

Amendments to Dodd-Frank Swaps Push-Out Provision Passed in Omnibus Spending Bill

On December 16, 2014, President Obama signed the Consolidated and Further Continuing Appropriations Act, 2015 (the "Act")¹ into law. The Act effects two significant amendments to the "swaps push-out" provision enacted as Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").²

These amendments codify the eligibility of U.S. branches and agencies of foreign banks for the exception to the Federal assistance prohibition available only to "insured depository institutions" ("IDIs") under the original provision.³ The amendments additionally limit the push-out requirement for qualifying "covered depository institutions" to certain "structured finance swaps" that are not entered into for hedging or risk management purposes.

Section 716 generally prohibits the provision of "Federal assistance," including advances from the Federal Reserve discount window and insurance or guarantees from the Federal Deposit Insurance Corporation ("FDIC"), to any "swaps entity"⁴ with regard to any swap, security-based swap⁵ or other activity of the swaps entity. As originally enacted in Dodd-Frank, Section 716(d) provided that this prohibition would not apply to an IDI that limits its swaps activities, as described below.

Although the Act did not repeal Section 716, its amendments will permit both IDIs and the uninsured U.S. branches and agencies of foreign banks to continue to engage in a broader scope of swaps activities than was originally permitted.⁶ To the extent

¹ The Act is available [here](#).

² 12 U.S.C. § 8305.

³ Previously, the Board of Governors of the Federal Reserve System (the "Board") and the Office of the Comptroller of the Currency (the "OCC") had exercised administrative authority to address this disparity in treatment. See 79 Fed. Reg. 340 (Jan. 3, 2014), available [here](#) (final Board rule treating uninsured U.S. branches and agencies of foreign banks as IDIs for purposes of Section 716); see also OCC, Transition Required by Section 716(f) of [Dodd-Frank], available [here](#) (listing responses to requests from uninsured U.S. branches and agencies of foreign banks for a transition period under Section 716(f) pursuant to OCC guidance).

⁴ "Swaps entity" was originally defined to include any registered swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant, other than an IDI that is a major swap participant or major security-based swap participant.

⁵ In this memorandum, we refer to "swaps" and "security-based swaps" collectively as "swaps."

⁶ A blackline of the changes to Section 716 is attached as Annex A.

such institutions have not yet implemented plans to “push out” nonconforming swaps activities, the Act could significantly reduce the dislocations, costs and client inconvenience associated with Section 716 compliance. The Act will also significantly ameliorate the discrepancy in the scope of swaps that foreign banks are able, through their head offices, to offer clients, on the one hand, and the scope of swaps that U.S. banks (and their foreign branches) were permitted to offer their clients under Section 716, as originally enacted, on the other hand.

The amendments also raise new questions about the scope of permitted swaps activities by covered depository institutions that will need to be answered through future rules or guidance jointly adopted by the prudential regulators.⁷

The Act made two key changes to Section 716:

First, the Act expands the scope of entities that benefit from the original IDI swaps entity carve-out and the IDI exemption in Section 716(d) to include all “covered depository institutions,” which are defined to include both IDIs as well as uninsured U.S. branches and agencies of foreign banks. This change remedies a widely acknowledged drafting error in Section 716 that could have been read to exclude foreign banks’ uninsured U.S. branches and agencies from the relief provided to IDIs.

Second, the Act significantly broadens the scope of permitted swaps activity under Section 716 for a covered depository institution, although it may potentially narrow the scope of permitted structured finance swap activity.

Under Section 716(d) as originally enacted, IDIs were permitted to transact in (1) swaps for hedging and risk mitigation purposes and (2) otherwise, where limited to swaps on rates or reference assets permitted for investment by a national bank, including swaps on foreign currencies, interest rates, precious metals, government securities and investment grade debt securities (including certain asset-backed securities), but excluding uncleared credit default swaps. Thus, very generally, the major swap asset categories that IDIs were required to push out included commodity swaps, equity and sub-investment grade debt swaps and uncleared credit default swaps, unless entered into for hedging or risk mitigation purposes.

