

**Meeting between Federal Reserve Board Staff and  
Representatives of Citigroup Global Markets, Inc.  
October 15, 2012**

**Participants:** Laurie Schaffer, Jordan Bleicher, Victoria Szybillo, Christopher Paridon, Christine Graham, and Kerrie Brophy (Federal Reserve Board)

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**Summary:** Staff of the Federal Reserve Board met with representatives of Citigroup Global Markets Inc. (“Citigroup”) to discuss section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), otherwise known as the so-called “swaps push-out” provision.

Among matters discussed were Citigroup’s views regarding: ability to request an extension of the transition period under section 716; benefits of netting cleared swaps and the utility of establishing CCPs prior to the implementation of section 716; what economic and quantitative data might be necessary in order to make the statutory findings related to the transition period under section 716; and the relationship of section 716 to FX transactions and other activities.

Citigroup’s representatives also provided the attached materials.

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The Dodd-Frank “Derivatives Push-Out” Does Not Apply to the  
Non-U.S. Operations of U.S. Banks

I. Introduction.

Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) is entitled a “Prohibition Against Federal Government Bailouts of Swaps Entities.”<sup>1</sup> This provision is commonly referred to as the “derivatives push-out” or the “Lincoln Amendment” and was apparently intended to protect U.S. taxpayers from shouldering the cost of failures of depository institutions that engage in certain derivatives activities.<sup>2</sup>

Section 716’s convoluted language does not directly prohibit depository institutions from engaging in derivatives activities, although this is the effective consequence. Rather, it provides that, subject to certain exceptions, “no Federal assistance may be provided to a swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity.” The statute then defines “Federal assistance” as Federal Reserve advances or Federal Deposit Insurance Corporation insurance or guarantees provided in certain specified types of transactions listed in the statute (such as making a loan to a swaps entity).<sup>3</sup> Because depository

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<sup>1</sup> Codified as 15 U.S.C. § 8305.

<sup>2</sup> 156 Cong. Rec. S3141 (daily ed. May 5, 2010) (“Section 716 is designed to ensure that the American taxpayer is not the banker of last resort . . .”) (statement of Sen. Lincoln).

<sup>3</sup> § 716(b)(1).

institutions engaged in swaps dealing activity would be “swaps entities,”<sup>4</sup> Section 716 could effectively prevent them from engaging in certain swaps activities<sup>5</sup> in order to maintain their eligibility for Federal assistance.<sup>6</sup>

Certain U.S. depository institutions (hereinafter, each a “Covered Entity”) have substantial non-U.S. operations through which they conduct, among other things, swaps activities that, if conducted in the United States, would not be permissible under Section 716(d) for depository institutions seeking to maintain their eligibility for Federal assistance. In some jurisdictions, these activities are conducted in Edge Act corporation subsidiaries (“Edges”), in other jurisdictions, through branches (“foreign branches”), and, in certain jurisdictions, through both.

This memorandum addresses the reasons that Section 716 should be interpreted not to apply to the non-U.S. swaps activities of Edges or foreign branches. Any expansive interpretation of Section 716 to cover these activities would be inconsistent with, or at least not required by, the statutory language and would contravene multiple sound national policy objectives.

## II. Statutory Framework.

Section 716 prohibits the Federal Deposit Insurance Corporation (“FDIC”) and the Federal Reserve Banks (“Federal Reserve”) from providing “Federal assistance” to a

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<sup>4</sup> The literal language of Section 716 applies to a “swaps entity” and not to a “depository institution.” Nonetheless, the definition of “Federal assistance” effectively limits the prohibition to depository institutions (including the U.S. branches of foreign banks) because no other entity receives Federal assistance as defined.

<sup>5</sup> Section 716 specifically permits insured depository institutions to: (i) engage in swaps and security-based swap activities for “[h]edging and other similar risk mitigating activities directly related to the institution’s activities [and] (ii) act[] as a swaps entity for swaps or security-based swaps involving rates or reference assets that are permissible for investment by national banks under 12 U.S.C. § 24(7).” See § 716(d).

<sup>6</sup> Even if a depository institution could “opt out” of Federal assistance, it would normally be imprudent to do so.

depository institution in certain circumstances. For the Section 716 prohibition to be applicable, each of three distinct elements must be satisfied: (1) the depository institution must be a “swaps entity” that is engaged in swaps activity not exempted by Section 716(d);<sup>7</sup> (2) the proposed assistance must qualify as “Federal assistance” as defined in Section 716; and (3) the Federal assistance must be provided “with respect to any swap, security-based swap, or other activity of the swaps entity.”<sup>8</sup>

A. What is a “swaps entity”?

A “swaps entity” is defined as any “swap dealer, security-based swap dealer, major swap participant, [sic] major security-based swap participant, that is registered under” the Commodity Exchange Act (“CEA”) or the Securities Exchange Act of 1934 (“Exchange Act”).<sup>9</sup> The term “swaps entity,” however, excludes any “major swap participant” or “major security-based swap participant” that is an “insured depository institution.”<sup>10</sup> Thus, an insured depository institution would qualify as a swaps entity only if it were a swaps dealer or security-based swaps dealer.

Although this exclusion literally appears to exempt a Covered Entity that is both a major swap participant or major security-based swap participant, as well as a swaps dealer or security-based swaps dealer,<sup>11</sup> we think it unlikely that the regulators would read this exclusion

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<sup>7</sup> See *supra* note 5.

<sup>8</sup> See § 716(a).

<sup>9</sup> See § 716(b)(2)(A). For purposes of this document, we assume that the “swap dealer” and “security-based swap dealer” definitions set forth in Dodd-Frank will not be modified by the Commodity Futures Trading Commission (“CFTC”) or Securities and Exchange Commission (“SEC”) pursuant to authority granted under Section 712(d) of Dodd-Frank.

