Clients&FriendsMemo

The Dodd-Frank Act's Impact on Affiliate Transactions

April 21, 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") contains several provisions that will tighten the restrictions that govern transactions between banks[1] and their affiliates – Sections 23A and 23B of the Federal Reserve Act[2] – beginning in July 2012. These new provisions will (i) **significantly increase the cost and burden** of certain types of transactions between a bank and its nonbank affiliates, in particular, derivatives, securities lending/borrowing, and repo transactions; (ii) **expand the scope of "affiliates"** subject to Sections 23A and 23B; and (iii) **increase the collateral burdens** applicable to extensions of credit. As a result, banks (as defined in footnote 1 below) **should review, and may be required to modify**, existing business arrangements with affiliates (as newly redefined) to comply with the new requirements.

I. Background

Sections 23A and 23B of the Federal Reserve Act are prophylactic statutes that restrict certain types of transactions between a bank and its non-bank "affiliates." These restrictions apply without regard to whether the transactions are beneficial to the bank – or at least pose no greater risk than if the transactions were with third parties. As the Federal Reserve has stated, the objectives of Sections 23A and 23B are twofold: (i) preventing bank losses arising from transactions between a bank and the bank's affiliates, and (ii) precluding the bank from transferring to its nonbank affiliates the subsidy arising from the

---

[1] Sections 23A and 23B apply by their own terms solely to "member banks" – national banks and those state banks that choose to become members of the Federal Reserve System – and their controlled subsidiaries. The Federal Deposit Insurance Act extends the application of Sections 23A and 23B to cover all FDIC-insured state banks, 12 U.S.C. § 1828(j), and the Home Owners' Loan Act extends Sections 23A and 23B to cover federal and state savings associations, 12 U.S.C. § 1468. Thus, Sections 23A and 23B now apply to all FDIC-insured depository institutions. For convenience, in this memo, the term "bank" will be used to refer to all of the foregoing. Sections 23A and 23B also apply to uninsured U.S. branches of foreign banks, but only with respect to transactions between the uninsured branch and an affiliate engaged directly in the U.S. in activities permitted solely to financial holding companies, namely, (i) merchant banking; (ii) insurance underwriting; (iii) securities underwriting, dealing, or market-making; or (iv) insurance company portfolio investing. *See* 12 C.F.R. § 223.61.

[2] 12 U.S.C. § 371c & 371c-1.

bank's access to the Federal Deposit Insurance safety net.[3] In that regard, the Federal Reserve has stated that it considers Section 23A "[a]mong the most important tools that U.S. bank regulators have to protect the safety and soundness of U.S. banks."[4]

In short, Sections 23A and 23B are two of the most significant provisions of federal banking regulation and together have a significant impact on the structure of transactions between a bank and its affiliates, and, because of the attribution component of the sections (discussed below), the structure of three-party transactions involving a bank, an affiliate and a customer. That said, because of the broad and somewhat inflexible nature of their provisions, and because of the critical importance attached to them by the banking regulators, Sections 23A and 23B can also pose significant difficulty for banks even under current law.

II. The Current Requirements of Section 23A and Section 23B.

A. Section 23A's Four Principal Elements:

1. Quantitative Limits. A bank's ***covered transactions*** (i) with any single ***affiliate*** are limited to no more than 10% of the bank's capital stock and surplus, and (ii) with all affiliates (*i.e.*, a bank's Section 23A transactions in the aggregate) are limited to no more than 20% of the bank's capital stock and surplus.[5] ***Covered transactions*** include purchases of assets from an affiliate, loans or extensions of credit[6] to an affiliate, investments in securities issued by an affiliate, guarantees on

---

[3] *See* Final Regulation, Board of Governors of the Federal Reserve System, *Transactions Between Member Banks and Their Affiliates*, 67 Federal Register 76,560, 76,560 (December 12, 2002).

[4] Testimony of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System, Before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (March 5, 2008).

[5] 12 U.S.C. § 371c(a)(1).

