



FEDERAL RESERVE SYSTEM

12 CFR Part 231

Regulation EE; Docket No. R - 1661

RIN 7100-AF 48

Netting Eligibility for Financial Institutions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: The Board of Governors (Board) is seeking comment on a proposal to amend Regulation EE to include certain new entities in the definition of “financial institution” contained in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) so that they will be covered by FDICIA’s netting provisions. The proposal would also clarify how the existing activities-based test in Regulation EE applies following a consolidation of legal entities.

DATES: Comments must be received on or before [INSERT 60 DAYS AFTER DATER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: When submitting comments, please consider submitting your comments by e-mail or fax because paper mail in the Washington, DC area and at the Board may be subject to delay. You may submit comments, identified by Docket No. R-1661, RIN 7100-AF 48, by any of the following methods:

- *Agency Web Site:* <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- *E-mail:* regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- *Fax:* (202) 452-3819 or (202) 452-3102.
- *Mail:* Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's website at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons or to remove personally identifiable information at the commenter's request. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room 146, 1709 New York Avenue, NW, Washington, DC 20006, between 9:00 a.m. and 5:00 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Evan Winerman, Senior Counsel (202-872-7578), Justyna Bolter, Attorney (202-452-2686), Legal Division. Users of Telecommunication Device for Deaf (TDD) only, call (202) 263-4869.

SUPPLEMENTARY INFORMATION:

I. Background

Sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)¹ validate netting contracts among financial institutions. Parties to a netting contract agree that they will pay or receive the net, rather than the gross, payment due under the netting contract. FDICIA provides certainty that netting contracts will be enforced, even in the event of the insolvency of one of the parties. FDICIA's netting

¹ Pub. L. 102-242; 105 Stat. 2236, 2372-3; 12 U.S.C. 4401-4407.

provisions were designed to promote efficiency and reduce systemic risk within the banking system and financial markets.² As market participants generally manage their counterparty risk by setting bilateral exposure limits vis-à-vis other market participants, FDICIA's netting protections allow market participants to rely on net exposure values, thereby enhancing market liquidity and reducing counterparty risk.

The netting provisions apply to bilateral netting contracts between two financial institutions and multilateral netting contracts among members of a clearing organization. FDICIA section 402(9) defines "financial institution" to include a depository institution, a securities broker or dealer, a futures commission merchant, or any other institution as determined by the Board. In Regulation EE, the Board broadened the definition of "financial institution," consistent with FDICIA's purpose of enhancing efficiency and reducing systemic risk in the financial markets. In defining "financial institution" in Regulation EE, the Board intended to include financial market participants that regularly enter into financial contracts on both sides of a financial market, where the failure of the participant could create systemic problems in the financial markets in terms of losses to counterparties or market confidence and liquidity.³ Specifically, Regulation EE expands the FDICIA definition of "financial institution"—and therefore expands FDICIA's netting protections—using an activities-based test that includes a qualitative component and a quantitative component. The qualitative component requires that the person "represent[], orally or in writing, that it will engage in financial contracts as a counterparty on both

² See FDICIA section 401, 12 U.S.C. 4401.

³ 58 FR 29149, 29150 (May 19, 1993).

sides of one or more financial markets.”⁴ A person that makes this representation demonstrates that it is willing to engage in transactions on both sides of the market and is, in effect, holding itself out as a market intermediary.⁵ The quantitative component requires that the person have either (1) 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) 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 Since Regulation EE was finalized in 1994, the Board has made only a non-substantive amendment in 1996 to clarify that the representation of financial market intermediary status can be made orally or in writing.

Regulation EE does not expand the definition of “financial institution” by rule to include institutions or individuals who are end users and not market intermediaries. However, the Board has issued a limited number of case-by-case “financial institution” determinations with respect to certain government-sponsored end users and members in a large-value fund transfer system.⁷

⁴ 12 CFR 231.3(a). Regulation EE generally defines the term “financial contract” by reference to the term “qualified financial contract” under section 11(e)(8)(D) of the Federal Deposit Insurance Act, 12 U.S.C. 1821(e)(8)(D). 12 CFR 231.2(c),

⁵ 59 FR 4780, 4782 (Feb. 2, 1994).

⁶ *Id.*

⁷ Pursuant to these case-by-case determinations, the Board has granted “financial institution” status to certain members of the CHIPS[®] funds-transfers 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.

