September 27, 2017

MEMORANDUM TO: The Board of Directors [redacted]

FROM: Arthur J. Murton, Director
Office of Complex Financial Institutions

Doreen R. Eberley, Director [redacted]
Division of Risk Management Supervision

SUBJECT: **Final Rule Establishing Restrictions on Qualified Financial Contracts of Certain FDIC-supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions**

I. SUMMARY OF RECOMMENDATIONS:

This Memorandum concerns a final rule ("Final Rule") that requires restrictions on certain qualified financial contracts ("QFCs") of FDIC-supervised institutions that are subsidiaries of global systemically important banking organizations ("GSIBs"), as well as any subsidiaries of such supervised institutions (collectively, "covered FSIs"). The Final Rule also makes technical, conforming amendments to definitions in the FDIC's capital and liquidity rules. Staff recommends that the Board:

A. Approve the attached Final Rule as set forth in the attached *Federal Register* document and authorize its publication in the *Federal Register* with an effective date of January 1, 2018.

B. Authorize the General Counsel, or designee, and the Executive Secretary, or designee, to make technical, non-substantive or conforming changes to the draft *Federal Register* documents to prepare them for publication or to ensure consistency with the other agencies' substantially similar final rules.

II. DISCUSSION:

A. Background

In October 2016, the FDIC invited comment on a notice of proposed rulemaking ("NPR")[1] to impose restrictions on the QFCs—such as derivatives contracts and repurchase agreements—of covered FSIs. QFC transactions are a major source of interconnectedness among financial institutions and, therefore, can pose risks to financial stability in times of market stress and in the event of the failure of a GSIB or its affiliates. The NPR would have required the QFCs of covered FSIs to contain contractual provisions that opt into the stay-and-transfer provisions[2] of the Federal Deposit Insurance Act ("FDI Act") and Title II of the Dodd-Frank Act, thereby reducing the risk that the stay-and-transfer provisions would be challenged by a QFC counterparty or a court in a foreign jurisdiction. The NPR would have also prohibited the counterparties of QFCs of covered FSIs from exercising default rights related, directly or indirectly, to the entry into resolution of an affiliate of the covered FSIs ("cross-default rights"), subject to certain creditor protection exceptions that would not be expected to interfere with an orderly resolution. The NPR aimed to address QFCs entered into by entities in a GSIB group through the NPR's application to covered FSIs.

Like the NPR, the Final Rule is intended to facilitate the orderly resolution of a failed GSIB or its subsidiaries by limiting the ability of counterparties to QFCs entered into by covered FSIs to exercise certain contractual rights upon the entry of a covered FSI or one of its affiliates (including its parent GSIB) into resolution. In order to effectuate this, the Final Rule requires that certain QFCs to which a covered FSI is a party include contractual provisions to help ensure the

[1] 81 Fed. Reg. 74,326 (Oct. 26, 2016).

[2] *See infra* note 3 and accompanying text.

applicability of provisions of Title II of the Dodd-Frank Act and the FDI Act pertaining to the transfer of, and the exercise of default rights relating to, QFCs. Separately, the Final Rule amends the definition of “qualifying master netting agreement” in the FDIC’s capital and liquidity rules, and certain related terms in the FDIC’s capital rules. These amendments are intended to ensure that the regulatory capital and liquidity treatment of QFCs to which a covered FSI is party is not affected by the Final Rule’s requirements for such QFCs.

A party to a QFC generally has the right to take certain actions if its counterparty fails to meet specified contractual obligations. QFCs commonly include provisions that give the non-defaulting party the right to suspend performance of its obligations under the QFC, the right to terminate or accelerate the QFC, the right to set off amounts owed between the parties, and the right to seize and liquidate the defaulting party’s collateral. The QFC may provide that these and other default rights can be exercised in a variety of circumstances, including when a party to the QFC or any of its affiliates enters resolution, regardless of whether the party to the QFC is still meeting its obligations thereunder.

The exercise of QFC default rights can undermine financial stability in several ways. If all QFC counterparties of a failing party simultaneously exercise default rights, they may drain liquidity from the failing party, which could affect asset prices, volatility, and spread financial distress. Furthermore, covered FSIs can experience destabilizing effects in the event counterparties exercise default rights under QFCs against the covered FSI upon the entry into resolution of the covered FSI’s affiliates. Where these effects occur *en masse*, such as upon the failure of a GSIB that is party to a large volume of QFCs, they may pose a substantial risk to financial stability and the safety and soundness of individual institutions within the banking system.

