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Client**Alert**

Bank Advisory

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Foreign Banks May Continue Swaps Activities...and Still Access Discount Window

The Board of Governors of the Federal Reserve System ("Board") on June 5, 2013 took a bold step in issuing interim final rules ("Interim Rules") that allow a foreign bank's uninsured US branches and agencies to continue to access the Reserve Banks' discount windows notwithstanding that the foreign bank is a registered swaps dealer engaged in swaps activities.[1] The Interim Rules limit the effect on foreign banks of the ban on access by swaps entities to the discount window and other Federal Reserve credit facilities that was established by Section 716 of the Dodd-Frank Act.[2] That ban is effective as of July 16, 2013.

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This eleventh hour reprieve is undoubtedly welcome news for foreign banks with US branches and agencies. A now well-known inadvertent drafting omission limited the availability of the so-called swaps push-out exemptions from the Section 716 Federal funding ban to "insured depository institutions."[3] The Interim Rules correct this oversight by defining an uninsured US branch or agency of a foreign bank as an "insured depository institution" for the purposes of Section 716. That definitional change puts a foreign bank on equal footing with a US bank for Section 716 purposes and allows uninsured US branches and agencies of a foreign bank that is a swaps dealer to continue to access the discount window provided the foreign bank "pushes out" certain otherwise prohibited swaps activities to affiliates other than its US branches or agencies. It also permits the foreign bank's US branches and agencies to continue to conduct directly swaps activities involving hedging and risk-mitigating activities or swaps based on rates or reference assets that are permissible investments for a US national bank other than non-cleared credit default swaps.

1 Board Final Rule Release on Prohibition Against Federal Assistance to Swaps Entities (Regulation KK) (June 5, 2013), pending publication in the Federal Register, available at http://www.federalreserve.gov/newsevents/press/bcreg/20130605a.htm.

2 Section 716 is poorly drafted and may be read in several different ways—one of which only prohibits discount window proceeds from being used to assist in swaps-related activities. This subject approach is a narrower one but would meet the needs of most foreign banks.

3 *See* 156 Cong. Rec. S5903-5904 (daily ed. Jul. 15, 2010) (a colloquy on the floor of the Senate between the author of Section 716, Senator Blanche Lincoln, and the Chair of the Senate Banking Committee, Senator Dodd, in which Senator Lincoln acknowledges that the swaps push-out "safe harbor" of Section 716 was intended to extend to the uninsured branches and agencies of foreign banks which "should be subject to the same swaps desk push-out requirements as insured depository institutions under section 716."

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Equally as important, given the looming July 16, 2013 effective date of Section 716, the new definition of "insured depository institution" qualifies uninsured US branches and agencies for the statutory transition period that allows Federal banking supervisors to grant an insured depository institution an initial period of up to 24 months to conform its swaps activities to the push-out and permitted activity limitations of Section 716. The ban on access to the discount window would apply only after the end of the transition period and only if a US branch or agency continued to conduct directly any prohibited swaps activities.

Filing a Transition-Period Request

Section 716 gives the "appropriate Federal banking agency" the authority to grant an insured depository institution an initial period of up to 24 months to divest any swaps entity, which we would expect few to do, or cease the activities that require registration by the insured depository institution as a swaps dealer. As a practical matter, this transition period also may serve as a time to "push out" from the insured depository institution those swaps activities that would prohibit access to Federal Reserve funding or FDIC deposit insurance. The Section 716 funding prohibition applies only to swaps or security-based swaps entered into after the end of the transition period.

Who Is The "Appropriate Federal Banking Agency"?

The Dodd-Frank Act defines the "appropriate Federal banking agency" as the Office of the Comptroller of the Currency ("OCC") for Federally licensed insured or uninsured US branches and agencies of foreign banks, the Board for any state-licensed uninsured US branches and agencies and the Federal Deposit Insurance Corporation for any state-licensed insured US branches or agencies.[4]

Who Should File a Transition-Period Request?

Any transition-period request must be filed by the US branch or agency of a foreign bank that is a registered swaps entity.

A swaps entity for purposes of Section 716 is defined as (a) an entity that is registered as a swaps dealer or a security-based swaps dealer (together an "SD") or (b) an entity that is registered as a major swaps participant or major security-based swaps participant (together an "MSP") if that MSP entity is not an insured depository institution.

