DODD-FRANK: DERIVATIVES AS CREDIT EXTENSIONS OF BANKS

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I. INTRODUCTION

The Dodd-Frank Act is intended to address what is generally considered the most serious financial crisis since the Great Depression. Its 16 titles, covering hundreds of pages, impose major additions to the financial regulatory system of the United States. The Act provides for inter-agency coordination to focus specifically on emerging risks in the financial system, a mechanism to sell or liquidate those nonbank companies considered too important to the financial system to be allowed to go through insolvency proceedings under the Bankruptcy Act (commonly called "systemically significant financial institutions," and generally considered to be "too big to fail"), a regulatory system for derivatives, and a new consumer financial protection bureau intended to impose requirements on virtually all providers of credit to consumers.[1] It also tightens many existing regulatory restrictions on financial institutions and allows or requires regulatory agencies to impose enhanced restrictions, such as liquidity requirements, higher capital requirements, risk management requirements, and the preparation of a "living will" so that the sale or liquidation of a systemically significant organization can be conducted more easily if necessary.

The Act will impose Federal regulation on the significant players in the derivatives market. These requirements, set out in Title VII of the Act, are intended to provide a regulatory scheme for all entities active in derivatives generally, including requirements for registration, capital and margin, recordkeep-

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1. *See generally* Titles I, II, VII and X of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

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ing, business conduct, clearing and the like. These requirements will apply to banks as well as others that are significantly involved in the derivatives business.

However, banks will become subject to additional restrictions specific to them. Banks are subject to a variety of limitations and prohibitions that are intended to protect them against debilitating losses, such as limits on the extent to which they may be involved in non-financial lines of business, a prohibition on acquisitions of stock except in limited circumstances, and limitations on the types of transactions that they may engage in with persons controlled by their controlling shareholder(s). Derivative transactions have not been subject to these limitations and prohibitions. Rather, banks have been subject to general guidelines issued by bank supervisors requiring that controls be designed to protect against harm to the bank, but without explicit boundaries. The Act for the first time imposes such boundaries.

II.
THE ACT'S AMENDMENT OF LIMITS ON BANK LOANS TO A SINGLE BORROWER

One of the new limits on the derivatives business of banks is a requirement that all derivatives be included in a bank's exposure to risk of loss of its counterparties along with all other credit exposures to those counterparties.

Historically, banks in the United States have been subject to limits on their total credit exposure to a single borrower. It is because of this limit that banks are not allowed to be exposed to risk of loss to any one party above the maximum allowed by statute. The purpose of the limit is to avoid concentration of bank assets with any one party and to encourage diversification of assets. National banks, which are banks chartered pursuant to the National Bank Act and supervised by the Office of the Comptroller of the Currency ("OCC"), an office within the Department of the Treasury, are subject to a limit of 15 percent of the bank's capital and surplus for unsecured loans and an additional 10 percent for loans secured by appropriate collateral, subject to various exceptions.[2] State law sets the percentage limit and definition of terms applicable

2. 12 U.S.C. § 84 (2010); 12 C.F.R. pt. 32 (2010).

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to banks chartered under the law of the particular state, and U.S. branches and agencies of foreign banks are subject to the national bank lending limit, calculated on the basis of global capital of the foreign bank.[3]

However, OCC guidance has not indicated that derivative transactions are covered by the lending limits. Rather, the guidance has required that national banks have policies and procedures measuring and limiting their exposures on derivatives, but has not included those exposures within the lending limit applicable to the particular customer.[4] There appears to be no substantive reason for this exception since the types of obligations covered by the lending limit are broad, including off-balance-sheet items such as loan commitments.[5]

The Act requires that national banks include their credit exposures attributable to derivative transactions in the calculation of total credit exposures subject to the single-borrower limit. The Act amends the national bank lending limit statute to include:

> [A]ny credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction between the national banking association and the person.

Dodd-Frank Act, § 610(a), amending 12 U.S.C. § 84(b)(1).

This provision is effective one year after the "transfer date" which is either July 21, 2011 (one year after enactment of the Act) or a date up to six months after that date if the Secretary of the Treasury grants additional time to transfer the Office of Thrift Supervision into the OCC (the "Transfer Date").[6] Thus, this limit would be effective some time in the second half of 2012.