Certain payment, clearing, and settlement systems continue to rely on FDICIA's netting provisions to ensure that their netting agreements will be enforceable if a participant in the system becomes insolvent.⁸ An organization that relies on the bilateral netting provisions of FDICIA section 403 would require that all of its members qualify as financial institutions under FDICIA's statutory definition or under Regulation EE. An organization that relies on the multilateral netting provisions of FDICIA section 404 would generally require that all of its members qualify as either (1) financial institutions under FDICIA's statutory definition or under Regulation EE or (2) clearing organizations as defined in FDICIA section 402(2).⁹

II. Description of Proposed Rule

The Board proposes to extend "financial institution" status for purposes of FDICIA's netting provisions to certain new categories of entities. The Board also proposes to clarify how the existing activities-based test in Regulation EE applies following a consolidation of legal entities.

A. Qualification as a Financial Institution Based on Type of Entity

Consistent with the purposes of FDICIA's netting provisions, the proposal would apply the netting benefits in Regulation EE to entities whose coverage would reduce

⁸ The Board recognizes that certain financial institutions and clearing organizations may also rely on provisions of the Bankruptcy Code, the Federal Deposit Insurance Act, and other statutes to ensure the enforceability of netting agreements for particular financial contracts (*e.g.*, swap agreements and repurchase agreements) and master netting agreements for multiple types of financial contracts.

⁹ FDICIA section 402(2) generally defines "clearing organization" to include entities that provide clearing, netting, and settlement services to their members and in which all members of the entity are themselves financial institutions or clearing organizations. However, certain entities qualify as clearing organizations under FDICIA section 402(2)—and are therefore eligible for the multilateral netting protections under FDICIA section 404—without regard to whether all of their members qualify as financial institutions or clearing organizations. Specifically, an entity automatically qualifies as a clearing organization if it is (1) registered with the Securities and Exchange Commission (SEC) as a clearing agency or has been exempted from registration by SEC order or (2) registered with the Commodity Futures Trading Commission (CFTC) as a derivatives clearing organization or has been exempted from registration by the CFTC.

systemic risk and increase efficiency in the financial markets. (The Board recognizes that some entities that would qualify as financial institutions under the proposal might already qualify as financial institutions under FDICIA's statutory definition or under the existing activities-based test in Regulation EE.)

When the Board promulgated Regulation EE in 1994, the Board chose not to adopt a test for expanding financial institution status based on an entity's regulatory status or charter category. The Board stated at the time that such a test would have been over-inclusive because it would have extended financial institution status to entities that (1) were not market intermediaries and (2) did not engage in a volume of transactions that could create systemic risk.¹⁰ The Board also noted, when it proposed Regulation EE in 1993, that a test based on regulatory status or charter category would have been *under-inclusive* because it would have excluded "major unregulated market participants, such as swap dealers"¹¹

Since the Board promulgated Regulation EE in 1994, the domestic and global landscape for financial regulation has changed dramatically. For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),¹² signed into law on July 21, 2010, imposed or expanded federal supervision and regulation for multiple types of entities that serve as financial market intermediaries or are systemically important, including swap dealers, security-based swap dealers, nonbank financial companies that the Financial Stability Oversight Council (FSOC) has subjected to Board supervision and regulation, and FSOC-designated financial market utilities. In subjecting

¹⁰ 59 FR 4780, 4783 (Feb. 2, 1994).

¹¹ 58 FR 29149, 29150 (May 19, 1993).

¹² Pub. L. 111-203, 124 Stat. 1376.

these entities to higher levels of regulation and supervision due to their activities, transaction volumes, and risks presented to the financial markets, Congress indicated the importance of the smooth functioning of these entities to the financial markets.

In keeping with FDICIA's goals of reducing systemic risk and increasing efficiency in the financial markets, the Board believes that the addition of certain categories of institutions to the definition of "financial institution" would benefit financial markets that continue to rely on FDICIA's netting provisions.

1. Swap dealers and security-based swap dealers

As noted above, when the Board proposed Regulation EE in 1993, the Board recognized the important role that swap dealers played in the financial markets but stated that swap dealers were "unregulated."¹³ Congress subsequently imposed extensive new requirements on swap dealers and security-based swap dealers. Specifically, Title VII of the Dodd-Frank Act imposes a variety of requirements on swap dealers and security-based swap dealers, including a requirement to register with the CFTC or the SEC, respectively, when they exceed a de minimis level of dealing activity.¹⁴

The requirements in Title VII of the Dodd-Frank Act recognize the important role that swap dealers and security-based swap dealers play as intermediaries in derivatives markets. Proposed § 231.3(d)(1) and (2) would clarify that swap dealers registered with the CFTC and security-based swap dealers registered with the SEC are financial institutions.

