

## Financial Regulation (Click on a title below to read the article.)

- 43 [Implementation of the Volcker Rule](#)
- 44 [The New Swap Regulatory Regime](#)
- 46 [Financial Holding Companies in the 'Penalty Box'](#)
- 47 [Developments in U.S. Consumer Financial Litigation and Enforcement](#)
- 48 [Implementation of the EU Alternative Investment Fund Managers Directive](#)
- 51 [The EU Proposal for Financial Transactions Tax](#)
- 54 [The Vickers Report: UK Proposal to 'Ring-Fence' Banking Operations](#)

The financial crisis has brought about profound changes in the regulatory environment for financial institutions and other capital markets participants. These changes have been influenced not only by national factors and local political considerations, but also by the increasingly interconnected nature of the global financial system.

In the United States, implementation of many key provisions of the Dodd-Frank Act<sup>1</sup> will very likely remain contentious. Both political parties regard financial regulation and the role of Wall Street as key issues for the presidential and legislative elections in November 2012. The political implications and uncertain outcome of the elections will make it difficult for U.S. financial regulators to fill key posts, secure budget increases or establish a long-term strategic direction in the coming year. Internationally, market participants, regulators and governments are struggling with the continuing eurozone crisis and its fundamental implications for the future of a European economic, currency or fiscal union.

In this discussion, we highlight selected financial regulatory topics that will affect financial institutions and other capital markets participants in 2012. Other sections of this compendium address additional topics that will be of interest to financial institutions, including aspects of Basel III (see “Capital Markets/The Practical Impact of Basel III and Dodd-Frank on Loan Agreements”) and the so-called “living will” requirement for large banking organizations and other systemically important financial companies (see “Corporate Restructuring/‘Living Will’ Contingency Planning Required for Certain Financial Institutions”).

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<sup>1</sup> Enacted on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was the principal legislative response to the financial crisis in the United States. Its provisions will affect almost every area of U.S. financial regulation. Skadden is monitoring its implementation at <http://www.skadden.com/Index.cfm?contentID=52&search=Dodd-Frank>.

## Implementation of the Volcker Rule

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The Volcker Rule (Dodd-Frank Act § 619(a)) is a key element of the Dodd-Frank Act. It prohibits covered banking entities from engaging in proprietary trading and from acquiring or retaining an ownership interest in, or sponsoring, hedge funds or private equity funds, subject to certain enumerated exceptions. In October 2011, a number of U.S. financial regulatory agencies issued a joint notice of proposed rulemaking to implement the Volcker Rule. (For a detailed review of the proposed regulations and their implications, please see our recent report, "[Dodd-Frank Rulemaking: Volcker Rule and SIFI Proposals](#).")

The proposed regulations establish a framework to distinguish prohibited trading activity from permitted activities, such as those related to market making, underwriting and hedging. Covered banking entities wishing to engage in permitted activities would be required to satisfy a number of conditions, including conditions based on the types of revenues that the activities generate, the scale of the activities in relation to expected near-term customer demand, and the criteria used to determine the compensation provided to individuals who conduct the activities. Covered banking entities also would be subject to extensive recordkeeping and reporting requirements and, for certain activities, specific requirements with respect to internal compliance procedures.

The proposed Volcker Rule regulations are accompanied by questions and requests for public comment on hundreds of topics, covering virtually every aspect of the regulations. The agencies are required to implement a phased schedule of conformance to the Volcker Rule requirements beginning on July 21, 2012.

The complexity of the proposed Volcker Rule regulations may undermine their effectiveness. Prohibited proprietary trading is distinguished from permitted activities based on conceptual rules that are, in many important respects, imprecise and abstract. The rules may discourage banking entities from providing services, such as market making, to which the drafters of the Dodd-Frank Act ascribed social utility while, at the same time, allowing for circumvention (or "gaming") of the intended prohibitions.<sup>2</sup> The economic costs of the rules, such as costs arising from concentration of bank revenue sources, may outweigh their benefits. Industry observers continue to identify potential unintended consequences, such as reduced aggregate demand for securities that banking entities will be prohibited from trading, including non-U.S. sovereign debt (e.g., bonds issued by eurozone governments) and U.S. non-agency mortgage-backed securities.

The regulations may channel risk to U.S. nonbanks that are not subject to prudential regulation. An implicit assumption that prudential regulation will in time be imposed on these U.S. nonbanks (or "shadow banks") appears to underlie the view that the proposed restrictions on proprietary trading by banking entities will advance the objective of reducing systemic risk.<sup>3</sup> To the extent that this assumption proves inaccurate, the proportion of unregulated risk in the financial system will increase.

