Client Alert

June 30, 2016

The Federal Reserve's Proposed Rules for Financial Contracts of Global Systemically Important Banking Organizations and ISDA's Resolution Stay Jurisdictional Modular Protocol

Last month the Board of Governors of the Federal Reserve System (the "Board") issued proposed new rules (the "Proposed Rules") intended to reduce the potential risks posed to the U.S. financial system by too-big-to-fail banks.[1] The Proposed Rules would, among other things, require certain systemically important banks to include in their contracts provisions that would significantly limit their counterparties' default rights in over-the-counter swaps, repurchase and reverse repurchase agreements, securities lending and borrowing transactions, commodity contracts, and forward agreements. The Proposed Rules, available here, are open to public comment until August 5, 2016.

Contemporaneously with the Board's release of the Proposed Rules, the International Swaps and Derivatives Association, Inc. ("ISDA") released its ISDA Resolution Stay Jurisdictional Modular Protocol (the "JM Protocol"), intended to permit market participants to comply with the Proposed Rules (when adopted in their final form) and similar rules of foreign jurisdictions.

In this Client Alert, we examine the Proposed Rules and related ISDA protocols.

Goals of the Proposed Rules

The Proposed Rules have two primary goals, both aimed at facilitating the orderly liquidations of systemically important financial institutions, including under the orderly liquidation process created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2]

The first goal is to assure the cross-border application of U.S. special resolution regimes to certain transactions between a counterparty outside of the U.S. and a U.S. global systemically important bank ("GSIB") or certain U.S. subsidiaries, branches or agencies of U.S. or non-U.S. GSIBs. While it is clear that existing U.S. special resolution regimes provide the U.S. regulatory agencies with the powers to prevent counterparties from exercising contractual termination rights in certain circumstances, it is not entirely clear what might happen if a court outside of the U.S. were to disregard such powers. The Board intends that the Proposed Rules, if adopted, will require parties to add to their contracts provisions to make clear that the U.S. special resolution regimes will apply to cross-border transactions and will thus bind authorities and parties outside of the U.S.

The Board's second goal is to facilitate the resolution of a GSIB under a "single point of entry" strategy, in which only the top-tier holding company would enter into a resolution proceeding while its subsidiaries would continue

[1] Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 29,169 (May 11, 2016).
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 701–74, 124 Stat. 1376, 1641–802 (2010) (codified as amended in scattered sections of titles 7, 12 and 15 U.S.C. (2012)).

to operate and meet their financial obligations. The Board takes that view that, to facilitate such a resolution, it must ensure that operating subsidiaries of a GSIB are not parties to contracts containing cross-default rights that their counterparties could exercise based on the entry into resolution of an affiliate of such operating subsidiaries.

The common thread of these two goals is that, if and when the Proposed Rules are adopted and go into effect, they will likely require parties in many transactions facing certain GSIBs (and certain of their subsidiaries, branches and agencies) expressly to relinquish certain of their contractual rights.

Background: The U.S. Special Resolution Regimes

There are two special resolution regimes the cross-border application of which the Proposed Rules seek to assure. The first is Title II of the Dodd-Frank Act (titled "Orderly Liquidation Authority" and known in short as "OLA"), the enactment of which enhanced the federal government's receivership authorities by expanding them to large, interconnected financial companies. OLA provides the Federal Deposit Insurance Corporation ("FDIC") with the authority to serve as receiver for large financial companies whose failure would pose a significant risk to the financial stability of the United States. In addition, even prior to the Dodd-Frank Act, under the Federal Deposit Insurance Act ("FDI Act"),[3] the FDIC had receivership authority with respect to federally insured banks and thrift institutions. The Proposed Rules designate both the FDI Act and the OLA provisions (and related regulations) as "U.S. special resolution regimes."[4]

Both of the U.S. special resolution regimes in certain circumstances limit the contractual rights of counterparties facing certain bank entities. Under the OLA, after a determination is made that a financial company should be placed in receivership, the FDIC takes over as receiver, and the bank's counterparties are prohibited, or "stayed," from terminating certain contracts until 5 p.m. of the business day after the receivership is commenced.[5] Similarly, under the FDI Act, after a resolution is initiated and the FDIC becomes a bank's receiver, the bank's counterparties are prohibited from terminating certain contracts until 5 p.m. of the business day following the day on which the receiver was appointed.[6] Under both its OLA authority and the FDI Act, the FDIC has the right, among other things, to transfer certain contracts to a bridge financial company, which, as contemplated by the special resolution regimes, will be capable of performing under the transferred contracts. After such a transfer, the counterparty no longer has the right to terminate based on events that occurred prior to the transfer.

