Feature

KEY POINTS

- Sections 23A and 23B of the Federal Reserve Act, and the Federal Reserve Board's implementation of the statutory scheme in Regulation W, are intended to protect US depository institutions from losses resulting from credit exposures to affiliates and to prevent abusive, non-arm's length transactions.
- Within a broader regulatory framework, including most recently the Dodd-Frank Act, ss 23A and 23B and Regulation W affect not just traditional banking relationships, but the full range of financial transactions among US depository institutions and their affiliates, both domestic and foreign.
- As depository institutions operating in the syndicated loan market increasingly find themselves acting alongside non-bank lenders that are (or may become) their affiliates, the Regulation W "ring fence" may seem fundamentally incompatible with the share-alike mechanisms of the modern lending syndicate.

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Regulation W hazards in syndicated and other loan transactions

In this article, the authors outline the statutory restrictions imposed by ss 23A and 23B and Regulation W on certain transactions between US depository institutions and their affiliates, the common troubles in syndicated and other loan transactions and some practical drafting solutions.

BACKGROUND

Sections 23A and 23B of the US Federal Reserve Act, enacted as parts of a sweeping legislative response to the failure of nearly 5,000 US banks during the Great Depression, regulate transactions between US depository institutions and their affiliates. The limitations contained in ss 23A and 23B are intended both to protect US depository institutions from losses resulting from credit exposures to affiliates and to prevent such institutions from transferring the subsidy they receive from the US Federal safety net (eg Federal deposit insurance and access to liquidity at the "discount window") by entering into non-arm's length transactions with affiliates. As such, the 1933 enactment of ss 23A and 23B lay the foundation for a prudential "ring fence" regime in the US. With the 2002 adoption of Regulation W, the US Board of Governors of the Federal Reserve System (Fed) codified the numerous interpretations of ss 23A and 23B issued by the Fed and its staff in the intervening decades, comprehensively implementing the statutory restrictions and exemptions.

Section 23A restricts certain transactions in which a depository institution acquires credit exposure to an affiliate (Covered Transactions), and makes them subject to quantitative limits, collateral requirements and certain other prudential limitations.

Section 23B adds another layer of protection, requiring that transactions between a depository institution and its affiliate – including, but not limited to, Covered Transactions – be on market terms, or terms at least as favourable to the depository institution as those prevailing at the time for comparable transactions with non-affiliates.

DEPOSITORY INSTITUTIONS SUBJECT TO SS 23A AND 23B

By themselves, ss 23A and 23B apply only to banks that are members of the US Federal Reserve System, which includes national banks and some of the larger state-chartered banks. Section 18(j)(1) of the US Federal Deposit Insurance Act, however, extends ss 23A and 23B to insured banks that are not members of the Federal Reserve System (which includes a great many smaller state-chartered banks), and s 11(a)(1) of the US Home Owners' Loan Act makes ss 23A and 23B applicable to savings associations (or "thrift" institutions). Member banks, non-member insured banks and savings associations are collectively referred to as "US Banks" herein.

To a limited extent, ss 23A and 23B also extend to the US branches, agencies and commercial lending company subsidiaries (collectively, "Onshore Banking Offices") of foreign banks. Regulation W provides that ss 23A and 23B apply to transactions between a foreign bank's Onshore Banking Office and any entity that would be a Covered Affiliate (as defined below) if the Onshore Banking Office was a US Bank, but *only* if the Covered Affiliate:

- is directly engaged in the US in insurance underwriting, securities underwriting or dealing, or certain merchant banking or insurance company investment activities;
- is a portfolio company, as defined in the Fed's merchant banking rules, controlled by the foreign bank or certain of its affiliates; or is a subsidiary of either of the foregoing.

US Banks and Onshore Banking Offices collectively are referred to as "Covered Institutions" in this article.

COVERED AFFILIATES

General definition

Sections 23A and 23B define which affiliates of a US Bank are subject to the statutory restrictions (each, a "Covered Affiliate"). Under Regulation W, a Covered Affiliate of a US Bank includes any entity in the following categories:

(a) **Parent company:** An entity that controls the US Bank (ie a parent company).

