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Hedging with “Financial Weapons of Mass Destruction”: Cleaning Up the Fallout of Treating All Derivative Transactions Between Bank Affiliates the Same.

I. INTRODUCTION

Derivatives are one of the most misunderstood products in our financial markets today.¹ Much has been made of speculative derivative products, as they are often cited as causes of the Financial Crisis of 2008 (“the financial crisis”)² and have been made infamous by Hollywood movies³ and congressional hearings.⁴ Warren Buffet famously called derivatives “financial weapons of mass destruction.”⁵ These financial products played a role in exacerbating the financial crisis,⁶ in particular AIG’s spectacular credit default swap losses and its resulting bailout.⁷ The outcome of such a dramatic event during the financial crisis has

1. Shelly Antoniewicz, *Derivatives—Please Don’t Let Them Be Misunderstood*, INV. CO. INST. (Feb. 22, 2016), https://www.ici.org/viewpoints/view_16_derivatives_imf.

2. See Kimberly Amadeo, *Role of Derivatives in Creating Mortgage Crisis: The True Cause of the Mortgage Crisis*, THE BALANCE (June 30, 2017), <https://www.thebalance.com/role-of-derivatives-in-creating-mortgage-crisis-3970477> (“The real cause of the 2008 financial crisis was the proliferation of unregulated derivatives in the last decade.”).

3. See, e.g., THE BIG SHORT (Plan B Entertainment & Regency Enterprise 2015) (explaining credit default swap’s role in the Financial Crisis).

4. See Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES (Oct. 23, 2008), <http://www.nytimes.com/2008/10/24/business/economy/24panel.html> (describing the congressional testimony of Alan Greenspan in the wake of the financial crisis).

5. Letter from Warren Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to the Shareholders of Berkshire Hathaway Inc. 15 (Feb. 21, 2003).

6. See Mark Gongloff, *Derivatives are Weapons of Slow Economic Destruction: Study*, HUFFINGTON POST (June 14, 2013, 1:23 PM), http://www.huffingtonpost.com/2013/06/14/derivatives-weapons-destruction_n_3442229.html (“[T]he financial crisis showed that derivatives make the system way more dangerous by encouraging these banks and investors to pile up more and more risk.”).

7. See Bruce Tuckman, *In Defense of Derivatives: From Beer to Financial Crisis*, CATO INST. CTR. FOR MONETARY & FIN. ALT. POLICY ANALYSIS, No. 781 (Sept. 29, 2015) <https://object.cato.org/sites/cato.org/files/pubs/pdf/pa781.pdf> ([AIG’s] failure and bailout were due to losses partly from credit default swaps and partly—and comparably—from nonderivative mortgage products.”).

caused derivatives to be generally seen as risky and dangerous financial products.⁸

However, not all derivative transactions are like the highly speculative trades that helped bring the financial markets to the brink of collapse.⁹ Common derivative products, such as futures, forwards, options, and swaps, are regularly used in risk-mitigating transactions to hedge against investments in all industries.¹⁰ These hedging derivatives, as opposed to speculative derivatives, can reduce losses when goods, currency, securities, or resources a company relies on fall in value.¹¹ These hedging transactions are common practice for financial and non-financial institutions as a way to limit their losses, and are a major component of risk management for many companies,¹² including Warren Buffet's Berkshire Hathaway.¹³

Following the financial bailout of AIG and others, Congress sought to institute new regulation to restrict speculative derivative transactions.¹⁴ Passed in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") addressed many of the speculative uses of derivatives that were seen as contributors to the financial crisis.¹⁵ Dodd-Frank actively distinguishes transactions for

8. See Ron Hera, *Forget about Housing, The Real Cause of the Crisis was OTC Derivatives*, BUSINESS INSIDER (May 11, 2010, 2:50 PM), <http://www.businessinsider.com/bubble-derivatives-otc-2010-5> ("From the perspective of those outside the bubble, the explosion of OTC derivatives is a mania.").

9. See Craig Donofrio, *Maybe Derivatives Aren't So Bad After All*, THE STREET (Apr. 3, 2014, 8:04 AM), <https://www.thestreet.com/story/12785552/1/maybe-derivatives-arent-so-bad-after-all.html> (describing a study that has shown that derivatives for hedging purposes actually increase a company's value).

10. Kimberly Amadeo, *Derivatives, Their Risks and Their Rewards?*, THE BALANCE (Apr. 20, 2017), <https://www.thebalance.com/what-are-derivatives-3305833>.

11. See Tuckman, *supra* note 7, at 2 ("Derivatives enable those enterprises to run large-scale operations without bearing commensurately large business risks that could threaten their survival.").

12. See Tuckman, *supra* note 7, at 1 ("The vast majority of large businesses use derivatives to hedge their business risks.").

13. See Andrew Ross Sorkin, Column, *Derivatives, as Accused by Buffett*, N. Y. TIMES (March 14, 2011, 9:17 PM), https://dealbook.nytimes.com/2011/03/14/derivatives-as-accused-by-buffett/?_r=0 ("In the fourth quarter [of 2011] alone, Berkshire made \$222 million on derivatives.").

14. Shahien Nasiripour, *Derivatives Just "A Sophisticated Form of Gambling," U.S. Senators Say; Propose Bill Allowing State Gambling Laws to Apply*, HUFFINGTON POST, (Mar. 18, 2010, 5:12 AM), http://www.huffingtonpost.com/2009/11/10/derivatives-just-a-sophis_n_352994.html.

15. See generally SEC. & EXCH. COMM'N, DODD-FRANK SPOTLIGHT: DERIVATIVES, <https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml> (last modified May 4, 2015).

speculative purposes from those used for hedging in a number of its sections.¹⁶ However, it does not differentiate between the two in its changes to Section 23A of the Federal Reserve Act (“Section 23A”)¹⁷ and Regulation W, the statute and Federal Reserve regulation governing transactions between Federal Reserve member banks (“member banks”) and their affiliates.¹⁸

The amendment to Section 23A in the Dodd-Frank Act requires that all derivative transactions with bank affiliates, including those used for hedging purposes, are to be considered “covered transactions” to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.¹⁹ If these transactions create credit exposure, the amendment requires that the transactions meet certain qualitative, quantitative, and collateral standards set forth in Section 23A.²⁰ These standards, such as limiting transactions between member banks with any of their affiliates to those transactions of less than 10% of the bank’s available capital, affect how some banks manage their risk and could increase the systemic risk of banking institutions.²¹

Despite the negative effect of these standards, the Federal Reserve Board (“FRB”) has not yet revised Regulation W to define “credit exposure” in light of the passage of Dodd-Frank and the amendments to Section 23A.²² The FRB should revise Regulation W so that the interpretation of “credit exposure” is viewed strictly, ensuring the standards of covered transactions under Section 23A do not apply to derivative transactions that are made for good-faith hedging and risk management purposes.²³ Such an interpretation would alleviate the

16. See Dodd-Frank § 619, 12 U.S.C. § 1851(d)(1)(C) (2016) (distinguishing between hedging and speculative proprietary trading); *id.* § 716, 15 U.S.C. § 8305(a) (repealed 2014) (exempting financial institutions from being considered swap dealers if swaps used for hedging purposes only).

