ALERT MEMORANDUM

Federal Reserve Board Proposes Expansion of Regulation EE's "Financial Institution" Definition

May 23, 2019

On May 2, 2019, the Board of Governors of the Federal Reserve System (the "Board") proposed amendments to Regulation EE to expand the definition of "financial institution" for purposes of the bilateral netting provisions of Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").[1] The Proposal would provide that the following types of entities constitute "financial institutions" for purposes of FDICIA:

- registered swap dealers, security-based swap dealers, major swap participants and major security-based swap participants;
- designated nonbank systemically important financial institutions;
- U.S.-registered central counterparties;
- designated financial market utilities;
- bridge institutions;
- Federal Reserve Banks; and
- foreign banks.

The Proposal would also clarify how the quantitative prong of the existing Regulation EE test applies following a consolidation.

With limited exceptions, the Proposal would not materially augment market participants' ability to exercise netting rights, since many of the institutions above would likely already be "financial institutions" under FDICIA or otherwise subject to insolvency regimes that respect netting rights. The Proposal appears aimed, instead, at eliminating uncertainty under existing law.

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[1] Board of Governors of the Federal Reserve System, Notice of Proposed Rulemaking: Netting Eligibility for Financial Institutions, 84 FR 18741, 12 CFR 231 (May 2, 2019), online at https://www.federalregister.gov/documents/2019/05/02/2019-08898/netting-eligibility-for-financial-institutions. The Proposal would not affect the clearing organization netting provisions set forth in Section 404 of FDICIA.

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Background

Sections 403 and 405 of FDICIA provide certainty that netting contracts between "financial institutions" will be enforced, even if one such financial institution becomes the subject of insolvency proceedings. These protections promote efficiency and reduce systemic risk by ensuring that market participants are not placed in a position in which they must make gross payments to an insolvent counterparty and receive discounted payments back.

However, FDICIA's protection is only available if both parties to a particular agreement are "financial institutions." Section 402 of FDICIA defines the term "financial institution" to mean "a broker or dealer, a depository institution, a futures commission merchant, or any other institution as determined by [the Board]."[2]

In 1994, the Board exercised the authority granted to it in Section 402 to adopt Regulation EE. Although FDICIA's "financial institution" definition uses a test based on an institution's regulatory or organizational status, the Board opted to establish an activities-based test in Regulation EE. Specifically, the Board provided that a person[3] would constitute a "financial institution" for purposes of FDICIA if it met the following two requirements:

1. Qualitative Prong: The person must "represent[], orally or in writing, that it will engage in financial contracts[4] as a counterparty on both sides of one or more financial markets."[5]
2. Quantitative Prong: The "person" must either:
    a. Have one or more financial contracts of a total gross dollar value of at least $1 billion in notional principal amount outstanding on any day during the previous 15-month period with counterparties that are not its affiliates; or
    b. Have total gross mark-to-market positions of at least $100 million (aggregated across counterparties) in one or more financial contracts on any day during the previous 15-month period with counterparties that are not its affiliates.[6]

In addition, in the 1990s, the Board issued a series of letters declaring particular institutions to be "financial institutions." Under existing law, the following entities would generally be considered "financial institutions" within the meaning of FDICIA by virtue of either the statutory definition or the letters issued by the Board:

- Any broker or dealer registered as such with the Securities and Exchange Commission (the "SEC");
- Any bank the deposits of which are insured by the Federal Deposit Insurance Corporation;
- Any credit union the member accounts of which are insured by the National Credit Union Administration;
- Any U.S. branch or agency of a foreign bank as well as any foreign bank that has established a U.S. branch or agency;
- Any futures commission merchant registered with the Commodity Futures Trading Commission (the "CFTC");
- The Student Loan Marketing Association;
- The Farm Credit System Banks;
- The Federal National Mortgage Association;
- The Federal Home Loan Mortgage Corporation;
- The Federal Agricultural Corporation; and
- The Federal Home Loan Banks.

[2] 12 U.S.C. § 4402(9).
[3] Regulation EE defines "person" broadly to mean "any legal entity, foreign or domestic, including a corporation, unincorporated company, partnership, government unit or instrumentality, trust, natural person, or any other entity or organization." 12 C.F.R. § 231.2(f).
[4] Regulation EE defines a "financial contract" to include a "qualified financial contract" under the Federal Deposit Insurance Act, as amended. 12 C.F.R. § 231.2(c).
[5] 12 C.F.R. § 231.3(a).
[6] 12 C.F.R. § 231.3(a)(1)-(2).