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3. As an example of a State's single-borrower lending limit, see New York's requirement at N.Y. BANKING LAW § 103 (McKinney 2010). Foreign banks: 12 U.S.C. § 3105(h)(2) (2010). An agency of a foreign bank is simply an office that, unlike a branch, does not accept deposits from U.S. citizens or residents. 12 U.S.C. § 3101(b)(1) (2010).

4. For example, see the OCC's Interpretive Letter No. 892, Sept. 13, 2000, [2000-2001 Tr. Binder] Fed. Banking L. Rep. (CCH) ¶¶ 81-411, and previous interpretive letters cited therein.

5. 12 C.F.R. §§ 32.2(f), (k), (l) (2010).

6. Dodd-Frank Act §§ 2(17), 311.

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A. *The Act's Definition of "Derivative Transaction"*

The provision adds a definition of "derivative transaction" to include:

> [A]ny transaction that is a contract, agreement, swap, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets.

Dodd-Frank Act, § 610(b).

This same definition is incorporated by reference in the provisions discussed below concerning other limits imposed on derivative transactions.

This definition is not the same as the definition of derivatives used in other portions of the Act. Title VII of the Act imposes a regulatory regime on all derivatives dealers and major participants for the first time, a provision that is likely to have far-reaching consequences for the structure of the derivatives market. Title VII is intended to cover all derivatives in order to protect the safety and soundness of the derivatives market, require that participants have sufficient capital to support their exposures, and obtain current information on the size and nature of the market. For that purpose, the definition of derivatives is extremely broad.[7]

The definitions used for purposes of lending limits are far less detailed than those used for Title VII. For example, "swap" includes an "option" on a "security," which under Title VII remains a "security" rather than a "swap." Also, it appears to include various structured notes the returns on which are linked to other reference assets, which are probably not swaps for purposes of Title VII. Accordingly, for purposes of calcu-

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7. The definitions are of the terms "swap" and "security-based swap" because of the split of authority between the Securities and Exchange Commission and the Commodity Futures Trading Commission. The definitions are very long. For example, the term "swap" includes "any agreement, contract, or transaction (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind. . .." Additional types of instruments are included. Dodd-Frank Act, § 721(a)(47).

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lating exposures for lending limit purposes, a national bank will not be able to simply take all swaps subject to the requirements of Title VII and include them in the calculation. Rather, a national bank will have to establish a system to track swaps as defined for lending limit purposes, rather than for Title VII, in order to comply with lending limit requirements.

B. *The Act's Concept of "Credit Exposure"*

The term "credit exposure" is not defined in the Act. Accordingly, the OCC will have to provide a definition so that national banks will know how to calculate it. However, this same term is used in other provisions discussed below. Whether the relevant agencies agree on a common definition of the term will be one of many things to look for when proposed regulations under the Act begin to be issued.

How the OCC requires national banks to calculate the amount of credit exposure will be a key element in understanding the impact of this provision. The higher the amount of credit exposure for a given amount of derivatives with a single counterparty, the more likely it is that the counterparty's single-borrower credit limit will be reached, which would limit the amount of additional credit that the bank may extend to that counterparty. Thus, it could make a significant difference whether the term is defined as the maximum possible amount that a bank might be required to pay on a derivative, or rather as a risk-adjusted amount based on the probability of payment or a mark-to-market value. The latter amounts by definition would be lower than the maximum possible payout that the bank might be obligated to make, and accordingly would leave more "headroom" between the counterparty's total credit amount and the maximum amount allowable for that bank.

For purposes of comparison, an existing statutory requirement imposing limits on banks' exposure to other banks, set forth in Regulation F of the Board of Governors of the Federal Reserve System ("Fed"), uses the term "credit exposure" and includes within it all assets and off-balance-sheet items that are subject to capital adequacy requirements of the bank's Federal supervisor "on the basis of current exposure."[8] This provision

8. Regulation F, 12 C.F.R. § 206.4(b) (2010). The regulation is authorized by Section 23 of the Federal Reserve Act, added in 1991 by the Federal Deposit Insurance Corporation Improvement Act of 1991. It does not set

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seems to incorporate by reference the treatment of off-balance-sheet items, which include most derivative transactions, in the capital adequacy rules. The limitation to "current exposure" in Regulation F means that potential or future exposure on a derivative included in risk-weighted capital calculations is not included within the scope of the regulation. If the agencies exclude exposures other than current exposure, then the aggregate amount of exposure to a counterparty will be lower than the maximum possible amount payable, and therefore be beneficial for banks.