¹³ 58 FR 29149, 29150 (May 19, 1993).

¹⁴ See 7 U.S.C. 6s (swap dealer registration requirement) and 17 CFR 1.3 (swap dealer definition and de minimis thresholds); 15 U.S.C. 78o-10 (security-based swap dealer registration requirement) and 17 CFR 240.3a71-1 and 240.3a71-2 (security-based swap dealer definition and de minimis thresholds).

2. Major swap participants and major security-based swap participants

Title VII of the Dodd-Frank Act not only imposes new requirements on swap dealers and security-based swap dealers, but also on major swap participants (MSPs) and major security-based swap participants (MSBSPs). MSPs and MSBSPs are, generally, entities that hold large derivatives positions but are not swap dealers or security-based swap dealers.¹⁵ Like swap dealers and security-based swap dealers, MSPs and MSBSPs must, *inter alia*, register with the CFTC and SEC, respectively.¹⁶ The requirements in Title VII of the Dodd-Frank Act recognize that, while MSPs and MSBSPs are not necessarily intermediaries, they may present an important source of risk in the derivatives markets. Proposed § 231.3(d)(1) and (2) would clarify that MSPs registered with the CFTC and MSBSPs registered with the SEC are financial institutions.

3. Nonbank systemically important financial institutions

Title I of the Dodd-Frank Act¹⁷ extends Board supervision and regulation to certain nonbank financial companies that could pose a threat to financial stability.¹⁸ Title I authorizes the FSOC to subject nonbank financial companies to supervision and regulation by the Board in order to address any potential risks that these companies pose to financial stability (such designated entities are referred to as “nonbank systemically important financial institutions” or “nonbank SIFIs”).¹⁹ In determining whether to designate an entity as a nonbank SIFI, the FSOC considers its leverage, off-balance-sheet exposures,

¹⁵ See 7 U.S.C. 1a(33) (MSP definition) and 15 U.S.C. 78c(a)(67) (MSBSP definition).

¹⁶ See 7 U.S.C. 6s (MSP registration requirement) and 15 U.S.C. 78o-10 (MSBSP registration requirement).

¹⁷ 12 U.S.C. Chapter 53, Subchapter 1.

¹⁸ 12 U.S.C. 5311(a)(4).

¹⁹ 12 U.S.C. 5323.

interconnectedness with other entities, importance as a source of liquidity, source of credit, manner of asset management, asset mix, other regulatory oversight, amount and nature of financial assets, amount and types of liabilities, and other risk-related factors.²⁰

FSOC designation of a nonbank SIFI indicates that the nonbank SIFI plays an important role in U.S. financial markets. Consistent with FDICIA's purpose of enhancing efficiency and reducing systemic risk in the financial markets, proposed § 231.3(d)(6) would define "financial institution" to include nonbank SIFIs.

4. Certain financial market utilities

Financial market utilities (FMUs) are entities that manage or operate multilateral systems for the purpose of transferring, clearing or settling payments, securities, or other financial transactions among participants or between participants and the FMU itself.²¹

FMUs include payment systems, central securities depositories (CSDs), securities settlement systems (SSSs), and central counterparties (CCPs). Since FDICIA was enacted in 1991, lawmakers and regulators around the world have increasingly recognized the importance of FMUs, which can serve a critical role in fostering financial stability but can also pose significant risks to the financial system.

a. Derivatives clearing organizations and clearing agencies

The Dodd-Frank Act and other post-FDICIA legislation demonstrate specific Congressional interest in derivatives clearing organizations (DCOs) and clearing agencies (CAs).²² For example, the Commodity Futures Modernization Act of 2000²³ amended the

²⁰ *Id.*

²¹ 12 U.S.C. 5462.

²² DCOs provide clearing services for CFTC-regulated derivatives, while CAs provide clearing services for securities. See 7 U.S.C. 1a(15) and 15 U.S.C. 78c(a)(23).