17. Dodd-Frank § 608(a), 12 U.S.C. § 371c(b)(7)(G) (2016).

18. 12 C.F.R. § 223.33 (2017).

19. 12 U.S.C. § 371c(b)(7) (2016).

20. *Id.* § 371c; see *infra* Part III.A.

21. James I. Kaplan & Corbin J. Morris, *Dodd-Frank Amendments to Sec 23A Are Problematic: Part I*, LAW360 (Jan. 7, 2014, 1:29 PM), <https://www.law360.com/articles/498401/dodd-frank-amendments-to-sec-23a-are-problematic-part-1>.

22. *Regulation W – The Operational Challenges*, ACCENTURE, <http://financeandriskbl og.accenture.com/regulatory-insights/regulatory-compliance/regulation-w-the-operational-challenges> (last visited Feb. 10, 2018).

23. See Kaplan & Morris, *supra* note 21 (emphasizing that interpretation of ‘credit exposure’ may lessen impact).

negative impacts of the Section 23A while also remaining consistent with Dodd-Frank.²⁴

This Note proceeds in six parts. Part II details what derivative transactions are and how they are used in affiliate transactions.²⁵ Part III discusses how derivative transactions are regulated under both Section 23A and Regulation W, and the changes made to these regulations by Dodd-Frank.²⁶ Part IV describes the negative impacts of the changes and how an exception for hedging transactions would mitigate these unintended consequences.²⁷ Part V discusses how the FRB can craft such an exception by narrowly defining credit exposure under Regulation W.²⁸ Part VI encourages adoption of this exception and concludes the Note.²⁹

II. DERIVATIVES AND AFFILIATE TRANSACTIONS

A. *What is a Derivative?*

Financial derivatives are defined as “financial instruments that are linked to a specific financial instrument or indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right.”³⁰ In other words, a derivative is a contract between two parties that commit to exchange goods, such as cash or securities, if the underlying asset meets a specified metric.³¹ Such metrics include interest rates, currency exchange rates, and commodity, credit, and equity prices.³² Derivatives that are tied to these types of metrics include structured debt obligations, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof.³³ These products are

24. *See infra* Part IV.

25. *See infra* Part II.

26. *See infra* Part III.

27. *See infra* Part IV.

28. *See infra* Part V.

29. *See infra* Part VI.

30. *Financial Derivatives*, INT’L MONETARY FUND, <https://www.imf.org/external/np/sta/fd/index.htm> (last visited Feb. 10, 2018).

31. *See* Tuckman, *supra* note 7, (explaining how derivatives work through the example of a brewery).

32. *Derivatives*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, <https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/index-derivatives.html> (last visited on Sept. 17, 2017).

33. *See generally* Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling? Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987 (1992) (in-depth derivative product description).

often attractive to many companies, banks, and other financial institutions as they generally do not require any upfront payment and are written in a legal form that allows for swift remedial action in the event of a default without the approval of a bankruptcy court.³⁴ Derivatives are generally transacted for two purposes: hedging and speculation.³⁵

In the context of a derivative transaction used for hedging purposes, the derivative traded is usually tied to an underlying asset that could create a loss for the hedging company if the asset's price rises or falls.³⁶ A classic example of a hedging transaction would be an interest rate swap.³⁷ An interest rate swap is an exchange of interest rates between two financial instruments.³⁸ Generally, a banker owns a product of which the rate is variable or floating, and the banker would rather have a fixed rate.³⁹ In that case, an investor will offer to make a deal: if the floating rate stays above a certain specified rate, the investor will pay the banker the difference between the specified rate and the floating rate.⁴⁰ However, if the rate falls below the specified rate, the banker will have to pay the investor the difference.⁴¹ This essentially allows the banker to change the floating interest rate into a fixed rate, "hedging" the risk of any rise in interest rates.⁴² The other purpose of a derivative transaction is speculation.⁴³ An investor speculates that interest rates will drop, so he or she will bet that over the long run, the variable rate will be lower than the fixed interest rate they offered to the banker, and he or she will

34. Tuckman, *supra* note 7, at 2.

35. See Sam Peterson, *There's a Derivative in Your Cereal*, THE ATLANTIC (July 29, 2010), <https://www.theatlantic.com/business/archive/2010/07/theres-a-derivative-in-your-cereal/60582> (comparing speculative over-the-counter derivative products with hedging derivatives that a vast majority of large companies use).

36. See *id.* (explaining that derivatives are often tied to goods and services businesses rely on for profits).

37. *Interest Rate Swaps*, PIMCO, <https://global.pimco.com/en-gbl/resources/education/understanding-interest-rate-swaps> (last visited Oct. 7, 2017).

38. See Hera, *supra* note 8 (describing an interest rate swap transaction).

39. See Tuckman, *supra* note 7 (explaining how derivatives work through the example of a brewery).

40. See Hera, *supra* note 8 (describing an interest rate swap transaction).

41. See Tuckman, *supra* note 7 (explaining how derivatives work through the example of a brewery).

42. See Tuckman, *supra* note 7 (giving the example of a brewer hedging the price of wheat futures to maintain a consistent price of beer over a long period of time without worrying about the rise and fall of the price of wheat).

43. See Hera, *supra* note 8 (describing the dangers of speculative derivatives).

end up receiving more money from the banker than he or she will have to pay to them.⁴⁴

Because they appeal both to risk-averse and risk-seeking investors, derivative transactions have an enormous impact on the American financial system, as most large companies use derivatives for one or both purposes.⁴⁵ A 2009 survey found that 94% of Fortune Global 500 companies used derivatives.⁴⁶ Another study earlier in the decade found that 88% of almost 7,000 nonfinancial firms with listed stock across forty-seven countries used derivatives.⁴⁷ Of the more than 2,000 nonfinancial firms in the United States in that same study, 94% used derivatives.⁴⁸

B. *Derivative Transactions Between Banks and Their Affiliates*

Derivative transactions are not only entered into between unaffiliated investors, but also transactions between affiliates,⁴⁹ which are commonly used as a hedging mechanism by many large, multinational financial institutions and banks.⁵⁰ These transactions generally arise either when an institution finds it unfavorable to hedge directly due to the risk generated by a transaction or if the institution is unable to hedge the

44. Hera, *supra* note 8.

45. Tuckman, *supra* note 7.

46. *ISDA Research Notes*, ISDA (Apr. 23, 2009), <https://www.isda.org/a/yPDDE/isda-research-notes2.pdf>.

47. See Tuckman, *supra* note 7, at 2 (citing Söhnke Bartram, *Corporate Hedging and Speculation with Derivatives*, (2015), available at <https://ssrn.com/abstract=891190>).

48. See Tuckman, *supra* note 7, at 2 (citing Söhnke Bartram, *Corporate Hedging and Speculation with Derivatives*, (2015), available at <https://ssrn.com/abstract=891190>).

