

Treatment of Foreign Banks under Section 716 of the Dodd-Frank Act and Related Push-out Provisions

July 10, 2013

Last month, the Federal Reserve Board issued an Interim Final Rule that treats uninsured U.S. branches and agencies of foreign banks the same as insured depository institutions ("IDIs") for purposes of Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and related push-out provisions.^[1] As a result, federal and state-licensed U.S. branches and agencies of foreign bank swaps entities may take advantage of the same exemptions, transition period and grandfathering privileges afforded to IDIs under Section 716.

Section 716 Restrictions on Federal Assistance

Section 716 of the Dodd-Frank Act, known as the "Swaps Push-out Provisions," prohibits any person that is a registered swap dealer, security-based swap dealer, major swap participant or major security-based swap participant (each a "swaps entity"),^[2] from receiving "Federal assistance" as defined in that section, including FDIC deposit insurance and access to the Federal Reserve's discount window.^[3] In effect, the section mandates that banks "push out" certain swap dealing activities into separate legal entities: The section does not prohibit IDIs from establishing or maintaining a separate affiliate that is a swaps entity if the IDI is part of a bank holding company supervised by the Federal Reserve and the swaps entity affiliate complies with Sections 23A and 23B of the Federal Reserve Act and other applicable requirements. An IDI bank that is a major swap participant is not a swaps entity for purposes of Section 716 and, therefore, is not subject to the restrictions on Federal assistance. An IDI may continue to deal in interest rate swaps and swaps involving bank-permissible reference assets (currencies, loans, bank-eligible debt securities, precious metals), and engage in hedging and other similar risk-mitigating activities, without restriction. Dealing in credit default swaps is permissible only if the transactions are cleared by registered or exempt derivatives clearing organizations or clearing agencies.

Section 716 will become effective on July 16, 2013. The statute permits a swap dealer that is an IDI to petition the appropriate Federal banking agency for an extension of up to 24 months (with a further extension of up to one year) to comply with the push-out and other provisions. The prohibition against Federal assistance would apply only to swaps entered into by the IDI after the expiration of the transition period.

Application of Section 716 to Foreign Banks

A U.S. branch or agency of a foreign bank that is not a separate entity is treated as an extension of the foreign bank under CFTC and SEC rules and guidance. Accordingly, a U.S. branch or agency of a foreign bank that is a registered swaps entity must push out prohibited swap activities or forfeit its rights to any Federal assistance.

The Interim Final Rule remedies what was widely acknowledged to be a legislative oversight by enabling uninsured U.S. branches and agencies of foreign banks to take advantage of the relief available to IDIs under Section 716. The Federal Reserve Board reasoned that, among other things, the relief furthers the objectives of the Dodd-Frank Act by enabling a U.S. branch or agency of a foreign bank to effect the cessation of prohibited activities or the divestiture of its swaps business in an orderly manner. In this regard, the relief establishes a process for uninsured state branches and agencies of foreign banks to seek a transition period of up to two years from July 16, 2013 (or such later date upon which the foreign bank becomes a swaps entity), by submitting a written application to the Federal Reserve Board.^[4] The application must include, among other things, a description of the impact of immediate cessation or divestiture of swaps activities on the institution,^[5] and a description of the institution's plan for conducting its activities in accordance with Section 716.^[6] Federal-licensed insured and uninsured U.S. branches and agencies of foreign banks may make a similar application to the Office of the Comptroller of the Currency ("OCC") for transition relief.^[7]

Section 716 of the Dodd-Frank Act does not apply to banks and other entities that rely on the *de minimis* exception to the definition of swap dealer and do not otherwise meet the definition of a swaps entity. Any foreign bank that nevertheless becomes a swaps entity after July 16, 2013, should keep in mind the limitations on Federal assistance with regard to its U.S. branches or agencies under Section 716, and timely request transition relief if necessary to conform its activities to the law. In this regard, foreign banks that presently are relying on the CFTC's temporary exemptive order suspending certain aggregation requirements for purposes of the *de minimis* threshold calculation should monitor developments at the CFTC in the coming days. The temporary exemptive order, which took effect on December 21, 2012, and expires on July 12, 2013, permits a foreign bank that is a control affiliate of a registered swap dealer to exclude for aggregation purposes the swap dealing activities of the registered swap dealer (and any other registered swap dealer affiliates) and all other non-U.S. affiliates engaged in swap dealing activities with U.S. persons as of December 21, 2012.^[8] Unless the terms of the temporary exemptive order are extended beyond July 12, 2013, or the CFTC issues modified, final cross-border guidance, a foreign bank will face stricter aggregation requirements that could affect its status as a swap dealer and the eligibility of its U.S. branches or agencies for Federal assistance absent compliance with Section 716 and related push-out provisions.

The CFTC has scheduled an open meeting for July 12, 2013, to consider final cross-border guidance and any continuation of the exemptive order. Recently, it has been reported that the Chairman of the CFTC favors implementing certain provisions of the cross-border guidance while delaying others.

^[1] Prohibition Against Federal Assistance to Swaps Entities (Regulation KK), 78 Fed. Reg. 34,545 (June 10, 2013).

^[2] Unless the context otherwise requires, reference herein to a "swap," "swap dealer" or "major swap participant" includes "security-based swap," "security-based swap dealer" or "major security-based swap participant," respectively.

^[3] "Federal assistance" does not include any credit or other facility that might be made available from time to time as part of a program or facility with broad-based eligibility under Section 13(3)(A) of the Federal Reserve Act.

[4] The appropriate Federal banking agency for a state-licensed insured U.S. branch or agency of a foreign bank is the Federal Deposit Insurance Corporation.

[5] The description should address the impact of divestiture or cessation on the institution's mortgage lending and small business lending, job creation and capital formation, versus the potential negative impact on insured depositors and the Deposit Insurance Fund of the FDIC.

[6] An application to extend the transition period for up to one additional year may be made no later than 60 days before the end of the transition period.

[7] On June 12, 2013, the OCC issued a notification informing uninsured federal branches and agencies of foreign banks that they may request a transition period in accordance with previously published OCC guidance for insured federal depository institutions. (See Transition Period Under Section 716 of Dodd-Frank Wall Street Reform and Consumer Protection Act, 78 Fed. Reg. 1,306 (Jan. 8, 2013).)

[8] See Final Exemptive Order Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 858 (Jan. 17, 2013).