Commodity Exchange Act to create core principles with which a DCO must comply in order to be registered and to maintain registration as a DCO, while Title VII of the Dodd-Frank Act amended the Commodity Exchange Act to provide explicitly that the CFTC can implement these core principles via rulemaking.²⁴ Similarly, Title VII of the Dodd-Frank Act amended the Securities Exchange Act to, *inter alia*, require the SEC to adopt rules governing CAs that clear security-based swaps.²⁵

Under FDICIA section 402(2), DCOs and CAs are “clearing organizations,” and therefore their members are eligible for the multilateral netting protections under FDICIA section 404 without regard to whether all participants in a DCO or CA qualify as financial institutions or clearing organizations. However, DCOs and CAs do not themselves automatically qualify as “financial institutions.” Ensuring that DCOs and CAs are “financial institutions” would ensure that DCOs and CAs can participate in *other* FMUs that rely on the bilateral netting protections in FDICIA section 403, which would reduce systemic risk and increase efficiency in the financial markets.

Accordingly, proposed § 231.3(d)(3) would define “financial institution” to include DCOs that are registered with the CFTC or have been exempted from registration by the CFTC,²⁶ and proposed § 231.3(d)(4) would define “financial institution” to include CAs that are registered with the SEC or have been exempted from registration by the SEC.²⁷

²³ Pub. L. 106-554, 114 Stat. 2763 (2000).

²⁴ See 7 U.S.C. 7a-1(c)(2).

²⁵ 15 U.S.C. 78q-1(j).

²⁶ See 7 U.S.C. 7a-1(a) and (h).

²⁷ See 15 U.S.C. 78q-1(b) and (k).

b. Designated financial market utilities

Under Title VIII of the Dodd-Frank Act, the FSOC can designate FMUs as systemically important, after which such designated FMUs (DFMUs) become subject to an enhanced supervisory framework.²⁸ In determining whether to designate an entity as a DFMU, the FSOC considers the aggregate monetary value of its transactions, its aggregate exposure, interconnectedness with other entities, effect of its failure or disruption on the financial system and any other factors that the FSOC deems appropriate.²⁹ The FSOC has currently designated eight FMUs, including a U.S. dollar payment system,³⁰ a multi-currency foreign exchange settlement system,³¹ a CSD/SSS,³² and CCPs for securities and derivatives.³³ Ensuring that all DFMUs (not just those that are CAs or DCOs, which are captured in the discussion above) qualify as “financial institutions” would ensure that all DFMUs can participate in other FMUs that rely on FDICIA’s netting protections, which would reduce systemic risk and increase efficiency in the financial markets.

Accordingly, proposed § 231.3(d)(5) would define “financial institution” to include DFMUs.

5. Foreign banks

FDICIA section 402(9) defines the term “financial institution” to include “a depository institution,” and FDICIA section 402(6) defines “depository institution” to

²⁸ See 12 U.S.C. 5461-5472.

²⁹ 12 U.S.C. 5463.

³⁰ The Clearing House Payment Company, L.L.C., on the basis of its role as operator of the Clearing House Interbank Payments System.

³¹ CLS Bank International.

³² The Depository Trust Company.

³³ Chicago Mercantile Exchange, Inc.; ICE Clear Credit L.L.C.; The Options Clearing Corporation; Fixed Income Clearing Corporation; and National Securities Clearing Corporation.

include “a branch or agency of a foreign bank, a foreign bank and any branch or agency of the foreign bank, or the foreign bank that established the branch or agency, as those terms are defined in section 1(b) of the International Banking Act of 1978.” The International Banking Act defines “foreign bank” broadly to encompass banking institutions organized under the laws of a foreign country, a territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands.³⁴

The Board believes that FDICIA’s statutory definitions of “depository institution” and “financial institution” extend to all foreign banks, including foreign banks that do not have a U.S. branch or agency. This view is consistent with the statutory language as well as the relevant legislative history.³⁵ Certain market participants have expressed concern that an alternative reading of the statute is possible and that a court might find that a foreign bank does not qualify as a “depository institution”—and thus does not meet FDICIA’s statutory definition of “financial institution”—unless the foreign bank has a U.S. branch or agency. Proposed § 231.3(d)(7) would clarify that all foreign banks are financial institutions, including foreign banks that do not have a U.S. branch or agency and bridge banks that foreign authorities establish to facilitate the resolution of foreign banks.