49. “Affiliate” with respect to a member bank under Section 23A means: (1) Parent companies; (2) Companies under common control by a parent company; (3) Companies under other common control; (4) Companies with interlocking directorates; (5) Sponsored and advised companies; (6) Investment Companies in which the member bank or affiliate is an investment advisor; (7) Depository institution subsidiaries; (8) Financial subsidiaries; (9) Companies held under merchant banking or insurance company investment authority; (10) Partnerships associated with the member bank or affiliate; (11) Subsidiaries of affiliates; and (12) Other companies the FRB finds appropriate to label as an affiliate. 12 C.F.R. § 223.2 (2017).

50. See ERNST & YOUNG, DODD-FRANK AND INTER-AFFILIATE TRADING OF DERIVATIVES, [http://www.ey.com/Publication/vwLUAssets/EY-Dodd%E2%80%93Frank-and-inter%E2%80%93affiliate-trading-of-derivatives/\\$FILE/EY-Dodd%E2%80%93Frank-and-inter%E2%80%93affiliate-trading-of-derivatives.pdf](http://www.ey.com/Publication/vwLUAssets/EY-Dodd%E2%80%93Frank-and-inter%E2%80%93affiliate-trading-of-derivatives/$FILE/EY-Dodd%E2%80%93Frank-and-inter%E2%80%93affiliate-trading-of-derivatives.pdf) (last visited Sept. 17, 2010) (“[M]any large multinational companies have moved toward centralizing their hedging and derivatives trading operations through the use of [centralized derivative holding entity].”).

risk directly because it is not authorized to hold the hedging asset.⁵¹ In either case the institution may have an affiliate acquire the hedging asset instead.⁵² The institution would then engage in a bridging derivative transaction between itself and the affiliate holding the hedging asset.⁵³ The advantages of such a transaction are numerous, including having a comprehensive view of risk and liquidity across portfolios, centralized risk management, savings in collateral posted, reduced transaction costs, and other tax and accounting benefits.⁵⁴ This type of transaction also limits systemic risk by insuring against the failure of the underlying asset within the overall company structure, rather than transacting with excessive unaffiliated entities.⁵⁵

Other derivative transactions between a member bank and its affiliates are affiliate-driven.⁵⁶ To accomplish its risk management goals, an institution's affiliate may enter into an interest rate or foreign-exchange derivative transaction with the institution.⁵⁷ For example, an institution's holding company may hold a substantial amount of floating-rate assets, but issue fixed-rate debt securities to obtain cheaper funding.⁵⁸ The holding company may then enter into a fixed-to-floating interest-rate swap with its subsidiary member bank to reduce the holding company's interest-rate risk.⁵⁹ This would result in the bank being protected from any changes in interest rates and normalizing its cash-flows, thereby meeting its risk management goals.⁶⁰

51. BD. OF GOVERNORS OF THE FED. RESERVE SYS., SUPERVISION MANUAL, INTERCOMPANY TRANSACTIONS 20 (2008).

52. *Id.*

53. *Id.*

54. ERNST & YOUNG, *supra* note 50, at 2.

55. See SCOTT CAMMARN ET AL., CADWALADER WICKERSHAM & TAFT LLP, CLIENT ALERT: THE DODD-FRANK ACT'S IMPACT ON AFFILIATE TRANSACTIONS (Apr. 21, 2011), http://www.cadwalader.com/resources/clients-friends-memos/the-dodd-frank-acts-impact-on-affiliate-transactions#_ftn23 (explaining that less systemic risk created by using affiliated derivative transactions than unaffiliated ones).

56. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52, at 20.

57. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52, at 20.

58. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52, at 20.

59. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52, at 20.

60. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52, at 20.

III. REGULATING DERIVATIVE TRANSACTIONS BETWEEN BANKS AND THEIR AFFILIATES

A. Section 23A Provisions

With the establishment of federal deposit insurance during the Great Depression, there was a fear of bank runs caused by ill-advised banking transactions costing the government billions in insurance payouts.⁶¹ One method of protecting banks from misusing funds was to limit their transactions with their affiliates.⁶² Section 23A was passed by Congress through the United States Banking Act of 1933 as an addition to the Federal Reserve Act of 1933, which regulates affiliate transactions of member banks.⁶³ Section 23A requires that certain “covered transactions” between Federal Reserve member banks and their affiliates are subject to qualitative limits, quantitative standards, and collateral requirements.⁶⁴ Covered transactions include numerous types of transactions, such as loans or extensions of credit, purchases of investment securities by either the parent or affiliate, and securities transactions that would cause a member bank or subsidiary to have credit exposure to an affiliate, among others.⁶⁵

The limits on a member bank’s covered transactions require that transactions with any single affiliate cannot exceed 10% of the bank’s capital, and transactions with all bank affiliates cannot exceed 20% of the bank’s capital.⁶⁶ An extension of credit by the bank to an affiliate and any guarantee on behalf of an affiliate must be secured by a defined amount of collateral.⁶⁷ Further, all covered transactions between a bank

61. See Julia Maues, *Banking Act of 1933 (Glass-Steagall)*, FED. RESERVE HISTORY (Nov. 22, 2013), https://www.federalreservehistory.org/essays/glass_steagall_act (describing the reasoning behind many of the provisions of Glass-Steagall).

62. See *id.* (stating tighter regulations were passed on member banks, including their affiliates).

63. *Id.*

64. The definition of affiliate under this statute is extremely broad, as it includes parent companies, companies under common control of parent company, companies under other common control, companies with interlocking directorates, sponsored and advised companies, investment companies for which the member bank or its affiliate serve as an investment adviser or has control over, depository institution subsidiaries, financial subsidiaries, and companies held under merchant banking or insurance company investment authority. 12 U.S.C. § 371c(a)(1) (2016).

65. 12 U.S.C. § 371c(b)(7) (2016).

66. *Id.* § 371c(a)(1)(A-B).

67. *Id.* § 371c(c).

and its affiliate must be on terms and conditions that are consistent with safe and sound banking practices.⁶⁸ Finally, a bank is generally prohibited from purchasing “low-quality assets”⁶⁹ from its affiliates.⁷⁰ These standards are subject to exemption,⁷¹ which include loans or guarantees to an affiliate which are fully secured by U.S. government obligations,⁷² the purchase of assets with a readily available market quotation at the quoted price from an affiliate,⁷³ or the deposit of funds in the affiliate bank in the ordinary course of correspondent business.⁷⁴

Congress later added additional restrictions to affiliate transactions.⁷⁵ Non-member banks and covered insured thrifts were included under the restrictions of Section 23A.⁷⁶ Additionally, in 1987, Congress added Section 23B, a twin section to Section 23A.⁷⁷ Under Section 23B, covered transactions must be conducted as an arm’s length transaction⁷⁸ or in good faith as if it were done between non-affiliated companies.⁷⁹

68. Sound banking practices requires that the bank shall consider, as appropriate, the interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risks presented by a proposed activity, and the particular activities undertaken by the bank must be appropriate for that bank. Further, the bank must believe that all obligations can be met, as well maintaining records of transactions for examination purposes. 12 C.F.R. §1.5 (2017).