<sup>2</sup> See Julian T.S. Chow and Jay Surti, *Making Banks Safer: Can Volcker and Vickers Do It?* 20-21 (International Monetary Fund, Working Paper Nov. 2011).

<sup>3</sup> See Paul Volcker, *Financial Reform: Unfinished Business*, New York Review of Books (Nov. 24, 2011), available at <http://www.nybooks.com/articles/archives/2011/nov/24/financial-reform-unfinished-business/>.

Moreover, it has become evident that regulation outside the United States is going in a different direction. An example of the lack of international coordination is the contrast between the Volcker Rule and the Vickers Report proposal in the UK, which would permit banking entities to engage in proprietary trading if the bank's retail activities are enclosed in a "ring-fence." (See "Financial Regulation/ The Vickers Report: UK Proposal to 'Ring-Fence' Banking Operations.") Financial activity (and attendant risk) may migrate across national borders for no reason other than this disparate regulatory treatment. Economic efficiency will be threatened further by the uncertain consequences awaiting banking entities with operations subject to two or more disparate regulatory regimes.

Citing the complexity of the relevant issues and the need to facilitate coordination of the rulemaking among the agencies responsible for the regulations under the Dodd-Frank Act, the agencies that issued the proposed regulations in October have extended the deadline for the submission of public comments from January 13 to February 13, 2012. The state of the proposed Volcker Rule regulations — and the vital importance of the activities they govern — creates an acute need for participants in the financial sector to provide the agencies with comprehensive and penetrating commentary. We urge interested parties to help the regulators identify and address deficiencies in and potential unintended consequences of the proposed regulations.

## The New Swap Regulatory Regime

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Title VII of the Dodd-Frank Act requires the CFTC and SEC to develop new, comprehensive regulations for swap transactions.<sup>4</sup>

During the past year, the CFTC and the SEC have been busy developing this swap regulatory regime. The CFTC issued more than 50 proposed rules and finalized more than 20 rules under the Dodd-Frank Act by the end of 2011. It has received more than 25,000 comment letters, entertained more than 1,000 visits by members of the public, conducted 14 public roundtables (some with the SEC) and held more than 600 meetings with other regulators. The SEC, which has broader Dodd-Frank Act implementation duties than just security-based swaps, also has been hard at work. More than 90 Dodd-Frank Act provisions require SEC rulemakings, and the SEC already has proposed or adopted more than 75 percent of those rules. Despite these efforts, many of the key Dodd-Frank Act swap rules were not finalized by the end of 2011.

In 2012, the CFTC and SEC will jointly define key terms of the new regulatory regime, including "swap" (and the exclusions from the swap definition), "swap dealer" and "major swap participant." The CFTC should finalize its rules governing swap reporting,<sup>5</sup> segregation of customer funds,<sup>6</sup> business conduct standards,<sup>7</sup> margin, swap execution

<sup>4</sup> Most swaps are subject to CFTC jurisdiction; whereas, the SEC regulates only security-based swaps, which generally are those tied to a single company or a group of nine or fewer companies.

<sup>5</sup> On December 20, 2011, the CFTC adopted certain reporting requirements for swaps but did not set minimum size requirements for block trades. It is expected that the CFTC will adopt block trade size thresholds in 2012.

<sup>6</sup> The CFTC considered a rule on the segregation of customer funds at a public meeting on January 11, 2012, but, as of the publication of this report, it has yet to publish its regulations in the Federal Register.

<sup>7</sup> The CFTC considered a rule on business conduct standards for swap dealers and major swap participants at a public meeting on January 11, 2012, but, as of the publication of this report, it has yet to publish its regulations in the Federal Register.

facilities, core principles for futures exchanges (referred to in the statute as designated contract markets) documentation and the important commercial end-user exemption. The CFTC also will issue a determination spelling out which swaps must be cleared and explaining how market participants must figure out which of those swaps must be traded on a regulated trading platform. Additionally, the SEC will finalize many of its rules under the Dodd-Frank Act.

Three wild cards could materially influence how the CFTC and SEC roll out their final commodities and derivatives rules.

**Litigation.** On October 18, 2011, the CFTC adopted, by a 3-2 vote, new position limit rules for futures, swaps and options on certain physical commodities. On December 2, 2011, the International Swaps and Derivatives Association (ISDA) and the Securities Industry and Financial Markets Association (SIFMA) sought judicial review of these rules. These industry associations contend that the CFTC's new position limits are based on a misreading of the statute, contain an inadequate cost-benefit analysis, and are otherwise unsupportable as arbitrary and capricious under the Administrative Procedure Act. As more CFTC and SEC rules are adopted, other interested parties may well turn to the courts in an effort to avoid perceived regulatory excesses. If they do, the judiciary will have a major impact on the implementation of the CFTC and SEC swap regulatory framework.