<sup>10</sup> § 716(b)(2)(B). Section 2(18) of Dodd-Frank incorporates the Federal Deposit Insurance Act’s (the “FDI Act”) definition of “insured depository institution” as meaning any bank or savings association the deposits of which are insured under the FDI Act. See 12 U.S.C. § 1813(c)(2).

<sup>11</sup> Depending on the final regulations to be issued by the CFTC and SEC, it may be possible for a single Covered Entity to be a swap dealer or security-based swap dealer for only a single class or category of

so broadly. Nevertheless, this ambiguity, one of a number contained in Section 716, is a reason to avoid an overly broad reading of that section as a whole.

B. What is “Federal assistance”?

Section 716(b)(1) very specifically defines “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 13(3)(A) of the Federal Reserve Act, 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.<sup>12</sup>

There are two components to this definition of “Federal assistance.” First, the assistance must involve either: (i) an advance from a Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility, or (ii) FDIC insurance or guarantees. Second, such Federal Reserve advance or FDIC insurance or guarantee, as the case may be, must be used by the Federal Reserve or the FDIC for the purpose of one of the specific transactions enumerated in clauses (A) through (D) of Section 716(b)(1).

The FDIC’s general insurance of deposits held by an insured depository institution is not among (that is, the general insurance of deposits is not “for the purpose of”) the

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swap or security-based swap, while it would simultaneously be a major swap participant or major security-based swap participant (and, therefore, excluded from the “swaps entity” definition) for another class or category of swap or security-based swap. See § 721(a)(21) (defining “swap dealer”).

<sup>12</sup> § 716(b)(1). This language is presumably misdrafted because, among other things, there is no conjunctive phrase between “Federal Reserve Act” and “Federal Deposit Insurance Corporation.”

transactions listed in clauses (A) through (D) of the definition of “Federal assistance.”<sup>13</sup>

Accordingly, under a plain reading of the statute, a depository institution whose deposits are insured by the FDIC does not appear on this basis alone to be prohibited from engaging in the swaps activities limited by Section 716.<sup>14</sup>

C. What is “with respect to”?

The third requirement for application of Section 716 is that the Federal assistance be provided “with respect to any swap, security-based swap, or other activity of the swaps entity.” As discussed below in Part III (B), the term “other activity” in Section 716 must mean a swaps-related activity. This language was clearly directed to swaps-related activity, and should be limited to such activity – notwithstanding the potentially highly expansive reference to “other activity.” Thus, Section 716 does not prohibit the provision of Federal assistance to a swaps entity for non-swaps-related activity.

D. Limitation on application of the Section 716 prohibition.

Section 716(c) clarifies that an insured depository institution may have or establish an “affiliate” that is a swaps entity, provided that the insured depository institution is

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<sup>13</sup> We do not believe that the phrase “debt issuance” can legitimately be read as the receipt of deposits. The term “debt issuance” should be given its normal meaning, which would not include accepting deposits, particularly in a banking context. If Congress had intended deposit taking to be included as one of the transactions referred to in clauses (A) through (D), it would have used the term “deposits” in Section 716, as it did elsewhere in Dodd-Frank and other Federal banking statutes. *See, e.g.*, § 165(e) (using the term “deposits”). Instead, Congress intended Section 716 to prohibit the guarantee of debt issuances, such as the guarantees made under the Temporary Liquidity Guarantee Program. *See* Temporary Liquidity Guarantee Program: Final Rule, 73 Fed. Reg. 72244, 72253 (Nov. 26, 2008) (the FDIC created a temporary program to guarantee the payment of certain newly issued senior unsecured debt).

<sup>14</sup> This reading is consistent with the purpose of the statute as reflected in its title, which is to prevent extraordinary Federal assistance – “Federal Government Bailouts” – from being directed to swaps entities. *See* 156 Cong. Rec. S3141 (daily ed. May 5, 2010) (statement of Sen. Lincoln) (stating that Section 716 is designed to ensure that American taxpayers are not the banker of last resort, as was true with the bank bailouts in 2008 and 2009); 156 Cong. Rec. S3889 (daily ed. May 18, 2010) (statement of Sen. Kaufman) (iterating that Section 716 would prohibit banks with swap dealers from receiving emergency assistance). *See also* §§ 716(i)(1), (3) (stating, in the specific context of liquidations, that taxpayers are to bear no losses from the exercise of any authority under the title).

“part of a bank holding company, or savings and loan holding company, that is supervised by the Federal Reserve and such swaps entity affiliate complies with sections 23A and 23B of the Federal Reserve Act and such other requirements as the Commodity Futures Trading Commission or the Securities and Exchange Commission, as appropriate, and the Board of Governors of the Federal Reserve System, may determine to be necessary and appropriate.” This provision represents a thoroughly considered determination that a more expansive scope for Section 716(a) could be damaging to the national interest.<sup>15</sup>

### III. Section 716 Does Not Directly or Indirectly Limit the Swaps Activities of Edges.

Edges are corporations organized under the Edge Act (now Section 25A of the Federal Reserve Act)<sup>16</sup> with the approval of the Board of Governors of the Federal Reserve System (“Federal Reserve Board”).<sup>17</sup> The purpose of the Edge Act is to permit U.S. banking organizations to engage in international or foreign banking and other financial operations to promote the foreign trade of the United States, and thus Edges are authorized to exercise “sufficiently broad powers to enable them to compete effectively with similar foreign-owned institutions in the United States and abroad.” 12 U.S.C. § 611a. Edges may be organized and established by member banks,<sup>18</sup> which are expressly permitted to hold their shares. 12 U.S.C. §§ 601, 24(7). Edges are authorized to establish branches and subsidiaries in foreign countries in order to conduct their activities. The Edge Act enumerates specific powers of Edges (including their branches and subsidiaries) and authorizes the Federal Reserve Board to add such powers

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<sup>15</sup> Prior to the addition of the affiliate exemption in subsection (c) during the legislative process, there was a great deal of concern and discussion over the effect of pushing swaps activities outside even the holding company structure. *See, e.g.*, 156 Fed. Rec. S3068 (daily ed. May 4, 2010) (statement of Sen. Gregg), 156 Cong. Rec. S3122 (daily ed. May 5, 2010) (statement of Sen. Chambliss) (noting how costly, for both banks and the national economy, such a provision would be). *See also* Letter of Chairman Sheila C. Bair, Federal Deposit Insurance Corporation, to Senators Christopher J. Dodd and Blanche L. Lincoln, dated April 30, 2010 (expressing reservations about pushing higher risk activities into the largely unregulated “shadow sector” of the financial system).

