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Financial Institutions Regulation Group Client Alert:

"Are You My Mother?"[1]: Which Agency Governs What Swap Entity Under the Margin Rules for Non-Cleared Swaps?

On October 22, 2015, the federal prudential regulatory agencies issued a final margin and capital rule for covered swaps entities (the "Prudential Margin Rules").[2] The issuing agencies were the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC"), the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "Prudential Regulators"). The Prudential Margin Rules implement Sections 731 and 764[3] of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and purport to jointly establish capital requirements and initial and variation margin requirements for those swap dealers, major swap participants, security-based swap dealers and major security-swap dealers (each, a "Covered Swap Entity") that fall under the Prudential Regulators' jurisdiction.

Under Section 731, Covered Swaps Entities that are banks for which there is a Prudential Regulator must comply with the Prudential Margin Rules; Covered Swaps Entities that are not banks or for which there is no Prudential Regulator are subject to rules issued by the Commodity Futures Trading Commission (the "CFTC") or the Securities and Exchange Commission ("SEC").[4] While the two sets of margin and capital rules share broad similarities, they differ in several critical respects – for example, the Prudential Margin Rules require a Covered Swap Entity to collect initial

[1] *Are You My Mother?*, P.D. Eastman (Random House 1960).
[2] *Margin and Capital Requirements for Covered Swap Entities,* 80 Fed. Reg. 74840 (Nov. 30, 2015).
[3] Section 764 of the Dodd-Frank Act sets forth the framework for the SEC's regulation of security-based swap dealers and major security-based swap participants, and largely tracks the CFTC's framework under Section 731. For ease of reference, this memorandum generally refers only to the CFTC's swaps regulatory authority under Section 731.
[4] The CFTC issued its final rules (the "CFTC Margin Rules") in December 2015. *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 6, 2016). The SEC has proposed, but has not yet finalized, its margin and capital rules for non-cleared swaps.

margin under non-cleared swaps with an affiliate, while the CFTC rules generally exempt interaffiliate transactions from the requirement to both post *and* collect initial margin.[5] Further, examination and enforcement of the rules by the Prudential Regulators and the CFTC could differ significantly.

It is only logical, therefore, to expect that the relevant statutory and regulatory backdrop would clearly define whether a Covered Swap Entity should expect to be overseen by the Prudential Regulators or by the CFTC. A closer look at the language shows that this is not the case. Rather, the original language in the Dodd-Frank Act contains what appear to be technical errors which are compounded by vague drafting and the subsequent failure of the Prudential Regulators to meaningfully clarify the statutory text in their final rulemaking. For example, it is not at all clear that uninsured state-licensed branches and agencies of foreign banks – to the extent they conduct swap dealing activities - should be subject to the Prudential Margin Rules, rather than the rules of the CFTC. We discuss this and other ambiguities below.

GENERAL FRAMEWORK

Section 731(e)(2)(A) of the Dodd-Frank Act provides that each Prudential Regulator shall, in consultation with the CFTC and SEC, jointly (with the other Prudential Regulators) adopt rules governing the swaps activities of Covered Swap Entities for which there is a Prudential Regulator imposing (i) capital requirements and (ii) both initial and variation margin on *all* swaps that are not cleared by a registered derivatives clearing organization. The Prudential Regulators have the statutory authority to issue capital and margin rules covering the entities that they, roughly speaking, charter or license to engage in banking and financial activities in the United States. The Prudential Regulators are then *required* to jointly issue rules for any such entities that are swap dealers or major swap participants and for which there is a Prudential Regulator imposing capital and margin requirements.

Section 731(e)(2)(B) of the Dodd-Frank Act then tasks the CFTC with issuing rules with respect to Covered Swap Entities for which there is not a Prudential Regulator imposing both capital requirements and initial and variation margin requirements on non-cleared swaps. This split of jurisdiction appears logical: the Prudential Regulators should continue to regulate the entities for which they are the responsible supervisor, and the CFTC will regulate and supervise all other entities as a catch-all.

However, there are two significant ambiguities in this structure: one in the statutory language, and one in the regulatory implementation.

[5] *See* § 23.159 of the CFTC's Margin Rules and § __.11(b) of the Prudential Margin Rules.

DEFINITIONS

To test the framework arranged under Section 731, we first examine how the jurisdiction of the Federal Reserve is defined. Section 721 of the Dodd-Frank Act, in adding a new Section 1(a)(39) to the Commodity Exchange Act, provides that the Federal Reserve is the prudential regulator of the following entities:[6]

1. State-chartered banks that are members of the Federal Reserve System;
2. State-chartered branches or agencies of a foreign bank;
3. Foreign banks that do not operate insured branches;
4. Edge corporations or Agreement corporations; and
5. Bank holding companies and foreign banks that are treated as bank holding companies under the International Banking Act of 1978, as amended, savings and loan holding companies, and certain subsidiaries thereof.

The above list largely includes those entities subject to the pre-existing prudential regulatory authority of the Federal Reserve prior to the Dodd-Frank Act. As noted, this makes sense as a policy choice by Congress.