**Extraterritorial Application of Dodd-Frank.** Swaps transact in a global marketplace. Many U.S. swap-market participants enter into swaps or trade with counterparties from other countries. Foreign countries and regulatory bodies are developing their own mechanisms and structures for regulating derivatives. Given the international nature of these markets, how will participants know which law applies to their transactions? The Dodd-Frank Act provides that it will not apply to swap activities outside the United States unless they have a "direct and significant" link to or impact on swap activities and commerce in the United States or were developed as a means of evading the Dodd-Frank Act. Analyzing when the Dodd-Frank Act applies under this standard, and when the laws of other countries apply, will not be easy. To this end, the CFTC and SEC have stated that they each will publish guidelines to assist market participants in making these jurisdictional determinations. Hopefully, this guidance will come early in 2012, as the extraterritorial dimension of the CFTC-SEC swaps regulatory structures raise issues that permeate each key area of new regulation. The CFTC and SEC already may be talking to (or even negotiating with) their counterparts in other countries in order to resolve these issues. We are hopeful the published guidance that emanates from these talks will remove much of the legal uncertainty that is of great concern to many market participants.

**Fallout From the MF Global Bankruptcy.** Segregation of customer funds is a basic protection for participants in the U.S. central counterparty clearing system. But the bankruptcy of MF Global and the apparent inability to locate hundreds of millions of dollars in customer funds held by the firm have caused Congress, the CFTC and the derivatives industry to concentrate considerable attention on the treatment of customer-segregated funds. The Dodd-Frank Act and CFTC rules generally extend futures-style clearing to many standardized swaps. Because what happened at MF Global (and whether customers will eventually receive the missing balances from

their accounts) is uncertain, it is equally uncertain what the impact of this episode will be. But surely it will spark a policy debate on how to best protect the interests of market participants that use the clearing system for futures and swaps.

In 2011, many swap market participants expressed concerns that the Dodd-Frank Act rules proposed and, in some cases, adopted by the CFTC and SEC will increase the cost of hedging and other derivative market trading without corresponding benefits. In 2012, we will begin to see how adaptable the U.S. swap markets are and whether these concerns will be realized.

## Financial Holding Companies in the 'Penalty Box'

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The Gramm-Leach-Bliley Act of 1999 created a new "financial holding company" (FHC) designation for banking organizations, which was available to any bank holding company if its bank subsidiaries met certain requirements. Qualification as an FHC allows a bank holding company and its nonbank subsidiaries to engage in a range of activities deemed by the Federal Reserve to be "financial in nature," or incidental or complementary to such a financial activity. Notably, these financial activities include a full scope of securities underwriting and dealing and insurance activities. FHCs also are permitted to make certain equity investments in nonfinancial companies under the so-called "merchant banking" authority. FHCs generally also are able to avoid the need for prior Federal Reserve approval when acquiring a nonbank company or commencing a new activity. Many of the largest U.S. and foreign banking organizations rely heavily on FHC status to conduct diversified financial activities in the United States. In addition, hundreds of U.S. community banking organizations have elected FHC status primarily to take advantage of more flexible authority for insurance agency businesses.

The criteria for qualification as an FHC previously were based on the capital and regulatory examination ratings of the organization's subsidiary banks. In order to qualify as an FHC, each insured depository institution controlled by the bank holding company was required to be well capitalized, to be well managed (based principally on examination ratings), and to receive a satisfactory or better rating under the Community Reinvestment Act. These bank-level measures do not take into account a supervisory assessment of the bank's parent company or nonbank affiliates. An organization with a strong bank subsidiary could maintain its FHC status even if the regulators had supervisory concerns related to the bank's parent company or affiliates.

Section 606 of the Dodd-Frank Act expanded the FHC criteria to take into account the capital and regulatory examination ratings of the consolidated organization. This assessment is made by the Federal Reserve and considers the condition of both the subsidiary banks and the parent company and its nonbank affiliates. Among other things, the FHC must itself be well capitalized and receive strong management and composite ratings from the Federal Reserve during its examination and supervisory process. These confidential ratings reflect the Federal Reserve's assessment of the consolidated organization's overall financial condition, risk profile, internal controls, compliance and oversight.