6. Bridge institutions

Under certain circumstances, governmental authorities can charter bridge institutions to facilitate the resolution of another legal entity, including a non-bank entity.

³⁴ 12 U.S.C. 3101(7).

³⁵ See H.R. Rep No. 109-31, at 126 (2005) (noting that expanding FDICIA’s definition of “financial institutions” to include foreign banks would “extend the protections of FDICIA to ensure that U.S. financial organizations participating in netting agreements with foreign banks are covered by [FDICIA], thereby enhancing the safety and soundness of these arrangements”).

For example, under Title II of the Dodd-Frank Act, the Federal Deposit Insurance Corporation (FDIC) can establish a “bridge financial company” when the FDIC acts as receiver for a nonbank “covered financial company.”³⁶ Title II allows a bridge financial company to, inter alia, assume liabilities of the covered financial company and purchase assets from the covered financial company.³⁷ Similarly, section 11(n) of the Federal Deposit Insurance Act allows the FDIC to establish a bridge bank or savings association to facilitate the resolution of a failed bank or savings association.³⁸ Foreign authorities can establish similar bridge institutions.³⁹

The Board believes that any bridge institution, foreign or domestic, would require uninterrupted access to payment systems or clearing organizations, some of which might require participants to be financial institutions for purposes of FDICIA’s netting provisions. A bridge bank or savings association that the FDIC establishes pursuant to section 11(n) of the Federal Deposit Insurance Act would qualify as a financial institution under FDICIA’s statutory definition, which extends financial institution status to any “depository institution.”⁴⁰ The Board also believes that a foreign bridge bank would

³⁶ 12 U.S.C. 5390(h).

³⁷ 12 U.S.C. 5390(h)(1)(b).

³⁸ 12 U.S.C. 1821(n).

³⁹ See, e.g., Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, 2014 OJ (L 173) 190, Article 40.

⁴⁰ The first prong of FDICIA’s definition of “depository institution” includes a depository institution as defined in section 19(b)(1)(A) of the Federal Reserve Act (other than clause (vii)). The relevant section of the Federal Reserve Act states that the term “depository institution” includes, inter alia, any insured bank as defined in section 3 of the Federal Deposit Insurance Act and any savings association (as defined in section 3 of the Federal Deposit Insurance Act) which is an insured depository institution (as defined in such Act). Section 3(h) of the Federal Deposit Insurance Act in turn defines the term “insured bank” to mean any bank, the deposits of which are insured in accordance with the provisions of the Act, and section 3(c)(2) of the

qualify as a financial institution under FDICIA’s statutory definition, because FDICIA’s statutory definitions of “depository institution” and “financial institution” extend to all foreign banks, including foreign bridge banks.⁴¹

Proposed § 231.3(d)(8) would ensure that all bridge institutions that are established to help resolve financial institutions—including bridge financial companies established by the FDIC and similar nonbank bridge institutions established under foreign law—can qualify as financial institutions. Proposed § 231.3(d)(8) would provide that “[a] bridge institution established for the purpose of resolving a financial institution” is itself a financial institution.⁴² Proposed § 231.2(c) would define “bridge institution” as “a legal entity that has been established by a governmental authority to take over, transfer, or continue operating critical functions and viable operations of an entity in resolution. A bridge institution could include a bridge depository institution or a bridge financial company organized by the Federal Deposit Insurance Corporation in accordance with 12 U.S.C. 1821(n) or 5390(h), respectively, or a similar entity organized under foreign law.”

7. Federal Reserve Banks

Federal Deposit Insurance Act defines “insured depository institution” to mean any bank or savings association, the deposits of which are insured by the Corporation pursuant to the Act. Section 11(n)(d) of the Federal Deposit Insurance Act states that a bridge depository institution shall be an insured depository institution from the time it is chartered as a national bank or Federal savings association. Accordingly, at the time the FDIC charts a bridge bank or savings association, the deposits of that bridge bank or savings association are insured by the FDIC, and the bridge bank or savings association therefore qualifies as (1) an insured bank and/or an insured depository institution under the Federal Deposit Insurance Act and (2) a depository institution under Federal Reserve Act section 19(b)(1)(A) and FDICIA section 402.

⁴¹ As noted above, proposed § 231.3(d)(7) would codify the Board’s existing view that all foreign banks are financial institutions, including foreign bridge banks.