[6] The phrase, ***loan or extension of credit*** is not defined by Section 23A. However, the Federal Reserve's implementing regulation, Regulation W, has a broad definition of ***extension of credit***:

the making or renewal of a loan, the granting of a line of credit, or the extending of credit in any manner whatsoever, including on an intraday basis, to an affiliate. An extension of credit to an affiliate includes, without limitation:

(1) An advance to an affiliate by means of an overdraft, cash item, or otherwise;

(2) A sale of Federal funds to an affiliate;

(3) A lease that is the functional equivalent of an extension of credit to an affiliate;

(4) An acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate;

behalf of an affiliate, and certain other transactions that expose the bank to an affiliate's credit or investment risk (such as a bank extending credit to a third party collateralized by securities issued by an affiliate).[7] A bank's ***affiliates*** include any company that controls the bank, any company under common control with the bank, and certain investment funds that are advised by the bank or an affiliate of the bank.[8]

2. Qualitative Limits. A bank generally cannot purchase ***low-quality assets*** from an affiliate.[9]

3. Collateral Requirements. A bank's "extensions of credit" to affiliates and guarantees on behalf of affiliates must be appropriately secured by a statutorily defined value of collateral, ranging from 100% to 130% of the initial amount of the extension of credit depending on the nature of the collateral. Certain forms of collateral, such as low-quality assets or securities issued by an affiliate, are not eligible as collateral for extensions of credit to affiliates.

4. Safe & Sound Terms. All covered transactions between a bank and its affiliates must be on terms and conditions that are consistent with safe and sound banking practices.[10]

Section 23A also has an ***attribution rule***, which treats a transaction between a bank and a third party as a covered transaction if the proceeds of the transaction are used for the benefit of, or are transferred to, an affiliate of the bank. For example, a bank's loan to a third party to acquire assets or securities from a bank's affiliated broker-dealer is treated as if it were a Section 23A covered transaction.

---

(5) Any increase in the amount of, extension of the maturity of, or adjustment to the interest rate term or other material term of, an extension of credit to an affiliate; and

(6) Any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent).

12 C.F.R. § 223.2(o).

7 12 U.S.C. § 371c(b)(7).

8 12 U.S.C. § 371c(b)(1).

9 12 U.S.C. 371c(a)(3). A *low-quality asset* includes assets that are classified or treated as "substandard," "doubtful," "loss," or "other loans especially mentioned"; assets in nonaccrual status; any asset in which principal or interest are more than 30 days past due; or any asset the terms of which have been renegotiated or compromised due to the obligor's deteriorating financial condition. 12 U.S.C. § 371c(b)(10).

10 12 U.S.C. § 371c(a)(4).

Section 23A, by its terms, does provide for a few exceptions, most significantly for: (i) transactions between sister banks, (ii) a bank's extension of credit to an affiliate that is fully collateralized by cash or U.S. Treasuries, (iii) a bank's purchase of assets from an affiliate if the assets have a readily identifiable and publicly available market quotation, (iv) a bank's giving of credit for items in the process of collection, and (v) a bank's repurchase of loans sold to an affiliate with recourse.[11] The Federal Reserve Board is authorized to create further exemptions by order or by rule, and the Federal Reserve Board's regulation implementing Sections 23A and 23B – Regulation W – creates additional exemptions for certain types of transactions.[12] In addition, the Federal Reserve Board also from time to time has issued orders granting limited exemptions to individual banks.

In summary, Section 23A effectively discourages banks from entering into covered transactions with their affiliates. The ***quantitative limit*** caps the total amount of covered transactions that may be outstanding at any one time,[13] and banks therefore use their 23A capacity quite sparingly. The ***qualitative limits*** effectively bar transactions involving certain types of assets altogether. The ***collateral requirement*** artificially increases the cost of covered transactions by requiring, at a minimum, 100% collateral (in some cases Section 23A requires up to 130% collateral – in effect imposing *above market* conditions on extensions of credit to an affiliate).

B. Section 23B.

Section 23B is intended to protect a bank by requiring that transactions between the bank and its affiliates occur on market terms, *i.e.*, on terms and under circumstances that are substantially the same, or at least as favorable to the bank as those prevailing at the time for comparable transactions with unaffiliated companies.[14] Section 23B applies this restriction to any ***covered transaction*** with an affiliate as well as certain other transactions, such as (i) any sale of assets by the bank to an affiliate; (ii) any payment of money or furnishing of services by the bank to an affiliate; and (iii) any transaction by the bank with a third party if an

[11] *See* 12 U.S.C. § 371c(d).

[12] *See, e.g.,* 12 C.F.R. §§ 223.41, 223.42.

[13] Covered transactions count against the quantitative limits as long as they remain on the books of the bank, whether in the form of the outstanding balance of a loan or extension of credit, a contingent obligation (such as a guarantee), the unamortized value of an asset purchased from an affiliate, or the greater of the purchase price or carrying value of affiliate securities in which the bank is invested.

[14] 12 U.S.C. § 371c-1(a)(1).

affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction.[15] Like Section 23A, Section 23B has its own attribution rule, and thus Section 23B applies to a bank's transactions with a third party that benefit an affiliate or transactions in which the proceeds of which are transferred to an affiliate.[16]

III. The Changes Made by the Dodd-Frank Act.

The Dodd-Frank Act amends Sections 23A and 23B effective one year after the "transfer date" (*i.e.*, effective July 21, 2012), as explained below.