“. . . as may be usual . . . in connection with the transaction of the business of banking or other financial operations in the countries . . . in which [the Edge] shall transact business . . . .”<sup>19</sup> The only activities of an Edge permitted in the United States are those that are incidental to its international or foreign business.

Edges are not subject to the restrictions on swaps activities contained in Section 716 (and their parent member banks are likewise not rendered ineligible for Federal assistance as a result of their Edge subsidiaries’ swaps activities) for each of three independent reasons:

- Edges should not fall within the definition of “swaps entity” to the extent that their swaps activities are conducted overseas and not with U.S. residents;
- Edges are not depository institutions and do not and cannot receive “Federal assistance,” an essential prerequisite to the Section 716 prohibition; and
- Edges are “affiliates” of a bank and therefore may rely on the exemption for an “affiliate” established by an insured depository institution or held by such an institution.

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<sup>16</sup> In this document, references to “Edges” include “Agreement corporations,” which are state-chartered entities that may engage only in activities permissible for Edges. 12 U.S.C. §§ 601, 603. In addition, references to Edges include any subsidiary of an Edge or Agreement corporation.

<sup>17</sup> 12 U.S.C. § 611.

<sup>18</sup> Member banks are national banks or state banks that are members of the Federal Reserve System. 12 U.S.C. § 221.

<sup>19</sup> 12 U.S.C. § 615(a). The Federal Reserve Board has previously determined, in Regulation K, that swaps activity is “usual . . . in connection with the transaction of the business of banking or other financial operations” in other countries. *See* 12 C.F.R. § 211.10(a)(19) (commodity swaps); § 211.10(b) (incorporating all of the activities permitted under Regulation Y, including § 225.28(b)(8)(ii) of Regulation Y which permits broad swaps activities). The “usual in connection with” provisions of the statute still retain independent significance, as the Federal Reserve Board is permitted to approve, and has approved, activities that may not be listed in Regulation K or Regulation Y. Some activities have been approved notwithstanding the fact that they are impermissible for depository institutions under U.S. regulations and impermissible under Regulation Y. *See, e.g.*, Citibank Overseas Inv. Corp., 1985 Fed. Res. Interpretive Ltr. (Dec. 9, 1985) (approving an Edge Corporation’s application to conduct real estate brokerage activities through a subsidiary); 67 Fed. Res. Bulletin 269, 366 (April 1981) (approving an Edge Corporation’s application to engage in the underwriting of credit life, credit accident and credit health insurance regardless of whether the insurance is directly related to the extension of credit by the Edge Corporation or its affiliates); and 12 C.F.R. §§ 211.10(a)(14), (15) (permitting Edges to underwrite and deal in equity securities outside of the U.S.).

Stated conversely, for any of these three reasons, Edges would not be subject to the swaps activity limitations of Section 716.

A. *Edges are not, and will not be, “swaps entities” and thus are not subject to the swaps activity limitations in Section 716.*

As noted, Section 716 prohibits the provision of “Federal assistance” to a “swaps entity” with respect to certain swaps activities. A “swaps entity,” in turn, is defined as any swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant that is registered under the CEA or the Exchange Act.<sup>20</sup> Thus, Section 716 is not applicable unless the entity to receive Federal assistance is registered under the CEA or Exchange Act. Edges should not be required to register under these statutes to the extent that their swaps activities are conducted wholly outside the United States.

Under long-standing policies of the Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”), an entity engaged in activities outside the United States does not trigger the registration requirements of the CEA or the Exchange Act.<sup>21</sup> These policies are reinforced by a strong judicial presumption against extraterritorial application of Federal statutes.<sup>22</sup>

In Dodd-Frank, Congress explicitly adopted these policies and did not extend the registration requirements of the CEA and Exchange Act, to which Section 716 is keyed, extraterritorially. Section 722(d) of Dodd-Frank, amending the CEA, states that “[the]

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<sup>20</sup> See § 716(b)(2)(A).

<sup>21</sup> See generally Exemption of Certain Foreign Brokers or Dealers, SEC Release No. 34-58047 (June 27, 2008) (stating that the Commission typically takes a territorial approach to registration requirements); CFTC Statement of Policy, *Exercise of Commission Jurisdiction Over Reparation Claims That Involve Extraterritorial Activities by Respondents*, 49 Fed. Reg. 14721 (1981) (requiring registration only when either the conduct in question occurred within the United States, or conduct outside the United States had a significant effect within the United States).

<sup>22</sup> *Morrison v. Nat’l Australia Bank*, 130 S. Ct. 2869, 2877 (2010).

provisions of this Act relating to swaps . . . shall not apply to activities outside the United States” unless they are directly and significantly connected to activities in, or having an effect on, the commerce of the United States, or are meant to evade the rules and regulations of the CEA.<sup>23</sup> Similarly, Section 772(b), amending the Exchange Act, would not apply the Dodd-Frank provisions of the Exchange Act to any person transacting business in security-based swaps outside the jurisdiction of the United States.<sup>24</sup> The only exception is if the person transacts business in violation of regulations meant to prevent evasion of the Act.<sup>25</sup> Therefore, to the extent that an Edge’s swaps activities are conducted solely outside the United States and exclusively with non-U.S. persons, or U.S. persons located or residing outside the United States,<sup>26</sup> the Edge should not be required to register under the CEA or the Exchange Act.