Another question that national banks will have to resolve is whether an existing netting agreement in place with a client may use the net number as a basis for measuring exposure. Netting agreements have the effect of reducing the amount of the bank's exposure to any counterparty to an amount that is usually less than the simple sum of exposures on all derivatives because some derivatives transactions will be positive in favor of the bank while others will be positive in favor of the counterparty. In those cases, the net amount will be less than the sum of all total positive exposures. This treatment may be recognized by a bank only if the arrangement satisfies regulatory requirements applicable to capital calculations, under which the netting arrangement must be found to be recognized in the event of the counterparty's insolvency.[9] Because of their recognition in bankruptcy proceedings, netting agreement should be recognized for purposes of calculating lending limit compliance. Legally valid netting agreements are sufficient to allow use of a net amount of exposure for purposes of Regulation F.[10]

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out firm limits generally but rather requires banks to adopt and implement policies and procedures designed to limit their exposures to other banks.

9. Banks reduce their risk-based capital adequacy requirements by netting exposures on derivative transactions with the same counterparty. In some cases, a bank will owe funds to a counterparty on one derivative while the counterparty owes funds to the bank on another derivative. If done properly, the bank may net these two transactions and show a net amount less than the total of the gross amounts, thereby lowering the amount of risk-adjusted assets against which capital must be maintained. *See* 12 C.F.R. pt. 225, App. A, § III(E)(3) (2010) (Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure).

10. 12 C.F.R. § 206.4(c) (2010).

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It is not clear how the fluctuation in value of derivatives transactions will be handled. Because the obligations owed by each party on a derivative transaction to the other may change, depending on the terms of the transaction and the changes in value of the asset or index underlying the transaction, the amount owed to a bank at any particular time during the life of the transaction may change. There is no equivalent for changes in loan principal, without amending the loan agreement, in the OCC's existing regulations. A possible analogy is the OCC's provision regarding changes in value of collateral. A loan would not violate the lending limit if the value of the collateral has declined.[11] However, the bank is required to bring the loan into conformity within 30 days of a decline below the amount needed to be in compliance.[12] One way to deal with this issue would be to require that the bank measure its exposure on a monthly or quarterly basis and use that amount as the credit exposure on a particular derivative for the following monthly or quarterly period, without requiring the bank to obtain additional collateral or take action to reduce its exposure.

In addition, the OCC will have to decide whether to grant an exemption from coverage for a derivative transaction that a national bank enters into with another U.S. bank. The regulation excludes from coverage as an extension of credit a one-day or continuing loan to another U.S. bank or U.S. branch of a foreign bank, known as a "Federal funds sale," but not one with a maturity of more than one day.[13]

1. *Identifying the "Single" Borrower*

The national bank lending limit treats all members of a corporate group that meet certain standards to qualify as a single borrower for purposes of applying the lending limit.[14] Thus, a corporate family consisting of many different companies may be treated as one borrower for purposes of the limit. The Dodd-Frank Act does not change this requirement. However, the inclusion of derivatives within the lending limit will complicate the calculation. If a national bank enters into de-

11. 12 C.F.R. § 32.6(a)(2) (2010).
12. *Id.*
13. 12 C.F.R. § 32.2(k)(1)(vi) (2010).
14. *See* 12 C.F.R. §§ 32.5(a), (d) (2010).

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rivatives with more than one member of a corporate group, it will have to make the determination whether the particular members are a single borrower for purposes of the single-borrower lending limit.

In the event that the OCC recognizes the effect of a master netting agreement for this purpose, national banks will likely not be allowed to make the calculation by netting all exposures with all members of a particular customer's corporate group. As a legal matter, a netting agreement with a particular company nets transactions only with that company unless the agreement explicitly allows netting across affiliates, generally difficult to arrange. In the absence of a legally valid netting arrangement covering all derivatives between a bank on one side and each affiliate of a corporate group that constitutes a single borrower for lending limit purposes, banks will not be allowed to net all exposures to the entire group down to a single number. Rather, the bank will have to calculate a net amount for each member of the group and then sum the positive amounts for each such member, without subtraction for negative amounts for certain members, in order to calculate the bank's total credit exposure to that group.

2. *Effect of Collateral*

As noted above, the national bank single-borrower lending limit may be higher than the generally applicable unsecured limit depending on the nature of any collateral held by the bank. In addition, the credit is completely exempt from the limit, to the extent that an extension of credit is secured by U.S. Government and agency securities, municipal securities or cash.[15] The regular use of such collateral for derivative transactions may greatly reduce the cost of compliance with the lending limit. However, this effect will need to be considered in conjunction with any new collateral requirements imposed on derivatives under Title VII.