A. Nonregistered Funds will be Treated as Affiliates

Section 23A currently defines an ***affiliate*** in terms of "control," whether through ownership of voting shares, by having the ability to appoint a majority of the directors or trustees, or by exercising a controlling influence over the management or policies of the entity.[17] In that respect, Section 23A uses an approach very similar to that used in the Bank Holding Company Act. In addition, irrespective of whether voting "control" exists, Section 23A currently defines an ***affiliate*** to include:

> any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the ... bank or any subsidiary or affiliate of the ... bank; or
>
> any investment company with respect to which a ... bank or any affiliate thereof is an investment adviser as defined in [the Investment Company Act of 1940].[18]

In addition, by regulation the Federal Reserve has determined that any "investment fund" (whether or not registered under the '40 Act) is also an ***affiliate*** for purposes of Section 23A if (i) the bank (or one of its affiliates) advises the fund **and** (ii) the

[15] 12 U.S.C. § 371c-1(a)(2).

[16] 12 U.S.C. § 371c-1(a)(3).

[17] 12 U.S.C. § 371c(b)(3).

[18] 12 U.S.C. § 371c(b)(1)(D).

bank (or one of its affiliates) holds 5% or more of the voting securities or equity capital of the fund.[19]

The Dodd-Frank Act repeals both of the above statutory provisions, effective July 2012, and in its place, inserts the following:

> any investment fund with respect to which a ... bank or an affiliate thereof is an investment adviser.[20]

The new term ***investment fund*** (which will be used in lieu of the term investment company) is not defined by the Dodd-Frank Act,[21] but presumably was intended to include a broader category of funds than '40 Act registered investment companies and REITS to the extent they are advised by a bank or any of its affiliates.[22] The effect of the Dodd-Frank amendment is to treat *any* fund (for example, hedge funds, private equity funds, or offshore funds) advised by the bank (or by one of its affiliates) as an affiliate for Section 23A purposes, regardless whether the fund is a '40 Act fund or whether the fund is sponsored by the bank (or one of its affiliates), and regardless whether the bank or its affiliates hold 5% or more of the fund's voting shares or equity capital. The amendment thus discourages a bank from engaging in fund-related covered transactions – loans to, investments in, or asset purchases – with a broad range of funds that are simply advised by the bank or its affiliate, and makes it more difficult for banks to provide implicit support to funds advised by the bank or its affiliates.[23]

---

[19] 12 C.F.R. § 223.2(a)(6).

[20] Dodd-Frank Act § 608 (amending 12 U.S.C. § 371c(b)(1)(D)).

[21] While the term ***investment fund*** is currently used in Regulation W, the term is not defined there, either. In the Supplementary Information accompanying the final rule, the Federal Reserve indicated that the term ***investment fund*** was intended to encompass funds that are exempt from registration under the '40 Act, either due to the 3(c)(1), 3(c)(7), or 3(a)(1) exemptions, or due to the fact that the fund is located offshore. *See* Final Regulation, Board of Governors of the Federal Reserve System, *Transactions Between Member Banks and Their Affiliates,* 67 FEDERAL REGISTER 76,560, 76,562 (December 12, 2002).

[22] Likewise, the term ***investment adviser*** is not defined by the Dodd-Frank Act, but clearly was intended to encompass persons other than registered investment advisers. Presumably the term was intended to cover the providing of investment advice on a regular or routine basis and not merely the one-off provision of advice. However, it should be noted that, in amending Section 23A, Congress removed the prior language that required the advice be provided "on a contractual basis."

[23] A separate provision of the Dodd-Frank Act, Section 619 (known as the Volcker Rule) restricts the ability of a bank or its affiliates to invest in or sponsor a private equity fund or hedge fund, subject to certain exceptions, and also prohibits a bank or its affiliates from entering into a transaction with an advised, managed, or sponsored fund if the transaction otherwise would constitute a ***covered transaction*** under Section 23A (again, subject to certain exceptions). Thus, the Volcker Rule establishes further restrictions on the relationship between banks (and their affiliates) and private equity or hedge funds. For