69. “Low-quality assets” are defined as: an asset (including a security) classified as “substandard,” “doubtful,” or “loss,” or treated as “special mention” or “other transfer risk problems,” either in the most recent report of examination or inspection of an affiliate prepared by either a Federal or State supervisory agency or in any internal classification system used by the member bank or the affiliate (including an asset that receives a rating that is substantially equivalent to “classified” or “special mention” in the internal system of the member bank or affiliate); an asset in a nonaccrual status; an asset on which principal or interest payments are more than thirty days past due; an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor; and an asset acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted, if the asset has not yet been reviewed in an examination or inspection. 12 C.F.R. § 223.3(v) (2017).

70. 12 U.S.C. §371c(a)(3) (2016).

71. *Id.* § 371c(a)(4).

72. *Id.* § 371c(d)(4).

73. *Id.* § 371c(d)(6).

74. *Id.* § 371c(d)(3).

75. Staff Letter to Board of Governors of Federal Reserve, Regulations implementing Sections 23A and 23B of the Fed. Reserve Act (Apr. 24, 2001).

76. *Id.*

77. 12 U.S.C. § 371c-1 (2016).

78. *Id.* § 371c-1(a)(2)(A).

79. *Id.* § 371c-1(a)(1)(B).

B. *Regulation W*

With the passage of the Gramm-Leach-Bliley Act (“GLBA”) in 1999,⁸⁰ member banks had a far greater breadth of transactions available between themselves and their affiliates.⁸¹ GLBA repealed provisions of the Glass-Steagall Act that prohibited depository institutions and investment banks from consolidating; under GLBA, a bank holding company could now have both investment banks and depository institutions as subsidiaries and affiliates.⁸² This change drastically deregulated the banking industry.⁸³ A flood of mergers and acquisitions followed the passage of the bill, giving rise to many of our modern-day banking behemoths, such as J.P. Morgan Chase, Citigroup, and Bank of America.⁸⁴

After GLBA became law, Section 23A became the central statutory mechanism for protecting depository institutions from the potentially risky activities of their affiliates.⁸⁵ Within GLBA, the FRB was required to adopt rules to address “credit exposure arising out of derivative transactions” between banks and their affiliates.⁸⁶ In response, the FRB issued Regulation W,⁸⁷ a regulatory implementation of both Section 23A and 23B.⁸⁸ Regulation W codifies various FRB decisions made in prior years and clarifies interpretations of the statute in light of the enactment of GLBA.⁸⁹ Regulation W specifies certain exceptions and exemptions to Section 23A, excluding derivative transactions from the

80. Gramm-Leach-Bliley Act, Pub.L. 106–102, 113 Stat. 1338 (1999).

81. See Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1707 (2011) (“[T]hose more numerous affiliated entities engaged in a much broader range of newly permissible financial activities.”).

82. See Omarova, *supra* note 82, at 1706 (“The enactment and implementation of the GLB Act . . . finally removed the Glass-Steagall’s Act prohibition on combining commercial and investment banking under common corporate ownership.”).

83. See David Leonhardt, *Washington’s Invisible Hand*, N.Y. TIMES MAGAZINE (Sept. 26, 2008), <http://www.nytimes.com/2008/09/28/magazine/28wwln-reconsider.html> (“[I]t’s easily the biggest piece of financial deregulation in recent decades.”).

84. See *id.* (“Thus were born Citigroup, Bank of America and J. P. Morgan Chase, behemoths that owned bank branches, bought and sold stocks and shepherded corporate mergers.”).

85. Omarova, *supra* note 81, at 1683.

86. 12 U.S.C. § 371c(f)(3)(A) (2016).

87. 12 C.F.R. § 223 (2017).

88. Omarova, *supra* note 81, at 1697-98.

89. Omarova, *supra* note 81, at 1698.

definition of covered transactions, but does not define “credit exposure.”⁹⁰

Under Regulation W, banks are required to establish and maintain internal policies and procedures regarding their credit exposure to affiliates under derivatives transactions, rather than comply with the covered transaction requirements.⁹¹ These policies include monitoring and controlling the credit exposure by imposing appropriate credit limits, mark-to-market requirements, and collateral requirements by the member banks.⁹² Notably, the FRB did consider subjecting derivative transactions to the standards of covered transactions, but felt that their reliance on bank-designed policies and procedures, Section 23B’s arm-length requirements, and active examiner supervision were enough to regulate bank-affiliate derivatives.⁹³

C. *Section 23A Amendments under Dodd-Frank*

In response to the financial crisis, Congress sought to drastically change the regulatory atmosphere of the financial industry, specifically in how derivatives were regulated.⁹⁴ As derivatives were widely regarded as a cause of the financial crisis,⁹⁵ several derivative-focused provisions were included in Dodd-Frank.⁹⁶ In particular, Dodd-Frank significantly changed how derivative transactions were regulated between affiliates.⁹⁷

90. See Transactions Between Banks and Their Affiliates, 67 Fed. Reg. 76560, 76588 (Dec. 12, 2002) (“The Board is not prepared at this time to subject credit exposure arising from bank-affiliate derivatives to all the requirements of section 23A.”) (codified at 12 C.F.R. § 223.33 (2017)).

91. 12 C.F.R. § 223.33 (2017).

92. To the Officer in Charge of Supervision and Appropriate Supervisory and Examination Staff at each Federal Reserve Bank and to Domestic and Foreign Banking Organizations Supervised by the Federal Reserve from the Board of Governors of the Federal Reserve, Docket No. SR 03-2 (Jan. 9, 2003).

93. *Id.*

94. Marcy Gordon, *Congress Urged to Stiffen Rules for Derivatives Trading*, SEATTLE TIMES (Mar. 11, 2010), <https://www.seattletimes.com/business/congress-urged-to-stiffen-rules-for-derivatives-trading/>.

95. Amadeo, *supra* note 2.

96. Dodd-Frank, §§ 712, 716, 721-722, 731, 764; see generally PAULA S. GREENMAN ET AL., SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, CLIENT ALERT: REGULATION OF OVER-THE-COUNTER DERIVATIVES UNDER THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT https://files.skadden.com/newsletters%2FFFSR_A_Regulation_of_Over-the-Counter_Derivatives.pdf (last visited Oct. 1, 2017) (detailing specific derivative transaction regulations in Dodd-Frank).

97. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52, at 20.

Despite the FRB's reluctance to do so when issuing Regulation W, Dodd-Frank amended Section 23A to include under covered transactions a "derivative transaction . . . with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate."⁹⁸ The bill does not make any reference to the purpose of the derivative transaction, choosing instead to regulate both hedging and speculative derivative transactions in the same way.⁹⁹ Electing not to exempt hedging activities from the same standards as speculative trades was inconsistent with other separate provisions in the Act.¹⁰⁰ Additionally, Dodd-Frank declines to address the definition of "credit exposure," choosing to leave it to regulatory authorities.¹⁰¹

Because the definition was left to regulatory authorities, regulatory interpretation was needed to determine the definition of "credit exposure" following the Act's passage and implementation.¹⁰² The FRB discussed a "consistent definition" of credit exposure in contemplating the expected amendment to Regulation W to follow the Section 23A changes,¹⁰³ but such a definition was never implemented.¹⁰⁴ Rather, the Office of the Comptroller of the Currency ("OCC") introduced methods of determining credit exposure on a quantitative basis for derivative affiliate transactions that do not include a distinction between speculative and hedging derivative transactions.¹⁰⁵ Thus, without any regulatory clarification from the FRB, speculative and hedging derivative transactions are treated equally for the purposes of affiliate transactions.¹⁰⁶

98. 12 U.S.C. § 371c(b)(7)(f) (2016).