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<sup>23</sup> § 722(d). The CFTC has requested comment on the extraterritorial application of the registration requirements under the CEA, including the level of swap dealing activity outside the United States that would require registration under the standard set forth in Section 722(d). *See* Registration of Swap Dealers and Major Swap Participants, CFTC Proposed Rulemaking, 75 Fed. Reg. 71379, 71382-83 (Nov. 23, 2010). We do not believe that the swaps dealing activities of Edges outside the United States with non-U.S. residents (as discussed above) would meet the standard for extraterritorial application of the CEA. In the CFTC’s request for comment, the CFTC has recognized that it “generally would not require a person to register as a swap dealer if their only connection to the United States was that the person uses a U.S. registered swap execution facility, designated clearing organization or designated contract market in connection with their swap dealing activities, or reports swaps to a U.S. registered swap data repository.” *Id.*

<sup>24</sup> *See* § 772(b).

<sup>25</sup> In *Morrison*, the Supreme Court stated that the same “prevent evasion” language in Section 30(b) of the Exchange Act was not sufficient to make that statute apply extraterritorially. “The provision seems to us directed at actions abroad that might conceal a domestic violation, or might cause what would otherwise be a domestic violation to escape on a technicality.” 130 S. Ct. at 2882-83. The Court recognized that it might be possible to interpret such language as creating an extraterritorial application, but held that “possible interpretations of statutory language do not override the presumption against extraterritoriality.” *See id.*

<sup>26</sup> In the interest of providing an efficient method for risk management, the Covered Entities should be permitted to centralize their risk management activities with respect to non-U.S. securities or other financial assets within an Edge through derivative transactions without thereby requiring the Edge to register under the CEA. In this scenario, the U.S. non-depository affiliate of the Edge would transfer the risk from its transactions with a third party involving a non-U.S. security to the Edge. In the joint SEC and CFTC release “Further Definition of ‘Swap Dealer,’ ‘Security-Based Swap Dealer,’ ‘Major Swap Participant,’ ‘Major Security-Based Swap Participant’ and ‘Eligible Contract Participant,’” the agencies noted preliminarily that a person may not be considered a dealer on the basis of swaps and security-based swaps conducted with its affiliates where such activity represents an allocation of risk within a corporate group. CFTC Release No. 34-63452, SEC File No. S7-39-10, pp. 37-38 (Dec. 3, 2010).

In addition to this historical lack of extraterritorial application of registration requirements, the CFTC and SEC should not apply the registration requirement to Edges for other reasons. First, the CFTC has recently stated that an entity will not be required to register as a swap dealer or a major swap participant merely by virtue of the fact that the entity engages in swaps activities that may have been curtailed, or “pushed out,” of an affiliated insured depository institution.<sup>27</sup> An entity will only have to register if the activities of the entity alone otherwise require the entity to register.<sup>28</sup> As we have noted, the non-U.S. activities should not require Edges to register as swaps entities.

Second, neither the SEC nor the CFTC has any precedent for requiring an entity to register as a regulated entity, such as a broker-dealer or a futures commission merchant, merely because it is a subsidiary of a registered broker-dealer or futures commission merchant, if it is not otherwise subject to registration. In addition, under SEC and CFTC precedent, subsidiaries of registered broker-dealers or futures commission merchants are not subject to the activity and prudential restrictions imposed on a registered entity, unless the subsidiary itself engages in activities that require registration.<sup>29</sup>

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<sup>27</sup> See CFTC Proposed Rulemaking, 75 Fed. Reg. at 71382-83. The SEC has not issued its proposed rules in this area, but has announced plans to do so during December 2010. See SEC Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act – Upcoming Activity, at <http://sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#12-10>.

<sup>28</sup> See *id.*

<sup>29</sup> See, e.g., Douglas Bremen & Co., Inc., SEC No-Action Letter (Dec. 19, 1988) (stating that prudential restrictions on the parent, a registered broker-dealer, need not apply to a subsidiary); Authorizing Subsidiary of FCM to Enter Into Certain Contracts with a Federal Power Marketing Agency, CFTC Order (CCH) ¶ 24,297 (Aug. 2, 1988) (allowing a subsidiary of a registered futures commission merchant to enter into option contracts without having to become subject to CFTC rules). Also, we note that, because the statute is focused on “entities,” it requires that the specific entity be subject to registration. Thus, conversely, if an insured depository institution is not itself a “swaps entity,” the actions of its subsidiary, as a separate entity, would not make the institution a “swaps entity.” This means that the activities of the Edge subsidiaries would not, and should not, be deemed activities of the parent bank, and should not render the parent bank ineligible for “Federal assistance” even if the Edge engages in activities falling outside the Section 716(d) exemption.

For all these reasons, an Edge should not be required to register under the CEA or the Exchange Act, and therefore would not fall within the definition of a “swaps entity” in Section 716. Accordingly, the limitation of that section on the conduct of swaps activities would be inapplicable to an Edge, even if it were deemed (incorrectly) to receive “Federal assistance.”

B. *Edges do not and will not receive “Federal assistance” and thus are not subject to the swaps activity limitations in Section 716.*

Edges do not receive, and are not eligible for, “Federal assistance.” Therefore, Section 716 does not limit their swaps activity, even if they were to be deemed a “swaps entity.” Edges are not “depository institutions” under the Federal Deposit Insurance Act (the “FDI Act”),<sup>30</sup> and thus their deposits are not eligible for FDIC insurance,<sup>31</sup> even if FDIC insurance of deposits at depository institutions were deemed “Federal assistance” under Section 716.<sup>32</sup> In addition, under the Federal Reserve Board’s Regulation A, Edges are not eligible for advances from the discount window. Regulation A limits access to the discount window to “depository institutions,” which do not include Edges.<sup>33</sup> Accordingly, an Edge would not have access to the types of Federal assistance that Section 716 was designed to prevent swaps entities from accessing. This conclusion is strongly supported by Section 716 when read as a whole, which

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<sup>30</sup> Under the FDI Act, a depository institution is defined as “any bank or savings association.” These terms, as defined in the FDI Act, do not include an Edge. *See* 12 U.S.C. §§ 1813(a), (b).