As amended, Section 716(d) now exempts a covered depository institution from the Federal assistance prohibition if it limits its swap activities to the following:

- Hedging and other similar risk mitigating activities directly related to the activities of the covered depository institution;

⁷ The prudential regulators are the Board, the FDIC, the OCC, the Federal Housing Finance Agency, and the Farm Credit Administration.

- Acting as a swaps entity for swaps other than a structured finance swap;⁸ or
- Acting as a swaps entity for swaps that are structured finance swaps, if such structured finance swaps are either (1) undertaken for hedging or risk management purposes or (2) each asset-backed security underlying such structured finance swaps meets credit quality and classification requirements to be set forth by prudential regulators in future regulations.

In essence, covered depository institutions must push out swaps on asset-backed securities, unless (1) the swap is for hedging or similar risk mitigation or (2) each of the underlying asset-backed securities satisfies credit or other criteria to be identified jointly by the prudential regulators. All other swaps are permitted.

The Act thus significantly broadens the scope of permitted activity under Section 716(d), but may narrow the scope of permitted swaps on asset-backed securities. Specifically, swaps based on certain investment grade asset-backed securities that would have been permitted under the original text of Section 716(d) now must be specifically authorized under regulations to be issued by the prudential regulators. In that regard, the Act does not provide any guidance to the prudential regulators or the industry regarding the credit quality and types of structured finance swaps that should be permitted in eventual regulatory standards, leaving the ultimate scope of swaps that will be required to be pushed out subject to continued uncertainty.

Finally, the Act did not amend the effective date of Section 716 or the provisions governing transition relief. A number of banks have already requested and received a 24-month extension of the transition period under Section 716, postponing the eventual compliance date to July 16, 2015.⁹ Although the Act's amendments to Section 716 have significantly eased their compliance burden with respect to a broad range of swaps activity, the continued ambiguities regarding the scope of Section 716 may lead some institutions to seek additional transition relief under Section 716, as amended.

* * *

⁸ The term "structured finance swap" is defined as a swap "based on an asset-backed security (or group or index primarily comprised of asset-backed securities)" The term "asset-backed security" adopts the definition set forth in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)).

⁹ 12 U.S.C. § 8305(f); see also 79 Fed. Reg. at 342.

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Annex A: Blackline of Dodd-Frank Section 716 (15 U.S.C. § 8305) as Amended by the Consolidated and Further Continuing Appropriations Act, 2015

15 U.S.C. § 8305. Prohibition against Federal Government bailouts of swaps entities

(a) Prohibition on Federal assistance

Notwithstanding any other provision of law (including regulations), no Federal assistance may be provided to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity.

(b) Definitions

In this section:

(1) Federal assistance

The term “Federal assistance” means the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 343(3)(A) of title 12, Federal Deposit Insurance Corporation insurance or guarantees for the purpose of—

(A) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;

(B) purchasing the assets of any swaps entity;

(C) guaranteeing any loan or debt issuance of any swaps entity; or

(D) entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity.

(2) Swaps entity

(A) In general

The term “swaps entity” means any swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, that is registered under—

(i) the Commodity Exchange Act (7 U.S.C. 1 et seq.); or

(ii) the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.).

(B) Exclusion

The term “swaps entity” does not include any major swap participant or major security-based swap participant that is ~~an insured~~a covered depository institution.

(3) Covered depository institution

The term “covered depository institution” means—

(A) an insured depository institution, as that term is defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); and

(B) a United States uninsured branch or agency of a foreign bank.

