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New Law Limits the Swaps Pushout Requirement to Apply Only to Certain ABS Swaps

By Julian Hammar

On December 16, 2014, President Barack Obama limited the scope of swaps and security-based swaps subject to the Dodd-Frank Wall Street Reform and Consumer Protection Act's ("Dodd-Frank Act's") pushout requirement to certain asset-backed security swaps when he signed into law the Consolidated and Further Continuing Appropriations Act, 2015. This Act contains an amendment to Section 716 of the Dodd-Frank Act, commonly known as the Lincoln Amendment,[1] or the Swaps Pushout Rule (hereinafter, "Swaps Pushout Rule"). The new amendment also codifies the Federal Reserve Board's rule that uninsured branches and agencies of foreign banks may receive the same exceptions as insured depository institutions ("IDIs") from the pushout requirement.[2] A redlined copy of the amendment is available here.

THE ORIGINAL SWAPS PUSHOUT RULE

The Swaps Pushout Rule generally prohibits "federal assistance" to "swaps entities," defined as swap dealers, major swap participants, security-based swap dealers and major security-based swap participants, that are registered under the Commodity Exchange Act or the Securities Exchange Act of 1934. Federal assistance is defined in the rule to include certain advances from a Federal Reserve credit facility or discount window and Federal Deposit Insurance Corporation ("FDIC") deposit insurance or guarantees. The Swaps Pushout Rule effectively requires banks that are swaps entities to push out certain swaps activities to a separately capitalized affiliate or cease the activities altogether, unless an exception applies.

Section 716 originally limited exemptions from the Swaps Pushout Rule to IDIs. The Federal Reserve Board issued an interim final rule in June 2013 that clarified that uninsured branches and agencies of foreign banks that were impacted by the prohibition are treated as IDIs for purposes of the Swaps Pushout Rule, including for purposes of the exemptions applicable to IDIs.[3]

The Swaps Pushout Rule was to become effective on July 16, 2013, but many U.S. banks and uninsured U.S. branches of foreign banks were granted a transition period of two years pursuant to Section 716 to continue dealing in swaps otherwise subject to the Swaps Pushout Rule.

SCOPE OF THE ORIGINAL SWAPS PUSHOUT RULE

As originally enacted, the Swaps Pushout Rule required pushout of the following types of instruments, unless they were used to hedge or mitigate risk related to an IDI's activities:

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[1] Senator Blanche Lincoln proposed the amendment to the Dodd-Frank Act.

[2] The amendment is substantially the same as H.R. 992, the Swaps Regulatory Improvement Act, which passed in the House of Representatives in October 2013 by a vote of 292 to 122, but was not taken up by the Senate.

[3] 78 Fed. Reg. 34545 (June 10, 2013).

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- Uncleared credit default swaps (including swaps and security-based swaps referencing the credit risk of asset-backed securities);
- Most equity swaps and total return swaps referencing equity or convertible debt; and
- Swaps referencing most physical commodities, other than bullion metals, including swaps based on agricultural or energy commodities.

The original Swaps Pushout Rule contained an exception from the pushout requirement for certain types of swaps and security-based swaps. Prior to the amendment, IDIs were not required to push out:

- Swaps or security-based swaps used to hedge or mitigate risk directly related to their activities;
- Swaps involving rates or assets that are permissible for investment by a national bank, such as interest rate swaps, foreign exchange swaps, swaps referencing bullion metals and swaps referencing loans or bank eligible debt securities (including asset-backed securities);
- Cleared credit default swaps; and
- For IDIs granted an extension of the transition period contained in the law, swaps entered into before the end of the transition period.[4]

AMENDED SWAPS PUSH OUT RULE

Under Section 716 as amended, IDIs, as well as uninsured U.S. branches and agencies of foreign banks, that are swap dealers and security-based swap dealers ("covered depository institutions"), [5] will only be required to push out certain swaps based on an asset-backed security or a group or index primarily comprised of asset-backed securities, defined in the amendment as "structured finance swaps."[6] A covered depository institution may nonetheless enter into structured finance swaps under Section 716 as amended if:

- They are undertaken for hedging or risk management purposes; or
- Each asset-backed security underlying such structured finance swaps is of a credit quality and of a type or category with respect to which the Prudential Regulators have jointly adopted rules authorizing such swap activity.[7]

As amended, Section 716 eliminates from the pushout requirement most of the swaps that were subject to pushout under the original rule, other than certain structured finance swaps as described above. For covered depository institutions actively trading equity and commodity derivatives, the amendment is a welcome development since these instruments are

[4] According to FDIC Vice Chairman Thomas M. Hoenig, these instruments, which are not subject to pushout, amount to almost 95% of IDIs' derivatives activities. *See* Statement available at https://www.fdic.gov/news/news/speeches/spdec1014.html.

[5] Section 716 provides that swap entities do not include IDIs that are major swap participants or major security-based swap participants. The amendment clarifies that this exception applies to uninsured U.S. branches and agencies of foreign banks. Thus, covered depository institutions are limited to swap dealers and security-based swap dealers.

[6] Asset-backed security is defined by cross-referencing the definition of the term in Section 3(a) of the Securities Exchange Act of 1934.

[7] The Prudential Regulators are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the FDIC, the Farm Credit Administration, and the Federal Housing Finance Agency.

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no longer subject to pushout. In some sense, though, the provision's exemption giveth and taketh away. The amended rule does not, for example, require pushing out commodity swaps that had been subject to pushout under the original rule. However, swaps based on bank eligible asset-backed debt securities (permissible assets for national banks) may be required to be pushed out under the new rule (unless used for risk mitigation or the Prudential Regulators adopt applicable rules), despite not having been subject to pushout under the old rule.

In addition, unless or until the Prudential Regulators adopt the applicable rules permitting swaps based on asset-backed securities, it is unclear what the scope of the pushout will be. The amendment also does not change the transition period provided for in Section 716 for the pushout of instruments subject to the pushout requirement. For those covered depository institutions that received transition period relief, that period expires on July 16, 2015, although the Prudential Regulators may extend the transition period up to one additional year.[8]

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[8] The amendment makes one additional change with respect to swaps required to be pushed out. The original Swaps Pushout Rule permitted only IDIs to push out swaps to a swap entity affiliate that does not receive federal assistance, if the IDI were part of a bank holding company or savings and loan holding company supervised by the Federal Reserve Board, and the swap entity affiliate complied with certain requirements. The amendment revises this provision to apply to covered depository institutions, which may be part of a foreign banking organization (as defined under the Federal Reserve Board's Regulation K, 12 C.F.R. 211.21(o)) in addition to a bank holding company or savings and loan holding company.

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