(b) **Entity commonly controlled by a parent company:** An entity under common control by the same parent company as the US Bank.

(c) **Entity commonly controlled by other means:** An entity under common control with the US Bank, not by the same parent company, but rather through control of the entity by or for the benefit of shareholders who also control, beneficially or otherwise, the US Bank or its parent company.

(d) **Entity with interlocking directors:** An entity, a majority of whose directors, trustees or general partners constitute a majority of the directors, trustees or general partners of the US Bank or its parent company.

(e) **US Bank subsidiary**: An entity controlled by the US Bank (ie a subsidiary) that is also a US Bank.

(f) **Financial subsidiary**: A "financial subsidiary" of the US Bank.

(g) **Portfolio company**: A company (subject to certain exemptions), 15% or more of the equity capital of which a parent company of the US Bank owns or controls pursuant to the merchant banking or insurance company investment authority.

(h) **Sponsored and advised entity**: An entity, including a real estate investment trust, that is sponsored and advised on a contractual basis by the US Bank or an affiliate of the US Bank.

(i) **Advised investment company:** An investment company for which the US Bank or an affiliate of the US Bank serves as an investment adviser within the meaning of the US Investment Company Act of 1940 (1940 Act).

(j) **Advised and owned investment fund**: An investment fund, whether or not an investment company for purposes of the 1940 Act, for which the US Bank or an affiliate of the US Bank serves as an investment adviser, if the US Bank and its affiliates own or control in the aggregate more than 5% of any class of the investment fund's voting securities or of its equity capital.

Section 608 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended the definition of "affiliate" in s 23A, eliminating Covered Affiliate categories (h), (i) and (j) and replacing them with "any investment fund with respect to which a [US Bank] or affiliate thereof is an investment adviser". The term "investment fund" is not defined, but it presumably encompasses investment companies registered under the 1940 Act, investment funds exempt from 1940 Act registration, real estate investment trusts, and any other entity advised by a US Bank or its affiliate – in each case, without regard to whether the US Bank or its affiliate "sponsors" the investment fund or owns any of its voting securities or equity capital.

In particular, the Fed may determine that a Controlling Influence exists even if both Voting Control and Majority Board Control are absent.

"Control"

In many cases, whether an entity is a Covered Affiliate depends on the existence of a control relationship with a US Bank. The definition of "control" for purposes of ss 23A and 23B is, for those unaccustomed to dealing with the US Federal banking laws, surprisingly broad. Generally, a person or entity has "control" over another entity if:

- the person or entity directly or indirectly owns, controls, or has power to vote 25% or more of any class of voting securities of the other entity (Voting Control);
- the person or entity controls in any manner the election of a majority of the directors of the other entity (Majority Board Control); or
- the Fed determines that the person or entity directly or indirectly exercises a controlling influence over the management or policies of the other entity (a Controlling Influence).

For a person or entity to be deemed to have "control" over another entity, only one of the three above conditions need to be met. In particular, the Fed may determine that a Controlling Influence exists even if both Voting Control and Majority Board Control are absent. Regulation W, for example, contains a rebuttable presumption that a person or entity that owns or controls 25% or more of the *non-voting* equity capital of another entity controls the other entity, notwithstanding the absence of any Voting Control.

Excluded affiliates

Sections 23A and 23B, together with Regulation W, specify that certain affiliates of a US Bank are excluded from Covered Affiliate status ("Excluded Affiliates"). Under Regulation W, an Excluded Affiliate of a US Bank includes any entity in the following categories:

(a) **Subsidiary**: A subsidiary of the US Bank, other than:
- a subsidiary that is also a US Bank;
- a "financial subsidiary"; or
- a subsidiary that is also controlled *directly* by the US Bank's parent company, by any of its affiliates (other than another US Bank) or by a shareholder or group of shareholders who control the US Bank.

(b) **Bank premises or safe deposit company**: An entity engaged solely in:
- holding the premises of the US Bank; or
- conducting a safe deposit business.

(c) **DPC entity**: An entity, "control" of which results from the exercise of rights arising out of a *bona fide* debt previously contracted.