⁴² This provision would apply to a bridge institution established for the purpose of resolving an entity that either (1) meets FDICIA’s statutory definition of financial institution or (2) qualifies as a financial institution under Regulation EE.

The Federal Reserve Banks participate in financial markets through various types of transactions, called “open market operations,” that are used to implement monetary policy.⁴³ In the event that a Federal Reserve Bank does not separately meet the quantitative test in Regulation EE, the Board believes that it should be clear that each Federal Reserve Bank is a “financial institution” and is able to benefit from the netting provisions of Regulation EE. Proposed § 231.3(d)(9) would ensure that the Federal Reserve Banks qualify as financial institutions.

8. Request for comment

The Board requests comment on whether the entities described above should qualify as financial institutions. The Board also requests comment on whether other categories of entities should qualify as financial institutions.

In addition, the Board requests comment on whether it should include in the definition of financial institution an entity that is a qualifying central counterparty under 12 CFR § 217.2. What entities might benefit from such inclusion?

B. Activities-based test

As noted above, the quantitative component of the activities-based test requires that a person have either (1) 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) 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

⁴³ See sections 12A and 14 of the Federal Reserve Act (allowing the Federal Open Market Committee to authorize the Federal Reserve Banks to engage in various types of open market operations).

that are not its affiliates.⁴⁴ The Board proposes to add language to clarify, consistent with its current understanding, that the “previous 15-month period” also includes the day on which the notional principal amount of \$1 billion is met by adding the words “at such time” to proposed §§ 231.3(a)(1) and (a)(2).⁴⁵

The Board also proposes to clarify how the existing activities-based test in Regulation EE applies following a consolidation of legal entities. The quantitative component of the activities-based test may not be clear if, for example, two or more entities consolidate and each of these entities did not, on its own, meet the quantitative thresholds described above. Accordingly, the Board is proposing to clarify that, upon the consolidation of two or more entities, the surviving entity may aggregate the total gross dollar value of notional principal amounts outstanding or the total gross mark-to-market positions of both entities on each calendar day during the previous 15-month period, and such total amounts would be used to determine whether the surviving entity meets the quantitative thresholds of the activities-based test.⁴⁶ Proposed § 231.3(b) would clarify

⁴⁴ 12 CFR 231.3(a). The Bankruptcy Code includes a test for identifying “financial participants” that is substantively identical to the quantitative test in Regulation EE. 11 U.S.C. 101(22A). Under the Bankruptcy Code, financial participants that enter into certain types of financial contracts and master netting agreements for those financial contracts are exempt from provisions of the Bankruptcy Code that might otherwise delay or prevent netting related to those contracts. *See, e.g.*, 11 U.S.C. 362(b)(6), (7), (17), and (27) (specifying that the Bankruptcy Code’s automatic stay does not prevent a financial participant from exercising a contractual right to, *inter alia*, “offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with” certain types of financial contracts and master netting agreements for those financial contracts).

⁴⁵ This amendment would align Regulation EE with the Bankruptcy Code test for identifying “financial participants”, which is substantively identical to the activities-based test in Regulation EE but includes the words “at such time.” 11 U.S.C. 101(22A).

⁴⁶ For 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 currently have financial contracts of a total gross notional value of \$1 billion. Similarly, if company A and company B each had, on the same, single calendar day in the last fifteen months, total gross mark-to-market positions of \$50 million in one or more financial contracts (equaling an aggregate gross mark-to-market position of \$100

that “[a]fter two or more persons consolidate, such as through a merger or acquisition, the surviving person meets the quantitative thresholds . . . if, on the same, single calendar day during the previous 15-month period, the aggregate financial contracts of the consolidated persons would have met such quantitative thresholds.” The Board requests comment on this proposed approach.

The Board also requests comment on whether it should make any other modifications to the existing activities-based test. The Board does not propose to make any other changes at this time.

IV. Regulatory Analysis

A. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR part 1320, Appendix A.1), the Board may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a valid Office of Management and Budget (OMB) control number. The Board reviewed the proposed rule under the authority delegated to the Board by the OMB and determined that it contains no collections of information under the PRA.⁴⁷ Accordingly, there is no paperwork burden associated with the rule.