An FHC that falls out of compliance with the FHC criteria becomes subject to notice and an agreement with the Federal Reserve under Section 4(m) of the Bank Holding

Company Act of 1956. The 4(m) agreement mandates corrective action within a prescribed conformance period. During the conformance period, the FHC generally is permitted to retain existing subsidiaries and investments, continue to engage in existing activities and grow existing activities organically. However, the organization generally is not permitted to expand into new financial activities or to make expansionary acquisitions or investments. Operating under these restrictions sometimes is called being in the “penalty box.” For large banking organizations, defining the scope of FHC activities that were or were not existing at the time the organization entered the penalty box often presents compliance challenges and interpretive questions.

Given the current regulatory climate and the Federal Reserve’s emphasis on enterprise-wide risk management, an increasing number of FHCs will face the possibility of downgrades in their supervisory ratings. Coupled with the Dodd-Frank Act’s establishment of new FHC criteria, we expect that banking organizations will find themselves more easily in the penalty box, which is intended as a concrete incentive for banking organizations to address the regulators’ concerns. Those banking organizations in the penalty box will face high hurdles in obtaining regulatory consent for expansionary proposals, such as new activities or acquisitions.

## Developments in U.S. Consumer Financial Litigation and Enforcement

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On July 21, 2011, the Dodd-Frank Act transferred consumer financial protection regulation authority to the Consumer Financial Protection Bureau (CFPB). The Dodd-Frank Act authorizes the CFPB to conduct examinations of large depository institutions, as well as many nondepository financial institutions, to take enforcement action against providers of consumer financial products and services, to issue rules under the federal consumer financial laws, and to issue rules and take other actions to prohibit unfair, deceptive or abusive practices. Since July, the CFPB has commenced large bank examinations, released examination guidance and progressed in developing streamlined mortgage disclosures.

Without a confirmed director, however, the CFPB has been unable to exercise many of its new authorities, such as supervision of nondepository institutions and promulgation of rules regarding unfair, deceptive and abusive practices. On July 17, 2011, President Obama nominated former Ohio Attorney General Richard Cordray to head the CFPB. Congressional Republicans indicated they would block confirmation of Cordray or any other nominee until legislation reforming the structure and funding of the CFPB could be enacted. In response, on January 4, 2012, President Obama used a “recess” appointment to install Cordray as the CFPB director. Congressional Republicans, who had convened *pro forma* sessions in an attempt to prevent a recess appointment, have criticized the method of the appointment and questioned its legitimacy.

With the appointment of a director, the CFPB is poised to supervise, and take enforcement action as necessary, against a wide swath of the consumer financial services industry. All eyes are on Washington to see if legislation altering the CFPB will move forward and how questions regarding the legitimacy of Cordray’s appointment will play out. There is a strong possibility that legal challenges to Cordray’s appointment and/or action taken by the CFPB pursuant to that appointment will be

pursued. Regardless of these controversies, we expect that 2012 will see the CFPB announce its initial enforcement actions and finalize some major rules, such as those related to new mortgage data reporting, "ability to repay" and "qualified mortgages."

There were two particularly significant judicial developments in 2011 related to U.S. consumer financial litigation. First, in June, the U.S. Supreme Court decided *Wal-Mart Stores, Inc. v. Dukes*, ruling that an employment discrimination lawsuit brought on behalf of approximately 1.5 million women challenging Wal-Mart's discretionary pay and promotion practices could not proceed as a class action because the plaintiffs had not shown sufficient commonality. In the wake of the *Wal-Mart* case, several federal district courts have held that fair lending lawsuits cannot proceed as class actions where the challenged policy is the existence of discretionary decision-making and where the plaintiffs are attempting to use aggregated statistical data to prove their case. In particular, several courts have declined to certify classes where plaintiffs have argued that, by permitting overages or discretionary broker pricing, mortgage lenders have violated the fair lending laws. (See "Global Litigation/Class Action Outlook.")

Second, in November the Supreme Court agreed to hear *Magner v. Gallagher*, which could decide whether the disparate impact theory is cognizable under the Fair Housing Act. The Supreme Court's decision in *Magner* could have major implications for future fair lending enforcement, as the Department of Justice recently has used the disparate impact theory aggressively in fair lending enforcement actions leading to multimillion-dollar settlements. A decision in *Magner* is expected in May or June 2012. (See "Global Litigation/U.S. Supreme Court Cases to Watch.")

Finally, 2011 saw developments involving card- and deposit-related products. A number of financial institutions drew unwanted publicity when they increased fees on certain banking services to offset limits on debit interchange fees imposed as a result of the Durbin Amendment.<sup>8</sup> Regulatory scrutiny around fees is likely, with a particular focus on overdraft fees, which have been the subject of detailed regulatory guidance that took effect on July 1, 2011. Regulators also continue to scrutinize features and marketing of prepaid cards, which increasingly are common.