<sup>31</sup> Federal deposit insurance may only be provided to a depository institution, which is defined as “any bank or savings association.” *See* 12 U.S.C. § 1813(c).

<sup>32</sup> Edges may theoretically be eligible for FDIC assistance under the emergency financial stabilization provisions of Section 1105 of Dodd-Frank because an Edge is an affiliate of an insured depository institution. This cannot be the relevant test, however. If it were, no affiliate of a depository institution could conduct swaps activity, which would obviously conflict with Section 716’s express authorization for affiliates to conduct such activities free from its prohibition. Moreover, if the Edge would be conducting swaps activity covered by Section 716, the Edge would no longer be eligible to receive the assistance as a result of the prohibition under Section 716.

<sup>33</sup> 12 C.F.R. § 201.2. Under Regulation A, only banks, savings associations and certain other specified financial institutions are eligible for discount window advances. Edges are not among these institutions. Although an Edge would theoretically be eligible for advances from a broad-based program or credit facility established by the Federal Reserve under Section 13(3) of the Federal Reserve Act, such advances are excluded from the definition of Federal assistance. § 716(b)(1).

repeatedly refers to insured depository institutions only and not to non-depository institutions more broadly.<sup>34</sup>

Section 716 refers to the actual provision (“may be provided”) of Federal assistance, and not some indirect benefit. Accordingly, an Edge should not be deemed to receive indirect “Federal assistance” because of its parent’s eligibility for Federal assistance. Likewise, the eligibility of an Edge’s parent depository institution for Federal assistance should not be affected because its subsidiary is engaged in swaps activities.<sup>35</sup>

Section 716 is a prohibition on the provision of Federal assistance by the Federal Reserve and the FDIC, as they are the only organizations that provide Federal assistance within the meaning of Section 716. It does not, by its terms, further limit the recipient swaps entity from using the proceeds of the assistance to extend credit to, or engage in any of the other enumerated transactions in clauses (A) through (D) of Section 716(b)(1) with, another swaps entity. Had Congress wished to bring that situation within the ambit of Section 716’s prohibition, it would have said so expressly, using the terms “directly or indirectly” as it did in other provisions of Dodd-Frank and Federal banking statutes,<sup>36</sup> or applying the prohibition to an

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<sup>34</sup> See § 716(c) (insured depository institutions not prevented from establishing an affiliate which is a swaps entity); § 716(d) (insured depository institution permitted to undertake bona fide hedging and certain traditional national bank swaps activities); § 716(e) (making Section 716 inapplicable to existing swaps and security-based swaps entered into by insured depository institutions prior to the end of a transition period); § 716(f) (establishing a transition period for insured depository institutions to comply with Section 716); § 716(m) (prohibiting proprietary trading of derivatives by insured depository institutions).

<sup>35</sup> As stated above, the restriction of Section 716 on Federal assistance is entity-based. The entity wishing to remain eligible for “Federal assistance” should conform its activities to those permitted by Section 716. The activities of other entities should not be attributed to it, nor should its activities be attributed to other entities. Any contrary conclusion would render the affiliate provisions of Section 716 (discussed below) meaningless.

<sup>36</sup> See, e.g., § 113(c)(1)(A) (regarding authority to require supervision and regulation of certain non-bank financial companies); § 619 (the Volcker Rule); § 753(a) (anti-manipulation authority under regulation of swaps markets). See also 12 U.S.C. § 1467a (Home Owners’ Loan Act); 12 U.S.C. § 1815 (FDI Act); 12 U.S.C. § 1843 (Bank Holding Company Act).

“associated person,” a term referenced in Title VII.<sup>37</sup> The absence of any such qualification is a strong indication that Congress intended to cover only the provision of Federal assistance by the Federal Reserve and the FDIC to a swaps entity engaged in activities not exempted under Section 716(d), and not to restrict the swaps entity’s use of that assistance in financial transactions with other swaps entities.

More significantly, an argument that Section 716 prohibits the use by an insured depository institution of the proceeds of Federal assistance to engage in the credit and other types of transactions enumerated in clauses (A) through (D) of Section 716(b)(1) with a swaps entity is not only inconsistent with the statutory language, but proves too much, producing an absurd result damaging to the U.S. financial system.<sup>38</sup> Such an interpretation would prevent an insured depository institution, whether or not it was a swaps entity, from extending credit or engaging in the other enumerated transactions with swaps entities, including other insured depository institutions that are swaps dealers or security-based swaps dealers, or financial firms, government sponsored entities or other customers that are swaps entities.<sup>39</sup> We submit that the statute cannot be read in such a fashion to prohibit transactions by insured depository institutions with swaps entities altogether, patently a result Congress could not have intended. Rather, consistent with its plain terms and the legislative intent evident in the title of the section, Section 716 operates as a limitation on the ability of the Federal Reserve and the FDIC to provide

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<sup>37</sup> See § 711.

<sup>38</sup> In construing a statute, one should assume that Congress, in passing laws, did not intend results that are absurd. See, e.g., *United States v. X-Citement Video*, 513 U.S. 64, 69 (1994); *Pub. Citizen v. United States Dep’t of Justice*, 491 U.S. 440, 470 (1989).

<sup>39</sup> As just one example, such a reading would prevent banks from being able to purchase Fannie Mae and Freddie Mac debt securities, as Fannie and Freddie are likely to be “swaps entities” under the Section 716 definition.

Federal assistance (“bailout”) to swaps entities, and not on the ability of a depository institution to use the proceeds of such assistance in financial transactions with swaps entities.