B. Derivative Transactions as "Loans or Extensions of Credit"

Currently, derivative transactions – other than credit derivatives in which the bank provides credit protection to the affiliate – are not considered to be a "loan or extension of credit" for purposes of Section 23A. When the Federal Reserve promulgated Regulation W in 2001, the Federal Reserve specifically chose not to subject derivatives to Section 23A, reasoning that banks and their affiliates typically engage in noncredit derivatives transactions for risk management and hedging purposes, and therefore one of the rationales for Section 23A – prohibiting a bank from transferring the benefits of the FDIC insurance subsidy – was not implicated.[24] Rather than subject derivatives to Regulation W, the Federal Reserve instead required that a bank engaging in non-credit derivative transactions with an affiliate must have policies and procedures to monitor and control the bank's credit exposure to affiliates in derivative transactions (including by imposing appropriate credit limits, mark-to-market requirements, and collateral requirements). In addition, the Federal Reserve required that such transactions comply with the arm's length requirements of Section 23B.[25] Thus, subject to the

---

further information concerning the Volcker Rule, please refer to Cadwalader's Clients & Friends Memos, *An Analysis of the Dodd-Frank Act's Volcker Rule* (October 15, 2010), http://www.cadwalader.com/assets/client_friend/101510VolckerRuleAnalysis.pdf., and *Fed Issues Final Regulations on the Volcker Rule's Extension Periods* (February 11, 2011), http://www.cadwalader.com/assets/client_friend/021111FedIssuesFinalRegsVolckerRule.pdf.

[24] In 2001, the Board recognized that noncredit derivatives transactions are largely entered into for risk management or hedging reasons:

> Derivative transactions between a bank and its affiliates generally arise either from the risk management needs of the bank or the affiliate. Transactions arising from the bank's needs typically arise when a bank enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract or is unable to hedge the risk directly because the bank is not authorized to hold the hedging asset. In order to manage the market risk, the bank may have an affiliate acquire the hedging asset. The bank would then do a "bridging" derivative transaction between itself and the affiliate maintaining the hedge.
>
> Other derivative transactions between a bank and its affiliate are affiliate-driven. A bank's affiliate may enter into an interest-rate or foreign-exchange derivative with the bank in order to accomplish the asset-liability management goals of the affiliate. For example, a BHC may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The BHC may then enter into a fixed-to-floating interest-rate swap with its subsidiary bank to reduce the holding company's interest-rate risk.
>
> Banks and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. Banks and their affiliates often choose to use each other as their derivative counterparties, however, in order to maximize the profits of and manage risks within the consolidated financial group.
>
> *See* Final Regulation, Board of Governors of the Federal Reserve System, *Transactions Between Member Banks and Their Affiliates,* 67 FEDERAL REGISTER 76,560, 76,587 (December 12, 2002).

[25] *See* 12 C.F.R. § 223.33.

foregoing, under existing law banks are free to engage in non-credit derivative transactions with their affiliates without being subject to Section 23A's quantitative limits or collateral requirements.

Section 608 of the Dodd-Frank Act reverses the Federal Reserve's position. Beginning in July 2012, all ***derivative transactions*** will be subject to Section 23A to the extent that they cause the bank to have ***credit exposure*** to the affiliate. The definition of the term ***derivative transaction*** is not reflected in Section 23A, but instead is incorporated by reference from the Dodd-Frank Act's amendments to the national bank lending limit statute. There, ***derivative transaction*** is defined as including:

> any 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.[26]

While not required by the Dodd-Frank Act, the Federal Reserve will likely engage in rulemaking to further define what constitutes a ***derivative transaction*** for purposes of Section 23A.

Credit exposure is not defined in the Dodd-Frank Act, but the term instead was left for the Federal Reserve to define through the rulemaking process.[27] Nor does the Dodd-Frank Act stipulate how often a derivative transaction would need to be re-valued to determine its utilization of capacity under the quantitative limits and the amount of collateral require, but again this was apparently left to the Federal Reserve to decide in rulemaking. These decisions will in good part determine the impact of Dodd-Frank Section 608. If ***credit exposure*** is defined narrowly – for

---

[26] Dodd-Frank Act § 610 (adding 12 U.S.C. § 84(b)(3)). The definition of ***derivative transaction*** is less detailed than the definition of ***swap*** and ***security-based swap*** in Title VII and in some respects may be broader than a Title VII swap. For example, ***derivative transaction*** includes an option on a security, which under Title VII is not a swap, and arguably includes various linked debt securities, also not considered swaps under Title VII. Bear in mind, however, that the Title VII definition of swap is extremely broad and includes many transactions not ordinarily regarded as swaps. While the CFTC is to issue a regulation that will further interpret the term ***swap*** as used in Title VII the CFTC's definition of ***swap*** is not specifically incorporated by reference into 12 U.S.C. § 84 and it is unclear to what extent the OCC will rely on the CFTC's rulemaking when construing the scope of the national bank lending limits.