99. *Id.*

100. *See* Dodd-Frank § 619, 12 U.S.C. 1851(d)(1)(C) (2016) (distinguishing between hedging and speculative proprietary trading); *id.* §716, 15 U.S.C. §8305(a) (repealed 2014) (exempting financial institutions from being considered swap dealers if derivatives used swaps for hedging purposes).

101. *See* Omarova, *supra* note 81, at 1765 ("[A]gency action will ultimately determine whether this provision of the Dodd-Frank Act affects any real change in large banking organizations' derivatives dealing and trading.").

102. Omarova, *supra* note 81, at 1765.

103. Chris Bruce, *Fed Staff Aiming for Consistent Definition on Derivatives-Related Credit Exposures*, [2013] Banking Daily (BNA) No. 07 (Aug. 13, 2013).

104. ACCENTURE *supra* note 22.

105. 12 C.F.R. §§ 32, 159, 160 (2017).

106. CAMMARN ET AL., *supra* note 55.

IV. A NECESSARY EXEMPTION

Treating all derivative transactions equally under Section 23A, regardless of purpose, was a mistake by Congress.¹⁰⁷ Given speculative derivative transactions' negative effect on the economy during the financial crisis, more regulatory oversight was reasonable.¹⁰⁸ However, holding hedging derivative transactions to the same standards under Section 23A as those for speculative purposes limits banks' flexibility in risk management, increases the overall systemic risk of derivatives, and creates costly compliance issues.¹⁰⁹ Exempting these hedging derivative transactions would alleviate these issues.¹¹⁰

A. *More Flexible Risk Management*

Treating hedging and speculative derivative transactions the same way under Section 23A undermines banks' efforts to ensure safe and reliable risk management.¹¹¹ The misuse of derivative transactions leading up to the financial crisis created a great deal of mistrust in all derivative-related transactions.¹¹² However, this mistrust should not extend to derivative transactions with affiliates for hedging purposes, as they are a central element in many companies' risk management policies, particularly those of banks and other financial institutions.¹¹³ The inclusion of these transactions under the covered transaction standards of Section 23A decreases the flexibility and usefulness of these risk management procedures.¹¹⁴

107. See Kaplan & Morris, *supra* note 21 (discussing problems with the amendments to Section 23A).

108. Mark Gongloff, *Derivatives are a Weapon of Slow Economic Destruction: Study*, HUFFINGTON POST (June 14 2014, 1:23 PM), http://www.huffingtonpost.com/2013/06/14/derivatives-weapons-destruction_n_3442229.html. (explaining the downsides of derivatives).

109. *Infra* Part IV.A–C.

110. See CAMMARN ET AL., *supra* note 55, at 9 (questioning why Congress did not include hedging transactions as exempt from covered transactions as they had in Volker and Lincoln Amendments).

111. Kaplan & Morris, *supra* note 21.

112. See Gordon, *supra* note 94 (showing an example of the pressure put on Congress to increase regulation on derivatives due to their supposed role in crisis).

113. See *supra* Part II.B.

114. Kaplan & Morris, *supra* note 21.

Covered transactions under Section 23A are limited by the 10% limitation imposed by Section 23A.¹¹⁵ This limitation's negative effect is best shown by how it impacts hedging transactions with a central derivative entity.¹¹⁶ Many member banks have established a non-bank central entity for all derivatives business for risk management purposes.¹¹⁷ In this risk management structure, bridging derivatives are transacted between the central entity and the bank when a trade is made with an outside company.¹¹⁸ This protects the parent member bank against the risk of the trade, as the affiliate takes on the investment risk for which it is better equipped than the bank.¹¹⁹ These transactions between the parent bank and central entity are considered affiliate derivative transactions and as such may be subject to the standards of covered transactions under Section 23A if they are deemed to create a credit exposure to the affiliate.¹²⁰ These standards constrain a bank's bridge derivative transactions with the parent bank, limiting the number of hedging transactions that they would otherwise undertake.¹²¹ Because of these constraints, banks may either have to completely change their risk management protections or use a similar hedging strategy with a third party.¹²²

Discouraging banks from engaging in derivative hedging transactions between affiliates limits their risk management flexibility.¹²³ Flexibility is beneficial to banks as it allows a more bank-specific risk management approach.¹²⁴ The flexibility to include these transactions in a risk management strategy for financial entities can create a more

115. See Kaplan & Morris, *supra* note 21 (“Such common structures (and there are others, of course) now are severely limited by the 10 percent limitation imposed by Section 23A.”).

116. Kaplan & Morris, *supra* note 21.

117. AZAM H. AZIZ ET AL., SHEARMAN & STERLING LLP, CLIENT ALERT: DODD-FRANK ACT: DERIVATIVES AS CREDIT EXTENSIONS OF BANKS (Aug. 16, 2010)

http://www.shearman.com/~media/files/newsinsights/publications/2010/08/doddfrank-act—derivatives-as-credit-extensions-_/files/view-full-memo-doddfrank-act—derivatives-as-cre_/fileattachment/fia081710derivativesascreditextensionsofbanks.pdf.

118. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52, at 20.

119. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52.

120. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52, at 21.

121. See AZIZ ET AL., *supra* note 117, at 15 (“The 10-percent limit in many instances could constrain a bank's back-to-back derivatives with a nonbank that serves as the central management point depending on the Fed's definition of ‘credit exposure.’”).

122. AZIZ ET AL., *supra* note 117, at 15.

123. Kaplan & Morris, *supra* note 21.

124. See ERNST & YOUNG, *supra* note 50 (encouraging each company to design a risk management strategy that is the most beneficial to themselves).

comprehensive view of risk and liquidity across portfolios, centralized risk management, savings in collateral posted, reduced transactions costs, and other tax and accounting benefits.¹²⁵ Without allowing an exemption for risk-mitigating hedging activities done in good faith under Section 23A, member banks would be unable to structure their risk management policies in order to meet institution-specific needs.¹²⁶

For example, a financial institution may reasonably feel that, due to specific investments, a risk management structure that includes derivative transactions with a central affiliate entity is the best way to hedge their risk.¹²⁷ However, if credit exposure is defined broadly, transactions between institution and parent will be subject to the restrictions of section 23A, regardless of the transaction's purpose.¹²⁸ This may cause the financial institution to not implement this strategy, despite believing it is best for its company, due to Section 23A's regulatory requirements.¹²⁹ In that way, Section 23A is discouraging institutions from following what they believe to be the best risk management for its investments.¹³⁰ However, if hedging transactions were exempted from the standards of Section 23A, such a company would be much more likely to use the most advantageous risk management strategy without fear of compliance or regulatory issues.¹³¹

Eliminating the requirement for derivative transactions for hedging purposes to follow the standards of Section 23A would not change or limit other restrictions on derivatives within the Dodd-Frank Act.¹³² Rather, this would only permit more flexible risk management strategies without subjecting them to unnecessary and limiting

125. See ERNST & YOUNG, *supra* note 50.

126. See ERNST & YOUNG, *supra* note 50.

127. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52, at 20 (explaining that banks often use central affiliate entities to hedge risk).