SECTION 23A COVERED TRANSACTIONS

Section 23A restricts Covered Transactions in which a Covered Institution acquires credit exposure to a Covered Affiliate. Covered Transactions are subject to quantitative limits, collateral requirements and certain other prudential limitations. Under Regulation W, with respect to a Covered Affiliate, a Covered Transaction includes any transaction in the following categories:

(a) **Extension of credit:** An extension of credit to the Covered Affiliate, including the making or renewal of a loan, the granting of a line of credit, or the extending of credit in any manner whatsoever, including on an intraday basis, to the Covered Affiliate.
(b) **Guarantee**: Issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the Covered Affiliate, or confirmation of a letter of credit issued by the Covered Affiliate.
(c) **Cross-affiliate netting**: A cross-affiliate netting (or "pooling") arrangement involving one or more Covered Affiliates and one or more third parties.
(d) **Investment in securities**: A purchase of, or an investment in, securities issued by the Covered Affiliate.
(e) **Asset purchase**: A purchase of an asset from the Covered Affiliate, including an asset subject to recourse or an agreement to repurchase.
(f) **Securities collateral**: Acceptance of securities issued by the Covered Affiliate as collateral for an extension of credit to any third party.

Regulation W defines transactions in Covered Transaction categories (a), (b) and (c) above as "credit transactions" subject to the collateral requirements of s 23A (Credit Transactions). Transactions in Covered Transaction categories (d), (e) and (f) above are subject to quantitative limits and certain other prudential limitations under s 23A, but not collateral requirements.

Section 608 of the Dodd-Frank Act amended s 23A to expand the range of transactions subject to the statute, resulting in the following additional Covered Transaction categories with respect to a Covered Affiliate:
(g) **Repo transaction**: A purchase of assets from the Covered Affiliate subject to an agreement to repurchase.
(h) **Securities borrowing and lending**: A transaction with the Covered Affiliate that involves the borrowing or lending of securities, to the extent that the transaction results in credit exposure to the Covered Affiliate.
(i) **Derivatives transaction**: A derivatives transaction with the Covered Affiliate, to the extent that the transaction results in credit exposure to the Covered Affiliate.
(j) **Debt obligations collateral**: Acceptance of debt obligations (as well as securities) issued by the Covered Affiliate as collateral for an extension of credit to any third party.

Under the Attribution Rule, for example, where the proceeds of a US Bank's loan to a third party are used to purchase assets from a Covered Affiliate of the US Bank, the loan is deemed to be a transaction with the Covered Affiliate.

Section 23A, as amended by the Dodd-Frank Act, treats transactions in Covered Transaction categories (g), (h) and (i) above as Credit Transactions subject to collateral requirements. One notable result is that a repo transaction is now classified as an extension of credit (and hence a Credit Transaction) rather than as an asset purchase followed by an asset sale. Securities borrowing and lending and derivatives transactions are now Covered Transactions (and Credit Transactions), but only to the extent of any resulting "credit exposure". The Fed has not yet amended Regulation W to define this term.

ATTRIBUTION RULE

Section 23A sets forth a significant rule of interpretation (Attribution Rule) stating that "any transaction by [a Covered Institution] with any person shall be deemed to be a transaction with [a Covered Affiliate] to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, [the Covered Affiliate]."

Under the Attribution Rule, for example, where the proceeds of a US Bank's loan to a third party are used to purchase assets from a Covered Affiliate of the US Bank, the loan is deemed to be a transaction with the Covered Affiliate. The resulting Covered Transaction, rather than being treated as an asset purchase from the Covered Affiliate, is classified as an extension of credit (and subject to collateral requirements), which would not have been the case had the US Bank purchased the assets from the Covered Affiliate directly.

Regulation W exempts certain third-party transactions that would otherwise, as an unintended consequence of the Attribution Rule, fall foul of s 23A. Extensions of credit to third parties pursuant to pre-existing lines of credit and general purpose credit card transactions are exempt from quantitative limits and collateral requirements under s 23A, while remaining subject to its general safety and soundness requirement. Extensions of credit the proceeds of which are used to purchase assets through a Covered Affiliate pursuant to certain agency and riskless principal transactions are exempt on a similar basis.