These provisions of the U.S. special resolution regimes are in accordance with recommendations of the Financial Stability Board ("FSB"). After the financial crisis of 2007-09, the FSB recommended that countries put in place special resolution regimes to address failing financial institutions, especially those whose collapse could have systemic consequences.[7] Thereafter, the Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision recommended that such resolution regimes include powers to continue needed contracts, terminate unnecessary contracts, and sell assets and transfer liabilities.[8] Many countries that are members of the G20 group of nations have adopted or are in the process of adopting similar resolution regimes.

Provisions of the Proposed Rules

Entities and Contracts Subject to the Proposed Rules

The Proposed Rules apply to "covered QFCs," that is, contracts that constitute "qualified financial contracts" to which a "covered entity" is a party.

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[3] 12 U.S.C. 1811 et seq.
[4] Proposed Rules at § 252.81, 81 Fed. Reg. at 29,190.
[5] Dodd-Frank Act at § 210(c)(10)(B).
[6] FDI Act at § 11(e)(10)(B).
[7] *See generally*, Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 15, 2014.
[8] Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March, 2010, at 23.

For these purposes, "covered entities" include:

- any U.S. bank holding company that is identified as a global systemically important bank holding company under the Board's rule establishing risk-based capital surcharges for GSIBs;
- any subsidiary of a U.S. GSIB described in the preceding bullet point that is not a national bank, federal savings association, federal branch or federal agency; and
- a U.S. subsidiary, U.S. branch, or U.S. agency of a non-U.S. GSIB (other than entities subject to regulation by the Office of Comptroller of the Currency (the "OCC"),[9] such as national banks, federal savings associations, federal branches or federal agencies).[10]

The Proposed Rules define the term "qualified financial contracts" in accordance with section 210(c)(8)(D) of the Dodd-Frank Act.[11] Accordingly, QFCs include many swaps, repurchase (and reverse repurchase) transactions, forward contracts, commodity contracts and securities sale, lending and borrowing transactions. The "QFC" definition also includes any master agreement that governs QFCs between parties.

The Proposed Rules expressly exclude centrally cleared QFCs from their scope.[12] Although cleared QFCs may pose some of the risks that the Proposed Rules were intended to address, the Board appears to justify the exclusion of cleared QFCs based on its view that the clearing of transactions provides unique benefits to the financial system.[13] The Board has asked for comments regarding the appropriate treatment of cleared QFCs.

Also excluded from the Proposed Rules are certain QFCs entered into under multi-branch master agreements of foreign GSIBs. The definition of QFC generally includes a master agreement that governs QFCs. Many such master agreements permit the parties to trade from multiple branches or offices. For non-U.S. GSIBs, the definition of QFC contained in the Proposed Rules, however, effectively excludes transactions that are not booked at, and for which no payment or delivery may be made at, a U.S. branch or U.S. agency of the non-U.S. GSIB.[14] The Board has invited comment on this point as well.[15]

Provisions Required to be Added to QFCs

The Proposed Rules would require covered entities to add two distinct provisions to their QFCs. One such provision would limit the exercise of default rights under Covered QFCs, and the other would permit transfers of QFCs to bridge entities as contemplated by the special resolution regimes.

Limitations on Default Rights under Covered QFCs

To clarify the cross-border application of the U.S. special resolution regimes, the Proposed Rules would require each covered QFC to expressly provide that "default rights" under such covered QFC "that may be exercised against the covered entity are permitted to be exercised to no greater extent than the default rights could be exercised under the U.S. special resolution regimes," assuming U.S. law applied and the covered entity were under a U.S. special resolution regime.[16] Such a provision, if and when inserted into covered QFCs, will make clear that the covered entity's counterparty, regardless of its jurisdiction, will have no right to terminate a covered QFC to the extent it would not have such right under the applicable U.S. special resolution regime.

[9] The OCC is expected soon to issue proposed rules similar to the Proposed Rules that will cover such entities that it supervises, including national banks and federal savings associations. *See* 81 Fed. Reg. at 29,169.
[10] Proposed Rules at § 252.82(a), 81 Fed. Reg. at 29,190.
[11] *Id.* at § 252.81, 81 Fed. Reg. at 29,190.
[12] *Id.* at § 252.88, 81 Fed. Reg. at 29,193.
[13] , 81 Fed. Reg. at 29,176.
[14] Proposed Rules at § 252.86, 81 Fed. Reg. at 29,192-93.
[15] *See generally* 81 Fed. Reg. at 29,176-77.
[16] Proposed Rules at § 252.83(b)(2), 81 Fed. Reg. at 29,190.