128. 12 U.S.C. § 371c (2016).

129. See Kaplan & Morris, *supra* note 21 (explaining the regulatory requirements that would keep banks away from hedging with affiliate derivative transactions.).

130. See Kaplan & Morris, *supra* note 21 (emphasizing that because of amendments, if a bank chooses to follow such a risk management strategy, it is now severely limited by the 10% limitation imposed by Section 23A).

131. See Kaplan & Morris, *supra* note 21 (explaining the banks would use such strategies if not for the problematic changes to 23A)

132. See Dodd-Frank § 619, 12 U.S.C. § 1851(d)(1)(C) (2016) (distinguishing between hedging and speculative proprietary trading); Dodd-Frank §716, 15 U.S.C. § 8305(a) (repealed 2014) (exempting financial institutions from being considered swap dealers if derivatives used swaps for hedging purposes).

regulation.¹³³ Financial institutions would be able to manage their risk in the way best suited to their companies.¹³⁴ Speculative derivative transactions that have no risk management value would still be required to meet the Section 23A covered transaction requirements.¹³⁵ Exempting hedging transactions from Section 23A's standards would encourage the types of activities that enhance banks' risk management policies while also discouraging derivative transactions that have greater risk.¹³⁶

B. Reduction of Systemic Risk

After the financial crisis, Congress passed Dodd-Frank with a stated goal of "promot[ing] the financial stability of the United States."¹³⁷ However, holding derivative transactions for hedging purposes to the same requirements as speculative transactions under Section 23A runs counter to that aim.¹³⁸ By subjecting derivative affiliate transactions to such requirements, Dodd-Frank discourages banks from entering into hedging transactions with affiliated parties.¹³⁹ This leads to banks increasingly looking to third parties for hedging derivative trades rather than their own affiliates.¹⁴⁰ Using third parties for hedging derivative transactions spreads the leverage of the derivative trade throughout the market rather than within a bank's own affiliates.¹⁴¹ Spreading leverage of a derivative trade throughout the market increases systemic risk in the financial market, as "liquidity shock at one bank is more likely to cause

133. See Kaplan & Morris, *supra* note 21 (emphasizing that because of amendments, if a bank chooses to follow such a risk management strategy, it is severely limited by the 10% limitation imposed by Section 23A).

134. Kaplan & Morris, *supra* note 21.

135. 12 U.S.C. § 371c (2016).

136. See CAMMARN ET AL., *supra* note 55 (implying that Volcker and Lincoln Exemptions allowed banks to maintain these risk management policies).

137. Dodd-Frank § 1376.

138. See CAMMARN ET AL., *supra* note 55 ("Section 608 seems at odds with the overall purposes of the Dodd-Frank Act to reduce systemic risk to the financial services industry; Section 608 will inadvertently encourage banks to enter into hedging transactions with other nonaffiliated entities, thereby increasing the intertwined relationships and systemic risks among banks.").

139. CAMMARN ET AL., *supra* note 55.

140. See CAMMARN ET AL., *supra* note 55 ("The application of . . . quantitative limit[s], coupled with the imposition of collateral requirements – with no exemption for bona fide hedging transactions – may lead some banks to enter into hedging transactions with third parties rather than with affiliates, simply in order to preserve the bank's 23A quantitative limit capacity.").

141. Kaplan & Morris, *supra* note 21.

liquidity problems at other connected banks because the same shock is spread over fewer banks and is therefore larger and more destabilizing.”¹⁴² The more parties that are involved in a derivative transaction, the greater the systemic risk to the financial markets.¹⁴³

Exempting good-faith risk-mitigating derivative hedging transactions from Section 23A covered transaction standards reduces concerns over systemic risk.¹⁴⁴ This is because it reduces the number of intertwined derivatives in the market by encouraging derivative transactions in-house rather than with third-parties.¹⁴⁵ If banks are encouraged to use risk management practices such as the central hedging entity, they will hedge their transactions without tying third-parties to the derivatives.¹⁴⁶ Keeping hedging derivatives attached to an affiliate will allow all the benefits of flexible risk management procedures, while also reducing systemic risk.¹⁴⁷

C. *Easing the Compliance Burden*

In addition to the increased systemic risk and reduction of risk management strategies, the inclusion of derivative transactions for hedging as covered transactions increases the compliance burden, specifically with Section 23A’s Attribution Rule.¹⁴⁸ The Attribution Rule of Section 23A may now apply to certain affiliate derivative transactions, which creates a difficult and expensive compliance burden on the banks.¹⁴⁹ The Attribution Rule states that any transaction with a company is treated as a transaction with an affiliate of such company “to the extent the proceeds of the transaction are used for the benefit of, or transferred

142. Janet L. Yellen, Fed. Reserve Bd. of Governors, Interconnectedness and Systemic Risk: Lessons from the Financial Crisis and Policy Implications, Address at the American Economic Association/American Finance Association Joint Luncheon (Jan. 4, 2013).

143. *Id.*

144. See CAMMARN ET AL., *supra* note 55 (inverting the theory that derivative transactions increase systemic risk if the current rule remains in place).

145. CAMMARN ET AL., *supra* note 55.

146. See Kaplan & Morris, *supra* note 21 (explaining that a lack of risk management flexibility to use central derivative entities will actually increase systemic risk by tying banks to one another in a greater amount).

147. Kaplan & Morris, *supra* note 21.

148. 12 U.S.C. § 371c(a)(2) (2016); see Kaplan & Morris, *supra* note 21 (arguing that many more regulations kick into place when following under covered transaction).

149. Kaplan & Morris, *supra* note 21.

to, that affiliate.”¹⁵⁰ This was included in Section 23A to prevent a bank from evading the restrictions in the section by using intermediaries and to limit the exposure that a bank had to customers of affiliates of the bank.¹⁵¹ Under Section 23A, if a borrower obtains a loan from a bank and uses the proceeds to make a payment to an affiliate of the bank, the loan is considered a covered transaction under the Attribution Rule.¹⁵²

A larger problem, however, is that the Attribution Rule applies even where the bank does not have knowledge that the proceeds of its preexisting loan—or other transaction—have been used to make payments to its affiliate.¹⁵³ With the addition of derivatives as covered transactions, the Attribution Rule now “ostensibly extends” to any derivative payment made by a bank to a third party where the third party has a separate obligation to the bank’s affiliate.¹⁵⁴ Even if trade proceeds are not “transferred to” the affiliate, there is still a risk that the transaction is made “for the benefit of” the affiliate.¹⁵⁵ This Rule was never intended by the FRB to apply to derivative transactions, as derivative transactions were specifically left out of the requirements of covered transactions under Regulation W.¹⁵⁶ With the inclusion of derivative transactions, the Attribution Rule now greatly increases compliance risks and can create both an accounting and monitoring nightmare.¹⁵⁷ This rule complicates even the most basic derivative transactions with third parties and makes compliance extremely difficult.¹⁵⁸

150. 12 U.S.C. § 371c(a)(2) (2016).