[27] However, in the Federal Reserve's 2001 proposed rulemaking under Regulation W, the Federal Reserve explored the concept of ***credit exposure*** when considering a number of alternatives for valuing a derivative transaction if Section 23A were to apply. *See* Notice of Proposed Rulemaking, Board of Governors of the Federal Reserve System, *Transactions Between Banks and Their Affiliates*, 66 FEDERAL REGISTER 24,186, 24,196-97 (May 11, 2001).

example, including only the non-intraday exposure between the bank and its counterparty after taking into account any margin and netting arrangements – the impact of Section 608 may be limited. On the other hand, if a broad definition of ***credit exposure*** is adopted – for example, disregarding any netting or applying the Section 23A 100% - 130% collateral standards to the total potential exposure rather than just the actual net exposure – the Section 23A amendment would have a significant negative impact on a bank's transactions with its affiliates.

Unlike other aspects of the Dodd-Frank Act that were intended to prohibit certain activities or at least drive the activities out of the bank – such as the Volcker Rule and the Lincoln Amendment[28] – Section 608 does not have an exemption for transactions where a bank is in good faith seeking to hedge the risk of its activities. Thus, while the Volcker Rule permits a banking entity to retain hedging-related private equity investments, and the Lincoln Amendment allows a bank to retain swaps dealing activities if necessary to hedge existing risk, no such exemption was created in Section 608. Section 608 would impose the 23A requirements to an affiliate derivative transaction even if the transaction is a *bona fide* hedge designed to reduce bank risk. By subjecting the derivatives transactions to the collateral requirements and quantitative limits of Section 23A, the Dodd-Frank Act in fact discourages a bank from entering into hedging transactions with its own affiliates. In this regard, Section 608 seems at odds with the overall purposes of the Dodd-Frank Act to reduce systemic risk to the financial services industry; Section 608 will inadvertently encourage banks to enter into hedging transactions with other nonaffiliated entities, thereby increasing the intertwined relationships and systemic risks among banks.

C. Securities Lending & Borrowing Transactions as "Loans or Extensions of Credit"

Section 608 also states that securities lending and securities borrowing transactions between a bank and its affiliate must be treated as a "loan or

---

[28] The Lincoln Amendment (also known as the "swaps pushout rule") bars banks from acting as a swap or security-based swap dealer except in certain circumstances – one of which is "hedging and other similar risk mitigating activities." *See* Dodd-Frank Act § 716. For further information concerning the Lincoln Amendment, please refer to Cadwalader's Clients & Friends Memo, *The Lincoln Amendment: Banks, Swap Dealers, National Treatment, and the Future of the Amendment* (December 14, 2010), http://www.cadwalader.com/assets/client_friend/121410FutureoftheLincolnAmendment.pdf.

The Volcker Rule likewise contains an exemption from its prohibition on private equity fund investments for "risk mitigating hedging activities." *See* Dodd-Frank Act § 619. For further information concerning the Volcker Rule, please refer to Cadwalader's Clients & Friends Memo, *An Analysis of the Dodd-Frank Act's Volcker Rule* (October 15, 2010), http://www.cadwalader.com/assets/client_friend/101510VolckerRuleAnalysis.pdf.

extension of credit" to the extent that ***credit exposure*** is created. This does not seem to be a material change in existing practices; while Section 23A did not specifically enumerate a securities lending transaction or a securities borrowing transaction as a form of covered transaction, the Federal Reserve construes them to be the equivalent of a loan and subjects them to Section 23A.[29]

It is interesting to note, however, that Section 608 stipulates that these transactions are deemed to loans or extensions of credit only to the extent ***credit exposure*** is created, rather than subjecting such transactions to Section 23A in their entirety. Thus, depending on how the term ***credit exposure*** is defined, Section 608 may result in a partial *relaxation* of existing law in a manner that is consistent with the market's understanding of the term "credit exposure." For example, if ***credit exposure*** is defined to include only the noncollateralized portion of the securities lending or borrowing obligation, then only a portion of the transaction is subject to Section 23A and only that portion would count against the quantitative limits.

D. Repo Transactions as "Loans or Extensions of Credit"

Section 608 of the Dodd-Frank Act provides that affiliate repurchase transactions – transactions in which the bank agrees to purchase certain assets from an affiliate on the condition that the affiliate repurchase those assets at a later date – must be treated as a "loan or extension of credit" for purposes of Section 23A. Currently, for purposes of Section 23A repo transactions generally are viewed as two separate transactions – an asset purchase followed by an asset sale – with only one leg of the transaction – the asset purchase – being treated as a covered transaction.[30] Inasmuch as this leg is treated as an asset purchase, the transaction is subject to the quantitative limits and qualitative limits (*i.e.*, the low-quality asset restriction), but the transaction is not subject to the collateral requirements. The Dodd-Frank Act collapses the two legs of the transaction and treats the transaction in its entirety as an extension of credit by the bank to its

---

[29] *See, e.g.,* Letter to Patrick S. Antrim, Assistant General Counsel, Bank of America Corporation (January 23, 2007) (securities lending transactions); Letter to John H. Huffstutler, Associate General Counsel, Bank of America Corporation (securities borrowing transaction).