Although we do not believe that Section 716 covers transactions by an insured depository institution with others, including their Edge subsidiaries, if Section 716 were to be so applied, it would only prohibit a transaction between a depository institution and its subsidiary Edge to the extent that the transaction was both (i) used to support the swaps activities of the Edge and (ii) derived from discount window advances or an FDIC emergency financial stabilization program.<sup>40</sup>

This conclusion is not contravened by the language in Section 716(a) that refers to “any swap, security-based swap, or other activity of the swaps entity.”<sup>41</sup> The words “other activity” in this phrase must be read in context to apply to the swaps-related activities of the swaps entity and not to all of its other financial activities. Otherwise, as discussed above, the provision would prevent an insured depository institution that received Federal assistance, whether or not it is a swaps entity, from making a loan not only to any affiliate, but even to any unaffiliated customer of the depository institution that is a swaps entity, irrespective of whether the purpose of the loan is related to the swaps activities of the affiliate or customer. This reading is supported by the long-standing statutory interpretative principle of *ejusdem generis*, whereby general words are construed to embrace those objects enumerated by the preceding specific words.<sup>42</sup> Thus, the multiple prior references to “swap” mean that “swap” also modifies “other

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<sup>40</sup> As noted, “Federal assistance” is not used when a bank uses deposits that may have been raised, in part, on the basis of FDIC insurance to engage in transactions covered by Section 716 with the bank’s Edge. The four types of transactions set forth in Section 716(b)(1) do not include the general insurance of deposits. In any event, it would be a relatively simple matter for a depository institution to designate all transactions with the Edge as involving funding other than insured deposits.

<sup>41</sup> § 716(a) (emphasis added).

<sup>42</sup> See, e.g., *Circuit City Stores, Inc. v. Saint Clair Adams*, 532 U.S. 105, 114-15 (2001).

activity.” Moreover, if Congress meant to encompass all activity of the Covered Entity, then the entire phrase “with respect to any swap [or] security-based swap” in Section 716(a) would have no meaning, and Section 716 would have been written to simply refer to any activity of the swaps entity.

In our view, it is implausible to argue that it was the intent of Section 716(a) to prevent U.S. banks from providing loans to, or engaging in other financial transactions with, any affiliate or unaffiliated customer that meets the definition of “swaps entity.”

C. *As an “affiliate” of an insured depository institution, an Edge is exempt from the swaps activity limitations of Section 716 even if it is a swaps entity.*

As noted, Section 716(c) provides that the prohibition in Section 716(a) “shall not prevent an insured depository institution from having or establishing an affiliate which is a swaps entity, as long as such insured depository institution is part of a bank holding company . . . and such swaps entity affiliate complies with sections 23A and 23B of the Federal Reserve Act . . . .” Even if an Edge were to be considered a swaps entity, the Edge subsidiaries of the Covered Entities would not be subject to the limitations on swaps activities in Section 716 because these Edges are affiliates under the relevant definition; the Covered Entities are each part of bank holding companies; and the Edges comply with Sections 23A and 23B of the Federal Reserve Act.

As a wholly owned subsidiary of an insured depository institution, an Edge is an “affiliate” of such an institution under the FDI Act as well as the Bank Holding Company Act (“BHC Act”).<sup>43</sup> Dodd-Frank defines “affiliate,” including for purposes of Section 716, by reference to the FDI Act definition, which incorporates the BHC Act definition.<sup>44</sup> Under both of

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<sup>43</sup> See 12 U.S.C. § 1813(w)(6); 12 U.S.C. § 1841(k).

<sup>44</sup> See § 2(l).

these statutes, an affiliate is broadly defined as “any company that controls, is controlled by, or is under common control with another company” and thereby covers “second tier” subsidiaries.<sup>45</sup>

The Edges also satisfy each of the two other requirements of the Section 716(c) exemption. First, the Covered Entities are each a “part” of a bank holding company as an indirect subsidiary of the parent holding company. Second, as a subsidiary of an insured depository institution, Edge subsidiaries are subject to, and comply with, Sections 23A and 23B of the Federal Reserve Act. Under Section 23A, loans by Edge subsidiaries to, and other covered transactions by Edge subsidiaries with, affiliates of its depository institution parent are subject to the quantitative and other requirements of that section.<sup>46</sup> Moreover, if the statute were to be read to require that covered transactions by the parent’s bank with its Edge comply with Sections 23A and 23B, the Edge subsidiaries would satisfy that requirement as well because such transactions are not subject to Sections 23A and 23B.<sup>47</sup>

Furthermore, the language of Section 716(c) appears to contemplate specifically that Edge subsidiaries of insured depository institutions qualify for this exemption. Section 716 authorizes an insured depository institution not only to have an affiliate that is a swaps entity (such as a sister subsidiary established and held by the depository institution’s parent holding company), but also to establish such an affiliate. The use of the term “establish” suggests a Congressional understanding and intent that Edge subsidiaries of member banks would be included within the exemption because they are one of the limited subsidiary corporations that a

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<sup>45</sup> See 12 U.S.C. § 1813(w)(6); 12 U.S.C. § 1841(k). Under the BHC Act, shares owned or controlled by any subsidiary of a bank holding company are deemed controlled by the bank holding company. 12 U.S.C. § 1841(g)(1). The Covered Entities are subsidiaries of their parent bank holding companies, and the shares of the Edge subsidiaries owned by these Covered Entities are thus controlled by their parent bank holding companies. The Edges thus fall squarely within the definition of “affiliate.”

<sup>46</sup> See 12 U.S.C. § 371c(b)(2)(A).

<sup>47</sup> Indeed, Section 23A, as originally enacted in the Banking Act of 1933, expressly exempted Edges. See 48 Stat. 162, 183.

member bank is authorized to “establish” as an entity separate and apart from the member bank.<sup>48</sup> This interpretation is strongly supported by the principle of statutory construction that all words in a statute should be given meaning.<sup>49</sup> Because a bank does not “establish” its holding company affiliates, to give the term “establish” meaning, it must encompass the establishment by the bank of its subsidiaries, as they are the only affiliates a bank can establish.

