Client Alert

September 29, 2017

Federal Reserve Board Issues Final Rules Imposing Restrictions on Qualified Financial Contracts of Global Systemically Important Banking Organizations

On September 12, 2017, the Board of Governors of the Federal Reserve System (the "Board") published in the Federal Register final rules (the "Final Rules") intended to reduce the potential risks posed to the U.S. financial system by banks deemed too big to fail.[1] The Final Rules will impose restrictions on certain non-cleared financial contracts entered into by U.S. global systemically important banking organizations ("GSIBs") and their subsidiaries, as well as the U.S. operations of foreign GSIBs (other than subsidiaries or operations subject to regulation by another banking regulator) (collectively, "covered entities"). These restrictions will significantly limit counterparty default rights in over-the-counter derivatives, repurchase and reverse repurchase agreements, securities lending and borrowing transactions, commodity contracts and forward agreements (such transactions and agreements, "qualified financial contracts" or "QFCs"). The Final Rules are largely similar to the rules proposed by the Board in May 2016 (the "Proposed Rules"),[2] but with a few significant differences, discussed below, primarily intended to alleviate their burden. The Final Rules are scheduled to become effective on November 13, 2017 and are available here.

Goals of the Final Rules

The Proposed Rules had two primary goals, both aimed at facilitating the orderly liquidation of systemically important financial institutions, including under the orderly liquidation process created under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] The Final Rules seek to effectuate these same goals.

The first goal is to assure the application of U.S. special resolution regimes to certain cross-border transactions between covered entities and their counterparties outside of the U.S. While 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 Final Rules will require covered entities to add to their

[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, 82 Fed. Reg. 42,882 (Sept. 12, 2017). The Federal Deposit Insurance Corporation ("FDIC") also recently approved final rules, not yet published in the Federal Register, that are substantively identical to the Board's Final Rules for entities such as state savings associations and state-chartered banks that are subject to regulation by the FDIC. See Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions (Sept. 27, 2017), available here. In addition, last year the Office of the Comptroller of the Currency ("OCC") proposed similar rules for entities subject to the OCC's supervision, and the OCC is also expected to finalize those rules in a form similar to the Final Rules. See Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 81 Fed. Reg. 55,381 (Aug. 19, 2016).

[2] 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).

[3] 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)).

QFCs provisions that will 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, whether 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 to operate and meet their financial obligations, or a "multiple point of entry" strategy in which multiple entities affiliated with a GSIB might enter separate resolution proceedings in different regions. The Board takes the view that, to facilitate such resolutions, 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.

To achieve these goals, the Final Rules will require parties facing covered entities in QFCs expressly to relinquish certain of their contractual rights. However, as detailed below, the Final Rules are in certain respects less burdensome than the Proposed Rules would have been. Among other things, the Final Rules clarify that certain QFCs are not in scope for the Final Rules, and they provide for a phased-in implementation schedule, with compliance for QFCs with non-financial counterparties or small financial institutions not required until January 1, 2020.

Background: The U.S. Special Resolution Regimes

The Final Rules designate two special "U.S. special resolution regimes," whose cross-border application the Final 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 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. The second is the Federal Deposit Insurance Act ("FDI Act")[4] which, even prior to the Dodd-Frank Act, gave the FDIC receivership authority with respect to federally insured banks and thrift institutions.

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.[7]

Provisions of the Final Rules

Entities and Contracts Subject to the Proposed Rules

The Final 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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[4] 12 U.S.C. 1811 et seq.
[5] Dodd-Frank Act at §210(c)(10)(B).
[6] FDI Act at §11(e)(10)(B).
[7] These provisions of the U.S. special resolution regimes are generally 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. See generally Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 15, 2014. Many countries that are members of the G20 group of nations have adopted or are in the process of adopting similar resolution regimes.