## Implementation of the EU Alternative Investment Fund Managers Directive

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On November 16, 2011, the European Securities and Markets Authority (ESMA) published advice to the European Commission (EC) on measures to implement the Alternative Investment Fund Managers Directive (AIFMD).<sup>9</sup> The EC will consider the advice and issue draft legislative proposals in 2012. The ESMA advice will influence asset management industry participants as to their approach to EU fund offerings, operations and fund structures.

The AIFMD regime will target the EU management and marketing of alternative investment funds (AIFs). AIFs include most funds that are not Undertakings for

<sup>8</sup> The Durbin Amendment is a provision in the Dodd-Frank Act that seeks to limit debit card interchange fees.

<sup>9</sup> See European Securities and Markets Authority, Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive (Nov. 16, 2011).

Collective Investment in Transferable Securities (UCITS) funds and, therefore, cannot be marketed without restriction in the EU through use of a UCITS passport. UCITS generally had been associated with retail offerings; however, institutional managers are now using UCITS to create institutional share classes and to take advantage of liberalized investment and borrowing powers. To avoid the need for AIFMD compliance, alternative asset managers may begin to increasingly develop UCITS for manufacture and distribution.

The AIFMD will regulate AIF managers (AIFMs) that perform the portfolio management and risk management functions for EU and non-EU AIFs, and the marketing of AIFs to EU investors. EU member states will be required to transpose the AIFMD requirements into national law by July 22, 2013, with a phased implementation expected to run to 2018.

The AIFMD permits an AIF to have only one AIFM responsible for portfolio management and risk management. If a fund manager acting for an AIF currently does not perform that risk management role, the AIF must determine whether to appoint the fund manager to perform that role or pursue an alternative, such as obtaining EU authorization as a self-managed AIF. An AIF also may appoint as its AIFM a non-EU management company, which would then delegate portfolio management to an EU fund manager. Non-EU asset management groups will need to evaluate their current structures and operations to identify what, if any, changes the AIFMD will require.

Each EU-based portfolio manager currently managing an AIF will need to determine whether it is to be the AIFM and, if so, consider the consequences under the AIFMD. An EU subsidiary of a non-EU fund management group may be an AIFM if it manages the portfolio assets of an AIF and other clients and uses the passporting provisions in the Markets in Financial Instruments Directive (MiFID) to conduct services in other EU member states. As another example, an EU company could be an AIFM if it manages the assets of a group entity. In any event, EU managers that require authorization as AIFMs solely managing AIF assets will no longer be MiFID firms and will not qualify for a MiFID passport, although other passports will be available under the AIFMD. Forthcoming regulations of member states will determine whether AIFMs managing the assets of other clients will continue to be able to use MiFID passports when they perform those roles.

An EU-based AIFM must obtain authorization from its local regulator under the AIFMD by July 2014. Depending on the speed of national implementation, a passporting regime may apply once the AIFM receives authorization from its "country of reference" with respect to the marketing of EU AIFs to professional investors in other EU countries. However, passporting rights with respect to the marketing of non-EU AIFs are unlikely to be available before September 2015. Until those passporting rights become available, an authorized EU-based AIFM managing a non-EU AIF will need to rely on national private placement regimes. It will be subject to most AIFMD requirements (with the important exception of some of the detailed depositary requirements) and any further rules that local regulators decide to apply. In addition, a written cooperation agreement needs to be in place between EU regulators and third-country regulators outside the EU before an EU-based AIFM can manage or market a non-EU AIF. According to the recent ESMA advice, the agreement should:

- Allow the exchange of information for supervisory and enforcement purposes;
- Allow EU regulators to obtain all information that they need to discharge their functions under the AIFMD;
- Allow the EU regulator to directly or through the third-country regulator conduct on-site inspections;
- Set out that the third-country regulator will assist the EU regulator in enforcing EU and national requirements;
- Allow EU regulators to transfer information received to other European regulators; and
- Allow for some form of cooperation arrangements for the purpose of systemic risk oversight.

If any third countries decline to enter into these types of cooperation arrangements, non-EU asset management groups will face difficulties in marketing AIFs in EU markets or using EU AIFMs.

Similar requirements exist for non-EU based AIFMs, including those that manage an EU AIF or a non-EU AIF that wishes to market fund interests to EU investors. These managers may apply for authorization (to benefit from consequent passporting rights) beginning in September 2015. Prior to such authorization, a manager may be able to use national private placement regimes to market fund interests, provided it complies with AIFMD requirements concerning regulatory reporting, investor disclosure and the taking of substantial stakes in EU businesses, as well as any further requirements imposed by national regulators. Any such AIFM will be permitted to manage an EU AIF or market a non-EU AIF in the EU only if cooperation arrangements are in place between regulators from the EU and the non-EU third country in which the AIFM is based.

