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Clients&FriendsMemo

The Lincoln Amendment: Banks, Swap Dealers, National Treatment and the Future of the Amendment

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One of the most contentious provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (the "**Dodd-Frank Act**") is Section 716 – commonly referred to either as the "Lincoln Amendment" after its principal proponent, Senator Blanche Lincoln of Arkansas, or alternatively by its functional name, the "swaps push-out rule." The Lincoln Amendment effectively forbids FDIC-insured institutions and other entities that have access to Federal Reserve credit facilities – including banks, thrifts, and U.S. branches of foreign banks – from acting as a "swap dealer"[2] except in certain limited circumstances, thus requiring such institutions to "push out" most swap dealing activities into an affiliate that is not FDIC insured and that does not otherwise access Federal Reserve credit facilities. The Lincoln Amendment will become effective in July 2012 and will have a significant, and likely not wholly anticipated, impact on banks and U.S. branches of foreign banks that are swap dealers – unless it is modified in the interim.

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[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203, 124 Stat. 1376 (2010) (H.R. 4173) (the "**Dodd-Frank Act**" or "**DFA**"). For further detail regarding the implications of the Dodd-Frank Act, please refer to Cadwalader's series of memos on the Act, which you may find at the following address: http://www.cadwalader.com/dodd_frank_act_memo.php.

[2] Unless otherwise, indicated, the term "swap dealer" is used in this memorandum generally to refer to both "swap dealers" (who will be regulated by the CFTC) and "security-based swap dealers" (who will be regulated by the SEC). For further detail on the distinction between the two categories, please refer to Cadwalader's summary of Title VII of the Dodd-Frank Act. See The New Scheme for the Regulation of Swaps (Cadwalader, July 20, 2010), *available at* http://www.cadwalader.com/assets/client_friend/072010_DF7.pdf.

Generally, a "swap dealer" is "any person who – (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, 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." *See* Dodd-Frank Act § 721(a)(49).

On December 7, 2010, the CFTC and the SEC issued a joint proposed rulemaking to define various terms, including "swap dealer" and "security-based swap dealer." *See* Commodity Futures Trading Commission and Securities and Exchange Commission, Joint Proposed Rule & Joint Proposed Interpretations, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant,"* __ FED REG. __ (Dec. 2010) (the "**Dealer Definition Release**").

History of the Lincoln Amendment

Neither the House version of the financial reform legislation, which passed the House in December 2009 (H.R. 4173), nor the initial version of the legislation introduced in the Senate in April 2010 (S. 3217) contained a provision comparable to the Lincoln Amendment. Both bills provided for the regulation and registration of over-the-counter swap dealers and major swap participants,[3] including banks acting in either capacity, and would not have required FDIC-insured entities to terminate their swap dealing activities. The first proposed prohibition on banks engaged in swap dealing was put forward by Senator Lincoln, then the Chair of the Senate Agriculture Committee, as part of an alternative version of derivatives legislation approved by the Senate Agriculture Committee in April 2010.

The Senate Agriculture Committee's alternative language, in particular the push-out rule, then became the subject of heated debate throughout April and May. Opponents of the Lincoln Amendment pointed out that there was no indication that swaps trading by insured depository institutions had been a material contributor to the financial crisis that the Dodd-Frank Act was intended to address. Both Federal Reserve Chairman Ben Bernanke and FDIC Chair Sheila Bair submitted letters opposing the push-out provision, arguing that the push-out of swaps activities would harm banks and would place swap dealing activities in a less regulated environment.[4] The Lincoln Amendment was also opposed by a number of Republican and Democratic Senators. In spite of this bipartisan opposition, and perhaps out of fear that removal of the provision would alienate Senator Lincoln and the provision's other proponents and therefore might undermine passage of the entire financial reform bill or might hurt Senator Lincoln's chances of re-election, the Lincoln Amendment survived and was included in the final bill approved by the Senate on May 20, 2010.

In the House-Senate conference, the debate over the Lincoln Amendment continued and threatened to delay the conference process. In conference, several changes were made to soften Section 716's impact, or at least delay the problems it might cause:

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[3] This memorandum will refer to "major swap participants" and "major security-based swap participants" under the general rubric of "major swap participants." *See* The New Scheme for the Regulation of Swaps, *supra*, fn. 2.