To address the risks posed by QFCs, the resolution frameworks that Congress enacted under the FDI Act and Title II of the Dodd-Frank Act (together, "U.S. special resolution regimes") impose temporary stays on the exercise of QFC default rights and authorize the FDIC as receiver to transfer a failed firm's QFCs (collectively, "stay-and-transfer provisions").[3] Nevertheless, although domestic entities are clearly subject to the temporary stay provisions of Title II of the Dodd-Frank Act and the FDI Act, these stays may be difficult to enforce in a cross-border context. Furthermore, stays related to cross-defaults based on the failure of an affiliate are not applicable under the FDI Act or under the Bankruptcy Code, the latter of which is the presumptive insolvency regime for a U.S. GSIB parent and many of its subsidiaries. Recognizing the need to address the risk posed by early termination of QFCs[4] and in consultation with representatives of the FDIC, the Federal Reserve Board ("FRB"), the Office of the Comptroller of the Currency ("OCC"), and foreign regulators, the International Swaps and Derivatives Association, Inc. ("ISDA") established the ISDA 2015 Universal Resolution Stay Protocol, including the Securities Financing Transaction Annex and the Other Agreements Annex ("Universal Protocol").[5]

[3] 12 U.S.C. §§ 1821(e)(8)–(10); 5390(c)(16); 12 C.F.R. § 380.12.

[4] On November 5, 2013, the FDIC, the Bank of England, the German *Bundesanstalt für Finanzdienstleistungsaufsicht* and the Swiss Financial Market Supervisory Authority wrote a joint letter to ISDA highlighting these risks and requesting that standard ISDA documentation be amended accordingly. Shortly thereafter, the Japanese Financial Services Agency sent a letter to ISDA in support of the joint letter. The ISDA working group subsequently consulted representatives from these authorities (as well as the FRB and the OCC in the United States and French *Autorité de contrôle prudentiel et de résolution*) as it worked to develop the ISDA 2014 Resolution Stay Protocol in 2014 to amend OTC derivatives documented under ISDA Master Agreements. In 2015, the same group developed the Securities Financing Transaction Annex (the "SFT Annex"), to amend repurchase agreements and securities lending transactions, and the ISDA 2015 Universal Dealer Protocol, which includes the substance of both the ISDA 2014 Resolution Stay Protocol and the SFT Annex. The 2015 Resolution Stay Protocol is available on the ISDA website at https://www2.isda.org/functional-areas/protocol-management/protocol/22.

[5] Firms may voluntarily elect to adhere to the Universal Protocol; those who adhere are referred to as "adhering parties." The ISDA website lists all adhering parties.

The Universal Protocol enables parties to amend the terms of their ISDA Master Agreements and other agreements covered by the Universal Protocol and any related credit support arrangements to contractually recognize the cross-border application of special resolution regimes (including Title II of the Dodd-Frank Act and the FDI Act) that stay the exercise of certain default rights and, in certain cases, override cross-default rights included in QFCs that arise upon the entry of a GSIB or of its affiliated entities (including covered FSIs) into receivership, insolvency, liquidation, resolution or similar proceedings. The Universal Protocol's cross-default restrictions do not become effective until U.S. regulations are promulgated requiring GSIBs to include cross-default restrictions in all their qualifying QFCs. In order to give effect to such cross-default restrictions, the FRB, OCC and FDIC (collectively, "Agencies") need to promulgate regulations requiring the entities in a GSIB group to amend their QFCs accordingly. ISDA is expected to develop a new protocol ("U.S. Protocol"), substantially similar to the Universal Protocol, that would seek to address the specific needs of buy-side market participants.[6]

On October 26, 2016, the FDIC published in the *Federal Register* its NPR that would have required covered FSIs and their counterparties to either adhere to the Universal Protocol or take the prescribed steps to amend the contractual provisions of their QFCs, consistent with the requirements in the NPR. These requirements were parallel to those contained in similar proposals that had been recently published by the FRB and the OCC with regard to entities they

[6] ISDA has developed the ISDA 2016 Jurisdictional Modular Resolution Stay Protocol ("JMP") as a separate protocol that is consistent with the Universal Protocol with some differences designed to facilitate adherence by non-GSIB entities. The JMP will have a "regulatory module" for each jurisdiction that enacts a regulation requiring "opt-in" to provisions of special resolution regime(s). Each regulatory module will track the requirements of the applicable regulation and is expected to be finalized upon publication of the applicable final regulation. FDIC expects that ISDA will develop a module for the JMP that tracks the requirements of the FRB, OCC and FDIC final rules and that GSIBs may use to comply with applicable regulation vis-a vis non-GSIB counterparties.

supervise. On May 11, 2016, the FRB published in the *Federal Register* a notice of proposed rulemaking ("FRB NPR")[7] applicable to U.S. and foreign GSIBs that operate in the United States and subsidiaries other than federally chartered banks, savings associations, and branches of foreign banks. The FRB NPR would have required those entities to adhere to the Universal Protocol or otherwise amend their QFCs consistent with the requirements of the FRB NPR. On August 19, 2016, the OCC published in the *Federal Register* a notice of proposed rulemaking ("OCC NPR" and, collectively with the NPR and the FRB NPR, "proposed rules"),[8] which would have required national banks, Federal savings associations, and Federal branches and agencies to take measures that mirror the requirements of the FRB NPR.

B. Comment Summary for NPR

The FDIC received 14 comment letters on the NPR from trade groups representing GSIBs or GSIB groups, buy-side and end-users of derivatives, individuals and community advocates. Staff also met with some commenters at their request to discuss their comments on the NPR.