The national private placement regimes will be phased out if and when passporting is permitted. These regimes will run parallel with the passporting requirements and, under current expectations, will expire sometime in 2018.

The consequences of the AIFMD will be complicated by the following factors:

- It is not clear whether AIFs can be marketed to certain categories of retail investors between 2013 and 2015, notwithstanding that some national placement regimes allow marketing to individuals who satisfy sophistication and high-net-worth tests.
- The AIFM regime is designed to deal with marketing to professional investors. However, the definitions of professional investor in the AIFMD are not aligned with those currently used in MiFID for professional clients.
- Marketing to retail investors will not be covered by the AIFMD passport. Individual national regulators may allow retail marketing but, eventually, will have to individually approve specific retail offerings, whose effect will be to make cross-border retail offerings cumbersome. Although AIFMs typically are not marketed to retail mass-market investors, the narrower professional investor definition will mean that some sophisticated investors who would have been professional investors under the MiFID regime will be treated as retail investors for AIFMD purposes.

Some private equity funds already have begun consulting with major investors regarding potential impacts on existing and future funds. In light of the anticipated impacts, non-EU investors may pursue alternative investments that are not subject to the regime.

Given the extra costs and compliance burdens that the AIFMD will engender, EU-based submanagers with allocations from non-EU managers and non-EU funds may have cause for concern about their competitiveness against non-EU managers. The implementation of AIFMD will, therefore, present both opportunities and challenges for industry participants.

## The EU Proposal for Financial Transactions Tax

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On September 28, 2011, the EC announced a proposal for a Financial Transactions Tax (FTT),<sup>10</sup> a measure with a specific financial regulatory objective and revenue-raising goals. This measure has genuine potential to become law in the near future and would produce profound, global impacts on financial transactions.

The tax as currently proposed would apply to many financial transactions between counterparties that are based within and outside the EU, and would be calculated at a minimum percentage based on the price of the transaction. Thus, it is a gross proceeds or value tax, similar to the UK's stamp duty reserve tax. There are widely differing estimates regarding its revenue-raising potential, which is impossible to predict with certainty because of inevitable behavioral and geographical adjustments by the financial sector.

The FTT also is, in its architects' eyes, aimed at reducing levels of high-frequency trading and other destabilizing or speculative trading patterns in securities, such as short-selling. As the basis for the FTT, the EC asserted (somewhat disingenuously, in the view of some observers), that failure to implement such a measure uniformly across the EU would be to deny a stated EU goal, *i.e.*, the consistent, nondistortive and stable operation of the financial markets.

The initiative is troubling in many other respects as well: The text of the legislation is flawed, the tax may cause business flight outside the EU, and implementation of the legislation is uncertain.

The FTT, however, has received the explicit backing of the French and German governments and already has been approved by vote of the European Parliament. Some national governments (*e.g.*, the UK and Sweden) are fighting hard at a conceptual level, not wishing to imply any concession to the conceptual debate by moving to a detailed discussion of the FTT Directive's terms. The main defensive thrust is that an FTT can work only if implemented globally. The United States and China, however, opposed a global FTT at the G20 summit in Cannes, on November 30, 2011.

Although the FTT is a flawed initiative in many senses and probably would cause real damage to the EU financial sector, we believe it has too much political and public

<sup>10</sup> See Council of the European Union (Consilium), Proposed European Tax on Financial Transactions (Nov. 11, 2011), available at <http://register.consilium.europa.eu>.

support to be withdrawn before it is implemented in some form. (Lobby groups are running public television advertising campaigns in its support.) At present, the FTT — as a taxation measure — must be passed unanimously by EU national governments. As widely reported, the UK has recently frustrated the ambitions of the French and Germans to pursue partial implementation by refusing to allow amendments to relevant EU treaties that would have permitted a smaller group of EU governments to implement it (in its present form, and based on current EU treaties, the FTT cannot be partially implemented). However, the French government has indicated that it will present suggestions on how to achieve the FTT, in some form, on January 23, 2012.