[4] *See* Letter from Sheila Bair, Chairman, Federal Deposit Insurance Corp., to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), *reprinted in* 111 CONG. REC. S3069-70 (May 4, 2010) (Bair Letter); Letter from Chairman Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, to Senator Christopher Dodd (May 12, 2010). ("Forcing these [swap dealers and major participant] activities out of insured depository institutions would weaken both financial stability and strong prudential regulation of derivative activities").

- The effective date of Section 716 was postponed until July 2012 (instead of the July 2011 effective date applicable to the bulk of the swaps provisions – Title VII – of the bill),[5] and a discretionary two-year transition period was added.[6]
- The push-out clause of Section 716 was made prospective, thus allowing an insured depository institution to retain any swap arrangement that was executed prior to the end of the transition period.[7]
- Additional provisions were added to Section 716, providing that the push-out requirement would not preclude a *bank or thrift holding company* or *nonbank affiliate* from acting as a swap dealer, or preclude an insured depository institution from engaging in hedging activities or acting as a swap dealer involving certain bank-eligible securities.[8]
- In addition, a provision was added clarifying that the push-out did not preclude an insured depository institution from being merely a major swap *participant* rather than a swap *dealer*.[9]

As modified, Section 716 survived the conference process. The Dodd-Frank Act, including the modified Section 716, passed both the House and the Senate and was signed into law on July 21, 2010.

How the Push-Out Works

Section 716 does not directly forbid a covered entity from engaging in swap dealing activities. Rather, in a somewhat circuitous fashion, Section 716 provides that, after the transition period, no *"Federal assistance"* may be provided to a "*swaps entity"* (a term that is itself defined to mean either a swap dealer or a major participant) other than an insured depository institution that is a *major swap participant*. For purposes of Section 716, *Federal assistance* is defined as including:

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5 *Compare* DFA § 716(h) *with* DFA §§ 712, 754 & 774 (imposing an effective date of 360 days after enactment for other provisions of Title VII).

6 DFA § 716(f). While Section 716 is somewhat ambiguous regarding when the two-year transition period begins, it appears to begin when the insured depository institution would otherwise be subject to the prohibition on Federal assistance, *i.e.,* in July 2012. The two-year discretionary transition period is extendable for up to one additional year. *Id.*

7 *See* DFA § 716(e).

8 *See* DFA § 716(c). This safe harbor for affiliates of insured depository institutions applies only to the extent the affiliate is part of a bank holding company or savings and loan holding company structure. Thus, under a strict reading of Section 716, an insured depository institution that is *not* part of a bank holding company or savings and loan holding structure – such as nonbank bank – would be required to cease swap and security-based swap dealing activity altogether and would unable to push out these activities to an affiliate. It is not clear that this result was intended.

9 *See* DFA § 716(b)(2)(B).

- Use of any advances from any Federal Reserve credit facility or discount window that is not part of a program with broad-based eligibility under Section 13(3)(A) of the Federal Reserve Act;[10] and
- Federal Deposit Insurance Corporation insurance or guarantees.[11]

Inasmuch as maintenance of FDIC insurance is a requirement for all national banks, all federal thrifts, all state Member banks, and all (if not virtually all) state non-Member banks and state thrifts, Section 716 effectively precludes a bank or thrift from being a *"swap dealer"* after the effective date of the Lincoln Amendment.

In a similar fashion, the push-out would apply to those branches of foreign banks operating in the U.S. that solicit retail deposits in the U.S. and therefore have obtained FDIC insurance: FDIC-insured branches of foreign banks are considered "insured depository institutions" under federal banking law.[12] These FDIC-insured foreign branches would be required also to push out any dealing activity into an affiliate (or alternatively forego Federal assistance, including FDIC insurance).

As described in greater detail below, the push-out would appear to apply as well to uninsured branches of foreign banks which, although not insured by the FDIC, have access to Federal Reserve credit facilities and the Federal Reserve discount window, both of which are "Federal assistance" prohibited to swap dealers.

What Activity is Prohibited?

As stated above, Section 716 effectively prohibits an insured depository institution from acting as a *swap dealer* (or *security-based swap dealer*). In Section 721, a *swap dealer* is defined as any person who:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

[10] 12 U.S.C. § 343.

[11] DFA § 716(b).