More generally, the clear intent of Section 716 is essentially to enable insured depository institutions to “push out” certain derivatives activities to their affiliates in order to avoid serious damage to the U.S. financial system. Section 716(c) was added, after thorough consideration, to confirm that Section 716(a) did not create a situation in which liquidity would be drained from the market, customers of U.S. banks would not be able to obtain needed services, and U.S. banks would be placed at a serious competitive disadvantage.<sup>50</sup> There is no reason why this intent should be frustrated by limiting this push out to affiliates that are not Edges. For the reasons discussed below (Part IV), such a limitation would be particularly inapt as contrary to the long-standing legislative and regulatory policy to promote the international competitiveness of Edges.

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<sup>48</sup> Although banks may establish so-called operating subsidiaries, these entities are not treated as entities separate from the bank and are only permitted to engage in activities that the parent may conduct. *See* 12 C.F.R. §§ 250.141, 5.34(e). Because the parent depository institution, in order to maintain eligibility for Federal assistance, would elect to engage in only those swaps activities described in Section 716(d), the operating subsidiary also would conduct only such activities. In contrast, Edges are subject to a completely separate regulatory regime, often with a separate regulator and separate permissible activities.

<sup>49</sup> *See, e.g., Bowsher v. Merck & Co.*, 460 U.S. 824, 833 (1983) (restating “the settled principle of statutory construction that we must give effect . . . to every word of the statute”).

<sup>50</sup> *See, e.g.*, 156 Cong. Rec. S3600 (daily ed. May 12, 2010) (statement of Sen. Enzi).

IV. Section 716 Should Not Limit the Swaps Activities of Foreign Branches of U.S. Banks.

U.S. banks may establish branches in foreign jurisdictions with the prior approval of the Federal Reserve Board.<sup>51</sup> Similar to many other activities conducted through a foreign branch, the swaps activities of foreign branches are focused overseas and generally conducted with non-U.S. residents. In addition, deposits payable at the foreign branches are not covered by Federal deposit insurance if they are not also payable in the United States.<sup>52</sup> Although foreign branches of member banks are not corporate entities separate and apart from their member bank parents, foreign branches have long been allowed to engage in a wider range of activities than are their U.S. head offices and have benefitted from the presumption against applying U.S. law extraterritorially.<sup>53</sup> A determination that Section 716 should not limit the swaps activities of foreign branches of U.S. banks conducted wholly outside the United States would be consistent with this precedent and would help avoid placing U.S. banks at a further competitive disadvantage. Furthermore, neither the stated objective of Section 716 nor a plain reading of the statute requires extending the application of Section 716 to the foreign branches.

Under Section 25 of the Federal Reserve Act, Congress granted the Federal Reserve Board authority to permit foreign branches of U.S. banks to exercise such further powers “as may be usual in connection with the transaction of the business of banking in the places where such foreign branch shall transact business,”<sup>54</sup> even if those activities were not permissible for a U.S. bank domestically. The Federal Reserve Board has exercised this authority and permits foreign branches to engage in activities that are not permissible for the

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<sup>51</sup> See 12 U.S.C. § 601.

<sup>52</sup> See 12 U.S.C. § 1813(1)(5)(A).

<sup>53</sup> See generally 12 C.F.R. § 211.4 (foreign branches may *inter alia* act as insurance agents or brokers, and may underwrite, distribute, deal, and invest in the obligations of foreign governments, agencies, instrumentalities and political subdivisions).

<sup>54</sup> See 12 U.S.C. § 604a.

bank's U.S. head office.<sup>55</sup> It would be consistent with almost 100 years of Congressional determinations and Federal Reserve Board precedent for a U.S. banking organization to be able to conduct financial activities in its foreign branches (or Edges) that it could not conduct domestically.<sup>56</sup>

We believe that the Federal Reserve Board and the FDIC should interpret Section 716, which is keyed to registration under the CEA and Exchange Act, in accordance with the long-standing national policy (discussed above) not to apply Federal securities and commodities law extraterritorially. As the Supreme Court recently stated in *Morrison*:

It is a longstanding principle of American law 'that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.' . . . It rests on the perception that Congress ordinarily legislates with respect to domestic, not foreign matters. Thus, 'unless there is the affirmative intention of the Congress clearly expressed' to give a statute extraterritorial effect, 'we must presume it is primarily concerned with domestic conditions.' . . . When a statute gives no clear indication of an extraterritorial application, it has none.<sup>57</sup>

Limiting the extraterritorial application of Section 716 is particularly appropriate here, where a contrary interpretation would create undue and unnecessary competitive disadvantages for U.S. banks in their non-U.S. activities and conflict with the established U.S. policy reflected in the Federal Reserve Act and Edge Act to promote the international competitiveness of U.S. depository institutions and U.S. commerce.<sup>58</sup>

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<sup>55</sup> See *supra* note 53.

<sup>56</sup> The Federal Reserve Board has similar authority in the case of Edge activities and has exercised that authority in the past to permit Edges, for example, to underwrite and deal in securities even though these activities were prohibited by Federal law for any affiliates of a member bank, including an Edge. See, e.g., 56 Fed. Reg. 19549 (April 29, 1991) codified at 12 C.F.R. 211.10(a)(10).

<sup>57</sup> *Morrison*, 130 S. Ct. at 2877-78 (quoting *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991)) (internal citations omitted).

<sup>58</sup> See 12 U.S.C. § 611a.

There is no indication in the language of Section 716, or its legislative history, that it was meant to apply extraterritorially. To the contrary, there are several provisions in Title VII of Dodd-Frank that make clear that the CEA and Exchange Act, upon which the “swaps entity” definition of Section 716 is based, are not to apply extraterritorially.<sup>59</sup> Moreover, as noted, the CFTC and the SEC have a long tradition of not asserting jurisdiction over transactions, or entities that engage in transactions, that take place or operate outside the United States. For example, the CFTC staff has taken the position that a foreign office of a U.S. entity that was not a separate legal entity could grant options on physical commodities if the transactions were conducted overseas, and the products were offered only to non-U.S. investors, even though the options could not have been offered in the United States to U.S. investors.<sup>60</sup> Thus, we believe this approach should be applied in the case of foreign branches of U.S. banks with respect to their non-U.S. swaps activities.