[30] The one exception is, the Federal Reserve has on occasion treated repo transactions involving U.S. Treasuries or other marketable securities as ***extensions of credit*** for purposes of Section 23A. *See, e.g.,* Amendments to Restrictions in the Board's Section 20 Orders, Board of Governors of the Federal Reserve System, *Bank Holding Companies and Change in Bank Control (Regulation Y)*, 62 FEDERAL REGISTER 45,295 (August 27, 1997) (discussing now-rescinded Section 20 Firewall 1(b), which treated securities repo transactions as Section 23A "extensions of credit" subject to the collateralization requirements).

affiliate. Thus, the repo transaction will be subject to the Section 23A collateral requirements.[31] By the same token, in reclassifying a repo transaction as an ***extension of credit*** rather than as a ***purchase of assets*** under Section 23A, Congress in effect lifted the prohibition against repo transactions involving low-quality assets.[32]

Section 608 does not contain the qualifier, "to the extent that the transaction causes the ... bank ... to have ***credit exposure*** to the affiliate." By comparison, this qualifier appears in both the newly added securities borrowing/lending provision and in the newly added derivatives provision. Thus, it appears that Congress may have intended the entire amount of the repurchase transaction to be subjected to the quantitative limits and collateral requirements, regardless of the amount of actual ***credit exposure*** (as that term is eventually defined by the Federal Reserve).[33]

E. Debt Obligations of an Affiliate Subject to Section 23A

Existing law provides that, in connection with a bank's loan or extension of credit to a third party (*i.e.*, to a non-affiliate), the acceptance of ***securities*** issued by the bank's affiliate as collateral results in a "covered transaction."[34] In promulgating Regulation W in 2002, the Federal Reserve stated that it looks primarily to federal securities laws to determine what constitutes a ***security*** for purposes of Section 23A. Thus, in promulgating Regulation W the Federal Reserve concluded that, for these purposes, ***securities*** includes both equity and debt securities, bonds, debentures, commercial paper, or notes.[35]

---

[31] The Dodd-Frank Act does not treat reverse repo transactions as if they are "loans or extensions of credit" for purposes of Section 23A. This makes sense; arguably, a reverse repo is the functional equivalent of a loan *to* the bank and should not be treated as if it is a Section 23A "loan or extension of credit." However, the aspect of the reverse repo transaction involving the bank's purchase of assets from a nonbank affiliate would continue to be treated as a "purchase" for Section 23A purposes.

[32] However, low-quality assets are not considered to be acceptable collateral for Section 23A's collateral requirements. *See* 12 U.S.C. § 371c(c)(3). Thus, any low-quality asset that is the subject of the repo transaction could not serve as collateral, and the transaction would need to be separately collateralized.

[33] This curious result is especially true with respect to repurchase transactions involving securities, which are functionally quite similar to a securities borrowing transaction. While the securities borrowing transaction is subject to Section 23A only to the extent ***credit exposure*** is created, no such limitation applies to securities repo transactions.

[34] 12 U.S.C. § 371c(b)(7)(D).

[35] *See* Final Regulation, Board of Governors of the Federal Reserve System, *Transactions Between Member Banks and Their Affiliates,* 67 FEDERAL REGISTER 76,560, 76,572 (December 12, 2002). While commercial paper is in many instances not considered a ***security*** under federal securities laws, the Federal Reserve reasoned that it was sufficiently similar to

Dodd-Frank amends Section 23A to provide that acceptance as collateral of ***debt obligations*** of an affiliate also results in a covered transaction for purposes of Section 23A. The intent was to make it clear that the acceptance-of-collateral provision is not limited to collateral that otherwise would constitute a ***security*** under federal securities laws. Thus, in making a loan to a third party, a bank's acceptance of *any* debt obligation of an affiliate – such as a loan or receivable – as collateral for the loan results in a covered transaction, effective July 21, 2012.