C. *The Dodd-Frank Act's Lending Limit Requirement of State Banks*

As noted above, banks chartered under state law are not subject to national bank lending limits but rather the limits set

15. *See* 12 C.F.R. §§ 32.3(c)(3)-(6).

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by each state. The Dodd-Frank Act does not impose the national bank lending limits directly on state banks.[16] However, it requires states to include derivative exposures in their calculation of lending limits or their banks will be disallowed from entering the derivatives market.

The Act provides that a state bank insured by the Federal Deposit Insurance Corporation ("FDIC") may engage in a derivative transaction, as defined in the provision applicable to national banks discussed above, "only if the law with respect to lending limits of the State in which the insured State bank is chartered takes into consideration credit exposure to derivatives transactions."[17] Thus, unless state law in some way provides for consideration of credit exposure from derivatives, the banks chartered by that state may not enter into derivatives transactions. There is no exception for hedging or other risk-management actions. Effectively, this imposes on each state a requirement to assure that its law on lending limits complies with this provision. There appears to be an understanding among some state supervisors that a regulation or interpretation, and not a formal statutory amendment, would be sufficient to satisfy the provision.

This provision is effective 18 months after the Transfer Date. Accordingly, it would be effective in the first half of 2013.

D. *Branches and Agencies of Foreign Banks*

Because branches and agencies of foreign banks are subject to the single-borrower lending limits imposed on national banks, they would be covered by the Act's requirement to include credit exposures on derivatives when calculating the single-borrower lending limit. This is true even for state-licensed branches and agencies, and therefore the requirements of the state law provision discussed above should not affect them,

16. An earlier provision in the legislation would have imposed the national bank lending limits on all state banks regardless of state law. *See* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 611 (2010). This provision was changed due to concerns about Federal pre-emption of state law on regulatory requirements generally.

17. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 611(a) (2010) (adding new Section 18(y) to the Federal Deposit Insurance Act (12 U.S.C. § 1828(y))).

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since they must comply with the national bank lending limit regardless of the provisions of state law.

III.
THE ACT'S NEW EXPOSURE LIMIT ON SYSTEMICALLY SIGNIFICANT COMPANIES

The Dodd-Frank Act requires that the Fed issue regulations prohibiting systemically significant bank holding companies and nonbank financial companies from having credit exposure to any unaffiliated company that exceeds 25 percent of the company's capital and surplus. The Fed may set the limit at a lower amount if it finds the lower amount "to be necessary to mitigate risks to the financial stability of the United States."[18]

Included in the definition of "credit exposure" for this purpose is "counterparty credit exposure to the company in connection with a derivative transaction. . ."[19] Again, "credit exposure" in this context is undefined. As a result, Fed regulations implementing this provision will have to specify how covered institutions will calculate their derivative exposure for purposes of the limit.[20]

This provision is effective three years after the date of enactment, or July 21, 2013, and may be extended by the Fed for two additional years. The reason for the long period before effectiveness was not stated in the legislative history, but it appears to be based on the significant change in current bank holding company operating and risk management procedures that this new limit will impose.

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18. Dodd-Frank Act § 165(e)(2). Systemically significant bank holding companies consist of those bank holding companies with at least $50 billion in total consolidated assets. *See id.* § 165(a)(1). Nonbank financial companies may be designated as systemically significant pursuant to standards set forth in Section 113 of the Dodd-Frank Act. *See id.* § 165(b)(3)(A)(i).

19. *See id.* § 165(e)(3)(E).

20. There is no statutory equivalent to a single-borrower lending limit in the BHCA. Lending limits have been imposed only on banks themselves, not their parent holding companies or affiliates.