The UK's reluctance to stand aside in allowing EU states to pursue partial implementation as an "enhanced cooperation" measure similar to that of the euro adoption in 1999 is motivated by the potential for even a measure with a limited geographic scope to damage major financial centers that stayed outside (such as London or Dublin), which would continue to face the frictional costs of dealing with other EU counterparties in the relevant in-scope instruments. Moreover, it is much more difficult for London or Dublin to reconfigure their current significant EU-facing financial interaction than, say, New York, Singapore or Hong Kong. Thus, the UK Chancellor has described any FTT that did not include the U.S. or China as "economic suicide" for Britain and for Europe and a "bullet aimed at the heart of London."<sup>11</sup>

Resistance also is being mounted by other nations (such as the Netherlands) and industry bodies. The Dutch Ministry of Finance, the Alternative Investment Management Association and the UK's National Association of Pension Funds all claim that end-users would bear the burden rather than financial institutions, and that pensions and other pooled capital institutions would be reluctant to engage in activities that support market liquidity, such as fee-based securities lending.

The UK's House of Lords also recently published a report expressing severe concerns about the FTT's impact, and academics have published critical studies. The Adam Smith Institute, for example, has stated that such a tax would cripple the UK economy by destroying derivatives trading in the City of London, which accounts for 74.4 percent of interest-rate derivatives trading volume within the EU. By contrast, governmental and industry observers in the U.S. have (thus far) been relatively cautious in their comments.

If the FTT is implemented, European governments and the private sector will need to materially engage on its details to reduce its more egregious impacts. EU governments that manage to keep their jurisdictions outside the direct scope of the FTT may find global opportunities from reconfiguration that allow them to benefit from being "offshore" to the FTT. That could take some time but, as was seen in the U.S. during the 1960s and the birth of the euro-dollar market, the financial sector often finds ways to adapt.

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<sup>11</sup>George Osborne, Comment, *Fix This Euro Crisis With the Smack of Firm Government*, London Evening Standard (Nov. 14, 2011), available at <http://www.thisislondon.co.uk/standard/article-24009665-fix-this-euro-crisis-with-the-smack-of-firm-government.do>.

The key elements of the draft FTT Directive are:

### **Scope**

- In effect beginning January 1, 2014.
- Applicable to all financial transactions where a financial institution is involved (as principal or agent) and one of the parties (whether the financial institution or its counterparty) is in the EU. Thus, non-EU financial institutions, such as U.S. broker-dealers transacting with EU nonfinancial institutions, would in theory become FTT collectors on behalf of the EU.
- Financial institutions include banks, broker-dealers, regulated markets and trading platforms, insurers and reinsurers, funds and their managers, pension funds, leasing companies, certain holding companies and financial SPVs.

### **Transactions**

Applicable to:

- Purchasing or selling a financial instrument.
- Transfers of risk in a financial instrument.
- Entering into (or amending) a derivative contract.

A financial instrument includes:

- Shares, bonds, options, futures, or units in unit trusts and other funds.
- Structured products and notes issued by an SPV.
- Sale and repurchase agreements (repos) and stock lending transactions, even though there may be no change of economic ownership of the securities.

Over-the-counter trades are covered, as well as trades conducted on an exchange or trading platform.

The FTT would not apply to:

- Primary issues of shares or bonds.
- Physical commodities trades and spot currency exchanges, loans and deposits, and certain retail financial products.
- Trades with EU central banks.

### **Amount of Charge and Liability**

- The FTT would be charged at a minimum of 0.1 percent of the total consideration, or market value if greater, for financial instruments, and a minimum of 0.01 percent of the notional value of derivatives irrespective of the length of the contract or the likely payment profile. Individual member states could choose to raise the rates.

- Derivative notional amounts often are large, so the FTT would be high. Also, movements of collateral in support of derivative transactions are also in-scope, leading to multiple charges on single transactions.
- Transactions would be taxed gross, before any netting.
- FTT generally would be due by the financial institution immediately on execution of a trade.
- Under the current draft, when both parties to a financial transaction are financial institutions and one is in the EU, each would be liable to pay FTT, thus doubling the FTT. (An earlier discussion document would have split the charge between the two.)
- Where neither party is a financial institution (even if in the EU), or neither party is in the EU (even if they are financial institutions), no FTT would be due.
- The FTT provides no exemption for financial intermediaries and other transactions aiding market liquidity, or for intragroup hedging.

## The Vickers Report: The UK Proposal to 'Ring-Fence' Banking Operations

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In September 2011, the UK's Independent Commission on Banking (ICB) released its final report on proposed reforms of the UK banking system (the Vickers Report).<sup>12</sup> Central to the many recommendations contained in the Vickers Report is the proposal that UK retail banking operations be "ring-fenced" in a separate subsidiary within the broader banking organization. The primary purposes of the ring-fence proposals are to insulate retail banking services (and associated deposits) from higher-risk activities, such as investment banking or trading businesses, performed elsewhere in the banking organization; simplify the crisis-driven segregation of ring-fenced and non-ring-fenced operations without the need for public solvency support; and reduce the risk of future taxpayer bailouts of financial institutions.

