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May 16, 2019

Federal Reserve Proposes Expansion to Definition of "Financial Institution" for Purposes of FDICIA

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The Federal Reserve Board of Governors (the "Board") issued a Notice of Proposed Rulemaking ("NOPR") seeking comment on a proposal to amend the definition of "financial institution" in the Federal Deposit Insurance Corporation Insurance Corporation Improvement Act of 1991 ("FDICIA").[1]

The proposed amendment would extend the scope of the "financial institution" category, ensuring that certain additional types of entities would be covered by FDICIA's netting provisions. In addition, the amendment would clarify how the existing activities-based test in Regulation EE[2] applies following a consolidation of legal entities. These amendments would provide an additional degree of certainty to financial institutions and their counterparties seeking to rely on FDICIA's netting provisions to protect their rights in case of an insolvency or resolution, particularly in the case of foreign financial institutions or other institutions not eligible for proceedings under the U.S. Bankruptcy Code (the "Bankruptcy Code").[3]

The NOPR amendments would operate by revising the definition of "financial institution" contained in Section 402 of FDICIA (as amended by Regulation EE). The NOPR was published in the Federal Register on May 2, 2019[4] and is available here. The Board has requested comments by July 1, 2019.

Importance of Netting and FDICIA

Netting is one of the primary tools of risk management for parties transacting in financial contracts in the financial markets. Upon the occurrence of a pre-defined trigger event with respect to a counterparty and/or one or more specified affiliates (typically including the insolvency of such counterparty and/or affiliate(s), but also potentially other specified defaults), outstanding transactions that are contractually included within the netting provisions are terminated, a value is determined for each transaction under an agreed valuation mechanism, and the value of each such transaction is aggregated and set off against other outstanding transactions and/or certain other specified obligations, resulting in a single net payment obligation owed by one party to the other. Put differently, thanks to netting, all of the relevant obligations cease to be treated individually and their aggregate value is calculated so as to result in a single net payment obligation. By enabling market participants to rely on net exposure values, netting enhances market liquidity and reduces counterparty risk and the amount of collateral that is required.

FDICIA protects netting rights with respect to obligations between two financial institutions and among members of a clearing organization, even in the event of the insolvency of one of the parties and (with some exceptions) notwithstanding any stay, injunction, moratorium, avoidance or similar order or proceeding.[5] Although certain financial institutions and clearing organizations may also be subject to the provisions of the Bankruptcy Code (or the Federal Deposit Insurance Act)[6] and its safe harbors protecting certain financial contracts and master netting

[1] Pub. L. No. 102-242 (Dec. 19, 1991).
[2] Regulation EE, Netting Eligibility for Financial Institutions, 12 CFR § 231.
[3] 11 U.S.C. §§ 101 et seq.
[4] 84 Fed. Reg. 18741 (May 2, 2019).
[5] 12 U.S.C. §§ 4401-4407. "Netting contract" is defined in Section 402(14) of FDICIA to mean "a contract or agreement between 2 or more financial institutions, clearing organizations, or members that provides for netting present or future payment obligations or payment entitlements (including liquidation or close out values relating to such obligations or entitlements) among the parties to the agreement...." 12 U.S.C. 4402(14)(B).
[6] 12 U.S.C. §§ 1811(a) et seq.

agreements, there are circumstances where FDICIA is the only applicable statute protective of netting arrangements. As such, the expansion and clarifications in the proposed amendments would provide additional certainty for parties relying on or seeking additional comfort under FDICIA.

Since the enactment of the Financial Netting Improvements Act of 2006 (the "2006 Amendments"),[7] FDICIA's protection of netting rights has expanded to encompass more broadly the modern concept of "close-out netting": the 2006 Amendments ensured that entities qualifying as financial institutions can exercise termination, liquidation and acceleration rights, in addition to netting rights, under agreements that qualify as netting contracts under FDICIA.

FDICIA's importance for financial market participants is not limited to close-out netting: the statute also provides for the enforceability of security agreements related to netting arrangements between two financial institutions and among members of a clearing organization, notwithstanding (with some exceptions) any stay, injunction, moratorium, avoidance or similar order or proceeding.[8]

Overview of Proposed Amendments

In order for FDICIA to apply, it is key that both parties must be "financial institutions." The original FDICIA definition of "financial institutions" included depository institutions, securities brokers or dealers, futures commission merchants, and other institutions as determined by the Board from time to time.[9] The definition was expanded by Regulation EE, promulgated in 1994, which introduced an activities-based test based on the total gross value of one or more financial contracts or the total gross mark-to-market positions in one or more financial contracts.[10] Over the years, the Board also issued a number of ad hoc "financial institution" determinations.[11]

With an emphasis on expanding the application of FDICIA's netting benefits for purposes of reducing systemic risk and increasing efficiency in the financial markets, the proposed amendments would extend FDICIA's definition of "financial institution" to explicitly include the following additional types of entities:

- Swap dealers registered with the Commodity Futures Trading Commission ("CFTC")
- Security-based swap dealers registered with the Securities and Exchange Commission ("SEC")
- Major swap participants registered with the CFTC and major security-based swap participants registered with the SEC
- Institutions designated as nonbank systemically important financial institutions ("nonbank SIFIs") by the Financial Stability Oversight Counsel ("FSOC")

[7] Pub. L. No. 109-390 (Dec. 12, 2006).
[8] 12 U.S.C. §§ 4403(f), 4404(h).
[9] 12 U.S.C. § 4402(9). This includes brokers and dealers registered or licensed under federal or state law (and certain affiliates as determined by the Board), national and state banks, credit unions, thrift institutions, foreign banks (with or without U.S. branches or agencies), Edge Act corporations, registered or licensed futures commission merchants and any other institutions as determined by the Board from time to time.
[10] The activities-based test has two components: a qualitative one and a quantitative one. The qualitative component requires that the person holds itself out as a market intermediary as a result of being willing to engage in transactions on both sides of one or more financial markets. The quantitative component requires the person to meet specified minimum gross dollar value or gross mark-to-market thresholds (as described in greater detail in footnote 14 below).
[11] As noted in footnote 7 of the NOPR, the Board has granted "financial institution" status to certain members of the CHIPS® funds-transfer system and to certain government-sponsored enterprises, including Fannie Mae, Freddie Mac, Sallie Mae, the Farm Credit System Banks and the Federal Home Loan Banks.