(c) Affiliates of ~~insured~~covered depository institutions

The prohibition on Federal assistance contained in subsection (a) does not apply to and shall not prevent ~~an insured~~a covered depository institution from having or establishing an affiliate which is a swaps entity, as long as such ~~insured~~covered depository institution is part of a bank holding company, ~~or~~ savings and loan holding company, or foreign banking organization (as such term is defined under Regulation K of the Board of Governors of the Federal Reserve System (12 CFR 211.21(o))) that is supervised by the Federal Reserve and such swaps entity affiliate complies with sections 371c and 371c–1 of title 12 and such other requirements as the Commodity Futures Trading Commission or the Securities Exchange Commission, as appropriate, and the Board of Governors of the Federal Reserve System, may determine to be necessary and appropriate.

(d) Only bona fide hedging and traditional bank activities permitted

(1) In General.—The prohibition in subsection (a) shall not apply to any ~~insured~~covered depository institution ~~unless the insured depository institution that~~ limits its swap ~~or~~and security-based swap activities to the following:

(4A) Hedging and Other Similar Risk Mitigation Activities.—Hedging and other similar risk mitigating activities directly related to the ~~insured~~covered depository institution's activities.

(2B) Non-Structured Finance Swap Activities.—Acting as a swaps entity for swaps or security-based swaps ~~involving rates or reference assets that are permissible for investment by a national bank under the paragraph designated as “Seventh.” of section 24 of title 12, other than as described in paragraph (3). other than a structured finance swap.~~

(C) Certain Structured Finance Swap Activities.—Acting as a swaps entity for swaps or security-based swaps that are structured finance swaps, if—

(i) such structured finance swaps are undertaken for hedging or risk management purposes; or

(ii) 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 swap or security-based swap activity by covered depository institutions.

(2) Definitions.—For purposes of this subsection:

(A) Structured Finance Swap.—The term ‘structured finance swap’ means a swap or security-based swap based on an asset-backed security (or group or index primarily comprised of asset-backed securities).

(B) Asset-Backed Security.—The term ‘asset-backed security’ has the meaning given such term under section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)).

~~(3) Limitation on credit default swaps~~

~~Acting as a swaps entity for credit default swaps, including swaps or security-based swaps referencing the credit risk of asset-backed securities as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) (as amended by this Act) shall not be considered a bank permissible activity for purposes of subsection (d)(2) unless such swaps or security-based swaps are cleared by a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or a clearing agency (as such term is defined in section 3 of the Securities Exchange Act (15 U.S.C. 78c)) that is registered, or exempt from registration, as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act, respectively.~~

(e) Existing swaps and security-based swaps

The prohibition in subsection (a) shall only apply to swaps or security-based swaps entered into by ~~an insured~~a covered depository institution after the end of the transition period described in subsection (f).

(f) Transition period

To the extent ~~an insured~~a covered depository institution qualifies as a “swaps entity” and would be subject to the Federal assistance prohibition in subsection (a), the appropriate Federal banking agency, after consulting with and considering the views of the Commodity Futures Trading Commission or the Securities Exchange Commission, as appropriate, shall permit the ~~insured~~covered depository institution up to 24 months to divest the swaps entity or cease the activities that require registration as a swaps entity. In establishing the appropriate transition period to effect such divestiture or cessation of activities, which may include making the swaps entity an affiliate of the ~~insured~~covered depository institution, the appropriate Federal banking agency shall take into account and make written findings regarding the potential impact of such divestiture or cessation of activities on the ~~insured~~covered depository institution’s (1) mortgage lending, (2) small business lending, (3) job creation, and (4) capital formation versus the potential negative impact on insured depositors and the Deposit Insurance Fund of the Federal Deposit Insurance Corporation. The appropriate Federal banking agency may consider such other factors as may be appropriate. The appropriate Federal banking agency may place such conditions on the ~~insured~~covered depository institution’s divestiture or ceasing of activities of the swaps entity as it deems necessary and appropriate. The transition period under this subsection may be extended by the appropriate Federal banking agency, after consultation with the Commodity Futures Trading Commission and the Securities and Exchange Commission, for a period of up to 1 additional year.

