THE LOAN SYNDICATIONS AND TRADING ASSOCIATION

Regulation W Recap

November 2, 2017- On Wednesday, the LSTA hosted a CLE webcast featuring William L. Kuhn IV (Executive Vice President and General Counsel of Regulatory, Disclosure and Employment Law) and Tracy Springer (Vice President and Senior Counsel for Global Banking and Commercial Banking) of HSBC on "Regulation W and its Implications for Syndicated Lending". Regulation W, which implements Sections 23A and 23B of the Federal Reserve Act, provides limits on transactions that US banks and their operating subsidiaries may enter into with their affiliates and can have some surprising consequences in syndicated lending transactions. Enacted after periods of stress in the banking industry, Regulation W seeks to preserve the assets of the bank and so it is designed to restrict the amount of transactions that a US bank has with its affiliates and the terms on which those transactions were conducted.

Generally speaking, absent an exemption, covered transactions under Section 23A are subject to restrictions on the types of collateral that may secure the loan and to certain specified credit levels based on the nature of the collateral. Additionally, a US bank is limited in the total amount of covered transactions it can conduct to 10% of its capital and surplus with any one affiliate and an aggregate of 20% for all affiliates unless an exemption applies. For asset purchases, a US bank is generally prohibited from purchasing a low-quality asset (e.g. delinquent and nonaccrual assets and classified or special mention assets) from an affiliate. This would include items for which the US bank compensates an affiliate, such as the purchase of a participation interest in a loan from an affiliate, and transactions in which an affiliate is relieved of an obligation such as under a revolver. As a result, a US bank generally would not be able to assume an affiliate's obligation under a revolver where the facility is classified as substandard. Issues can arise where an affiliate of a US bank takes on fronting risk for the US bank, such as in the role of L/C Issuer or Swingline Bank. If the borrower defaults in respect of advances made by an affiliate in this context and the US bank pays its pro rata share of the unreimbursed advance to its affiliate, then the US bank could be viewed as purchasing a low quality asset from its affiliate in violation of Regulation W. (We note that the LSTA's new form of credit agreement includes a footnote in the "Sharing of Payments" section reminding drafting parties to consider whether modifications "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.") Already at the initial stage of a transaction, the presenters cautioned that particular attention should be given to commitment letters where an affiliate of a US bank signs the letter and the US bank later desires to take on part of the affiliate's commitment or where an affiliate signs the letter on behalf of itself and the US bank committing both the affiliate and the US bank to lend. Issues can also be raised in NDAs. For instance, when an NDA includes a provision whereby the US bank agrees to indemnify the borrower for a breach of one or more of the bank's affiliates of the confidentiality obligations under the NDA. Such a provision could be viewed as an unlimited guaranty provided by the US bank to the borrower for its affiliates' obligations. Transactions between the US bank and third parties can be treated as covered transactions under the "attribution rule" to the extent that the proceeds are used for the benefit of, or transferred to, an affiliate of the US bank. For instance, potential issues can arise in refinancings if the US bank's commitment amount increases and the affiliate's commitment amount decreases in the new facility.

In addition, Section 23B requires transactions between a US bank and its affiliates be conducted on market terms unless an exemption applies. Such transactions would included "covered transactions" as well as any transaction in which the affiliate acts as agent or broker and receives a fee from the bank or from any other person, and any transaction (or series of transactions) with a non-affiliate if an affiliate has a financial interest in the non-affiliate or if the affiliate is a participant in the transaction.

In closing, the presenters encouraged early intervention by bank regulatory counsel in a transaction as most often it is possible to structure around Regulation W risks. For a replay of the webcast, please click here.