There was substantial overlap in the comments received by the Agencies regarding the proposed rules. Notably, comments received by the FDIC were generally accompanied by a copy of comments the commenter had already sent to the FRB or the OCC and were incorporated therein by reference. Commenters requested that the Agencies coordinate in developing final rules, consider comments submitted to the other Agencies regarding their proposed rules, including from entities not regulated by the particular Agency, and finalize rules with consistent conformance periods.

[7] 81 Fed. Reg. 29,169 (May 11, 2016).

[8] 81 Fed. Reg. 55,381 (August 19, 2016).

A number of commenters including GSIBs that would have been subject to the requirements of the proposed rules expressed strong support for the proposed rules. These commenters characterized the proposed rules as a well-considered effort to reduce systemic risk with minimal burden and as an important step to ensure a more efficient and orderly resolution process for all GSIB entities and thereby to protect the stability of the U.S. financial system. Other commenters, however, expressed concern with the proposed rules. These commenters generally argued that the Agencies should not restrict contractual rights of GSIB counterparties and contended that the proposed rules would have shifted the costs of resolving GSIBs to non-defaulting counterparties. Some commenters argued that the proposed rules would not assuredly mitigate systemic risk, as the requirements could result in increased market and credit risk for QFC counterparties of a GSIB. Commenters also argued that it would be more appropriate for Congress to impose the proposed restrictions on contractual rights through the legislative process.

The NPR applied to "covered FSIs," which was defined to mean any state savings association[9] or state non-member bank[10] that is a direct or indirect subsidiary of (i) a global systemically important bank holding company that has been designated pursuant to section 252.82(a)(1) of the FRB's Regulation YY;[11] or (ii) a global systemically important foreign banking organization that has been designated pursuant to section 252.87 of the FRB's Regulation YY.[12] A covered FSI included any subsidiary of a covered FSI. The NPR defined "subsidiary of a covered FSI" as an entity owned or controlled directly or indirectly by a covered

[9] *See* 12 U.S.C. § 1813(b)(3) (defining state savings association).

[10] *See* 12 U.S.C. § 1813(e)(2) (defining state nonmember banks).

[11] 12 C.F.R. § 252.82.

[12] 12 C.F.R. § 252.87.

FSI. “Control” was defined by reference to the Bank Holding Company Act of 1956, as amended (“BHC Act”). The FRB NPR and OCC NPR similarly used the definition of control from the BHC Act for purposes of determining the entities that would be subject to the proposed rules. Commenters urged the Agencies to move to a financial consolidation standard to define subsidiaries for this purpose, arguing that the concept of control under the BHC Act includes entities that are not under the operational control of a GSIB and over whom a GSIB does not have the practical ability to require remediation and which are unlikely to raise the types of concerns for the orderly resolution of GSIBs targeted by the proposed rules. For similar reasons including the ease of application of the rules, these commenters argued that, for purposes of the requirement that an entity conform existing QFCs if it enters into a new QFC with a counterparty or its affiliate, a counterparty’s “affiliate” should be defined by reference to financial consolidation rather than BHC Act control.

Commenters also expressed concern that the definition of “covered QFCs” under the proposed rules was overly broad. The NPR would have required a covered QFC to explicitly provide that it is subject to the stay-and-transfer provisions of the FDI Act and Title II of the Dodd-Frank Act and prohibited a covered FSI from being a party to a QFC that would allow the exercise of cross-default rights. Commenters argued that the final rules should exclude QFCs that do not contain any contractual transfer restrictions, direct default rights,[13] or cross-default rights, as these QFCs do not raise the risk that counterparties will exercise their contractual rights in a manner that is inconsistent with the provisions of the U.S. special resolution regimes. Commenters also urged the Agencies to exclude QFCs governed by U.S. law from the

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[13] For purposes of this memorandum, a direct default refers to a scenario where an entity that is itself a party to the QFC enters a resolution proceeding, or otherwise fails to perform on a QFC to which it is a party, giving rise to default rights such as, for example, termination, acceleration, or set off to its counterparty under the contract.

requirement that QFCs explicitly “opt in” to the U.S. special resolution regimes as it is already clear that such QFCs are subject to the stay-and-transfer provisions of the FDI Act and Title II of the Dodd-Frank Act. With respect to the proposed rules’ prohibition against provisions that would allow the exercise of cross-default rights in covered QFCs of a GSIB, commenters argued that the final rules should clarify that QFCs that do not contain such cross-default rights or transfer restrictions regarding related credit enhancements are not within the scope of the prohibition.

Commenters also requested that certain types of contracts that may include transfer or default rights subject to the NPR’s’ requirements (e.g., warrants, certain commodity contracts including commodity swaps, certain utility and gas supply contracts, certain retail customer and investment advisory agreements, securities underwriting agreements, securities lending authorization agreements) be excluded from all requirements of the final rules because these types of contracts do not raise the risks to the resolution of a GSIB or financial stability that are the target of the rules and certain existing contracts of these types would be difficult, if not impossible, to amend. Commenters also requested that certain securities contracts that typically settle in the short term or that typically include only transfer restrictions and not default rights similarly be excluded from all requirements of the final rules because they do not impose ongoing or continuing obligations on either party after settlement. In all of the above cases, commenters argued that remediation of these categories of outstanding contracts would be burdensome with no meaningful resolution benefits. Certain commenters also urged the Agencies to apply the final rules only to contracts entered into after their respective effective date, and not to contracts existing as of the effective date.

