ALERT MEMORANDUM

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

March 8, 2021

On February 26, 2021, the Board of Governors of the Federal Reserve System ("Board") finalized amendments to Regulation EE ("Final Rule") to expand the definition of "financial institution" for purposes of the bilateral netting provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").[1] The Final Rule provides 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;
- Qualifying central counterparties as defined in the Board's Regulation Q ("QCCPs");[2]
- Bridge institutions;
- Foreign banks;
- Federal Reserve Banks;
- Foreign central banks; and
- The Bank for International Settlements ("BIS").

The Final Rule also clarifies how the quantitative prong of the existing Regulation EE test applies following a consolidation.

The Board largely adopted the Final Rule as proposed, with the only changes being to expand the types of entities that qualify as "financial institutions." With limited exceptions, the Final Rule should not materially augment market participants' ability to exercise netting rights, since many of the institutions above likely independently qualify as "financial institutions" under FDICIA or are otherwise subject to U.S. insolvency regimes that respect netting rights. The Final Rule appears aimed, instead, at eliminating uncertainty under existing law.

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[1] Board of Governors of the Federal Reserve System, *Final Rule: Netting Eligibility for Financial Institutions*, 86 FR 11618, 12 CFR 231 (Feb. 26, 2021), available at: https://www.govinfo.gov/content/pkg/FR-2021-02-26/pdf/2021-03596.pdf. The Final Rule would not affect the clearing organization netting provisions set forth in Section 404 of FDICIA.

[2] 12 C.F.R. 217.2.

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Background

Sections 403 and 405 of FDICIA provide certainty that the close-out netting provision of 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]."[3]

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 ("Charter-Based Test"), the Board opted to establish an activities-based test in Regulation EE. Specifically, the Board provided that a person[4] would constitute a "financial institution" for purposes of FDICIA if it met the following two requirements ("Activities-Based Test"):

1. Qualitative Prong: The person must "represent[], orally or in writing, that it will engage in financial contracts[5] as a counterparty on both sides of one or more financial markets."[6]
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.[7]

The Board has explained that this test is aimed at capturing "market intermediaries."[8] 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 ("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 ("CFTC");
- The Student Loan Marketing Association;
- The Farm Credit System Banks;
- The Federal National Mortgage Association;

[3] 12 U.S.C. § 4402(9).

[4] 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).

[5] 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).

[6] 12 C.F.R. § 231.3(a).

[7] 12 C.F.R. § 231.3(a)(1)-(2).

[8] *See* Final Rule, at 11619; 84 FR 18741, 18741-2 (May 2, 2019); 59 FR 4780, 4782 (Feb. 2, 1994).

- The Federal Home Loan Mortgage Corporation;
- The Federal Agricultural Corporation; and
- The Federal Home Loan Banks.

Certain other institutions, such as Edge Act corporations, may also be considered financial institutions. The list of institutions included in the statutory text of FDICIA and addressed in letters issued by the Board is not exhaustive; a person can still be a financial institution if it meets the Activities-Based Test.

The Board's Proposal

In 2019, the Board proposed amendments to Regulation EE that would expand the scope of entities that constitute "financial institutions" for purposes of FDICIA ("Proposal").[9] Specifically, the Board proposed a Charter-Based Test under which an entity could qualify as a "financial institution" based on its organizational or regulatory status, irrespective of whether it satisfied the Activities-Based Test. In addition, the Proposal also included clarifications regarding the application of the Activities-Based Test in the context of a merger or consolidation.

The Final Rule

I. Additions to "Financial Institution"

The Final Rule expands Regulation EE's definition of "financial institution" to include new categories of entities, regardless of whether the particular entity satisfies the Activities-Based Test. Specifically, the Final Rule includes as "financial institutions" each category of entity specified in the Proposal:

- 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 ("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 ("DFMU");
- Foreign banks, including those without U.S. branches or agencies and bridge banks that foreign authorities establish to facilitate the resolution of foreign banks;[10]
- 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 Final Rule also includes the following categories of entities as "financial institutions":

- QCCPs;
- Foreign central banks; and
- The BIS.