PROBLEMS IN THE STATUTORY LANGUAGE

The above list of entities contains what appears to be, if not an error, then a deeply confusing choice of words. There is no such entity as a "State-chartered branch or agency of a foreign bank." U.S. branches and agencies of a foreign bank are *licensed* to operate in the United States, and are not chartered as separately capitalized entities. However, the Prudential Regulators adopted the "state-chartered" terminology without comment in the Prudential Margin Rules.[7]

Elsewhere in the preamble to the Prudential Margin Rules, however, the Prudential Regulators reference only a "state branch or state agency of a foreign bank," omitting the "chartered" qualifier.[8] It is possible that the Prudential Regulators decided to adopt a common sense reading of the phrase "State-chartered branch of a foreign bank" in order to preserve their jurisdiction over their licensed supervisees.[9] While an understandable intention and perhaps consistent with likely Congressional intent, this interpretation would ignore the plain language of the statute. The correct plain reading

[6] Section 721(a)(17) of the Dodd-Frank Act.
[7] *See* the preamble to the Prudential Margin Rules, at n. 4.
[8] *See* the preamble to the Prudential Margin Rules, at p. 74890.
[9] The statutory list of prudentially regulated entities subject to the OCC's jurisdiction shares the same error, referencing a "federally-chartered branch or agency of a foreign bank. *See* Section 721(a)(17) of the Dodd-Frank Act.

of this language refers to what is essentially a null set of entities. An oversight like this could have far-reaching consequences – after all, should a Covered Swap Entity not fall under the list of entities subject to the jurisdiction of the Prudential Regulators, inadvertently or otherwise, they would be subject to *CFTC's* rules.

In this case, the ultimate impact of this apparent error is unclear. To the extent state-*licensed* branches and agencies of foreign banks engage in swap dealing activities that require registration as a Covered Swap Entity, it is their parent entity that maintains the registration.[10] Additionally, certain other prongs in the list above – such as those prongs referring to a foreign bank which does not operate an insured branch or a foreign bank treated as a bank holding company under U.S. law – could potentially be read to include the swap dealing activities of a state-licensed branch or agency of a foreign bank. But such a reading is far from obvious, and if it is appropriate, it should be made and supported by the Prudential Regulators based on the statutory text and the Congressional Record.

PROBLEMS WITH THE REGULATORY IMPLEMENTATION OF CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

As described above, Section 731 requires a prudential regulator to "impose" minimal capital requirements <u>and</u> initial and variation margin requirements on Covered Swap Entities. This appears to be a Congressional attempt to level the playing field between those entities that were already subject to pre-existing capital requirements (and therefore did not need new requirements issued) and those entities that required both capital requirements and margin requirements to be issued. The assumption implicit in Section 731 was that the Prudential Regulators had already issued adequate capital rules applicable to the entities subject to their jurisdiction, while the CFTC would need to do so for newly regulated swap entities.

Consistent with that assumption, the Prudential Regulators declined to impose capital requirements on Covered Swap Entities pursuant to the Prudential Margin Rules. The preamble to the Prudential Margin Rules states that "[g]iven that … existing regulatory capital rules specifically take into account and address the unique risks arising from swap transactions and activities, the [Prudential Regulators] will rely on these existing rules as appropriate and sufficient to offset the greater risk to the covered swap entity and the financial system arising from the use of swaps that are not cleared …".[11]

However, it is unclear whether it is technically correct to imply that *all* Covered Swap Entities are already subject to existing regulatory capital rules. In particular, State-

[10] Foreign banking organizations provisionally registered as swap dealers are registered through (i) their head offices and/or (ii) their nonbank subsidiaries. The list of provisionally registered swap dealers can be found at <u>http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer</u>.
[11] *See* the preamble to the Prudential Margin Rules, at p. 74846.

licensed branches and agencies of foreign banks are not subject to U.S. capital rules imposed by the Prudential Regulators. The capital requirements that the Prudential Margin Rules cite as applicable to state-licensed branches and agencies of foreign banks, at § 225.2(r)(3) of the Federal Reserve's Regulation Y,[12] do not separately impose capital requirements for such branches and agencies. Rather, those provisions essentially define a branch's capitalization by reference to the capital ratios of the parent foreign banking organization.[13] Left unexplained is (i) how, or whether, that satisfies the statutory mandate that a Prudential Regulator "impose" capital requirements on its Covered Swap Entities, and (ii) how categorically defining a branch's capital levels with reference to the parent organization's capital ratios is meant to address the "unique risks arising from swap transactions and activities" faced by such a branch.

CONCLUSION

The ambiguities inherent in the drafting of Section 731 have naturally become more prevalent in the wake of the issuance and implementation of the margin and capital rules. As Covered Swap Entities struggle to analyze and interpret what are often equivocal rules and regulations, it is disappointing that the one bedrock of regulation on which market participants should be able to rely– the identity of their regulator – is unclear. Even more discouraging is the lack of any forthcoming clarity or guidance with respect to this issue or any other ambiguity noted above, especially given the impending effectiveness of the final rule. Therefore, market participants should continue to strive for clarity with their regulators on the topic of regulatory authority.

[12] *See* § 237.12(c) of the Prudential Margin Rules.
[13] 12 C.F.R. § 225.2(r)(3)(ii). These rules generally only apply to foreign banking organizations with a U.S. banking presence. Therefore, it is also unclear whether the Prudential Regulators intend to impose these same capital requirements on a foreign bank that does *not* have a U.S. banking presence and therefore is not treated as a U.S. bank holding company, such as a Covered Swap Entity that falls under the prong of the Prudential Regulator definition capturing a "foreign bank which does not operate an insured branch."

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