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IV.
THE ACT'S AMENDMENT OF SECTION 23A

Section 23A of the Federal Reserve Act ("Section 23A") imposes significant limitations on transactions between a U.S. FDIC-insured bank and its affiliates.[21] Section 23A is subject to interpretation by the Fed, which has issued its Regulation W providing detailed guidance on the meaning of its terms and how to comply with its requirements.[22]

Generally, Section 23A requires that "covered transactions" between a bank and an affiliate comply with quantitative and qualitative limits. A bank can engage in covered transactions with any one affiliate in an amount up to 10 percent of the bank's capital and surplus, and may do so with all affiliates in the aggregate only up to 20 percent of capital and surplus.[23] In addition, certain covered transactions, such as extensions of credit, must be fully collateralized.[24]

A. *Derivatives as Covered Transactions*

In 2002 the Fed determined that a bank may enter into a derivative transaction with an affiliate without being considered a covered transaction so long as the bank has risk measurement and monitoring systems in place for such transactions, including credit limits on derivatives exposures, and the derivative transaction is on "market terms."[25] Accordingly, derivatives between a bank and its affiliates meeting these requirements have been exempt from Section 23A limits. Many bank holding companies have established a central entity, either a bank or a nonbank, as a risk management center for all derivatives businesses with third parties and have set up back-to-back derivatives with that central entity in order to hedge all

21. 12 U.S.C. § 371c (2010).
22. 12 C.F.R. pt. 223 (2010).
23. 12 C.F.R. §§ 223.11-12 (2010) (stating the maximum amounts of covered transactions that a member bank can enter into with an affiliate).
24. 12 U.S.C. § 371c(c) (2010); 12 C.F.R. § 223.14 (2010).
25. *See* 12 C.F.R. § 223.33 (2010). See the discussion in the adopting release of Regulation W at 67 Fed. Reg. 76560, 76587-89 (Dec. 12, 2002) (hereinafter Regulation W Adopting Release). There is an exception for a credit derivative with a third party that constitutes effectively a guarantee of performance of an obligation of an affiliate; such derivatives are covered transactions, since guarantees of affiliate obligations are covered transactions under Section 23A. 12 U.S.C. § 371c(b)(7)(E) (2010).

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companies' exposure to third-party derivatives. The advantages of such an arrangement are that the central point measures both the organization's risk of loss based on the instruments underlying each derivative transaction and the organization's credit exposure on a net basis to each counterparty. This system allows management to have a good overview of the organization's risks in conducting a derivatives business and to exert a greater degree of control over those risks. Freedom from compliance with Section 23A makes this arrangement attractive.

The Act reverses the Fed's 2002 decision. It includes within the definition of "covered transaction" any derivative transaction, using the national bank definition provided above, with an affiliate "to the extent that the transaction causes a [bank] to have credit exposure to the affiliate."[26] As with the national bank provision, there is no statutory definition of "credit exposure." Presumably the Fed will have to amend Regulation W in order to incorporate one. The Act explicitly authorizes the Fed to issue regulations or interpretations in "the manner in which a netting agreement may be taken into account in determining the amount of a covered transaction" for purposes of calculating the amount of a bank's covered transaction as well as the requirement for the affiliate to provide collateral.[27]

This amendment is effective one year after the Transfer Date.

B. *Implications of Derivatives as Covered Transactions*

Many of the questions discussed above on the national bank lending limit will similarly apply to the Section 23A amendment. However, as noted above, the amendment to Section 23A could have a serious effect on the manner in which major banking organizations centrally manage their derivatives businesses. The 10-percent limit would likely constrain a bank's back-to-back derivatives with a nonbank affiliate that serves as the central management point for the entire banking organization. The new rule imposed by the Dodd-

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26. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 608(a)(1)(A) (2010) (adding new subsection (G) to Section 23A(b)(1)).

27. *Id.* § 608(a)(4)(B) (adding new subsection (4) to Section 23A(f)).

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Frank Act will require that banks calculate and comply with these limits when engaging in derivatives transactions with affiliates. Thus, the 10- and 20-percent limits will have to be complied with, and net exposures to affiliates will have to be collateralized.

However, as for the national bank lending limit, the use of U.S. Government and agency securities or cash as collateral generally exempts a covered transaction from the percentage limits. Many banks obtain such collateral in order to meet the "market terms" requirement noted above. If they continue to do so, then the percentage limits will not pose a significant constraint since covered transactions fully collateralized by U.S. Government and agency securities are exempt from coverage by Section 23A.