B. Regulatory Flexibility Act

In accordance with section 4 of the Regulatory Flexibility Act (RFA), 5 U.S.C. 601 *et seq.*, the Board is publishing an initial regulatory flexibility analysis for the proposed

million on such day), company A would meet the quantitative test even if it does not currently have financial contracts with a total gross mark-to-market positions of at least \$100 million. Each of these qualifications under the quantitative test for surviving company A would last 15 months from the day on which the relevant quantitative threshold was reached, unless surviving company A subsequently independently meets the test.

⁴⁷ See 44 U.S.C. 3502(3).

rule. The RFA generally requires an agency to assess the impact a rule is expected to have on small entities. The RFA requires an agency either to provide a regulatory flexibility analysis or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities.

Two of the requirements of an initial regulatory flexibility analysis⁴⁸—a description of the reasons why the action is being considered and a statement of the objectives of, and legal basis for, the proposed rule—are contained in the information above. There are no reporting provisions or relevant federal rules that duplicate, overlap, or conflict with the proposed rule.⁴⁹

Another requirement for the initial regulatory flexibility analysis is a description of, and where feasible, an estimate of, the number of small entities to which the proposed rule will apply. The Small Business Administration (SBA) has adopted small entity size standards which generally provide that financial entities are “small entities” only if they have (1) at most, \$38.5 million or less in annual receipts or (2) for depository institutions and credit card issuers, \$550 million or less in assets.⁵⁰ The Board does not believe that the proposed rule would apply to any small entities. The proposed rule would extend “financial institution” status to swap dealers, security-based swap dealers, MSPs, MSBSPs, DCOs, clearing agencies, bridge institutions, and Federal Reserve Banks.⁵¹ The

⁴⁸ 5 U.S.C. 603(b).

⁴⁹ As noted above, certain entities and financial markets do not rely on FDICIA’s netting provisions to ensure the enforceability of their netting agreements, but instead rely on provisions of the Bankruptcy Code, the Federal Deposit Insurance Act, and other statutes to ensure the enforceability of netting agreements for particular financial contracts (e.g., swap agreements and repurchase agreements) and master netting agreements for multiple types of financial contracts.

⁵⁰ 13 CFR 121.201, sector 52 (SBA small entity size standards for finance and insurance entities).

⁵¹ As explained above, the proposed rule would also codify the Board’s existing view that foreign banks are financial institutions.

Board has previously determined that DFMUs are not small entities;⁵² the CFTC has previously determined that swap dealers, MSPs, and DCOs are not small entities;⁵³ and the SEC has previously determined that security-based swap dealers, MSBSPs, and clearing agencies are not small entities.⁵⁴ The Federal Reserve Banks are not small entities.⁵⁵

Similarly, a bridge financial company would not be a small entity.⁵⁶ As noted above, under U.S. law, the FDIC can establish a bridge financial company when it acts as receiver for a failing financial company. In order for the FDIC to be appointed as receiver for a financial company, the Secretary of the Treasury must determine that, *inter alia*, “the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States.”⁵⁷ The failure of a financial company that is a “small entity” would not affect financial stability in the United States.⁵⁸ Accordingly, the FDIC would not act as receiver—and would not form a bridge financial company—for a small entity. It is therefore unlikely that a bridge financial company would be a small entity.

⁵² 79 FR 65543, 65556 (Nov. 5, 2014).

⁵³ *See, e.g.*, 81 FR 80563, 80565 (Nov. 16, 2016); 76 FR 69334, 69428 (Nov. 8, 2011).

⁵⁴ *See, e.g.*, 81 FR 29959, 30142 (May 3, 2016); 81 FR 70744, 70784 (Oct. 13, 2016).

⁵⁵ None of the industry codes in the SBA’s small entity size standards necessarily apply to the Federal Reserve Banks *per se*, but the SBA’s size standards for commercial depository institutions are instructive. Generally, the SBA’s size standards provide that depository institutions are small entities if they have \$550 million or less in assets. 13 CFR 121.201, sector 52. Each of the Federal Reserve Banks holds significantly more than \$550 million in assets. *See* the Statement of Condition of Each Federal Reserve Bank, <https://www.federalreserve.gov/releases/h41/current/h41.htm#h41tab10a>.

⁵⁶ A bridge depository institution might be a small entity, but this proposed rule would not affect the status of bridge depository institutions under FDICIA because (as noted above) such institutions qualify as “financial institutions” under FDICIA’s statutory definition.

⁵⁷ 12 U.S.C. 5383(b)(2).

