June 28, 2010

Senate-House Conference Agrees on Swap Pushout Rule

On June 25, 2010, the Senate-House conference on the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Bill**") agreed on the final legislative text of the Bill, including Section 716 (the "**Swap Pushout Rule**"). The Swap Pushout Rule is a revised version of a provision originally introduced by Senator Blanche Lincoln (D–AR) to the Senate Agriculture Committee. The provision led to significant controversy, including the objections of several key politicians and regulators. The controversy continued through the early morning hours of June 25, when compromise language was finally agreed upon. The result is a provision that includes an unusual number of ambiguities and apparent contradictions.

Executive Summary.

At the heart of the Swap Pushout Rule is a prohibition on the provision of certain types of "Federal assistance" to certain swap dealers and major swap participants referred to as "swaps entities."[1] Insured depository institutions are excluded from the term "swaps entity" if they are only major swap participants and not swap dealers. In addition, insured depository institutions and covered financial companies under the new orderly liquidation authority in Title II of the Bill are excluded from the term if they are under federal conservatorship, receivership or resolution proceedings.

The Swap Pushout Rule also exempts insured depository institutions acting as swap dealers from the prohibition on Federal assistance if they limit their swap activities to hedging and other similar risk management activities or to swaps involving rates or reference assets in which national banks are permitted to invest under the National Bank Act. It also provides that the prohibition on Federal assistance does not apply to, and will not prevent an insured depository institution from having, an affiliate that is a swaps entity if the insured depository institution is part of a bank holding company or savings and loan holding company that is supervised by the Federal Reserve, and subject to compliance with Sections 23A and 23B of the Federal Reserve Act and such other requirements as the SEC or CFTC, as appropriate for the type of swap, and the Federal Reserve determine to be necessary and appropriate. The Council has the discretion to prohibit Federal assistance to swaps entities, regardless of the exemptions in the statute, if necessary to mitigate systemic risk and protect taxpayers as determined by two-thirds of the Council, including the Treasury Secretary, the Federal Reserve Chairman and the FDIC Chairperson.

The Swap Pushout Rule will become effective 2 years after the derivatives title of the Bill becomes effective, which is 360 days after the date of enactment. The Swap Pushout Rule has up to an additional 2-year transition period for insured depository institutions, plus the possibility of a discretionary 1-year extension.

The Swap Pushout Rule will require certain entities that rely on Federal assistance and have significant swaps business to move aspects of that business into non-bank affiliates, subject to additional rules, or in certain cases divest or cease to engage in that business.

[1] For ease of presentation, the term "swap" will be used in this memorandum to refer to both "swaps" and "security-based swaps," the term "swap dealers" will be used in this memorandum to refer to both "swap dealers" and "security-based swap dealers," and the term "major swap participants" will be used in this memorandum to refer to both "major swap participants" and "major security-based swap participants."

Prohibition on "Federal Assistance" to Swaps Entities.

What is "Federal assistance"?

- Federal assistance means "the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act [or] Federal Deposit Insurance Corporation insurance or guarantees for the purpose of:
  - making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;
  - purchasing the assets of any swaps entity;
  - guaranteeing any loan or debt issuance of any swaps entity; or
  - entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity."

What is a "swaps entity"?

- The term "swaps entity" means any swap dealer or major swap participant that is registered under the Commodity Exchange Act or Securities Exchange Act of 1934. These are new categories of swap market participants added by the Bill as part of its regime to regulate the previously unregulated swap markets.
  - "Swap dealer" is a newly-defined category that includes any person that "regularly enters into swaps with counterparties as an ordinary course of business for its own account," in addition to persons that hold themselves out as dealers or who make a market in swaps. Significantly, however, in the final hours of the conference, a proviso was added to the definition of "swap dealer" that "in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." Based on the placement of this proviso, it is unclear whether it is a carve-out from all definitional prongs of the definition of "swap dealer" or only the definitional prong including as a swap dealer a person who is commonly known in the trade as a dealer or market maker in swaps.
  - Depending on its interpretation, the foregoing carve-out has the potential to exempt certain banks and thrifts that have a traditional lending function and limited swap activities from becoming "swap dealers," allowing them to receive "Federal assistance" without pushing out their swap activities.
  - "Major swap participant" is a newly-defined category generally meant to encompass entities that are not swap dealers but have significant positions in swaps that could pose systemic danger. The SEC and CFTC are mandated under the Bill to clarify the scope and reach of these definitions through regulation.
  - In addition to the Swap Pushout Rule, swap dealers and major swap participants are subject to new requirements for registration, clearing and exchange trading of formerly over-the-counter derivatives, reporting of non-cleared swaps, minimum capital and margin, segregation of customers' collateral, business conduct standards and position limits.

