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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Loans to Insiders and Affiliates

Loans to Insiders and Affiliates

Regulation O became effective in 1979 and governs extensions of credit by banks to executive officers, directors or principal shareholders and their related interests (commonly referred to as insiders) and was a result of the allegations of shady bank dealings by Burt Lance, who served as director of the Office of Management and Budget in President Jimmy Carter's administration during the 1970s.

Regulation O was adopted with the intent to prevent insiders from obtaining extensions of credit on preferential terms, and it limits the amounts and terms a bank may lend to insiders.

On April 1, 2003, Regulation W became effective placing additional quantitative and qualitative limitations on transactions a bank may have with an affiliate with the intent to limit the exposure that a bank may have to one or more affiliates. The term affiliate under Regulation W is broadly defined and includes parent companies, companies under common control and companies with interlocking directorates.

Regulation W implements and interprets Sections 23A and 23B of the Federal Reserve Act. Regulation W requires that transactions with affiliates be adequately collateralized to assure that transactions are not unsafe or unsound.

In recent years, a number of banks have been criticized in connection with loans involving insiders such as in loan transactions (depending on the facts in each case) where the insider is an agricultural land owner and the bank makes loans to tenants of the insider. An extension of credit is attributed to an insider of the bank to the extent that the proceeds are "transferred to" or used for the "tangible economic benefit of" the insider or if the loan or extension of credit is made to a "related interest" of the insider. This "attribution rule" was designed to prevent circumvention of Regulation O through the use of nominee borrowers.

Regulation W was designed under the "attribution rule" to prevent a bank from evading statutory restrictions by using intermediaries and to limit the exposure of a bank. Any transaction by a bank with a person will be deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate, subject to certain exemptions.

Both Regulation O and Regulation W were designed to prevent a bank from evading the statutory restrictions by using intermediaries and to limit the exposure of

the bank. A loan will be attributed to an insider if the loan proceeds are transferred to or used for the tangible economic benefit of the insider or if the loan is made to a related interest of the insider.
A loan will be attributed to an insider (other than the borrower) when either (i) the proceeds of the loan are used for the direct benefit of the insider or (ii) a common enterprise exists between the borrower and the insider.

The common enterprise test will be met if the borrower is under common control (including where one of the persons in question controls the other) and there is a substantial interdependence between the borrower and the insider, i.e., where at least 50% of the gross receipts or expenditures of the borrower comes from transactions with the insider. The facts in any given situation would have to be reviewed to determine the benefits of a specific loan transaction.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") increased the restrictions on affiliate and insider transactions to include financial products such as derivatives, repurchase agreements and securities purchase and sales transactions that involve a credit exposure.

Sections 608 and 609 of the Dodd-Frank Act expanded the categories of "covered transactions" under Section 23A to include derivative transactions, the borrowing or lending of securities, including debt obligations, and expanded categories of repurchase agreements. The extended definition of "covered transactions" includes almost any transaction in which a bank would experience credit exposure relating to a transaction by or with an affiliate.

Section 608 of the Dodd-Frank Act requires the Federal Reserve to treat subsidiaries and their bank holding company parents as affiliates subject to the transactional limitations of Sections 23A and 23B.

Section 609 of the Dodd-Frank Act extended the applicability of Sections 23A and 23B to otherwise "covered transactions" between a bank and its financial subsidiaries.

Section 615 of the Dodd-Frank Act expanded similar valuation restrictions to those in Section 23B on transactions between an insured financial institution and one of its executive officers, directors or principal shareholders. Section 23B requires transactions with affiliates to be on market terms, and Section 615 of the Dodd-Frank Act requires that a sale of assets by or from an insider must also be on market terms. In addition, if a transaction constitutes more than 10% of the financial institution's capital stock and surplus, a majority of the uninterested directors of the bank or bank holding company must pre-approve the transaction.

Section 610 of the Dodd-Frank Act extended the definition of loans and extensions of credit to include credit explosure created by repurchase agreements and derivative transactions which are defined as "a contract, agreement, swap, warrant, note or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets."

Section 614 of the Dodd-Frank Act expanded the current law restrictions on loans to directors, officers and principal shareholders of a bank to also include repurchase agreements, securities lending transactions and derivative transactions.

Section 611 of the Dodd-Frank Act extended similar lending limits to derivative transactions for state banks. The Dodd-Frank Act permits state banks to engage in derivative transactions if the applicable state

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lending limit statute considers credit exposure from derivative transactions.

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