⁵⁸ *See* 13 CFR 121.201, sector 52 (Small Business Administration small entity size standards for finance and insurance entities), which generally provides that financial entities are “small entities” only if they have (1) at most, \$38.5 million or less in annual receipts or (2) for depository institutions and credit card issuers, \$550 million or less in assets.

C. Plain Language

Section 722 of the Gramm-Leach Bliley Act requires the Board to use plain language in all proposed and final rules published after January 1, 2000. The Board invites your comments on how to make this proposed rule easier to understand. For example:

- Has the Board organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the proposed rule clearly stated? If not, how could the proposed rule be more clearly stated?
- Does the proposed rule contain language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the proposed rule easier to understand? If so, what changes to the format would make the proposed rule easier to understand?
- What else could the Board do to make the regulation easier to understand?

List of Subjects in 12 CFR Part 231

Banks, banking, financial institutions, netting.

For the reasons set forth in the preamble, the Board proposes to amend Regulation EE, 12 CFR part 231, as follows:

PART 231 – NETTING ELIGIBILITY FOR FINANCIAL INSTITUTIONS

(REGULATION EE)

1. The authority citation for Part 231 continues to read as follows:

Authority: 12 U.S.C. 4402(1)(B) and 4402(9).

2. In § 231.2, redesignate paragraphs (c) through (f) as paragraphs (d) through (g), and add new paragraph (c) to read as follows:

§ 231.2—Definitions.

* * * * *

(c) Bridge institution means a legal entity that has been established by a governmental authority to take over, transfer, or continue operating critical functions and viable operations of an entity in resolution. A bridge institution could include a bridge depository institution or a bridge financial company organized by the Federal Deposit Insurance Corporation in accordance with 12 U.S.C. 1821(n) or 5390(h), respectively, or a similar entity organized under foreign law.

3. Amend § 231.3 by revising paragraph (a), re-designating paragraph (c) as paragraph (d) and paragraph (b) as paragraph (c) and adding new paragraphs (b) and (e) to read as follows:

§ 231.3—Qualification as a financial institution.

(a) *Activities-based test*: A person qualifies as a financial institution for purposes of sections 401-407 of the Act 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 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 at such time or 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 at such time or on any day during the previous 15-month period with counterparties that are not its affiliates.

(b) After two or more persons consolidate, such as through a merger or acquisition, the surviving person meets the quantitative thresholds under paragraphs (a)(1) and (a)(2) if, on the same, single calendar day during the previous 15-month period, the aggregate financial contracts of the consolidated persons would have met such quantitative thresholds.

* * * * *

(e) *Other financial institutions:* A person qualifies as a financial institution for purposes of sections 401–407 of the Act if it is—

(1) A swap dealer or major swap participant registered with the Commodity Futures Trading Commission pursuant to section 4s of the Commodity Exchange Act (7 U.S.C. 6s).

(2) A security-based swap dealer or major security-based swap participant registered with the U.S. Securities and Exchange Commission pursuant to section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10).

(3) A derivatives clearing organization registered with the Commodity Futures Trading Commission pursuant to section 5b(a) of the Commodity Exchange Act (7 U.S.C. 7a-1(a)) or a derivatives clearing organization that the Commodity Futures Trading Commission has exempted from registration by rule or order pursuant to section 5b(h) of the Commodity Exchange Act (7 U.S.C. 7a-1(h)).

(4) A clearing agency registered with the U.S. Securities and Exchange Commission pursuant to section 17A(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78q-1(b)) or

a clearing agency that the U.S. Securities and Exchange Commission has exempted from registration by rule or order pursuant to section 17A(k) of the Securities Exchange Act of 1934 (15 U.S.C. 78q-1(k)).

(5) A financial market utility that the Financial Stability Oversight Council has designated as, or as likely to become, systemically important pursuant to 12 U.S.C. 5463.

(6) A nonbank financial company that the Financial Stability Oversight Council has determined shall be supervised by the Board and subject to prudential standards, pursuant to 12 U.S.C. 5323;

(7) A foreign bank as defined in section 1(b) of the International Banking Act of 1978 (12 U.S.C. 3101), including a foreign bridge bank;

(8) A bridge institution established for the purpose of resolving a financial institution; or

(9) A Federal Reserve Bank.

By order of the Board of Governors of the Federal Reserve System, April 26, 2019.

Ann Misback,
Secretary of the Board.

Billing Code 3210-01p

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