The Proposed Rules define broadly the "default rights" to which this mandatory provision applies. "Default rights" include, among other things, a right of a party, whether contractual or otherwise, to liquidate, terminate, cancel, rescind, or accelerate an agreement or transactions thereunder; set off or net amounts owing; exercise remedies in respect of collateral or other credit support or related property; demand payment or delivery, suspend, delay, or defer payment or performance; or modify the obligations of a party. The "default right" definition does not generally prevent, however, the exercise of rights to (i) net same-day payments, (ii) demand delivery of collateral based on a change in the value of relevant transactions or (iii) terminate a contract based on a provision that allows termination at a party's option without the need to show cause.[17]

Transfers of Covered QFCs

The Proposed Rules would also require each covered QFC to support the U.S. special resolution regimes by permitting transfers of such QFCs to bridge entities as contemplated by the special resolution regimes. Specifically, the Proposed Rules would require covered QFCs expressly to provide that the transfer of the covered QFC (and any interest in, or property securing, the covered QFC) from the covered entity will be effective to the same extent as the transfer would be effective under the U.S. special resolution regimes, assuming U.S. law applied and the covered entity were under a U.S. special resolution regime.[18]

Support for "Single Point of Entry" Resolutions

The Proposed Rules also contain provisions intended to support "single point of entry" resolutions of banking organizations, in which only a single legal entity, the GSIB's top-tier bank holding company, is to enter into a resolution proceeding. The Board contemplates that a GSIB may enter into QFCs through operating subsidiaries, and, to the extent that such QFCs cause losses, those losses will be passed up from the operating subsidiaries where they were incurred to the holding company, where, by means of the resolution process, the losses will be imposed on the holding company's equity holders and unsecured creditors. The "single point of entry" strategy is intended to ensure that the operating subsidiaries will remain adequately capitalized and able to meet their financial obligations without defaulting or entering resolution.[19] To facilitate this resolution strategy, in which operating subsidiaries are expected to remain continuously in operation and out of resolution, the Board believes that it must prevent counterparties facing operating subsidiaries of GSIBs from exercising default rights based on the entry into resolution or insolvency proceedings of the operating subsidiaries' affiliates.

Accordingly, the Proposed Rules, if finalized in their proposed form, would provide that a covered QFC may not permit the exercise of any default right with respect to the covered QFC that is related, directly or indirectly, to an affiliate of a covered entity becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding. However, a covered QFC could permit the exercise of default rights based on (i) a covered entity itself becoming subject to receivership, insolvency, liquidation, resolution, or similar proceeding, other than under a special resolution regime, or (ii) a party to a QFC, or an affiliated credit support provider, failing to meet a payment or delivery obligation under the covered QFC.[20]

The Proposed Rules would also generally provide that no covered QFC may prohibit the transfer of a credit enhancement supporting such QFC provided by an affiliate of the covered entity upon an affiliate of the covered entity becoming subject to a receivership, insolvency, liquidation, resolution or similar proceeding.[21]

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[17] *Id.* at § 252.81, 81 Fed. Reg. at 29,190.
[18] *Id.* at § 252.83(b)(1), 81 Fed. Reg. at 29,190.
[19] 81 Fed. Reg. at 29,172.
[20] Proposed Rules at § 252.84(b)(1) and (e), 81 Fed. Reg. at 29,191. In addition, under the Proposed Rules, a covered QFC would be required to provide that, after an affiliate of the covered party has become subject to a receivership, insolvency, liquidation, resolution, or similar proceeding, a party seeking to exercise a default right must prove by clear and convincing evidence or a similar standard that the exercise is permitted under the covered QFC. Proposed Rules at § 252.84(j), 81 Fed. Reg. at 29,192.
[21] Proposed Rules at § 252.84(b)(2), 81 Fed. Reg. at 29,191. The Proposed Rules would also amend certain definitions contained in the Board's capital and liquidity rules to help ensure that the regulatory capital and liquidity treatment of QFCs to which a covered entity is party is not affected by the proposed restrictions on such QFCs. Specifically, the Proposed Rules would amend the definition of the term "qualifying master netting agreement" contained in the Board's regulatory capital and liquidity rules and would similarly amend the definitions of the terms "collateral agreement," "eligible margin loan," and

