PROMONTORY Sightlines ALERT

promontory.com JUNE 7, 2013

FBOs Win Half the Battle on Swaps

The Federal Reserve on June 5 relieved foreign banking organizations from provisions of the Dodd-Frank Act that could have required them to push all derivatives transactions out of their U.S. branches and agencies by July 16. The Federal Reserve's interim final rule, "Prohibition Against Federal Assistance to Swaps Entities," addressed one of the two short-term compliance burdens faced by FBOs registered with the Commodity Futures Trading Commission as swap dealers under Title VII of Dodd-Frank.[1] The looming question now is how they will comply with the extraterritorial application of Title VII upon the July 12 expiration of a CFTC exemptive order.

A first read of the Federal Reserve's rule appeared to provide FBOs only the same two-year transition period for compliance with the push-out provisions that the Office of the Comptroller of the Currency provided in January guidance to national banks, federal savings associations, and insured federally licensed branches.[2] Due to the rule's crafting, however, the relief on push-out provisions is much broader and could put foreign banks on equal footing with U.S. banks.

The Federal Reserve's Solution

The push-out provisions are spelled out in section 716 of Dodd-Frank, which, through a drafting error, distinguished the treatment of U.S. branches of foreign banks registered as swap dealers from that of U.S. banks registered as swap dealers chiefly in four ways:

- Its "insured depository institution" exemption required U.S. banks to push out derivatives into holding company affiliates only if the underlying asset was one that was historically bank-ineligible — typically, agricultural and energy products, equities, and certain debt securities. But because U.S. branches of FBOs generally do not have U.S. deposit insurance, they could not take advantage of the exemption. That left open the possibility that the FBO swap dealers would have to push all derivatives out of the bank.

- The "insured depository institution" exemption also provided that push-out provisions did not apply to swaps entered into prior to Dodd-Frank's enactment. FBOs, on the other hand, would have had to push out even their legacy swaps, requiring the costly and time-consuming process of re-documenting them with other affiliates.

[1] http://www.federalreserve.gov/newsevents/press/bcreg/section-716-attachment20130605.pdf
[2] http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-2a.pdf

- It gave U.S. bank regulators the authority to extend a two-year transition period to U.S. banks, as the OCC subsequently did. No such explicit authority was granted for foreign banks. They were facing a hard compliance date of July 16.

- Most significantly, section 716 was widely interpreted to apply to the whole of the FBO swap dealer and not just its U.S. branch, meaning that it could be read to require that swaps be pushed out of banks anywhere — including Tokyo, Hong Kong, Toronto, Paris, and London, for instance — and not just the U.S. branch. The prevailing hope was that the Federal Reserve would apply the "separate entity" doctrine that treats U.S. branches as separate legal entities from the foreign banks of which they are a part, such that only the U.S. branches would be required to push out their derivatives activities.

The interim rule eliminated those distinctions by determining that foreign banks' uninsured U.S. branches and agencies "would appear to be properly considered to be insured depository institutions." In doing so, the Federal Reserve extended the section 716 exemptions to foreign banks and effectively gave itself the authority to provide a two-year transition period — which can be extended for an additional year — to any foreign bank that requests it. It also applied the "separate entity" doctrine without mentioning it.

State banks and state-licensed branches of FBOs seeking a two-year transition period must submit a request by July 16.

What the Rule Doesn't Do

The rule does not resolve all the push-out provisions that apply only to U.S. branches of FBOs. The Federal Reserve's broadening of the exemption applies to both federal branches and agencies licensed by the OCC and state-licensed branches and agencies. But the process for requesting the transition period applies only to those state-licensed branches and agencies that the Federal Reserve itself regulates —and not federally licensed branches and agencies of FBOs. The OCC's guidance only provides a transition-period application process for "insured Federal depository institutions," which does not include uninsured OCC-licensed branches and agencies of FBOs. The OCC could address this inconsistency by amending its earlier notice to extend the application process to uninsured federally licensed branches.

Even in that circumstance, relief from the push-out provisions is only half the short-term battle for FBO swap dealers. If the CFTC does not extend its cross-border exemptive relief, these entities will have to apply the CFTC's rules to some of their non-U.S. derivatives transactions on July 16 — unless the CFTC has determined that the compliance with the rules in the FBO's home jurisdiction constitutes "substituted compliance." The CFTC has not yet made that determination for any foreign jurisdiction, and the deadline is fast approaching.

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