(g) Excluded entities

For purposes of this section, the term “swaps entity” shall not include any insured depository institution under the Federal Deposit Insurance Act [12 U.S.C. 1811 et seq.] or a covered financial

company under title II which is in a conservatorship, receivership, or a bridge bank operated by the Federal Deposit Insurance Corporation.

(h) Effective date

The prohibition in subsection (a) shall be effective 2 years following the date on which this Act is effective.

(i) Liquidation required

(1) In general

(A) FDIC insured institutions

All swaps entities that are FDIC insured institutions that are put into receivership or declared insolvent as a result of swap or security-based swap activity of the swaps entities shall be subject to the termination or transfer of that swap or security-based swap activity in accordance with applicable law prescribing the treatment of those contracts. No taxpayer funds shall be used to prevent the receivership of any swap entity resulting from swap or security-based swap activity of the swaps entity.

(B) Institutions that pose a systemic risk and are subject to heightened prudential supervision as regulated under section 5323 of title 12

All swaps entities that are institutions that pose a systemic risk and are subject to heightened prudential supervision as regulated under section 5323 of title 12, that are put into receivership or declared insolvent as a result of swap or security-based swap activity of the swaps entities shall be subject to the termination or transfer of that swap or security-based swap activity in accordance with applicable law prescribing the treatment of those contracts. No taxpayer funds shall be used to prevent the receivership of any swap entity resulting from swap or security-based swap activity of the swaps entity.

(C) Non-FDIC insured, non-systemically significant institutions not subject to heightened prudential supervision as regulated under section 5323 of title 12

No taxpayer resources shall be used for the orderly liquidation of any swaps entities that are non-FDIC insured, non-systemically significant institutions not subject to heightened prudential supervision as regulated under section 5323 of title 12.

(2) Recovery of funds

All funds expended on the termination or transfer of the swap or security-based swap activity of the swaps entity shall be recovered in accordance with applicable law from the disposition of assets of such swap entity or through assessments, including on the financial sector as provided under applicable law.

(3) No losses to taxpayers

Taxpayers shall bear no losses from the exercise of any authority under this title.

(j) Prohibition on unregulated combination of swaps entities and banking

At no time following adoption of the rules in subsection (k) may a bank or bank holding company be permitted to be or become a swap entity unless it conducts its swap or security-based swap activity in compliance with such minimum standards set by its prudential regulator as are reasonably calculated to permit the swaps entity to conduct its swap or security-based swap activities in a safe and sound manner and mitigate systemic risk.

(k) Rules

In prescribing rules, the prudential regulator for a swaps entity shall consider the following factors:

- (1) The expertise and managerial strength of the swaps entity, including systems for effective oversight.
- (2) The financial strength of the swaps entity.
- (3) Systems for identifying, measuring and controlling risks arising from the swaps entity's operations.
- (4) Systems for identifying, measuring and controlling the swaps entity's participation in existing markets.
- (5) Systems for controlling the swaps entity's participation or entry into in 2 new markets and products.

(l) Authority of the Financial Stability Oversight Council

The Financial Stability Oversight Council may determine that,³ when other provisions established by this Act are insufficient to effectively mitigate systemic risk and protect taxpayers, that swaps entities may no longer access Federal assistance with respect to any swap, security-based swap, or other activity of the swaps entity. Any such determination by the Financial Stability Oversight Council of a prohibition of federal assistance shall be made on an institution-by-institution basis, and shall require the vote of not fewer than two-thirds of the members of the Financial Stability Oversight Council, which must include the vote by the Chairman of the Council, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairperson of the Federal Deposit Insurance Corporation. Notice and hearing requirements for such determinations shall be consistent with the standards provided in title I.

(m) Ban on proprietary trading in derivatives

An insured depository institution shall comply with the prohibition on proprietary trading in derivatives as required by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act [12 U.S.C. 1851].

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