151. *See* Transactions Between Banks and Their Affiliates, 66 Fed. Reg. 24,185, 24,190 (May 11, 2001) (to be codified at 12 C.F.R. § 223 (“This ‘attribution rule’ was included in section 23A to prevent a bank from evading the restrictions in the section by using intermediaries and to limit the exposure that a bank has to customers of affiliates of the bank.”)).

152. 12 U.S.C. § 371c(a)(2) (2016).

153. Kaplan & Morris, *supra* note 21.

154. Kaplan & Morris, *supra* note 21.

155. Kaplan & Morris, *supra* note 21.

156. BD. OF GOV. OF THE FED. RESERVE SYS., ADOPTION OF REGULATION W IMPLEMENTING SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT (Jan. 9, 2003) (“The final rule does not subject credit exposure arising from bank-affiliate derivatives to the quantitative limits and collateral requirements of Section 23A.”).

157. *See* DIXON HUGHES GOODMAN LLP, UNDERSTANDING REGULATION W (Sept. 2004), http://www2.dhglp.com/res_pubs/RAS-Reg-W-Article.pdf (“This nuance provides for a lot of interpretation risks on behalf of banks and can create both an accounting and monitoring nightmare.”).

158. *See* Kaplan & Morris, *supra* note 21 (explaining that because the Attribution Rule applies even when a bank has no knowledge that the proceeds of its preexisting loan (or other

Exempting hedging derivative transactions from Section 23A covered transaction requirements will save money and will reduce monitoring issues, as these hedging transactions will no longer fall within the Attribution Rule.¹⁵⁹ Exempting such transactions would eliminate costs and issues involved with compliance.¹⁶⁰ At the same time, however, the goals of Dodd-Frank will still be met, as speculative derivative trades will still be monitored and complied with under the Attribution Rule.¹⁶¹

V. CRAFTING THE EXEMPTION

A. *A Federal Reserve Interpretation*

As discussed, an exemption for derivative transactions whose purpose is for good-faith hedging and risk management reasons is beneficial for risk management, systemic, and compliance reasons.¹⁶² Although Congress could take it upon themselves to specify that the standards that apply for derivative transactions under Section 23A do not apply to hedging transactions, it is far more likely and easier for the FRB to take action through an update of Regulation W in light of the changes to Section 23A in Dodd-Frank.¹⁶³ Updating Regulation W would allow the FRB to define the meaning of “credit exposure” under the regulation.¹⁶⁴ In determining the definition, the FRB should specify that credit exposure is only created between a member bank and its affiliate by derivative transactions made for non-hedging purposes.¹⁶⁵ This would exempt derivative trades for hedging purposes from the standards of

transaction) have been used to make payments to its affiliate, it will be almost impossible to know if the bank is in compliance or not).

159. See Kaplan & Morris, *supra* note 21 (emphasizing that not treating hedging derivatives differently creates cost and monitoring issues).

160. See DIXON HUGHES GOODMAN LLP, *supra* note 157 (explaining as currently structured, Section 23A can be costly and troublesome minefield).

161. See *Infra* Part V.B.

162. *Supra* Part IV.

163. Bruce, *supra* note 104.

164. See Bruce, *supra* note 104 (stating that Federal Reserve may merely interpret or issue rules, and are not required to pass a new bill).

165. See *supra* Part IV (explaining that the benefits of derivative transactions for hedging purposes are being excluded from Section 23A covered transaction standards).

covered transactions under Section 23A, as only derivative transactions causing credit exposure are subject to Section 23A policies.¹⁶⁶

Although no action has yet been taken, the FRB has considered a “consistent” definition of credit exposure to apply not only to affiliate derivative transactions, but also to apply to some other credit exposures.¹⁶⁷ It is unclear if a desire for a wider approach will affect the thinking of the definition under Section 23A, but such an interpretation should refrain from casting a wide net in regards to what applies to credit exposure.¹⁶⁸ A broader definition will include derivative transactions for hedging purposes, continuing current practice.¹⁶⁹ If instead the definition is restricted to only speculative derivative transactions, hedging derivative transactions would be exempted from the requirements of Section 23A.¹⁷⁰ Such a position would be both beneficial and consistent with the Dodd-Frank Act.¹⁷¹

B. Consistent with Dodd-Frank’s Other Risk-Mitigating Exemptions

Language that is consistent with exempting risk-mitigating derivative transactions from higher regulatory standards can be found elsewhere in Dodd-Frank.¹⁷² In the Volcker Rule,¹⁷³ Congress created an exception to the ban on proprietary trading and private equity and hedge fund investing so long as the transactions are made for “risk-mitigating hedging activities . . . designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other

166. See 12 U.S.C. §371c(b)(7)(G) (“a derivative transaction . . . with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.”).

167. Bruce, *supra* note 104.

168. See Omarova, *supra* note 81, at 1765 (“[A]gency action will ultimately determine whether this provision of the Dodd-Frank Act affects any real change in large banking organizations’ derivatives dealing and trading.”).

169. Omarova, *supra* note 81, at 1765.

170. Omarova, *supra* note 81, at 1765.

171. Dodd-Frank § 619, 12 U.S.C. § 1851(d)(1)(C) (2016).

172. *Id.*

173. See SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, CLIENT ALERT: THE VOLCKER RULE (last visited Oct. 10, 2017) https://files.skadden.com/newsletters%2FFSR_The_Volcker_Rule.pdf (“The ‘Volcker Rule’ prohibits an insured depository institution and its affiliates from: engaging in ‘proprietary trading;’ acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or a private equity fund.”).

holdings.”¹⁷⁴ This exemption establishes that transactions made with the *intent* of mitigating risk are the types of transactions that Congress sought to encourage, while those speculative—and inherently riskier—transactions should be subject to higher regulatory standards.¹⁷⁵ The intent of the trade was Congress’ primary concern.¹⁷⁶

The Volcker Rule was not the only provision of Dodd-Frank to include such an exemption.¹⁷⁷ The since-repealed Lincoln Amendment, also known as the “swaps-pushout rule,” eliminated federal assistance to any swaps dealers that traded in speculative derivative transactions.¹⁷⁸ Similar to the Volcker Rule, the Lincoln Amendment exempted financial institutions that would otherwise be considered swaps dealers so long as they limited their derivative trading activities to hedging and other similar risk-mitigating measures.¹⁷⁹ This allowed financial institutions that use derivatives to hedge—sometimes via affiliates—from being considered a swaps dealer, as Congress sought to encourage hedging derivatives activity while more closely monitoring and regulating speculative trading.¹⁸⁰ In fact, this exception was added in conference to address concerns raised by Federal Deposit Insurance Corporation (“FDIC”) Chairman Sheila Bair and FRB Chairman Ben Bernanke that the Lincoln Amendment would be harmful to the financial industry by forbidding firms to use swaps and other derivatives as a part of their risk management structure.¹⁸¹ Again, an exclusion was allowed based on the *intent* of the derivative-trading party.¹⁸²

174. Dodd-Frank § 619; 12 U.S.C. § 1851(d)(1)(C) (2016).

175. SCOTT CAMMARN ET AL., CADWALADER WICKERSHAM & TAFT LLP, CLIENT ALERT: AN ANALYSIS OF THE DODD-FRANK ACT’S VOLCKER RULE (Oct. 15, 2010) <http://www.cadwalader.com/resources/clients-friends-memos/an-analysis-of-the-dodd-frank-acts-volcker-rule> [hereinafter ANALYSIS OF VOLCKER RULE].