Furthermore, subjecting the activities of a foreign branch (or an Edge) to Section 716 would be contrary to a long history of Congressional recognition that foreign branches (and Edges) should be allowed to engage in a wider range of activities than is permissible for the domestic operations of U.S. banking organizations.<sup>61</sup> The primary purpose of this approach is to promote the international competitiveness of U.S. banking organizations and the competitiveness of their U.S. customers in international markets.<sup>62</sup> Eliminating the ability of U.S. banks to

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<sup>59</sup> See, e.g., Dodd-Frank § 715 (allowing for the prevention of foreign entities from participating in swaps activities in the United States), § 722 (limiting extraterritorial application of the CEA), § 738 (concerning foreign boards of trade), § 752 (requiring consultation with foreign regulatory authorities), § 772 (limiting the extraterritorial reach of the Exchange Act).

<sup>60</sup> CFTC-OCG Interpretative Letter No. 86-2 (May 22, 1985).

<sup>61</sup> See, e.g., 58 Cong. Rec. S5074 (daily ed. Sept. 9, 1919) (statement of Sen. McLean) (espousing the need and desire that overseas operations of financial institutions be on par with the institutions of the countries in which they operate).

<sup>62</sup> See 12 U.S.C. §§ 604a, 611a.

provide swaps to their customers through their foreign branches (or Edges) would hamper the ability of U.S. banking organizations to compete globally and serve the needs of their clients, including overseas affiliates of their U.S. clients. This competitive disadvantage is underscored by the fact that non-U.S. jurisdictions have not taken any action to require that swaps activities be conducted outside of depository institutions. Furthermore, in many non-U.S. jurisdictions, only banks (and not their affiliates) are permitted to engage in swaps activities covered by Section 716, further demonstrating the reason and need for Congress to have limited the extraterritorial impact of Section 716.<sup>63</sup>

In this regard, Federal Reserve Chairman Bernanke has recognized the threat that Section 716 poses to U.S. global competitiveness:

Section 716 would force derivatives activities out of banks and potentially into less regulated entities or into foreign firms that operate outside the boundaries of our Federal regulatory system. The movement of derivatives to entities outside the reach of the Federal supervisory agencies would increase, rather than reduce the risk to the financial system. In addition, foreign jurisdictions are highly unlikely to push derivatives business out of their banks. Accordingly, foreign banks will have a competitive advantage over U.S. banking firms in the global derivatives marketplace, and derivatives transactions could migrate outside the United States.<sup>64</sup>

A logical construction of Section 716 indicates that the Section should not preclude Federal assistance to a U.S. bank engaged only in permissible swaps dealing activities in the United States because a foreign branch conducts swaps dealing activities outside the United States that do not require registration under the CEA or Exchange Act. Although the

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<sup>63</sup> For example, in China, Taiwan, and India, swaps products are limited to local banks and branches of foreign banks.

<sup>64</sup> Letter of Chairman Ben S. Bernanke, Board of Governors of the Federal Reserve System, to Senator Christopher J. Dodd, dated May 12, 2010. *See also* The Federal Reserve staff's Comments on Senate Agriculture Committee's OTC Derivatives Bill, dated April 24, 2010 (stating "[Section 716] would have serious consequences for the competitiveness of U.S. financial institutions; and would be highly disruptive and costly, both for banks and their customers").

foreign branch would be conducting swaps dealing activities that do not fall within the Section 716(d) exemption, the conduct of these activities, if wholly outside the United States, would not by itself require registration by the parent bank as a “swaps entity” under the CEA or Exchange Act and thereby preclude the provision of Federal assistance to the bank under Section 716. The fact that the parent bank is required to register under the CEA and Exchange Act solely because of swaps activities that are permitted by Section 716(d) (and that, therefore, do not preclude the provision of Federal assistance to it) should not trigger the prohibition of Section 716.

In other words, because neither of these swaps activities (those conducted wholly outside the United States and those exempt in the United States under Section 716(d)) precludes the provision of Federal assistance to a swaps entity, both activities should not be combined to have that effect. It would be anomalous to interpret Section 716 to prohibit Federal assistance to a swaps entity engaged in swaps activities wholly outside the United States that do not require registration under the CEA or Exchange Act simply because it is engaged in permissible swaps activities in the U.S. that would make it a “swaps entity,” but that do not preclude the provision of Federal assistance to it.

Finally, as the title and language of Section 716 make clear, the objective of this provision is to prevent Federal assistance from being used to support certain swaps activities.<sup>65</sup> This objective does not require that the prohibition of Section 716(a) be extended to foreign branches of U.S. banks. Based upon a plain reading of the statute, unless the proceeds of the Federal assistance are provided “with respect to” the swaps activities of the bank, the limitations of Section 716 are not applicable.

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<sup>65</sup> Section 716(l) recognizes that the risks to financial stability and the taxpayer that may be associated with the conduct of permissible swaps activities by insured depository institutions are addressed through other provisions of Dodd-Frank. Section 716(l) further provides that the Financial Stability Oversight Counsel may limit access to Federal assistance by swaps entities if these other provisions of Dodd-Frank are not sufficient to achieve those purposes.

In the final analysis, not extending coverage of Section 716 to foreign branches of U.S. banks would promote long-standing U.S. policy goals. The legislative history of this Section 716 is replete with references to the protection of the taxpayer and is of a markedly domestic bent.<sup>66</sup> There is no expression of concern over transactions conducted in foreign jurisdictions and involving foreign persons.

V. Conclusion.

For the reasons set forth above, the prohibition in Section 716(a) does not apply to Edge subsidiaries, and the objectives of both Section 716 and broader U.S. policy also mandate the conclusion that this prohibition should not apply to the foreign branches of U.S. banks.

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<sup>66</sup> See, e.g., 156 Cong. Rec. S3141 (daily ed. May 5, 2010) (statement of Sen. Lincoln); 156 Cong. Rec. S5814-15 (daily ed. July 14, 2010) (statement of Sen. Murray).