The proposed rules would have deemed as compliant covered QFCs amended by the existing Universal Protocol (which grants creditor protections in addition to those permitted by the proposed rules). Commenters generally supported this aspect of the proposed rules. Commenters, including ISDA itself, urged that the final rules should also provide a safe harbor for a future ISDA protocol, referred to in this memorandum as the U.S. Protocol, that would be substantially similar to the existing Universal Protocol except that it would seek to address the specific needs of buy-side market participants, such as asset managers, insurance companies, and pension funds which are counterparties to QFCs with GSIBs, to allow, for example, entity-by-entity adherence and the exclusion of certain foreign special resolution regimes.

Commenters expressed support for the exemption in the proposed rules for cleared QFCs but requested that this exemption be broadened to include the client leg of a cleared back-to-back transaction and also to include any contract cleared, processed, or settled on a financial market utility ("FMU"), as well as any QFC conducted according to the rules of an FMU. Commenters also requested an exemption for QFCs with sovereign entities and central banks. Commenters further requested a longer period of time for covered FSIs to conform covered QFCs with the requirements of the final rules in the case of certain types of counterparties. In addition, commenters requested confirmation that modifications to contracts to comply with the final rules would not trigger other regulatory requirements (e.g., margin requirements for non-cleared swaps) or impact the enforceability of QFCs.

Staff has considered the comments received on the NPR, including those of entities not regulated by the FDIC, as well as the comments submitted to the OCC and FRB regarding their respective proposals. Staff has engaged in extensive discussions with the FRB and OCC staff in the preparation of the Final Rule and responses to comments with a view to ensuring that the

Agencies' final rules are sufficiently substantively similar as to promote the goals of the regulations, avoid confusion and reduce the potential for regulatory arbitrage.

C. Final Rulemaking by the U.S. Federal Banking Agencies

As described in more detail below, and consistent with the NPR, the Final Rule applies to covered FSIs and sets forth requirements parallel to those contained in the final rule recently published by the FRB and the final rule that is expected to be published by the OCC. On September 1, 2017, the FRB adopted a final rule ("FRB Final Rule")[14] applicable to U.S. and foreign GSIBs that operate in the United States and subsidiaries (collectively, "covered entities") other than national banks, Federal savings associations, Federal branches, Federal agencies, state savings associations and state nonmember banks. The OCC is expected to adopt a final rule ("OCC Final Rule") that will require national banks, Federal savings associations, Federal branches, Federal agencies (collectively, "covered banks") to take measures that mirror the requirements applicable to covered entities under the FRB Final Rule in the near term.

To provide a uniform set of regulatory requirements and further improve GSIB resolvability, staff recommends the Board authorize the issuance of the attached Final Rule to address the QFCs of covered FSIs. Covered FSIs are FDIC-supervised institutions that are subsidiaries of the covered entities addressed in the FRB Final Rule, but will not be subject to the FRB Final Rule or the OCC Final Rule. The Final Rule is intended to work in conjunction with the FRB Final Rule and OCC Final Rule to ensure consistent regulatory treatment of QFCs among the various entities within a GSIB group. Staffs of the Agencies have endeavored to harmonize the final rules to the extent possible and to provide specificity and clarity in the final rules to minimize the possibility of conflicting interpretations or uncertainty in their application.

[14] 82 Fed. Reg. 42,882 (September 12, 2017).

D. FDIC Rulemaking

The FDIC's responsibilities include acting as: (i) the primary federal supervisor for state non-member banks and state savings associations; (ii) the insurer of deposits of insured depository institutions and manager of the Deposit Insurance Fund ("DIF"); and (iii) the resolution authority for all FDIC-insured institutions under the FDI Act and, if appointed by the Secretary of the Treasury in accordance with the requirements of Title II of the Dodd-Frank Act, for large complex financial institutions.[15] Thus, the FDIC's interests include ensuring that GSIBs are resolvable in an orderly manner and that FDIC-insured institutions operate safely and soundly. The Final Rule would further such interests by helping to minimize the destabilizing effects that may arise from the exercise of certain default rights and other remedies related to certain QFCs upon a covered FSI or its GSIB affiliate entering resolution in the United States.

The Final Rule is issued under the FDIC's authority under the FDI Act, including its general rulemaking authorities.[16] Staff believes the Final Rule is consistent with the FDIC's overall statutory mandate.[17] An overarching purpose of the Final Rule is to limit impediments to an orderly resolution of a GSIB and its subsidiaries, thereby furthering financial stability generally.

E. Restrictions on the QFCs of Covered FSIs

a. Entities Subject to the Final Rule

Consistent with the NPR, the Final Rule's requirements apply to all "covered FSIs." "Covered FSIs" include: any state savings association[18] or state non-member bank[19] that is a

[15] *See* 12 U.S.C. §§ 1811, 1816, 1818, 1819, 1820(g), 1828, 1828m, 1831p-1, 1831-u, 5301 *et seq*.