[12] *See* 12 CFR Part 347 (requiring FDIC insurance coverage for nongrandfathered U.S. branches of foreign banks that solicit "retail deposits" – deposits in increments less than the FDIC insurance limit of $250,000 – from U.S. residents). While "insured depository institution" is not defined in Section 716, for Federal Deposit Insurance Act purposes the term includes an FDIC-insured branch of a foreign bank. *See* 12 U.S.C. § 1813.

- engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.[13]

Section 721 excludes from the definition of *swap dealer*[14] an "insured depository institution" that offers to enter into swap with a customer in connection with originating a loan to that customer.[15]

The definitions of *swap dealer* (and *security-based swap dealer*) carve out swap and security-based swap transactions in which the entity is entering into transactions for its own account "but not as a part of a regular business." Thus, an entity would be permitted to transact in swaps or security-based swaps provided it was not carrying on a "business" (for example, transacting swaps for any internal purpose) without regard to Section 716's push-out requirement, because the entity would not be considered a *swap dealer* (or *security-based swap dealer*). Similarly, Section 716(b) states that an insured depository institution that is a major swap *participant* – but not a swap *dealer* – is not subject to the prohibition against Federal assistance.

Notwithstanding the foregoing, a separate provision – Section 716(d) – purports to limit the swaps activities of *insured depository institutions:*

> The prohibition in subsection (a) [*i.e.*, the denial of Federal assistance] shall apply to any insured depository institution unless the insured depository institution limits its swap or security-based swap activities to . . . [h]edging and other similar risk mitigating activities directly related to the insured institution's activities [or] [a]cting as a swaps entity for swaps or security-based swaps involving rates or reference assets that are permissible for investment by a national bank ....[16]

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[13] DFA § 721 (amending the Commodity Exchange Act).

[14] *Id.* A virtually identical definition is created for security-based swap dealer in Section 761 with respect to activities in which the underlying instrument is a security-based swap – although there is no exclusion for entities that offer to enter into security-based swaps in connection with a loan. *See* DFA § 761 (amending the Securities Exchange Act of 1934). For a discussion of the SEC's and CFTC's proposal with respect to swaps entered into "in connection with" a loan, *see* the Dealer Definition Release, *supra* n. 2, at 31-34.

[15] In the Dealer Definition Release, the CFTC, as part of its proposed definition of the term swap dealer, suggested that it would allow the excluded swap to relate to a "rate, asset, liability or other notional item" so long as the swap "directly related" to the financial terms of the loan. Further, the CFTC would define the term "originated" broadly so as to include almost any situation in which an insured depository institution extended credit to a customer, including where the bank had purchased a participation in a loan; however, the proposed rule expressly excludes swaps in connection with any "synthetic loan" including a loan CDS or a loan total return swap.

[16] DFA § 716(d)(1). A separate provision of Section 716 makes it clear that the Volcker Rule – Section 619 of DFA – applies to swap activities of insured depository institutions. *See* DFA § 716(m). Thus, insured depository institutions would be unable to engage in proprietary trading in swaps or security-based swaps unless an exemption can be found under Section 619. For an in-depth discussion of the Volcker Rule, please refer to Cadwalader's Clients & Friends Memo, An Analysis of the Dodd-Frank Act's Volcker Rule, http://www.cadwalader.com/assets/client_friend/101510VolckerRuleAnalysis.pdf.

To the extent Section 716(d) suggests that an insured depository institution must limit its non-dealing swaps activities to certain hedging activities and bank-eligible swaps, Section 716(d) appears to be inconsistent with an earlier provision, Section 716(b)(2)(B), which provides that an insured depository institution is *not* considered a *swaps entity* (and therefore *not* subject to the push-out) if it is merely a *major swap participant* rather than a *swap dealer*. Unfortunately Section 716(d) and Section 716(b)(2)(B) were not fully reconciled, and the exact scope of swaps activities that may remain in an insured depository institution remains unclear.[17]

Exemptions

As mentioned above, Section 716 creates a few express exemptions to its push-out requirement:

Interest Rate Swaps. Section 716(d)(2) allows an *insured depository institution* to transact in swaps if the swap involves rates.[18] Thus, interest rate swaps are exempted from the push-out requirement entirely, and insured depository institutions are free to continue to transact in them.