176. *See id.* (“The language suggests that *motives* of the banking entity when *initially* acquiring the security or instrument are highly relevant.”).

177. *See* 15 U.S.C. § 8305(a) (repealed 2014) (exempting risk-mitigating hedging activities).

178. 15 U.S.C. §8305(a) (repealed 2014).

179. *Id.* § 8305(d)(1)(A).

180. *Id.*

181. SCOTT CAMMARN ET AL., CADWALADER WICKERSHAM & TAFT LLP, CLIENT ALERT: THE LINCOLN AMENDMENT: BANKS, SWAP DEALERS, NATIONAL TREATMENT AND THE FUTURE OF THE AMENDMENT, (Dec. 14, 2010), <https://www.lexology.com/library/detail.aspx?g=6d4652ef-84ac-4750-ab3a-3f22727ccbb6>.

182. *See* ANALYSIS OF VOLCKER RULE, *supra* note 176 (“The language suggests that *motives* of the banking entity when *initially* acquiring the security or instrument are highly relevant.”).

With both amendments, Congress actively sought to ensure that using a derivative transaction as a risk-mitigating activity remained available without higher regulatory standards to financial institutions.¹⁸³ This was both for the benefit of banks as well as in the interest of limiting systemic risk.¹⁸⁴ Congress looked to the intent of the party making the derivative transaction to determine if such a transaction needed higher regulatory standards.¹⁸⁵

C. *Defining Credit Exposure*

One of the chief concerns with the Volcker Rule's exemption for risk-mitigating activities is that it is far too open to interpretation being that it is based on the intent of the parties, rather than following clear, black-letter rules.¹⁸⁶ Jamie Dimon, CEO of JPMorgan Chase, has said that under the Volcker Rule, "you have to have a lawyer and a psychiatrist sitting next to you determining what was your intent every time you did something."¹⁸⁷ This concern is based on the regulatory language of the Volcker Rule, which requires that an exempted risk-mitigating transaction be "designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks."¹⁸⁸ The "designed to" language is the intent of the parties, which is a clear grey area.¹⁸⁹

Such language would not be ideal in the interpretation of credit exposure by the FRB.¹⁹⁰ In many derivative transactions, it is unclear whether the transacting parties are making a trade for speculative or hedging purposes.¹⁹¹ As such, in drafting an interpretation of credit

183. CAMMARN ET AL., *supra* note 55.

184. CAMMARN ET AL., *supra* note 55.

185. *See* ANALYSIS OF VOLKER RULE, *supra* note 176 ("The language suggests that *motives* of the banking entity when *initially* acquiring the security or instrument are highly relevant.").

186. ANALYSIS OF VOLKER RULE, *supra* note 176.

187. Dan Fitzpatrick & Scott Patterson, *Dimon Applauds Certainty with Final Volcker Rule*, WALL ST. J. (Dec. 11, 2013) <https://www.wsj.com/articles/dimon-says-jp-morgan-will-spend-2-billion-on-controls-in-2014-1386769150>.

188. 12 C.F.R. § 44.5(b)(2)(ii) (2017).

189. Thilo Schweizer, *Volcker Rule Approved*, INST. OF INT'L FIN. (Jan. 2014) https://www.iif.com/system/files/volcker_rule_approved_feb2014.pdf.

190. *See id.* (explaining that there is still considerable room for interpretation of the scope of the exemptions).

191. *See generally* Hazen, *supra* note 33 (providing an in-depth discussion of the derivative products).

exposure to allow derivative transactions for hedging and risk-mitigating purposes, the FRB should make its best efforts to clearly identify what types of derivative transactions would be considered for purposes of hedging and risk-mitigating transactions.¹⁹² However, even if a clearer interpretation is impossible, the opening of a grey area of regulatory interpretation would still be an improvement from completely banning such transactions.¹⁹³

VI. CONCLUSION

Unlike other aspects of Dodd-Frank, the amendments to Section 23A do not include an exception for hedging derivative transactions between affiliates.¹⁹⁴ Congress should have included such an exemption.¹⁹⁵ Derivative hedging transactions with affiliates play a major role in how a financial institution manages risk and credit exposure.¹⁹⁶ These financial institutions manage the market risk by having an affiliate acquire the hedging asset, then bridge the hedge to the parent company.¹⁹⁷ This limits systemic risk by insuring against the failure of the underlying asset within the overall company structure, rather than transacting with unaffiliated entities.¹⁹⁸ These transactions are important for risk management in the financial industry and are the types of transactions that regulators should be encouraging rather than rendering more costly and difficult.¹⁹⁹ Derivatives may be mistrusted creatures, but a regulatory body that encourages better risk management, no matter the financial instrument, is healthier for financial markets and economic stability.²⁰⁰

The FRB should, in its eventual updated rule on affiliate transactions, interpret “credit exposure” as not applying to derivative

192. *See supra* Part IV.

193. *See supra* Part IV.

194. *See* CAMMARN ET AL., *supra* note 55 (explaining that it is unclear as to why risk-mitigating hedging was not also included in the Sec. 23A amendments of Dodd-Frank).

195. Kaplan & Morris, *supra* note 21.

196. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52.

197. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52.

198. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 52.

199. Kaplan & Morris, *supra* note 21.

200. Charles Goodhart & Wolf Wagner, *Regulators Should Encourage More Diversity in the Financial System*, VOX: CEPR'S POLICY PORTAL (Apr. 12, 2012), <http://voxeu.org/article/regulators-should-encourage-more-diversity-financial-system>.

transactions between affiliates that are made in good-faith for hedging and risk-mitigating purposes.²⁰¹ This would allow financial institutions to establish more flexible risk management profiles, reduce systemic risk, and ease the compliance maelstrom, all while maintaining the strict regulatory oversight of speculative derivative transactions.²⁰² Despite potential issues in its application, such an interpretation would still be in the best interests of the industry and financial markets.²⁰³ Congress has already used this type of exception within Dodd-Frank and should again do so with affiliate transactions.²⁰⁴ Hedging derivative transactions are used to protect banks from risks, and accordingly should not be treated like the “financial weapons of mass destruction” described by Warren Buffet.²⁰⁵

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201. *Supra* Part IV.

202. *See* CAMMARN ET AL., *supra* note 55 (explaining that it is unclear as to why risk-mitigating hedging was not also included in the Sec. 23A amendments of Dodd-Frank).

203. *Supra* Part IV.

204. *Supra* Part V.

205. Letter from Warren Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to the Shareholders of Berkshire Hathaway Inc. 15 (Feb. 21, 2003).

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