PRUDENTIAL LIMITATIONS ON COVERED TRANSACTIONS

Section 23A and Regulation W impose severe limitations on a Covered Institution's Covered Transactions with Covered Affiliates.

- **Quantitative limits**: A Covered Institution may not engage in a Covered Transaction with a Covered Affiliate if the aggregate amount of the Covered Institution's Covered Transactions with the Covered Affiliate would exceed 10% of the capital stock and surplus of the Covered Institution. A Covered Institution may not engage in a Covered Transaction with any Covered Affiliate if the aggregate amount of the Covered Institution's Covered Transactions with all Covered Affiliates would exceed 20% of the capital stock and surplus of the Covered Institution.

Biog box

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- **Collateral requirements:** A Covered Institution generally must ensure that each of its Credit Transactions with Covered Affiliates is secured by collateral having a market value from 100% to 130% of the amount of the Credit Transaction (depending on the type of collateral) at the time the Covered Institution becomes legally obligated to enter into the Credit Transaction.
- **Low-quality assets:** A Covered Institution generally may not purchase a low-quality asset from a Covered Affiliate. For this purpose, a "low-quality asset" is an asset:
  - that is classified as "substandard", "doubtful" or "loss" or treated as "special mention" in the Covered Affiliate's most recent report of examination or inspection;
  - that is in a nonaccrual status;
  - on which principal or interest payments are more than thirty days past due;
  - whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor; or
  - acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted.
- **Safety and soundness:** Any Covered Transaction, including any transaction that Regulation W otherwise exempts from the requirements of s 23A, must be on terms and conditions that are consistent with safe and sound banking practices.

HAZARDS IN SYNDICATED AND OTHER LOAN TRANSACTIONS

Sections 23A and 23B can give rise to numerous and sometimes unexpected problems in the context of syndicated and other loan transactions.

Common troubles

Some examples of the issues that arise under ss 23A and 23B in the commercial lending context are fairly straightforward. For instance, a Covered Transaction may include the mere purchase by a Covered Institution of a participation interest in a loan held by a non-bank Covered Affiliate that is a lender under a credit facility. The Covered Institution's assumption of the Covered Affiliate's obligations may amount to an asset purchase even if no consideration has been exchanged between the Covered Institution and the Covered Affiliate. Moreover, if the loan is past due or is otherwise classified as substandard, the Covered Institution's acquisition of a participation interest could fall foul of the prudential restriction on the purchase of low-quality assets. Another common problem arises where a Covered Institution, as a lender to a third-party obligor, commits to loan funds that are secured by a pledge of securities issued by a Covered Affiliate. The Covered Institution's acceptance of the Covered Affiliate's securities as collateral would constitute a Covered Transaction subject to quantitative limits under s 23A and Regulation W.

Special problems with syndicated lending

Credit agreements for syndicated loans, by their very nature, impose fundamental sharing rights and obligations on each lender in the syndicate that may be fundamentally incompatible with s 23A and Regulation W. For example, if an individual lender obtains any payment resulting in its receipt of a disproportionate share of the available proceeds, the lender is required to share such payment ratably with the other lenders in the syndicate, often by way of purchasing additional participations from the other lenders. Other situations frequently arise in which credit agreements require syndicate lenders to engage in transactions, involving the purchase of interests in the underlying loans, to preserve the ratable equilibrium of the syndicate.

When a loan syndication involves a Covered Institution as a syndicate lender, on the one hand, and a non-bank Covered Affiliate as an agent, issuing lender or swingline lender, on the other hand, a Covered Transaction may occur by virtue of the governing credit agreement's standard risk-sharing provisions. For example, if a syndicate member acting as letter of credit issuer or swingline lender incurs fronting obligations that are not repaid by the borrower, the other syndicate members are ordinarily required to purchase participations in the fronting member's obligations. In addition, customary indemnity provisions in credit agreements require syndicate lenders to indemnify the agents if the borrower defaults in its obligation to do so.