Certain other institutions, such as Edge Act corporations, may also be considered financial institutions. The list of institutions included in the FDICIA statute and addressed in letters issued by the Board is not exhaustive; a person can still be a financial institution if it meets the two-pronged test laid out in Regulation EE.

The Board's Proposal

I. Additions to "Financial Institution"

The Board is proposing to expand Regulation EE's definition of "financial institution" to include new categories of entities, regardless of whether the particular entity satisfies the quantitative or qualitative prongs of the existing Regulation EE framework. Specifically, the Board is proposing to include as "financial institutions" the following categories of entities:

- Swap dealers registered with the CFTC and security-based swap dealers registered with the SEC;
- Major swap participants registered with the CFTC and major security-based swap participants registered with the SEC;
- Nonbank systemically important financial institutions designated as such by the Financial Stability Oversight Council (the "FSOC");
- Derivatives clearing organizations registered with the CFTC or exempted from such registration and clearing agencies registered with the SEC or exempted from such registration;
- Financial market utilities designated as systemically important by the FSOC;
- Foreign banks, including those without U.S. branches or agencies and bridge banks that foreign authorities establish to facilitate the resolution of foreign banks;[7]
- Bridge institutions (i.e., institutions chartered by a governmental authority to facilitate the resolution of another legal entity); and
- Federal Reserve Banks.

In addition, the Board requests comment as to whether it should include in the definition of "financial institution" entities that are "qualifying central counterparties" under 12 CFR § 217.2. Such qualifying central counterparties include many of the large, systemically important central counterparties organized outside the United States.

The Board's general reasoning for treating the foregoing categories of entities as "financial institutions" is that the regulatory and financial landscape has changed markedly since the last amendment to Regulation EE in 1996. In particular, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 layered federal supervision over multiple entities that are considered systemically important or that serve as financial market intermediaries. The increased regulation of such entities signals to the Board that they are important to the smooth functioning of the financial markets. Accordingly, adjustments should be made to Regulation EE to bring such entities under its umbrella in order to fulfill the goal of FDICIA to reduce systemic risk and increase efficiency in financial markets.

II. Clarification of Quantitative Prong in Cases of Consolidation

The Board is also proposing to add a clarification of how the quantitative prong of Regulation EE applies following the consolidation of two or more entities. Specifically, the Board proposes to amend Regulation EE to state that when two or more entities merge into one another or otherwise consolidate, the quantitative

[7] In the Proposal, the Board clarified that it currently considers foreign banks to be covered by FDICIA's statutory definitions of "depository institution" and "financial institution" and believes that the addition of foreign banks to the "financial institution" definition in Regulation EE would simply avoid uncertainty. Proposal at 18743-18744.

test should apply in a manner that aggregates the financial contracts of the two entities prior to the consolidation. The Board set out the following example: "if company A acquires company B, and on the same, single calendar day in the last fifteen months, company A and company B each had financial contracts of a total gross dollar value of $500 million in notional principal amount outstanding (equaling an aggregate notional principal amount of $1 billion outstanding on that day), company A would meet the quantitative test even if it does not [as of the date of determination] have financial contracts of a total gross notional value of $1 billion."[8]

Implications

If the Board adopts the amendments as proposed, Regulation EE may provide additional certainty for market participants regarding the types of institutions that would be within the ambit of FDICIA's protections. However, the ultimate impact of the Proposal may be somewhat limited, as many of the institutions that the Board proposes to treat as "financial institutions" either would already satisfy the quantitative and qualitative prongs of the existing Regulation EE test or are eligible for insolvency proceedings, such as the U.S. Bankruptcy Code, that provide "safe harbors" for netting rights under financial transactions.

A potential exception in this regard may be the Federal Reserve Banks, which are not eligible for proceedings under the U.S. Bankruptcy Code. Additionally, clarifying that qualifying central counterparties, designated financial market utilities and U.S.-registered central counterparties are "financial institutions" may facilitate the ability of such institutions to engage in transactions with one another by eliminating doubt that such transactions' netting provisions will be enforced in the United States.

Market participants may be interested in providing comments to the Board to suggest that certain entities that serve functions similar to the entities that the Board proposes to treat as financial institutions also be expressly included as "financial institutions" under Regulation EE.

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[8] Proposal, at 18745, n. 46.