May an insured depository institution have a swaps entity affiliate and still receive Federal assistance?

- The Swap Pushout Rule specifically provides that an insured depository institution that is part of a bank holding company or savings and loan holding company supervised by the Federal Reserve

may have a swaps entity affiliate and still receive Federal assistance, so long as Sections 23A and 23B of the Federal Reserve Act are complied with and any additional requirements that the SEC or CFTC, depending on the type of swap, and the Federal Reserve may determine to be necessary and appropriate are complied with.

- Elsewhere in the Bill, Sections 23A and 23B of the Federal Reserve Act are modified to include derivatives with affiliates as "covered transactions" to the extent they create bank or thrift credit exposure to the affiliate, and, as a result, such derivatives will be subject to quantitative limits and collateral requirements under these sections.
- In addition, the authority given to the SEC or CFTC and Federal Reserve to make rules governing the relationship of insured depository institutions to swap entity affiliates is quite broad and could allow the regulators to impose limitations and restrictions that are more severe than those resulting from Sections 23A and 23B.

What additional authority does the Financial Stability Oversight Council have to prohibit Federal assistance to swaps entities?

- The Council, the systemic risk regulator created by the Bill, is provided the authority to ban, on an institution-by-institution basis, Federal assistance to swaps entities if it finds that the other provisions of the Bill are insufficient to effectively mitigate systemic risk and protect taxpayers. The Council may only take this step after notice and hearing and upon a two-thirds vote, which must include the vote of the Treasury Secretary, the Chairman of the Federal Reserve and the Chairman of the FDIC.

Exclusions from the Ban on Federal Assistance.

What exclusions exist from the definition of swaps entity?

- Explicitly carved out of the definition of swaps entity are insured depository institutions that are major swap participants but not swap dealers. As a result, an insured depository institution would be a swaps entity only if it is a swap dealer.
- In addition, the term "swaps entity" does not include insured depository institutions or covered financial companies under Title II of the Bill that are in conservatorship or receivership, or bridge banks operated by the FDIC.

What are the exemptions from the prohibition on providing Federal assistance?

- Insured depository institutions are not subject to the prohibition on Federal assistance if they limit their swaps activities only to the following:
  - hedging or similar risk mitigation directly related to its activities; or
  - swaps involving rates or reference assets that are permissible for investment by a national bank under the portion of the National Bank Act contained in 12 U.S.C. 24(Seventh), other than non-cleared credit default swaps, including those referencing the credit risk of asset-backed securities.
    - The National Bank Act permits national banks to invest in a wide range of assets, including loans; promissory notes; drafts; bills of exchange; other extensions of credit; foreign currency; coins; gold, silver and certain other precious metals; U.S. government and agency securities; certain investment shares in investment companies as long as the assets held by the investment companies are bank permissible; and other debt securities that are considered "investment securities" (generally investment grade debt securities or otherwise considered by the bank in

good faith to be reasonably liquid); and any other asset that the OCC has or may in the future determine to be part of the "business of banking" or an incident thereto. *See, e.g.*, *Ludwig v. Variable Annuity Life Insurance Co.*, 513 U.S. 251, 258, n.2 (1995).

- 12 U.S.C. 24(Seventh) expressly prohibits national banks from dealing in equity securities.

Rulemaking and Standards.

What additional rules and standards are provided for within the Swap Pushout Rule?