[16] *See* 12 U.S.C. § 1819.

[17] *See supra* note 15 and accompanying text.

[18] *See* 12 U.S.C. § 1813(b)(3) (defining state savings association).

direct or indirect subsidiary of (i) a global systemically important bank holding company that has been designated pursuant to section 252.82(a)(1) of the FRB's Regulation YY (12 CFR Part 252.82), or (ii) a global systemically important foreign banking organization[20] that has been designated pursuant to Subpart I of 12 CFR Part 252 (FRB Regulation YY). The term "covered FSI" generally includes any subsidiary of a covered FSI.

The Final Rule excludes subsidiaries held in satisfaction of debt previously contracted in good faith, portfolio companies held under the Small Business Investment Act of 1956, and companies owned as part of public welfare investments. Staff believes that, in general, interests held under these authorities are either temporary or not integrated into the operations of the covered FSI or GSIB in a way that poses significant risk to orderly resolution. The disorderly unwind of QFCs of these types of subsidiaries is not likely to impact the resolution of the covered FSI or the GSIB as a whole. Therefore, the impact of these exclusions should be relatively small and will reduce the burdens imposed by the Final Rule.

b. Financial Contracts Subject to the Final Rule

Like the NPR, the Final Rule defines "qualified financial contract" or "QFC" to have the same meaning as in section 210(c)(8)(D) of the Dodd-Frank Act[21] and includes, among other arrangements, derivatives, repurchase agreements (also known as "repos"), reverse repos, and securities borrowing and lending agreements. The Final Rule provides that only "in-scope QFCs" can be covered QFCs subject to the requirements of the Final Rule. A QFC is an "in-

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[19] *See* 12 U.S.C. § 1813(e)(2) (defining state nonmember banks).

[20] The definition of covered FSI does not include insured state-licensed branches of foreign banking organizations ("FBOs"). Any insured state-licensed branches of global systemically important FBOs would be covered by the FRB Final Rule. Therefore, unlike the FRB Final Rule, the Final Rule does not include special provisions relating to QFCs subject to certain multi-branch netting arrangements.

[21] 12 U.S.C. § 5390(c)(8)(D). *See* Final Rule § 382.1.

scope QFC" if it has transfer restrictions, direct default rights, or cross-default rights. Accordingly, the Final Rule makes clear that covered FSIs do not need to conform QFCs that have no transfer restrictions, direct default rights, or cross-default rights as these QFCs have none of the provisions that the Final Rule is intended to address.

The Final Rule also excludes retail investment advisory agreements, and existing warrants, and expressly provides the FDIC with authority to exempt one or more covered FSIs from conforming certain contracts or types of contracts to one or more of the requirements of the Final Rule after considering, in addition to any other factor the FDIC deems relevant, the burden the exemption would relieve and the potential impact of the exemption on the resolvability of the covered FSI or its affiliates. Although the Final Rule excludes retail investment advisory agreements and existing warrants from the scope of contracts covered by the Final Rule, staff believes it is appropriate to make clear that this exclusion is not an indication that the FDIC has determined that investment advisory agreements or warrants are necessarily QFCs. Rather, the exclusion was included in response to comments in order to provide clarity and, to the extent that such arrangements in fact constitute QFCs, after consideration of the relative burdens and benefits of including them within the scope of the Final Rule. Accordingly, the supplementary information to the Final Rule notes that the exclusion of a class of contracts from the scope of the Final Rule does not mean that such contracts are QFCs.

Subject to certain exceptions set forth in the Final Rule,[22] the Final Rule applies to any "covered QFC," which generally is defined as any in-scope QFC that a covered FSI enters into,

[22] Notably, consistent with the approach taken by the FRB and expected to be taken by the OCC in their respective final rules, the Final Rule excepts QFCs between FSIs and financial market utilities ("FMUs"), e.g., central clearing counterparties ("CCPs") and certain other financial market utilities that operate multilateral systems for the purpose of transferring, clearing or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person. This approach broadens the exception granted to QFCs with CCPs

executes, or otherwise becomes party to.[23] A covered FSI is required to bring an in-scope QFC entered into prior to the first compliance date into compliance with the Final Rule no later than the applicable date of the tiered compliance dates (discussed below in section II.E.h) if the covered FSI or an affiliate (that is also a covered entity, covered bank, or covered FSI) enters into a new covered QFC with the counterparty to the preexisting covered QFC or an affiliate of the counterparty on or after the first compliance date. Unlike the NPR, the Final Rule does not define an affiliate of a counterparty using a BHC Act control standard. Instead, in response to commenters' requests for clarity and ease of application of standards in determining whether or not an entity is an affiliate, the Final Rule defines an affiliate of a counterparty using an accounting consolidation standard.

