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Fed Rewrites Section 716 of Dodd-Frank

The Federal Reserve on Wednesday, June 5, issued an interpretation of the so-called "swaps push-out" section of the Dodd-Frank Act that corrects a drafting error that virtually everyone agrees needed to be fixed. The Federal Reserve's solution was simple: it rewrote the statute.

Section 716 of Dodd-Frank provides, in simplified form, that any US bank that engages in a significant amount of swaps activity may not be insured by the Federal Deposit Insurance Corporation ("FDIC") or use advances from the Federal Reserve's discount window in order to support its swaps business.[1] This provision is subject to numerous exceptions, the most important of which is that an FDIC-insured depository institution is exempt from most of the prohibitions.

Through what is generally acknowledged to be a drafting error, these exemptions were not explicitly extended to uninsured US branches and agencies of foreign banks. Thus, for almost three years, uninsured branches and agencies active in the swaps area have lived with the possibility that they would have to move almost all of their swaps out of their branches and agencies and into affiliates. Efforts to pass a technical corrections bill in Congress have not been successful.

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1 15 U.S.C. § 8305(a).

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With the effective date of July 16, 2013, looming, the Federal Reserve took action on two fronts. First, it adopted an interim final rule that allows all banking entities under its jurisdiction, which includes State member banks and uninsured State-licensed branches and agencies of foreign banks, to apply for a transition period of at least two years to conform their swaps activities to the statute. Second, and more importantly, it interprets the exemption in the statute to apply to uninsured branches and agencies.[2] This is very welcome to uninsured branches and agencies, but involves an interpretive sleight of hand that is extremely uncharacteristic of the normally cautious Federal Reserve lawyers.

- The Federal Reserve reasons as follows: Uninsured branches and agencies by definition are not FDIC-insured, so the statute's prohibition on using FDIC insurance to support swaps is not applicable. However, both insured and uninsured branches have access to the discount window on the same terms as do State member banks. Because insured and uninsured branches both have such access, Congress must have intended that both would be treated as "insured depository institutions." This idea is bolstered by legislative history since Senator Blanche Lincoln, the prime sponsor of Section 716, engaged in a colloquy with Senator Christopher Dodd during Senate consideration saying that they intended to give the exemption to uninsured branches and agencies. However, the statute's language does not give rise to this result.

- It is notable that the Federal Reserve's interpretation applies to Federally-licensed branches and agencies of foreign banks, and not just State-licensed ones. Usually the Office of the Comptroller of the Currency ("OCC"), which licenses and regulates Federal branches and agencies, takes such action. Indeed, the OCC in January 2013 published guidance providing the procedure for Federal depository institutions to file for a transition period, and the filing deadline passed on January 31.[3] The OCC's guidance explicitly refers only to insured Federal branches, not uninsured branches or any Federal agencies. It remains to be seen whether the OCC will issue new guidance for uninsured Federal branches and agencies to apply for a transition period to be consistent with the Federal Reserve's interim final rule.

- The Federal Reserve and OCC provide different wording for the information to be provided in a request for a transition period, but substantively they appear generally the same. The request must note the date to which the transition period would extend, a description of the quantitative and qualitative impact of immediate divestiture or cessation of swap activities on the institution (including on mortgage

[2] The interim final rule has not yet been published in the Federal Register and may be found on the Federal Reserve's website at http://www.federalreserve.gov/newsevents/press/bcreg/section-716-attachment20130605.pdf.

[3] Office of the Comptroller of the Currency, "Notice of Guidance", 78 Fed.Reg. 1306 (Jan. 8, 2013).

and small business lending, job creation, and capital formation), and a description of the plan to conform the activities to the statute's requirements.

- Applicability of Section 716 to any particular bank or US branch depends on whether it has registered as a swaps dealer (or security-based swaps dealer) under Title VII of Dodd-Frank. Insured depository institutions are exempt from coverage if they are only major swap participants, but not dealers. In addition, with one exception, swaps for the purpose of hedging related to the institution's activities and swaps involving rates or reference assets permissible for investment by a national bank are allowed for insured depository institutions.[4] Any US bank, branch or agency that so registered would be subject to Section 716, and would likely want to take advantage of the opportunity to obtain a two-year transition period, extending to mid-2015, to bring its swaps activities into compliance with the statute.
- The interpretation appears to have resolved another potential question, but by negative implication. Some foreign banks were concerned that Section 716 would apply to the banks' head office and other non-US branches on the theory that the foreign bank through its US branch or agency has access to the discount window. The Federal Reserve's interpretation speaks only of US branches and agencies, which appears to mean that it treats the US branches and agencies as separate entities for this purpose. Such treatment would be consistent with the general regulatory approach of Federal banking law toward the applicability of US regulatory restrictions.

The larger concern is whether interpreting Section 716 in this manner may be extended to other situations. This is a concern that is not readily allayed, no matter the good intentions that may have prompted the interim final rule in the first place. An alternative and less blunt approach could have been used, such as an intra-agency agreement not to enforce the statute should US branches and agencies observe criteria designed to mitigate the dangers that Dodd-Frank was enacted to prevent.

The Federal Reserve requests comments on the interim regulation by August 4, 2013. We will continue to follow these matters as the regulatory agencies come to grips with the difficult interpretive issues that Dodd-Frank presents.

4 Credit default swaps are not authorized unless they are cleared through a derivatives clearing organization. 15 U.S.C. § 8305(d)(3).

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