Likewise, Section 23A currently bars certain types of assets from serving as collateral for a bank's loan or extension of credit to an affiliate. In particular, under the terms of the statute, "securities issued by an affiliate" are ineligible. The Dodd-Frank Act amends this prohibition to make ***debt obligations of an affiliate*** equally ineligible as collateral for a covered transaction, effective July 21, 2012.[36]

F. Collateral Maintenance Requirement is Ongoing

Currently, Section 23A requires that collateral be posted in connection with a loan or extension of credit to an affiliate, in an amount ranging from 100% to 130%, with the exact percentage depending on the nature of the collateral posted. The amount of collateral posted is determined "at the time of the transaction," based on the transaction's "initial value" and the value of the collateral at the time of the transaction. If any portion of the posted collateral later amortizes or is retired, the amortized or retired collateral is required to be replaced with other collateral sufficient to maintain the appropriate percentage. However, if the collateral otherwise diminishes in value, additional collateral is *not* required to be posted to maintain the appropriate percentage.[37] For example, if an extension of credit to an affiliate is to be collateralized by publicly traded equity securities, the appropriate collateral percentage is 130% as of the time of the transaction, but if the equity securities later deteriorate in value, no additional collateral is required to maintain the 130% ratio.

Section 608 substantially changes these existing collateral practices, and requires maintenance of the required percentage "at all times" rather than merely "at the time of the transaction." Thus, banks will be required to add additional collateral if

"debentures" and "notes" and therefore specifically included commercial paper in Regulation W's concept of "securities." *Id.*

[36] Section 23A precludes a low-quality asset from serving as collateral for such a covered transactions. 12 U.S.C. § 371c(c)(3). Intangible assets (such as pledged mortgage servicing rights) are also ineligible as collateral.

[37] 12 C.F.R. § 223.14(e).

the posted collateral deteriorates in value below the required threshold. It is unclear whether the obligation to post additional collateral will be triggered upon a change in valuation required for GAAP purposes, or whether the bank will otherwise be required to mark-to-market the posted collateral (regardless of GAAP requirements) and, if so, how often.

G. Repeal of Quantitative Limit Exemptions for Financial Subsidiaries

Under current law, a ***financial subsidiary*** – a subsidiary of a national bank that engages in "financial in nature" activities not otherwise permissible for a national bank, such as certain insurance or securities activities[38] – is considered an ***affiliate*** for purposes of Section 23A. However, transactions between the national bank and its financial subsidiary are exempt from the 10% individual quantitative limit, although covered transactions with the financial subsidiary (including the national bank's investment in the financial subsidiary, other than retained earnings) are counted towards the 20% aggregate quantitative limit.

Section 609 of the Dodd-Frank Act withdraws the exemption from the 10% individual quantitative limit in its entirety. In addition, Section 609 repeals the provision that excludes retained earnings from the 20% aggregate quantitative limit. The effect of these changes is to restrict the amount of a national bank's investment in or other covered transaction with its financial subsidiaries. However, Section 609 states that these changes apply solely to covered transactions entered into after the effective date of the amendment (*i.e.*, after July 21, 2012). Thus, covered transactions (including investments) entered into prior to July 21, 2012 with a financial subsidiary should not be subject to the 10% limit, and retained earnings accrued in a financial subsidiary prior to July 21, 2012 should not count towards the 20% limit.

H. Change in Federal Reserve Exemptive Authority

Section 608 significantly changes the Federal Reserve's exemptive authority. Under current law, the Federal Reserve has the authority to grant exemptions, by both rule and order, from the provisions of Section 23A. Pursuant to that authority, the Federal Reserve has granted exemptions for certain types of transactions (such as intraday extensions of credit) by regulation,[39] and has granted exemptions

[38] *See, e.g.,* 12 U.S.C. § 24a; 12 C.F.R. 223.3(p).

[39] *See, e.g.,* 12 C.F.R. §§ 223.41, 223.42.

on a case-by-case basis to banks by order.[40] In granting exemptions by order, the Federal Reserve's practice has been to consult with the primary Federal banking agency for the bank that is the subject of the request.

Section 608 shifts to the primary Federal banking agency the authority to grant exemptions by order. Thus, with respect to national banks and federal savings banks, the authority to grant Section 23A exemptions by order is shifted to the OCC; with respect to state nonmember banks and state savings associations, the authority to grant Section 23A exemptions by order is shifted to the FDIC. In all cases, the primary Federal banking agency must conclude that the exemption "is in the public interest and ... consistent with the purposes of" Section 23A (with respect to state banks – whether member or not – the determination must be made jointly by both the Federal Reserve and the FDIC). In all instances, the FDIC is conferred a 60-day period in which it can object to the exemption order (and thus block the grant of the exemption) if the FDIC determines "that the exemption presents an unacceptable risk to the Deposit Insurance Fund."