C. *Effect of Section 23A's Attribution Rule*

Section 23A has a provision, known as the Attribution Rule, which states that a transaction between a bank and a third party will be treated as a covered transaction under Section 23A to the extent that the proceeds of the transaction are "used for the benefit of, or transferred to," an affiliate.[28] This provision is intended to prevent evasions of Section 23A; for example, a bank could request a customer to take a loan and then transfer the proceeds to an affiliate, with appropriate compensation to the customer.[29] However, there is no requirement in the statute that the bank have knowledge of the use of the proceeds, and the Fed explicitly declined to provide for such an exception in Regulation W.[30] For example, if a borrower obtains a loan from a bank and then uses the proceeds of the loan to repay an obligation to the bank's affiliate, technically the proceeds have been "transferred to" the affiliate and the Attribution Rule is invoked. However, if the bank

28. Section 23A(a)(2).

29. Regulation W Adopting Release at 76576.

30. *Id.* ("The [Fed] considers an exemption for transactions where the member bank does not know, or have reason to know, that the proceeds will flow to an affiliate as too broad in light of the important place of section 23A in the bank regulatory framework. The [Fed] is not willing to make the applicability of the attribution rule contingent in all cases on subjective factors such as a member bank's knowledge of the purpose of a transaction. . .").

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does not know that this has occurred, it cannot take action to comply with the rule.

This issue has not arisen in connection with derivatives because banks' derivative transactions with affiliates were not covered transactions at all, and accordingly there was no provision to evade. However, under the Act, the issue would arise whether the Attribution Rule would apply to a derivative by a bank with a third party and the third party had other derivative transactions with an affiliate of the bank. Another possible scenario would be when a third party borrows from an affiliate of the bank and then seek to enter into an interest-rate or other derivative with the bank in order to hedge some aspect of the borrowing from the affiliate. Would the derivative be "for the benefit of" the affiliate? One can argue that it would not so long as the affiliate has no direct interest in the derivative.

Such situations are ones that the Fed ought to address in Regulation W in order to avoid uncertainty in the use of derivatives with third parties to hedge risk or otherwise satisfy customer demands. The Fed has recognized the difficulties posed by the Attribution Rule and has provided "safe harbors" from coverage by the Rule for certain types of transactions, such as the use of credit cards issued by a bank in order to acquire goods and services provided by affiliates.[31] Similar action could be taken to deal with derivatives.

D. *Marking Collateral to Market Under Section 23A*

Another change imposed by the Act is the new requirement that collateral provided by an affiliate to a bank for any covered transaction, including derivatives, be marked to market.[32]

Previously, the Fed had not imposed this requirement in Regulation W due to a concern that the language of Section 23A, requiring collateral to be provided to the bank "at the time of the transaction," did not allow such a requirement.[33] The absence of a requirement to mark to market has greatly simplified ongoing compliance with Section 23A's collateralization requirements; banks have not had to measure periodi-

31. 12 C.F.R. § 223.16(c) (2010).
32. Dodd-Frank Act § 608(a)(2)(A) (amending Section 23A(c)(1)).
33. 12 U.S.C. § 371c(c)(1) (2010).

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cally the market value of the collateral held to satisfy Section 23A, but rather could simply use the value established at initiation of the transaction.

That phrase is deleted by the Act.[34] Presumably the Fed will amend Regulation W prior to the effective date to indicate how banks will have to deal with marks to market. For example, the Act's amendment does not state how often a bank must review market value in order to comply with the requirement.

E. *Foreign Banks*

U.S. branches and agencies of foreign banks are not subject to Section 23A unless they are financial holding companies ("FHCs") under the Bank Holding Company Act of 1956, as amended ("BHCA").[35] If they are considered FHCs, transactions with certain affiliates—generally U.S. affiliates engaged in securities underwriting and dealing activities, insurance underwriting and investment activities, and merchant banking investments—must comply with Section 23A.[36] Thus, transactions with the head office and with other affiliates are not subject to Section 23A.

Accordingly, those foreign banks that are FHCs, and have U.S. affiliates engaged in those activities, will have to comply with Section 23A when engaging in derivative transactions between their U.S. branches and agencies and those affiliates. However, the foreign bank's head office or an offshore branch may enter into a derivative transaction with a covered U.S. affiliate without having to comply.

V. IMPACT OF THE SECTION 23A AMENDMENT ON THE ACT'S NEW "VOLCKER RULE"

The Act's so-called "Volcker Rule" generally imposes a prohibition on banks and bank holding companies from engaging in proprietary trading and in sponsoring and investing in private equity and hedge funds.[37] It has a provision that

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34. Dodd-Frank Act § 608(a)(2)(A) (amending Section 23A(c)(1)).
35. 12 U.S.C. § 1841 (2010).
36. 12 C.F.R. § 223.61 (2010).
37. Dodd-Frank Act § 619(a)(1) (adding Section 13 to the BHCA). For more information on the Volcker Rule, see Bradley K. Sabel, *Volcker Rule*

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incorporates the definition of "covered transaction" as used in Section 23A in order to severely restrict the relationship between the bank holding company and certain private funds.