If an insured depository institution is not an SD, but is an MSP, or is neither, the depository institution is not a swaps entity for purposes of Section 716, and the requirement to push out swaps activities to an affiliate ("push-out requirement") does not apply.

The same should hold true for a foreign bank. That is, unless the foreign bank is an SD, the push-out requirement should not apply. We note that neither the Interim Rules nor the accompanying release state outright that, if the foreign bank is an MSP, the push-out requirement will not apply to the foreign bank's uninsured US branches and agencies.

A literal reading of the Interim Rules definition would be that a transition period may only be granted to an uninsured or insured US branch or agency that is itself as a swaps entity as defined in the Interim Rules. Unfortunately, the Commodity Futures Trading Commission and the Securities and Exchange Commission implementing regulations did not follow the separate entity doctrine in this case. The better and intended meaning appears to be that the US branch or agency is entitled to request and be granted a transition period even though it is the foreign bank that is the registered swaps entity.

The determination of whether a foreign bank is required to register as a swaps entity under Title VII and related regulations is based on the swaps activities of the foreign bank as a whole, including its US branches or agencies. Where the thresholds for registration are met, it is the foreign bank that registers as the swaps entity, not each branch or agency that individually meets the registration thresholds. The result is that no US branch or agency is required to register as a swaps entity. Any US branch or agency of a foreign bank that is a registered SD is entitled to request transitional relief. Absent such relief, the US branch or agency would not be entitled to continued access to the discount window if conducting directly any swaps activities prohibited by Section 716.

A final question is whether separate requests need be filed where a foreign bank operates multiple US branches or agencies. We would think that requests directed to the same supervisor may be combined. Those foreign banks with both uninsured state and Federal branches or agencies, of course, will have to make separate filings to the Board and the OCC, respectively.

When Should a Request Be Filed?

A US branch or agency of a foreign bank that is a registered SD should file a transition-period request as soon as practicable and in any case before July 16, 2013, if it is determined that a filing is required (i.e., the US branch or agency is engaged or plans to engage in any prohibited swaps activities). Any foreign bank whose US branches, agencies or subsidiaries are engaged in any swaps activities should consider whether registration as a swaps entity is required and, if so, whether a concurrent request for a transition period to push out prohibited swaps activities from its US branches or agencies is necessary.

4 12 U.S.C. §1813(q). Section 2 of the Dodd-Frank Act defines the "appropriate Federal banking agency" by reference to the Federal Deposit Insurance Act.

If a foreign bank becomes a swaps dealer after July 16, 2013, the foreign bank should, at that time, seek a transition period from the appropriate Federal banking agency for each of its US branches or agencies engaged in any prohibited swaps activities.

When and How Will Requests Be Handled by the Banking Authorities?

The Interim Rules specify that the Board will seek to act "expeditiously" on transition-period requests submitted by state uninsured US branches or agencies, but does not address what action, if any, a foreign bank would be expected to take should its request remain unaddressed by the Board as of the July 16 effective date. The OCC in its guidance for national banks also did not specify the timing of OCC review of transition-period requests, but did specify that "the OCC is prepared to consider such requests favorably."

What Should Be Included in a Transition-Period Request?

Section 716 does not require the Federal banking supervisors to issue a rulemaking on transition-period requests. The Board has done so, including in the Interim Rules the requirements for the contents of transition-period requests. Those provisions apply only to state member banks and to state uninsured US branches or agencies for which the Board is the primary banking supervisor. The OCC did not issue contemporaneous guidance for Federal uninsured US branches or agencies. The OCC's guidance to national banks earlier this year, however, may serve as a guide for Federally licensed uninsured US branches or agencies in preparing their requests.[5] The OCC may or may not expressly extend that guidance to or issue new guidance for Federal uninsured US branches or agencies.

Both the OCC guidance in respect of national banks and the Board's requirements for state uninsured US branches and agencies should serve as useful guidelines for the contents of a filing. A request for a transition period should include the following:

1. **Length of transition-period requested.** We can see no reason not to request the full 24 months envisioned by Section 716.[6]

2. **The plan for conforming swaps activities.** The response to this item should include a discussion of how any prohibited swaps activities are to be pushed out to nonbank subsidiaries or to non-US branches or agencies (assuming these non-US branches or agencies could engage in the pushed out swaps activities in compliance with the Volcker Rule) or otherwise divested by the US branch or agency.