Swaps Involving Bank Eligible Assets. Likewise, Section 716(d)(2) allows an *insured depository institution* to transact in swaps involving assets eligible for investment by a national bank,[19] which would include swaps referencing the following types of assets:

- loans;
- certain bank-eligible asset backed securities;
- U.S. government and agency securities;
- certain state and subdivision general obligation securities and certain municipal bonds;
- foreign currency;[20]

[17] Provided that the activities of the insured depository institution do not rise to the level of being a swap dealer, it appears that Congress did not intend to require push-out. *See* 111 CONG. REC. S5922 (July 15, 2010) (statement by Sen. Lincoln that the Conference Committee "also clarified in Section 716 that banks which are major swap participants are not subject to the federal assistance bans"). However, this interpretation renders the hedging and bank-eligible swaps restrictions of Section 716(d) as somewhat superfluous.

[18] DFA § 716(d)(2).

[19] *Id.*

[20] Although a full discussion of the issue is outside the scope of this memorandum, entities within the potential scope of the Lincoln Amendment should also be aware that Title VII affects foreign currency transactions in a variety of complicated, and still to-be-determined, ways. Most significantly, the Dodd-Frank Act includes both foreign exchange swaps and forwards in the definition of the term "swap," and therefore subjects both types of transactions to the Commodity Exchange Act ("CEA"),

- bullion;
- marketable corporate grade debt securities;
- certain international development bank securities; and
- certain Canadian federal and provincial securities.[21]

Notwithstanding the foregoing, the bank-eligibles exemption does not permit an insured depository institution to transact in credit default swaps ("CDS"), including CDS referencing the credit risk of asset backed securities, unless the swap is cleared by a registered derivatives clearing organization or clearing agency.[22]

Hedging Activities. Under Section 716(d)(1), an exemption is created for "hedging and other similar risk mitigating activities directly related to the insured depository institution's activities." As mentioned earlier, this exemption seemingly was added in conference to address concerns raised by FDIC Chairman Bair and Federal Reserve Chairman Bernanke that Section 716 would be harmful to banks by forbidding them to use swaps to hedge the bank's risk. Unfortunately, there is no guidance as yet on what would constitute a "direct" relationship between swap dealing activities and the bank's other activities, so the meaning of 716(d)(1) is not yet clear.[23]

Implications of the Push Out Requirement

Because of the limited exemptions afforded certain categories of swaps in Section 716, U.S. banks and U.S. branches of foreign banks will be required either

> (i) to bifurcate their swaps desks between (x) interest rate swaps and other bank-eligible swaps, which may remain in the bank or branch, and (y) all other swaps, which must be pushed to the holding company or another affiliate; or

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unless the Secretary of the Treasury makes a written determination that such transactions should not be regulated as swaps and are not structured with an improper purpose. In making this determination, the Secretary is required to consider *inter alia* the adequacy of supervision by bank regulations. However, foreign exchange transactions that receive this treatment nevertheless must comply with reporting requirements for swaps and business conduct standards. DFA § 721 (to be codified at CEA § 1a(47)(E)).

[21] *See* 12 U.S.C. § 24 (Seventh); *see also* 12 C.F.R. Part 1.

[22] As not all CDS can currently be cleared, this limitation on banks entering into CDS could significantly inhibit banks' ability to hedge lending risk. Either banks would be forced to retain commercial lending risk or they will be limited to distributing that risk through loan syndications and participations, arguably far more cumbersome and expensive hedging processes than buying credit protection by entering into a CDS. However, inasmuch as the CDS clearing requirement applies solely to the bank-eligibles exemption and does not apply to the hedging exemption, it appears that a bank may continue to transact in non-cleared CDS provided that the activity is part of the bank's hedging or risk management activities.

[23] DFA § 716(d)(1).

(ii) to push their entire swaps desks into the holding company or affiliate.

Neither alternative is attractive. The latter alternative would require clients to conduct swaps business with two separate entities within the bank holding company structure and would deprive the client of the netting privileges and other efficiencies that are inherent in doing business with a single legal entity. The former alternative would require the bank holding company to conduct all of its swaps desk activities outside the bank in an entity that typically carries a much higher internal cost of funds, and to maintain a large pool of capital – separate from the capital maintained at the bank – in order to support the pushed-out swap dealing activities.

Either alternative will also make banks less attractive counterparties to commercial and financial customers. Customers who are effectively pushed out of the bank will be effectively forced to transact with an entity that is smaller and likely less creditworthy than the bank itself. Customers whose business is split between the bank and another affiliate will now have to deal with double the documentation, additional operational issues, and the increases in credit risk (*e.g.*, loss of netting) that result from an inability to consolidate transactions with a single counterparty.