Proposed Effective Date

Covered entities would be required to comply with the Proposed Rules by the first day of the first calendar quarter that begins at least one year after the issuance of the final rule (such day, the "Effective Date"). If a covered entity were to enter into a new QFC after the Effective Date, such QFC would be required to comply. With respect to pre-existing QFCs, entered into prior to the Effective Date, a covered entity would be required to bring such QFCs into compliance no later than the first date on or after the Effective Date on which the covered entity or certain of its affiliates were to enter into a new covered QFC with the same counterparty to the preexisting QFC or an affiliate of the counterparty.[22]

ISDA's Resolution Stay Protocols

Contemporaneously with the Board's release of the Proposed Rules, ISDA released its JM Protocol,[23] intended to permit market participants to comply with the provisions of the Proposed Rules (when adopted in their final form) and similar rules of foreign jurisdictions. Like other ISDA protocols, the JM Protocol is a mechanism to allow parties to amend numerous agreements in one stroke. By adhering to the protocol, parties agree that their contracts with other adhering parties are amended in accordance with the terms of the relevant protocol. The heart of the JM Protocol consists of the country-specific modules, a large majority of which ISDA has not yet published. Nonetheless, it is not too soon for market participants to begin to consider the JM Protocol.

The JM Protocol is the third ISDA protocol to address compliance with the requirements of special resolution regimes. Prior to publishing the JM Protocol, ISDA published the ISDA 2015 Universal Stay Protocol (the "Universal Stay Protocol") and the ISDA 2014 Resolution Stay Protocol (the "Resolution Stay Protocol"). The Universal Stay Protocol covers a broader range of transactions than does the Resolution Stay Protocol but is otherwise quite similar to the Resolution Stay Protocol. Under the terms of both the Universal Stay Protocol and the Resolution Stay Protocol, adhering parties, among other things, opt in to numerous special resolution regimes of the U.S. and other countries. Within certain limitations, those protocols provide that if one adhering party is subject to a special resolution regime (regardless of the jurisdiction of that special resolution regime), then the other adhering party may exercise default rights under a "covered agreement" or related credit support arrangement only to the extent it would be able to do so under such special resolution regime.

Primarily it has been the largest, systemically important banks and their affiliates that, with the encouragement of their regulators, have adhered to the Universal Stay Protocol and the Resolution Stay Protocol. Other market participants have generally not adhered to those protocols. In particular, asset managers have been concerned about the possibility of breaching their fiduciary duties if they were to expressly relinquish default rights under numerous jurisdictions in the absence of any legal requirement to do so.

The JM Protocol differs from the Universal Stay Protocol and the Resolution Stay Protocol in that, by means of the JM Protocol's country-specific modules, parties will be able to specify exactly which special resolution regime modules they will opt in to. Thus, although the Proposed Rules specifically identify the Universal Stay Protocol as a permitted means for covered parties to amend their QFCs to comply with certain provisions of the Proposed Rules,[24] most market participants will likely prefer to adhere to the JM Protocol in order to comply.

The JM Protocol consists of a main agreement and separate jurisdictional modules, each of which relates to only one jurisdiction. So far, the only jurisdictional modules that ISDA has published are the modules for Germany and the UK. Presumably the U.S. jurisdictional module will not be published until after the Board finalizes the Proposed Rules.

"repo-style transaction" contained in the Board's regulatory capital rules. *See* 81 Fed. Reg. at 29,185. For more information regarding these definitions, please see our client alert here.

[22] *See* 81 Fed. Reg. at 29,184.

[23] JM Protocol documents are available here.

[24] *See* 81 Fed. Reg. at 29,181; Proposed Rules at § 252.85(a), 81 Fed. Reg. at 29,192.

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Conclusion

While it may be difficult to like regulations that, if adopted, will require parties expressly to give up their hard won contractual rights, the Proposed Rules do seem well tailored to the Board's aims of first, assuring the cross-border application of U.S. special resolution regimes and second, facilitating the resolution of GSIBs under a "single point of entry" strategy. If the Proposed Rules are adopted in their proposed form, the exercise of default rights in relation to QFCs will be subject to limitations contained in the U.S. special resolution regimes, and parties facing GSIBs and certain of their subsidiaries in covered QFCs will have fewer cross-default rights and thus fewer opportunities to cause multiple GSIB-related entities to enter insolvency or resolution proceedings.

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