c. Required Contractual Provisions Related U.S. Special Resolution Regimes

The Final Rule directly enhances the prospects of orderly resolution by requiring that covered QFCs with any non-U.S. counterparties (other than such counterparties whose principal place of business is in the U.S.) or QFCs not governed by Federal or state law include or incorporate provisions providing for the applicability of U.S. special resolution regimes to such QFCs. To achieve this, and consistent with the NPR, the Final Rule, requires, if such covered QFCs are not subject to the Universal or U.S. Protocol (as discussed in section II.E.e below), they must explicitly provide that (i) the transfer of the covered QFC in connection with the

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to QFCs with FMUs such as, for example, securities depositories. Although the issues that the Final Rule is intended to address with respect to non-cleared QFCs may also exist in the context of centrally cleared QFCs, clearing through a CCP provides unique benefits to the financial system while presenting unique issues related to the cancellation of cleared contracts. Accordingly, staff believes it is appropriate to exclude centrally cleared QFCs, in light of differences between cleared and non-cleared QFCs with respect to contractual arrangements, counterparty credit risk, default management, and supervision.

[23] See Final Rule § 382.2(c). For convenience, this memorandum generally refers to "a covered FSI's QFCs" or "QFCs to which a covered FSI is party" as shorthand to encompass this definition.

resolution of a covered FSI party or its affiliate under a U.S. special resolution regime will be effective to the same extent as permitted by the provisions of such regime and (ii) default rights with respect to the covered QFC may be exercised against the covered FSI to no greater extent than default rights can be exercised under a U.S. special resolution regime. Collectively, these provisions of the Final Rule require that non-excluded covered QFCs establish the parties' agreement to the application of the stay-and-transfer and limit on default rights provisions contained in Title II of the Dodd-Frank Act and the FDI Act. Financial regulators in other jurisdictions have taken similar actions to ensure the cross-border application of their own special resolution regimes.

In response to burden-related concerns raised by commenters, the Final Rule exempts from the contractual provision requirements related to the U.S. special resolution regimes a covered QFC that meets two requirements. First, the covered QFC must state that it is governed by the laws of the United States or a state of the United States. Second, the counterparty to the covered FSI on the QFC must be organized under the laws of the United States or a state or have its principal place of business located in the United States. Similarly, a counterparty that is an individual must be domiciled in the United States. It is expected that any issues relating to the stay-and-transfer provisions of contracts with these counterparties will be determined by U.S. courts, which will enforce U.S. law (including the requirements of the special resolution regimes) and, accordingly, there is no need for these contracts to include any special language recognizing the U.S. special resolution regimes. Accordingly, this exemption is expected to significantly reduce the burden associated with complying with the Final Rule while continuing to provide assurance that the stay-and-transfer provisions of the U.S. special resolution regimes will be enforced.

d. Prohibitions on the Exercise of Cross-default Rights

Like the NPR, the Final Rule prohibits a covered FSI from being party to a QFC that would permit the exercise of a default right that is related to the entry into resolution of an affiliate of the covered FSI. The Final Rule also generally prohibits a covered FSI from being party to a QFC that would prohibit the transfer of a credit enhancement applicable to the QFC (such as a guarantee) from an affiliate of a covered FSI to a transferee. These limits on default rights apply to default provisions triggered by an affiliate of a covered FSI's entry into resolution under the U.S. Bankruptcy Code or the FDI Act.[24]

Notwithstanding these general prohibitions, like the NPR, the Final Rule permits covered QFCs to include terms allowing a covered FSI's counterparty, in the case of a resolution under the U.S. Bankruptcy Code, to exercise default rights based on the covered FSI's own entry into resolution, the covered FSI's failure to make a required payment or delivery, or the failure of an affiliate covered FSI or a transferee to make a payment or delivery required under a credit enhancement that supports the covered QFC. Upon the expiration of the stay period required by the Final Rule, a covered QFC could allow the exercise of such default rights if the covered FSI's affiliate enters liquidation proceedings, if one or more of the counterparty's QFCs are not transferred or assumed, or if the affiliate's assets (if any) are not also transferred to the transferee.

Furthermore, notwithstanding the general prohibitions and exceptions referred to above, in the case of a resolution under the FDI Act, the Final Rule permits covered QFCs to include terms allowing a covered FSI's counterparty to exercise default rights based on the covered FSI's support provider becoming subject to FDI Act proceedings under the following circumstances:

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[24] See Final Rule § 382.4 (noting that the section relating to cross-default prohibitions does not apply to proceedings under Title II of the Dodd-Frank Act).

(i) after the FDI Act stay period, if the credit enhancement is not transferred pursuant to the FDI Act's stay-and-transfer provisions, or (ii) during the FDI Act stay period, if the default right consists of the suspension of performance by the counterparty, to the extent that party would be entitled to suspend performance if the covered QFC were with the credit support provider itself and were treated in the same manner as the credit enhancement.

