or individuals trading in securities, futures, or swaps.

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Please feel free to contact Steven Lofchie if you have any questions about this memorandum.

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