Under the Volcker Rule, a bank holding company is prohibited from "sponsoring" a private equity or hedge fund with specified exceptions, but not from advising such a fund sponsored by a third party. As to an advised fund or a permissible sponsored fund, the bank holding company and its affiliates are disallowed from entering into a transaction that would be a covered transaction under Section 23A with the fund, treating the fund as though it were an affiliate and the bank holding company (and all affiliates) as though they were banks.[38] That is, the bank holding company and all of its subsidiaries are treated as though they are a "bank" subject to Section 23A, and the fund is an affiliate of the "bank."

This prohibition has a number of implications and difficult interpretive issues that will need to be addressed in rulemaking. However, the important point is that, with the addition of derivatives to Section 23A and this new prohibition being keyed off of such coverage, a bank holding company that sponsors or advises private equity or hedge funds will be prohibited from entering into at least some derivative transactions with any such fund. As a result, such funds may be forced to obtain at least some derivatives from third parties.[39]

The imposition of the requirements of Section 23A on associated funds under the Volcker Rule raises a subtle issue

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Continues to Garner Outsized Attention, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 31, 2010, 9:46AM), http://blogs.law.harvard.edu/corpgov/2010/10/31/volcker-rule-continues-to-garner-outsized-attention/#more-13648.

38. Dodd-Frank Act § 619(f)(1) (adding Section 13(f)(1) to the BHCA).

39. The Fed is explicitly authorized to allow such transactions to occur as "prime brokerage transactions" with any private equity or hedge fund in which a bank-sponsored or -advised fund has invested, subject to various requirements. Dodd-Frank Act § 619(f)(3). This provision appears not to authorize prime brokerage transactions, which might include derivatives, with the sponsored or advised fund itself. *See id.* It is clear that this result was intentional. On the date that the Senate voted in favor of the Act, Sen. Merkley (D-OR) discussed the Volcker Rule provision on funds and said, " 'Covered transactions' under section 23A includes loans, assets purchases, and, following the Dodd-Frank bill adoption, derivatives between the member bank and the affiliate." 156 CONG. REC. S5898 (daily ed. July 15, 2010) (statement of Sen. Jeff Merkley).

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concerning the scope of the prohibition on holding derivatives. As noted, the definition of "covered transaction" now includes "a derivative transaction, . . . to the extent that the transaction causes a [bank] to have credit exposure to the affiliate. . ." It does not appear to cover all derivatives, but rather only those that give rise to a credit exposure to the affiliated bank. At least theoretically, a derivative in which only the affiliate has "credit exposure" to the bank (and the bank has no such exposure to the affiliate) would not be subject to the prohibition.

This reading would be consistent with the treatment of other transactions as covered transactions. For example, a loan by a bank to an affiliate is a "covered transaction" because the bank incurs risk of loss to the affiliate, while a loan by an affiliate to a bank is not a "covered transaction." The Volcker Rule treats the entire banking organization as a "bank" and a sponsored or advised fund as an "affiliate." As a result, a derivative in which the fund always owes payments to the counterparty affiliate, and the affiliate never owes to the fund, would not be prohibited. Whether the Fed will agree with this understanding when it issues regulations remains to be seen. Even if it does, the question remains whether this possibility gives a meaningful avenue for banking organizations to engage in derivative transactions with their sponsored or advised funds.

Even if a sponsored or advised fund enters into derivative transactions with third parties, the Attribution Rule issue might enter into the picture. If a fund enters into a derivative with a third party, the Attribution Rule may prohibit the third party from entering into a derivative transaction with the bank holding company or affiliate in order to hedge it. The next question will be whether any derivative transaction between the third party and an affiliate will be questioned, rather than a derivative mirroring the same terms as the fund's derivative. This might be another issue that would be appropriate for the Fed to address in dealing with Attribution Rule issues raised by making derivatives covered transactions. However, it is not clear that the Fed has the authority to provide a safe harbor for purposes of the Volcker Rule. A safe harbor applicable to derivative transactions with third parties generally, as discussed above, might be applicable to the Volcker Rule prohibition.

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The Volcker Rule becomes effective no later than two years after enactment, and then there is a period of at least two years during which covered entities will have to come into compliance. Presumably the Fed will have amended Regulation W by that time so that the Volcker Rule and Section 23A may be read consistently with each other.