Under the Dodd-Frank Act, the Federal Reserve retains the authority to grant exemptions by regulation. However, the FDIC is once again conferred a 60-day period in which it can object to the regulation if it determines "that the exemption presents an unacceptable risk to the Deposit Insurance Fund."

I. Netting Regulations

Section 608 of the Dodd-Frank Act states that the Federal Reserve may issue regulations or interpretations addressing whether a netting agreement between a bank and its affiliate may be taken into account in determining the amount of covered transactions between a bank and its affiliates, and whether a covered transaction is appropriately collateralized. Currently, Section 23A does not formally recognize netting agreements, and the quantitative limits and collateral requirements on their face apply without taking into account the existence of any such netting arrangements that might effectively reduce the bank's exposure to the affiliate.

Section 608 requires that any such netting regulation or interpretation must be issued "jointly with the appropriate Federal banking agency for such ... bank,

[40] The Federal Reserve typically publishes on its website its Section 23A exemptive orders as legal interpretations of the Federal Reserve Act. *See* http://www.federalreserve.gov/boarddocs/legalint/.

subsidiary, or affiliate." As Section 23A applies to OCC, FDIC, and Federal Reserve -regulated banks and thrifts, this provision will require across-the-board joint agency rulemaking. If adopted, this provision could significantly reduce the amount of collateral required for loans or extensions of credit with affiliates (especially derivatives) and somewhat ease the pressure on the quantitative limits as well.

J. FDIC Consent Required for Section 23B Exemptions

Currently, the Federal Reserve has authority to grant exemptions or exclusions from Section 23B by regulation.[41] Section 608 amends Section 23B to require that any such exemption or exclusion be "in the public interest and ... consistent with the purposes of" Section 23B, and further confers on the FDIC a 60-day period in which it can object to the regulation if the FDIC determines "that the exemption presents an unacceptable risk to the Deposit Insurance Fund."

IV. Next Steps

Dodd-Frank's amendments to Sections 23A and 23B will have a significant impact on transactions between banks and their affiliates. Anticipated Federal Reserve rulemaking, such as establishing the definitions of ***credit exposure*** and ***derivative transaction***, whether to recognize netting arrangements, and determining how the appropriate amount of collateral should be maintained "at all times," will heavily influence the impact.

The impact of these changes will be felt most heavily with respect to a bank holding company's derivative programs and fund advisory relationships. Bank holding companies that advise funds will need to be cognizant that transactions directly with those funds (or, under the attribution rule, with third parties but the proceeds of which are transferred to those funds) will be subject to Section 23A's quantitative limits, and if in the form of an extension of credit, the onerous collateral requirements as well. Bank holding companies will need to re-evaluate the structure of their derivative programs, too. Bank holding companies in which a bank enters into back-to-back derivatives transaction with a single nonbank affiliate will need to be cognizant that this structure may place a strain on the bank's 10% individual quantitative limit. In any case, the application of the 20% aggregate quantitative limit, coupled with the imposition of collateral requirements – with no exemption for *bona fide* hedging transactions – may lead some banks to enter into hedging

[41] 12 U.S.C. § 371c-1(e).

transactions with third parties rather than with affiliates, simply in order to preserve the bank's 23A quantitative limit capacity.

Undoubtedly the Federal Reserve will issue proposed amendments to Regulation W to reflect the changes required by the Dodd-Frank Act, and to add new definitions (such as the critical term, ***credit exposure***), although no timeline for issuing the proposed amendments has been announced.

In the meantime, banks should be preparing *now* for the application of expanded Sections 23A and 23B:

- Banks should identify any new "affiliates" created by the expanded definition. In particular, banks should identify funds advised by the bank or any affiliate and determine to what extent the bank has existing, or is expected to enter into, covered transactions with (or for the benefit of) those funds, and should assess the quantitative and collateral implications of these transactions as well.

- Banks should identify all derivative transactions, repos, and securities lending / borrowing transactions with affiliates. Banks should determine the individual and aggregate quantitative limit and collateral impacts of these transactions, especially with respect to the amount of exposure not covered by any existing netting or margin.

- Banks should identify all transactions with third parties in which the bank has accepted debt obligations of an affiliate as collateral. These transactions should be re-evaluated in light of the quantitative limits and collateral requirements.

- Banks that rely on covered transaction collateral that is not routinely marked-to-market should consider replacing that collateral with marked-to-market collateral.

* * * *

Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

Scott A. Cammarn	+1 704 348 5363	scott.cammarn@cwt.com
Steven D. Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Ray I. Shirazi	+1 212 504 6376	ray.shirazi@cwt.com
Brian D. Foster	+1 212 504 6736	brian.foster@cwt.com