The purpose of the Final Rule's prohibitions on the exercise of cross-default rights is to facilitate orderly resolution under either a single point of entry ("SPOE") strategy or a multiple point of entry ("MPOE") strategy. The Final Rule's prohibitions on cross-default rights are designed to assist an orderly resolution under these strategies by helping to prevent the failure of one entity within a GSIB group from leading to the disorderly unwind of its affiliates' covered QFCs and prohibiting restrictions on the transfer of related credit enhancements to an entity that is not in resolution.

e. Compliance through the Universal Protocol or U.S. Protocol

Unless the FDIC determines otherwise based on the specific facts and circumstances,[25] the Final Rule deems a covered QFC to comply with the requirements of the Final Rule if it is amended through adherence to, or by incorporation of the terms of, the Universal Protocol. The two primary operative provisions of the Universal Protocol are Section 1 and Section 2. Under Section 1, adhering parties essentially "opt in" to the U.S. special resolution regimes and certain other special resolution regimes. Under Section 2, adhering parties forego, subject to the creditor protections of Section 2, cross-default rights and transfer restrictions on affiliate credit enhancements. Staff views the Universal Protocol as generally consistent with the requirements of the Final Rule.

[25] The purpose of this exception is to mitigate the risk of evasion.

In response to comments and to further facilitate compliance with the Final Rule, the Final Rule also provides that, unless the FDIC determines otherwise based on specific facts and circumstances, covered QFCs amended through adherence to, or by incorporation of the terms of, the "U.S. Protocol" will be deemed to conform to the requirements of the Final Rule. In order for covered QFCs amended through adherence to the U.S. Protocol to be deemed to comply with the requirements of the Final Rule, the U.S. Protocol must be substantively identical to the Universal Protocol except for the differences specifically permitted by the Final Rule.

f. Procedure for FDIC Approval of Alternative Contractual Provisions

The Final Rule establishes a process whereby a covered FSI may request the FDIC approve as compliant with the Final Rule proposed contractual provisions of one or more forms of QFCs or proposed amendments to one or more forms of covered QFCs with creditor protections that are broader than, or different from, those permitted by the Final Rule. The FDIC may approve such a request if, in light of several enumerated considerations,[26] the terms of the QFC, as compared to a covered QFC containing only the limited exceptions permitted by the Final Rule, would promote the safety and soundness of covered FSIs by mitigating the potential destabilizing effects of the resolution of a GSIB that is an affiliate of the covered FSI to at least the same extent. Staff contemplates that the FDIC would consult with the FRB and OCC during its consideration of such a request. This approval process will give the FDIC the flexibility to approve different contractual arrangements without the need for a new rulemaking.

g. Rights of the FDIC as Receiver Unaffected

Like the definitions in the FRB Final Rule and the OCC Final Rule, the Final Rule's definition of default rights is consistent with the Universal Protocol definition. However, the

[26] *See* Final Rule § 382.5(c).

definition of default rights under the Final Rule does not cover certain default rights and other actions that may be asserted or taken by a counterparty that may be unenforceable under the FDI Act or Title II of the Dodd-Frank Act. In addition, certain of the stay-and-transfer provisions that counterparties of covered FSIs will be required to contractually agree to pursuant to the Final Rule are less expansive in certain respects than those set forth in the FDI Act or Title II. In order to avoid any possible misunderstanding on this matter, the Final Rule states that it does not modify or limit, in any manner, the rights and powers of the FDIC as receiver under the FDI Act or Title II of the Dodd-Frank Act, including, without limitation, the rights of the receiver to enforce provisions of the FDI Act or Title II of the Dodd-Frank Act that limit the enforceability of certain contractual provisions.

h. Transition Period

The effective date for the Final Rule will be January 1, 2018. Although the effective date of the Agencies' final rules vary, each Agency's final rules are expected to have substantially identical phase-in compliance schedules.

In order to reduce the compliance burden of the Final Rule, the Final Rule adopts a phased-in compliance schedule as requested by commenters. The Final Rule provides a covered FSI must conform a covered QFC with a covered entity, covered FSI, or covered bank to the requirements of the Final Rule by January 1, 2019 (referred to in this discussion as the "first compliance date"). This provision allows the counterparties that should be the most familiar with the requirements of the Final Rule one year to conform with the Final Rule's requirements. Many GSIBs, including all U.S. GSIBs, with covered QFCs have already adhered to the Universal Protocol and, accordingly, it is expected that there is a limited set of additional QFCs that would need to be amended before January 1, 2019.

As compared with the NPR, the Final Rule provides additional time for compliance with the requirements for other types of counterparties. In particular, for other types of financial counterparties (other than small financial institutions) the Final Rule provides 18 months from the effective date of the Final Rule for compliance with its requirements as requested by commenters. For small financial institutions and other non-financial counterparties, including sovereign entities and central banks, the Final Rule provides two years from the effective date of the Final Rule for compliance with its requirements as requested by commenters. Adopting a phased-in compliance approach based on the size and status of the counterparty will allow market participants time to adjust to the new requirements and make required changes to QFCs in an orderly manner. It will also give time for development of the U.S. Protocol or any other protocol that would meet the requirements of the Final Rule.