3. **An assessment of the impact of divestiture or cessation of prohibited swaps activities.** The response to this item should discuss the potential impact on each of the following activities of the US branch or agency as a result of divesting or ceasing prohibited swaps activities:

   - Mortgage lending
   - Small business lending
   - Job creation and
   - Capital formation (and, if applicable, the resulting potential negative impact on insured depositors and the Deposit Insurance Fund of the Federal Deposit Insurance Corporation)

4. **Risks mitigated by a transition period.** The response to this item should include a discussion of the operational and other risks that would be lessened or eliminated by the availability of a transition period to bring swaps activities into conformance.

5. **Other relevant factors.**

Observations on Section 716 Implementation

Statutory Authority for the Definition of Insured Depository Institution

Crafting a fix for the inadvertent drafting error that excluded uninsured US branches and agencies of a foreign bank from the push-out and permitted activities exemptions of Section 716 has been the subject of extensive debate and more than one piece of proposed legislation since the passage of the Dodd-Frank Act nearly three years ago. The Board has solved this protracted debate with a simple rulemaking. The Board's reasoning is creative but perhaps at the limits of its interpretative authority.

The Interim Rules cite as the authority "the reasons stated in the Supplementary Information." Those are that:

- Treating uninsured US branches or agencies as insured depository institutions affords each a transition period to conform or cease their swaps activities in an orderly manner and allows each to continue permitted swaps activities.
- Treating uninsured US branches or agencies as insured depository institutions is consistent with the purpose of Title VII of the Dodd-Frank Act which is "generally" to reduce systemic risks from derivative activities and supports inclusion of uninsured US branches and agencies in the definition of "insured depository institutions." This might be a more persuasive argument if the text of Title VII actually included a statutory purpose.

5 Our *Alert* on the OCC guidance for national banks and insured Federally licensed US branches is available at http://www.whitecase.com/files/Publication/f2888134-b1da-485c-8115-3947fe44801c/Presentation/PublicationAttachment/8d6c52b5-58f0-4e32-a9cb-43d92685150f/alert-swaps-push-out-transition-period-3.pdf.

6 Section 716 also provides for requests for an additional one-year extension of the transition period. The Interim Rules provide that state uninsured US branches or agencies may request such an extension no later than 60 days before the initial transition period ends.

- Uninsured US branches or agencies appear to be properly considered to be insured depository institutions as they are treated in the same manner as US state member banks for purposes of receiving Reserve Bank advances, the only Federal funding that causes uninsured US branches or agencies to be affected by Section 716.

- The "ambiguity" created by lack of a definition of insured depository institution in Section 716 merits a rulemaking. The Board recognizes that the Dodd-Frank Act does define "insured depository institution" in respect of all titles of the Act by reference to the definitions in section 3 of the Federal Deposit Insurance Act ("FDI Act"), but also notes that such definition applies "except as the context otherwise requires." The Board applies the FDI Act definition that includes uninsured branches and agencies and commercial lending companies of a foreign bank as "insured depository institutions." That FDI Act definition is to be used for the purposes of determining eligibility for deposit insurance and is deemed the proper definition for the purposes of application of Section 716, as uninsured branches and agencies are treated as insured member banks in respect of access to the discount window.[7]

- Finally, the Board cites Senator Lincoln's statements as to the inadvertent omission of uninsured US branches and agencies. We note here that Senators Lincoln and Dodd in discussing this oversight anticipated that Congress, not the banking agencies, would act to correct the error. This fix, in fact, is the subject of sister House and Senate bills that, among other things, would amend Section 716 to add "and uninsured branches and agencies" after each reference to "insured depository institution."

Scope of Section 716 Federal Funding Ban

It is worth keeping in mind that Section 716 does not apply to Federal Reserve broad-based funding programs, such as TARP and the related emergency funding programs put in place following the global financial crisis. A US branch or agency engaged in prohibited swaps activities would still have access to such funding programs were the Board to implement any in the future.

7 12 U.S.C. §1813(c)(2) and (3). The Board qualifies this finding by excluding commercial lending companies from the definition of "insured depository institutions" even though they are included in the FDI Act definition, as commercial lending companies are not permitted access to the discount window.

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