The Vickers Report defines the scope of the UK retail ring-fence within the banking organization by its "location" (the activities in which the ring-fenced retail bank subsidiary is permitted to engage) and its "height" (the amount of separation required between the ring-fenced bank and the remainder of the banking organization).

Consequently, the Vickers Report attempts to categorize banking activities into mandated services (those that are required to take place inside the ring-fence), prohibited services (those that are prohibited from taking place inside the ring-fence) and those ancillary services that may (but are not required to) take place inside the ring-fence.

Mandated activities generally include activities performed by the majority of the retail and commercial banking divisions of existing UK banks, including taking deposits from, and providing payment services to, consumers and small- to medium-size enterprises (SMEs) and lending to consumers and SMEs that are not financial institutions. Prohibited services generally include activities performed by wholesale and investment banking

<sup>12</sup> Independent Commission on Banking, Final Report Recommendations (2011) (Vickers Report), available at <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2011/07/ICB-Final-Report.pdf>.

“ Similar to the questions raised in the U.S. regarding the Volcker Rule, the retail ring-fencing proposals contained in the Vickers Report have raised concerns regarding their feasibility, cost of implementation and associated cost/benefit analysis. ”

divisions of existing UK banks and include providing services outside the European Economic Area (EEA), providing services (other than deposit-taking and payment services) to financial institutions, and engaging in securities and derivatives transactions. Ancillary activities (*e.g.*, risk management, employing staff) are permitted to take place inside the ring-fence if and to the extent that they are “necessary for the efficient provision” of nonprohibited services, but are not permitted as a standalone line of business.

The Vickers Report addresses the “height” of the ring-fence by recommending the imposition of numerous specific organizational and governance requirements on the subsidiary, including the constitution of a board of directors that is independent from the rest of the banking organization. Additionally, the ring-fenced bank’s relationship with the rest of the banking organization must be on an arm’s-length basis and otherwise comply with rules on permitted interconnectedness with affiliates. The ring-fenced bank also would be required to meet numerous regulatory requirements independently applicable to it without regard to the rest of the banking organization (including capital requirements in excess of those required under Basel III, as well as other exposure, liquidity, funding and operational requirements) and make public disclosures as if separately listed.

The Vickers Report seeks to engage in a balancing act — proposing a functional subsidiarization intended to ensure the self-sufficiency and separateness of the ring-fenced retail activities, including during a financial crisis, but stopping short of a requirement for full separation of retail-funded operations from other, higher-risk businesses due to an implicit acknowledgment of the operational synergies of a diversified banking model. The goal is to ensure that, notwithstanding a failure of the banking organization outside the ring-fence (or a portion thereof), the ring-fenced retail subsidiary can continue to operate without the need for government support, reducing the risk of governmental assistance for activities not directly connected to the general public (such as wholesale, investment banking or derivatives businesses).

The recommendations contained in the Vickers Report represent a departure from the universal banking model under which the UK banking industry has been permitted to operate both retail and investment banking businesses within a common legal entity or a group of closely associated entities. Such recommendations are in line with legislative and regulatory efforts in the United States and elsewhere to structurally reform the business activities of diversified banking organizations. In fact, from the perspective of a U.S. observer, the retail ring-fencing proposals present a convergence with existing principles of U.S. banking law, for example, those relating to the separation of deposit-taking activities from other financial services and the establishment of rules regarding affiliate transactions.

Similar to the questions raised in the U.S. regarding the Volcker Rule, the retail ring-fencing proposals contained in the Vickers Report have raised concerns regarding their feasibility, cost of implementation and associated cost/benefit analysis. In addition, questions have been raised over whether the proposals would create an advantage for EEA banks that can establish a retail presence in the UK through “passporting” a branch into the UK under existing EU law and not subject themselves to the Vickers Report regime.

The ICB has recommended the implementation of its ring-fencing proposals by the end of 2019 on a similar timetable to the implementation of the Basel III capital and liquidity measures. Given broad support for the Vickers Report proposals across the UK political spectrum, it appears likely that legislation will be enacted to implement a retail ring-fencing requirement in the UK. It remains to be seen how the requirement will be implemented and how effectively it will address its key objectives. Regardless of the ultimate means of implementation and effectiveness of the requirement, however, organizational and operational restructurings and capitalization required to comply with ring-fencing requirements can be expected to add to the cost of running a retail banking business in the UK.