Refinancing transactions

Covered Transactions may also occur in connection with syndicated loan refinancing transactions. In one example, the borrower may refinance a loan where the syndicate includes a Covered Institution, one of its non-bank Covered Affiliates, or both. If, after giving effect to the refinancing, the Covered Institution ends up increasing its proportionate interest in the loan relative to the proportionate interest of its Covered Affiliate, the refinancing may be deemed to constitute a Covered Transaction subject to quantitative limits under s 23A and Regulation W. Alternatively, a Covered Institution may participate in an acquisition financing, the proceeds of which are used to repay the target company's existing financing arrangements with a Covered Affiliate, giving rise to similar s 23A problems.

Commitments and other letter agreements

Signs of trouble with s 23A can appear in the early stages of a syndicated financing. For example, it is common for a non-bank Covered Affiliate lender to execute a commitment letter with a borrower in which the non-bank lender agrees to arrange financing for a particular transaction. Depending on whether the relevant Covered Institution features in its Covered Affiliate's commitment, and whether the Covered Institution ultimately becomes obligated to acquire a participation from the arranging Covered Affiliate, a Covered Transaction may occur for purposes of s 23A and Regulation W.

Less obvious issues may arise when

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a commitment letter is executed by a Covered Affiliate both on behalf of itself and on behalf of the relevant Covered Institution, committing both of them to lend. Alternatively, while acting in an investment banking role, a Covered Affiliate may sign a non-disclosure agreement that purports to bind the relevant Covered Institution, as a potential lender. Either of the foregoing letter agreements may call for the Covered Institution to indemnify a prospective borrower on a joint and several basis for any breach by the Covered Affiliate. The indemnity obligation on the part of the Covered Institution may be seen as amounting to an uncapped guarantee on behalf of the Covered Affiliate that implicates not only the quantitative limits of s 23A and Regulation W, but also the collateral requirements applicable to a Credit Transaction. Attentive drafting is required to limit the extent to which a Covered Institution becomes jointly liable for (and hence a guarantor in respect of) the liabilities that a Covered Affiliate may incur as it sources and develops deal opportunities.

Reallocations

A Covered Transaction may also arise when a Covered Institution increases its proportionate interest in a loan relative to the proportionate interest of its non-bank Covered Affiliate co-lender as a result of a reallocation by the borrower. For example, a multi-currency facility might include a US Bank, committing US dollars, and its non-US non-bank Covered Affiliate, committing a US dollar equivalent in local currency. Pursuant to the applicable credit agreement, the borrower may wish to reallocate the respective commitments of the lenders based on the borrower's foreign currency requirements. Any reallocation that reduces the Covered Affiliate's commitment and increases the US Bank's commitment could be deemed to constitute a Covered Transaction subject to quantitative limits under s 23A and Regulation W.

DRAFTING SOLUTIONS

Covered institutions have various options to address some of the concerns raised above in their credit documentation. Indeed, the Loan Syndications and Trading Association, in its latest model credit agreement, counsels "Parties to consider whether modifications to [the Sharing of Payments] Section are appropriate so as not to require a regulated banking institution to purchase a participation from an affiliate if such purchase would constitute a 'covered transaction' under Regulation W".

Such modifications to standard documentation include, among other things:

- disclaiming any responsibility to investigate the borrower's use of proceeds;
- mandating that borrowers respond to information requests intended to highlight potential Regulation W compliance concerns (eg a borrower's use of loan and letter of credit proceeds);
- prohibiting borrowers from engaging in behaviour likely to give rise to a Covered Transaction, eg using loan proceeds to purchase assets or securities from a Covered Affiliate, for the benefit of a Covered Affiliate, or that would result in a Covered Institution lender's noncompliance with s 23A and Regulation W by way of the Attribution Rule or otherwise; and
- providing for the reallocation of any potentially problematic loans or letters of credit to other syndicate members not facing potential s 23A and Regulation W concerns. ■

Further Reading:

- Intra-group transfers at "market value": good intentions count (2011) 7 JIBFL 416.
- Intra-group lending in Switzerland – risky business? (2017) 6 JIBFL 376.
- LexisPSL: Banking & Finance: Practice note: Guarantees – commercial benefit.