- Derivatives clearing organizations ("DCOs") registered with the CFTC or exempted from registration by the CFTC and clearing agencies ("CAs") registered with the SEC or exempted from registration by the SEC[12]
- Entities designated as designated financial market utilities ("DFMUs") by the FSOC
- Foreign banks, including those that do not have a U.S. branch or agency and bridge banks established by foreign authorities in connection with the resolution of foreign banks[13]
- Bridge institutions established in connection with the resolution of financial institutions, including bridge depository institutions or other bridge financial companies established by the Federal Deposit Insurance Corporation ("FDIC") as well as similar bridge banks or nonbank bridge institutions established under foreign law in connection with the resolution of foreign financial institutions
- Federal Reserve Banks

In addition, the proposed amendment is intended to align Regulation EE with the Bankruptcy Code by making a minor timing clarification for the lookback period used to determine whether an entity meets the existing quantitative thresholds of the activities-based test under Regulation EE to qualify as a "financial institution."[14] To the extent that Regulation EE should be read consistently with the Bankruptcy Code, the quantitative tests should look to the gross notional amount of financial contracts and/or gross mark-to-market positions of financial contracts that are outstanding at the time the entity enters into a financial contract or any given day during the 15-month lookback period (*i.e.*, not only the 15-month period preceding such date). The proposed amendment to Part 231.3(a) of Regulation EE is not entirely clear in this respect, however.[15]

Finally, the proposed amendment would clarify that, upon a merger or other consolidation of two or more entities, the surviving entity may aggregate the gross notional amounts and/or the gross mark-to-market positions of both entities for purposes of determining whether the surviving entity meets the quantitative thresholds under Regulation EE's activities-based test.

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[12] In the NOPR, the Board notes that CFTC-registered DCOs and SEC-registered CAs already qualify as "clearing organizations" under FDICIA Section 402(2), meaning that their members are eligible for the protection of netting rights under FDICIA without regard to whether all DCO or CA participants would otherwise qualify as "financial institutions" or "clearing organizations". The Board noted, however, the possibility that DCOs and CAs themselves might not qualify as "financial institutions", which would threaten their own ability to rely on FDICIA's netting protections to the extent that such DCOs or CAs act as participants in or counterparties to other clearing systems, central counterparties or other financial market utilities and seek to rely on FDICIA netting rights in such capacity. Therefore, the Board believes it is prudent to extend "financial institution" status to cover such DCOs and CAs explicitly.

[13] With respect to foreign banks, the Board believes that FDICIA's statutory definition does extend to all foreign banks, including those that do not have a U.S. branch or agency, but in recognition of concerns expressed by certain market participants that an alternative reading of the statute is possible and that a court might find that a foreign bank without a U.S. branch or agency does not qualify as a "financial institution", the Board proposes to make inclusion of such foreign banks explicit pursuant to the proposed amendment.

[14] Under Regulation EE, an activities-based test was introduced such that an entity would qualify as a "financial institution" if "it represents, orally or in writing, that it will engage in financial contracts as a counterparty on both sides of one or more financial markets" (the "qualitative test") and "either – (1) Had 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 (2) Had 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" (the "quantitative test"), 12 CFR 231.3(a). The proposed amendment would revise the lookback period in the quantitative test by replacing the phrase "on any day during the previous 15-month period" in both of the foregoing clauses (1) and (2) with "at such time or on any day during the previous 15-month period" (emphasis added).

[15] We would expect that comments to the proposed amendment of Regulation EE will likely touch upon the need to clarify that the new language "at such time" should more clearly refer to the time the financial institution entered into one or more financial contracts.

Rationale for the Proposed Amendments

The Board noted that, since the enactment of Regulation EE in 1994, the financial regulation landscape has changed dramatically. A much larger number of entities today serve as financial market intermediaries or are systemically important (*e.g.*, swap dealers, nonbank financial companies that are subject to Board supervision and regulation, and financial market utilities). Expanding the application of netting under FDICIA through the recognition of such entities within FDICIA's "financial institution" definition reflects the goals of ensuring the smooth functioning of these entities, reducing systemic risk, and increasing efficiency in the financial markets.

Request for Comments

The NOPR specifically requests comments on whether qualifying central counterparties under 12 CFR 217.2 should also be included in the definition of "financial institution" for purposes of FDICIA, and asks what entities might benefit from such inclusion.

Under 12 CFR 217.2, a "central counterparty" is defined to mean "a counterparty (for example, a clearing house) that facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts." Because the proposed amendments (described above) would already explicitly include CFTC-registered DCOs, SEC-registered CAs and FSOC-designated DFMUs within the definition of "financial institution", this question appears to be aimed at exploring whether there are other such central counterparties facilitating trades under netting contracts that are not registered with the CFTC as DCOs or with the SEC as CAs, and have not been designated as DFMUs by the FSOC.

Finally, the NOPR requests comments on whether the additional numerated categories of entities (listed above) should qualify as "financial institutions" for purposes of FDICIA as proposed, or whether other categories of entities should be added.

For more information or questions on the matters covered in this publication, please contact any of the lawyers below or a member of our Finance Practice Group.

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