A. *Foreign Banks*

Foreign banks subject to the BHCA are covered by the Volcker Rule. However, an explicit exemption allows foreign banks to engage in proprietary trading and in private fund sponsoring and investment "solely outside of the United States" pursuant to sections 4(c)(9) and 4(c)(13) of the BHCA.[40] Thus, sponsoring and investing in non-U.S. funds outside of the U.S. generally should be permissible for foreign banks. However, the precise rules applicable to this exemption will have to await regulations.

Similarly, it would be logical to conclude that the rule permits a foreign bank's non-U.S. subsidiaries to engage in derivative transactions with non-U.S. funds that the bank sponsors or invests in. However, there is no explicit exclusion of non-U.S. offices and subsidiaries of a foreign bank from the definition of "banking entity" for this purpose. The Fed might be willing to interpret the provision of the statute that carves-out activities authorized by sections 4(c)(9) and 4(c)(13) to extend to offshore derivative transactions.[41] Fed precedent indicates this carve-out does extend to non-U.S. subsidiaries. Whether U.S. offices or subsidiaries may engage in derivatives with an affiliated offshore fund would be a more difficult question in light of the phrase "*solely* outside of the United States."

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40. Section 13(d)(1)(H) of the BHCA, added by Dodd-Frank Act § 619(d)(1)(H).

41. There is support in the legislative history for this position. Sen. Hagan (D-MD) on the Senate floor said, "For consistency's sake, I would expect that, apart from the U.S. marketing restrictions, these provisions will be applied by the regulators in conformity with and incorporating the Federal Reserve's current precedents, rulings, positions, and practices under sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act so as to provide greater certainty and utilize the established legal framework for funds operating by bank holding companies outside of the United States." 156 CONG. REC. S5889-90 (daily ed. July 15, 2010) (statement of Sen. Kay Hagan).

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VI. THE ACT'S AMENDMENT OF REGULATION O

The Fed's Regulation O imposes strict requirements on transactions with shareholders, directors, officers and others considered "insiders."[42] Regulation O applies to all FDIC-insured banks as well as those U.S. branches and agencies of foreign banks that are FDIC-insured. These restrictions also apply to companies controlled by insiders. Among the restrictions is a limit on credit extended to an insider similar to the single-borrower lending limit described above.

The Act requires that any derivative transaction, as defined for national banks, be included in the measure of credit exposure for this purpose.[43] Because virtually all derivative transactions are with companies rather than individuals, this inclusion will likely cause derivatives with companies associated with insiders to be included in calculations of the credit extended to those companies.

This provision is effective one year after the Transfer Date, and accordingly will be effective some time during the second half of 2012.

VII. THE MARGIN REGULATIONS?

One set of financial regulations for which the Act does not require derivatives to be treated as credit exposures is the Fed's margin regulations — Regulations T, U and X.[44] These regulations impose limitations on extensions of credit that satisfy two conditions: the credit must be secured by certain types of securities, and the proceeds of the credit must be used for the purpose of acquiring or holding securities.[45] The Fed has never officially stated that derivative transactions constitute an extension of credit subject to the margin regulations, though many cautious market participants treat them as such. Not including them is consistent with the Fed's longstanding ap-

42. *See* 12 C.F.R. § 215.4 (2010) (issued pursuant to Federal Reserve Act § 22(h), 12 U.S.C. § 375b (2010)); Federal Deposit Insurance Act § 18(j)(3), 12 U.S.C. § 1828(j)(3) (2010).

43. Dodd-Frank Act § 614 (amending Federal Reserve Act § 22(h)(9)(D)(i)).

44. 12 C.F.R. pts. 220, 221, 225 (2010).

45. 12 C.F.R. § 221.3 (2010).

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proach that the margin regulations not be further extended beyond their traditional coverage.

VIII. CONCLUSION

The several provisions discussed above will require U.S. and foreign banks subject to the Dodd-Frank Act to make significant adjustments to their current compliance procedures and monitoring systems as the provisions become effective. While it might appear that the time periods prior to effectiveness are long enough that planning can be delayed, in practice the amount of time available to take the necessary actions almost always turns out not to be long enough. It would be advisable for institutions to consider the effects of these provisions on their current operations and begin to plan how to make conforming adjustments. The regulatory process applicable to these provisions will bear close monitoring.

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