Although commenters requested that QFCs with central bank and sovereign counterparties be excluded from the Final Rule, staff (along with the staff of other Agencies) continues to believe that covering QFCs with sovereigns and central banks under the Final Rule is an important requirement. Excluding QFCs with sovereigns and central banks would be inconsistent with the FDI Act and Title II of the Dodd-Frank Act. Moreover, the mass termination of such QFCs has the potential to undermine the resolution of a GSIB and its affiliates. The Final Rule provides covered FSIs two years from the effective date to conform covered QFCs with central banks and sovereigns. This additional time should provide covered FSIs sufficient time to modify covered QFCs with sovereigns and central banks.

F. Expected Effects

Staff has considered the effects of the Final Rule on the covered FSIs. The Final Rule is intended to promote the financial stability of the United States by reducing the potential that resolution of a GSIB or its subsidiaries, including through bankruptcy, will be disorderly. The

Final Rule will help meet this policy objective by enabling the more effective and efficient management of the exercise of cross-default rights and restrictions contained in certain QFCs. It will therefore help mitigate the risk of future financial crises and imposition of substantial costs on the U.S. economy.[27] The Final Rule furthers the FDIC's mission and responsibilities, which include resolving failed institutions in the least costly manner and ensuring that FDIC-insured institutions operate safely and soundly. The Final Rule only applies to FDIC-supervised institutions that are subsidiaries or affiliates of a GSIB, and subsidiaries of such supervised institutions. Of the 3,717 institutions that the FDIC supervises,[28] eleven are subsidiaries or affiliates of GSIBs.[29] Out of those eleven institutions, eight had QFC contracts at some point over the past five years. Those eight institutions had an average of $39 billion of QFC contracts, as measured by notional amount, over the same time period compared to an average of over $200 trillion in notional value for all FDIC-insured GSIB affiliates.[30] Therefore, this Final Rule applies only to a small number of institutions and to a small portion of total QFC activity.

In developing the Final Rule, staff considered information regarding burden and effects of the proposed rules provided by commenters. The Final Rule contains a number of changes to respond to commenter concerns. Staff believes the changes incorporated into the Final Rule address many of the concerns raised by commenters regarding the burden of the Final Rule and serve to mitigate the administrative and compliance costs of the Final Rule.

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[27] A recent estimate of the unrealized economic output that resulted from 2007–09 financial crisis in the United States amounted to between $6 and $14 trillion. *See* "How Bad Was It? The Costs and Consequences of the 2007–09 Financial Crisis," Staff Paper No. 20, Federal Reserve Bank of Dallas, July 2013. https://dallasfed.org/assets/documents/research/staff/staff1301.pdf.

[28] Consolidated Reports of Condition and Income, June 2017.

[29] FFIEC National Information Center.

[30] Consolidated Reports of Condition and Income, June 2012 – June 2017.

G. Technical Amendments to Certain Definitions in FDIC Capital and Liquidity Rules

The Final Rule makes technical amendments to the definitions of the following terms in the FDIC's capital and liquidity rules: qualified master netting agreement, collateral agreement, eligible margin loan, and repo-style transaction. These amendments are intended to ensure that the regulatory capital and liquidity treatment of covered QFCs to which a covered FSI is party would not be affected by the Final Rule's restrictions on such QFCs. The Final Rule's amendments of these definitions are consistent with those in the FRB Final Rule and those that are expected to be in the OCC Final Rule.

The FDIC's regulatory capital rules permit a banking organization to measure exposure from certain types of financial contracts on a net basis and recognize the risk-mitigating effect of financial collateral for other types of exposures, provided the contracts are subject to a "qualifying master netting agreement" or agreement that provides certain rights upon the default of a counterparty. The FDIC has previously defined "qualifying master netting agreement" to mean a netting agreement that permits a banking organization to terminate, apply close-out netting, and promptly liquidate or set-off collateral upon an event of default of the counterparty, thereby reducing its counterparty exposure and market risks. When a firm measures the amount of exposure of these contracts on a net basis, rather than on a gross basis, it results in a lower measure of exposure and thus a lower capital requirement.

The FDIC's current definitions of qualifying master netting agreement, collateral agreement, eligible margin loan, and repo-style transaction do not recognize all of the changes that the Final Rule requires covered FSIs to make in their covered QFCs. Accordingly, the Final Rule amends the current definition of qualifying master netting agreement, collateral agreement, eligible margin loan, and repo-style transaction so that each will qualify if amended as necessary to comply with the requirements of the Final Rule. This revision maintains the existing treatment for these contracts under the FDIC's capital and liquidity rules by accounting for the restrictions that the Final Rule requires on default rights related to covered FSIs' QFCs.

Certain commenters requested technical modifications to the proposed modifications to the definitions to better distinguish the requirements related to special resolution regimes from the requirements related to cross-defaults arising from insolvency proceedings. In response to this comment, the Final Rule includes clarifying edits.

III. CONCLUSION:

Staff recommends that the Board:

A. Approve the attached Final Rule as set forth in the attached *Federal Register* document and authorize its publication in the *Federal Register* with an effective date of January 1, 2018.

B. Authorize the General Counsel, or his designee, and the Executive Secretary, or designee, to make technical, non-substantive or conforming changes to the draft *Federal Register* documents to prepare them for publication or to ensure consistency with the other agencies' substantially similar final rules.

CONCUR:

[redacted]
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9/20/17
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