Regardless which alternative is adopted, U.S. banks and bank holding companies will be less competitive with entities not subject to Section 716, such as foreign banks without a U.S. banking presence.

Application to U.S. Branches of Foreign Banks

The reach of Section 716 to U.S. branches of foreign banks is unclear, largely due to ambiguous drafting. Section 716's denial of Federal assistance was written quite broadly, and applies to any *swaps entity*, presumably including any foreign bank that maintains an insured or uninsured branch in the United States engaged in swaps activities. To the extent such entities receive "Federal assistance", either in the form of FDIC insurance or access to Federal Reserve credit facilities (such as the discount window) – which they often do – Section 716 would require push-out of the swaps activities.

However, the *exemptions* to Section 716 were written much more narrowly, and apply only to an *insured depository institution*. For example, the *major swap participant* definition, and the hedging, interest rate, and bank-eligible assets exemptions, are available only to "insured depository institutions." The exclusion for swaps offered in connection with a loan, embedded in the definition of *swap dealer*, also applies only to insured depository institutions. Likewise, the transition period as well as the provision carving out swaps entered into prior to the expiration of the transition period, are available only to insured depository institutions. The safe harbor (clarifying that affiliates may continue to engage in swaps activities) is available only to affiliates of an insured depository institution that is "part of bank holding company" or "savings and loan holding company."

Application to FDIC-Insured Branches. The FDIC-insured branches of a foreign bank are considered "insured depository institutions" for purposes of the Federal Deposit Insurance Act,[24] and therefore insured U.S. branches of a foreign bank would be permitted to act as a *major swap participant* and would remain eligible for the hedging, interest rate, and bank-eligible assets exemption, and the exclusion for swaps originated in connection with a loan. Likewise, insured U.S. branches of foreign banks may be comfortable that swaps entered into between now and the end of the transaction period are not subject to the prohibition. However, insured U.S. branches of foreign banks are typically not part of a "bank holding company" or "savings and loan holding company," and the safe harbor provision therefore would not seem to apply. In short, FDIC-insured branches of foreign banks would be treated much like a U.S. bank in terms of the push-out purposes, but would not have the benefit of the safe harbor, which also raises questions of fair national treatment. In this regard, it is also notable that the exclusions as to bank-eligible swaps in Section 716 encompass a variety of U.S. assets, such as U.S. governments and state obligations, but there are no comparable exemptions for swaps on assets of governmental entities outside the United States other than Canada.

Application to Uninsured Branches. Uninsured branches of a foreign banks are *not* considered insured depository institutions for most purposes. Read literally, none of Section 716's swaps exemptions would be available to uninsured branches. To the extent that an uninsured branch is deemed a *swaps entity*, which could happen as early as July 2012, the uninsured branch would be required to cease its swaps activities or forego access to the Federal Reserve credit facilities (including the discount window). This cessation would be required to occur *immediately*, because the transition period – which delays the application of the push-out – also is available only to insured depository institutions. Thus, uninsured branches of foreign banks would be treated in a dramatically harsher fashion from their FDIC-insured counterparts.

In light of the various inconsistencies in the treatment of insured and uninsured branches by the Lincoln Amendment, after the Conference Committee voted out the bill but before full Senate approval, on July 15, 2010 Senator Lincoln made a statement on the floor of the Senate, stating that it was not the intent of the Senate to exclude uninsured branches of foreign banks from the exemptions and safe harbors, and that they should be treated under Section 716 in the same fashion as insured branches of foreign banks. At the same time, Senator Dodd indicated that this would likely be addressed on a technical corrections bill.[25]

Given the ambiguities within Section 716, it seems likely that some form of technical corrections bill should be entered to resolve some of the significant drafting errors – although any technical

[24] *See* 12 U.S.C. § 1813(a)(1), (c)(2).

[25] 111 CONG. REC. S 5903-5904 (July 15, 2010).

corrections bill will not likely be introduced by Senator Lincoln, who did not win her re-election bid in November 2010. Regardless, it remains to be seen whether Congress will go further and attempt to scale back a provision of Dodd-Frank that was introduced late in the process, not widely supported at the time, raises significant questions of fair national treatment, and remains controversial to this date.

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this Memorandum.

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