The Board's general reasoning for treating the categories of entities identified in the Proposal as "financial institutions" is that the regulatory and financial landscape has changed markedly since the last amendment to Regulation EE in 1996. In particular, Congress has imposed or expanded federal supervision over many of these entities since the Board first adopted Regulation EE. The increased regulation of such entities signals to the Board that they are important to

[9] 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), available at: https://www.federalregister.gov/documents/2019/05/02/2019-08898/netting-eligibility-for-financial-institutions.

[10] 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.

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.

In adding QCCPs to the categories of entities that qualify as "financial institutions," the Board largely intended to capture foreign-based central counterparties that are subject to home-country risk management standards that are comparable to those applicable to a DFMU.[11] Under Regulation Q, a central counterparty only qualifies as a QCCP if it is supervised and regulated in a manner comparable to a DFMU and has robust risk management standards similar to those that would be applicable to a DFMU. The Board noted that including QCCPs as "financial institutions" would benefit financial markets by allowing these foreign-based entities to participate in other financial market utilities that require participants to be "financial institutions."[12]

In adding foreign central banks and the BIS, the Board noted that these entities participate in financial markets in similar ways as Federal Reserve Banks, and assist in monetary policy and managing foreign exchange reserves. Accordingly, the Board stated, adding foreign central banks and the BIS as "financial institutions" for purposes of Regulation EE would reduce systemic risk and increase efficiency in financial markets.

The Board declined requests from commenters to include other categories, including (i) supranational institutions, such as multilateral development banks; (ii) foreign systemically important financial market infrastructures that are subject to the Principles for Financial Market Infrastructures as implemented in their respective jurisdictions, and their operators; (iii) sovereign wealth funds; and (iv) electronic money institutions and payment institutions. The Board asserted that it was not clear the extent to which these entities, as categories, are active in financial contracts such that smooth functioning of netting provisions is important to reducing systemic risk. Moreover, the Board stated, it is not clear the extent to which some of these entities function as market intermediaries. However, the Board noted that some of these entities, especially foreign systemically important financial market infrastructures, may be captured by the categories enumerated in the Final Rule, that the Board has the authority to issue case-by-case determinations of whether an entity is a "financial institution," and that the individual entities may still qualify under the Activities-Based Test.

II. Clarification of Quantitative and Qualitative Prongs of the Activities-Based Test

The Board also adopted, as proposed, a clarification of how the quantitative prong of the Activities-Based Test applies following the consolidation of two or more entities. Specifically, the Board amended Regulation EE to state that when two or more entities merge into one another or otherwise consolidate, the surviving entity may look to the aggregate financial contracts of all entities prior to their consolidation on any single calendar day during the preceding 15-month period to determine whether it satisfies the quantitative prong.[13]

The Board additionally included language clarifying that, for any person, the quantitative threshold may be examined as of the date the person evaluates its status or any day during the preceding 15-month period.

The Board also clarified, in response to a commenter, that satisfying the qualitative component of the

[11] Although many U.S. central counterparties would qualify as QCCPs, the addition of the QCCP category is not necessary to capture such entities, since U.S. central counterparties would generally be registered with the CFTC or SEC as derivatives clearing organizations or clearing agencies, respectively.

[12] 12 C.F.R. 217.2.

[13] The Proposal contained this 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." Proposal, at 18745, n. 46.

Activities-Based Test does not in and of itself affect a person's regulatory status for any other purpose.

Implications

The Board's amendments to 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 Final Rule may be somewhat limited, as many of the institutions included as "financial institutions" either already satisfy the Activities-Based 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 and foreign central banks, which are not eligible for proceedings under the U.S. Bankruptcy Code. Additionally, including QCCPs along with DFMUs and U.S.-registered central counterparties as "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.

Moreover, the Board's statements in the preambles to both the Final Rule and the Proposal indicate that the Board generally expects the Activities-Based Test to capture only market intermediaries. However, those statements, as well as the retention of the Activities-Based Test more generally, make clear that an institution need not have a specific organizational or regulatory status in order to be such an intermediary for purposes of Regulation EE.

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