- In order to be or become a swaps entity, banks and bank holding companies will be required to meet minimum standards set by their prudential regulator meant to permit the entity to conduct its swap activities in a safe and sound manner and to mitigate systemic risk. In creating these rules, the prudential regulator must consider:
  - the expertise and managerial strength of the swaps entity, including systems for effective oversight;
  - the financial strength of the swaps entity;
  - systems for identifying, measuring and controlling risks arising from the swaps entity's operations;
  - systems for identifying, measuring and controlling the swaps entity's participation in existing markets; and
  - systems for controlling the swaps entity's participation or entry into in new markets and products.
- The prudential regulator's authority to promulgate rules under this provision seems quite broad, and it is possible that under extreme circumstances such authority could be used to severely limit or effectively ban the use of swaps by certain banks and bank holding companies.

Ban on Losses to Taxpayers and the Insolvency of a Swaps Entity.

What does the Swap Pushout Rule provide regarding the use of taxpayer funds with respect to insolvent or potentially insolvent swaps entities?

- The Swap Pushout Rule precludes the use of taxpayer funds to prevent the receivership of any swap entity that is FDIC insured or has been designated systemically significant (as designated under Section 113 of the Bill) resulting from swap activity.
- If, nonetheless, such an FDIC-insured or systemically significant institution is put into receivership or declared insolvent due to swap activity, then its swap activity will be subject to termination or transfer in accordance with applicable law.
- No taxpayer resources may be used for the orderly liquidation of any swaps entity that is non-FDIC insured or non-systemically significant institution not subject to heightened prudential supervision as regulated under Section 113 of the Bill.
- All funds expended on the termination or transfer of swap activity of a swaps entity must be recovered, either through the disposition of assets of the swap entity or by assessments, including on the financial sector.
- In addition, the Swap Pushout Rule contains the following remarkably broad provision: "Taxpayers shall bear no losses from the exercise of any authority under [the derivatives title of

the Bill].” The provision does not define the terms “loss” or “taxpayer” or specify any remedies for the breach of the provision.

Interaction of Swap Pushout Rule and the Volcker Rule

How does the Swap Pushout Rule work with the Volcker Rule?

- The Swap Pushout Rule explicitly provides that insured depository institutions are subject to the Volcker Rule, as adopted in Section 619 of the Bill, with respect to their proprietary activity in derivatives. Further analysis of the Volcker Rule may be found in Davis Polk's memorandum “Senate-House Conference Agrees on Final Volcker Rule” dated June 25, 2010, available here.

Effectiveness and Transition Period.

When does the Swap Pushout Rule become effective?

- The Swap Pushout Rule becomes effective two years after the effective date of the derivatives title, which is 360 days after its enactment.

What transition period exists for the Swap Pushout Rule?

- The Swap Pushout Rule requires the appropriate Federal banking agency, in consultation with the SEC and CFTC, to permit insured depository institutions a transition period for compliance with the Swap Pushout Rule, during which the insured depository institution may divest the swaps entity or cease the activity that requires registration as a swaps entity [sic].[2] The length of the transition period is in the discretion of the appropriate Federal banking agency, in consultation with the SEC and CFTC, up to a maximum of three years.
- There does not appear to be a similar transition period for entities that are not insured depository institutions.

[2] It is unclear what registration requirement is referred to. Possibly, this is intended to be registration as a “swap dealer.”

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

Daniel N. Budofsky	212 450 4907	daniel.budofsky@davispolk.com
Robert L.D. Colby	202 962 7121	robert.colby@davispolk.com
Luigi L. De Ghenghi	212 450 4296	luigi.deghenghi@davispolk.com
John L. Douglas	212 450 4145	john.douglas@davispolk.com
Randall D. Guynn	212 450 4239	randall.guynn@davispolk.com
Arthur S. Long	212 450 4742	arthur.long@davispolk.com
Annette L. Nazareth	202 962 7075	annette.nazareth@davispolk.com
Reena Agrawal Sahni	212 450 4801	reena.sahni@davispolk.com
Margaret E. Tahyar	212 450 4379	margaret.tahyar@davispolk.com

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