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, among other things, an entity subject to regulation by the OCC, such as a national bank, a federal savings association, a federal branch or federal agency, or an entity subject to regulation by the FDIC, such as a state savings association or a state nonmember bank; and
- a U.S. subsidiary, U.S. branch, or U.S. agency of a non-U.S. GSIB (other than, among other things, entities subject to regulation by the OCC or the FDIC).[8]

The Final Rules define the term "qualified financial contracts" in accordance with section 210(c)(8)(D) of the Dodd-Frank Act. 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 generally includes any master agreement that governs QFCs between relevant parties.

QFCs entered into before January 1, 2019 are subject to the requirements of the Final Rules if the covered entity (or certain types of affiliates of the covered entity) enters into a QFC with the same person or with a "consolidated affiliate" of the same person on or after January 1, 2019. "Consolidated affiliate" for these purposes is defined with reference to consolidation of financial statements.[9]

QFCs Excluded From the Final Rules

Similar to the Proposed Rules, the Final Rules expressly exclude from their scope centrally cleared QFCs (that is, transactions to which a central counterparty is a party). In addition, unlike the Proposed Rules, the Final Rules also exclude:

- QFCs that do not expressly provide one or more default rights that may be exercised against a covered entity or restrict the transfer of the QFC from a covered entity;[10]
- with respect to non-U.S. GSIBS, certain transactions booked in such entities' non-U.S. offices;[11]
- certain warrants, and certain investment advisory contracts with retail customers; and
- contracts to which each party is a financial market utility.

The Final Rules further provide that by order the Board may, after consideration, exempt one or more covered entities from the requirements of the Final Rules.[12]

Provisions Required to be Added to QFCs[13]

The Final Rules will require covered entities to add two distinct provisions to their QFCs. One such provision will limit the exercise of default rights under covered QFCs, and the other would facilitate 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 Final Rules will require each covered QFC to expressly provide that, if the covered entity or an affiliate of the covered entity becomes subject to

[8] Final Rules at § 252.82(b), 82 Fed. Reg. at 42,922.
[9] Id. at § 252.81, 82 Fed. Reg. at 42,920.
[10] Id. at § 252.82(c), (d), 82 Fed. Reg. at 42,922.
[11] Id. at § 252.86, 82 Fed. Reg. at 42,925.
[12] Id. at § 252.88, 82 Fed. Reg. at 42,926.
[13] In the Final Rules the Board noted that, while the matter was beyond the scope of the rulemaking, the Board did not expect that the amendments necessary to conform non-cleared swaps to the requirements of the Final Rules would constitute amendments that would make regulatory margin requirements applicable to such swaps. See Final Rules, 82 Fed. Reg. at 42,908.

a proceeding under a U.S. special resolution regime, "default rights" under the 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 regime if the covered QFC were governed by the laws of the United States or a state of the United States."[14] Such provision 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.

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, including, among other things, altering the amount of required collateral or margin. 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.[15]

Transfers of Covered QFCs

The Final Rules 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 such resolution regimes. Specifically, the Final Rules require covered QFCs expressly to provide that, if the covered entity becomes subject to a proceeding under a U.S. special resolution regime, the transfer of the covered QFC (and any interest and obligation 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 regime if the covered QFC were governed by U.S. law.[16]

The Final Rules 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.[17]

Support for "Single Point of Entry" and "Multiple Point of Entry" Resolutions

The Proposed Rules also contain provisions limiting the exercise of cross-default rights against a covered entity. The Board intends those provisions to support both "single point of entry" and "multiple point of entry" resolutions of banking organizations

In a "single point of entry" resolution, only a single legal entity, the GSIB's top-tier bank holding company, will 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 that incurred them 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.[18] In contrast, in a "multiple point of entry" resolution, more than one entity or part of banking group may be subject to resolution, potentially under different resolution regimes. Such a resolution could involve, for example, a foreign GSIB's U.S. intermediate holding

[14] Final Rules at § 252.83(b)(2), 82 Fed. Reg. at 42,923.
[15] Id. at § 252.81, 82 Fed. Reg. at 42,920. In addition, the Final Rules provide that a covered QFC must require, after an affiliate of a party to the QFC has become subject to a receivership, resolution or similar proceeding, that the party seeking to exercise a default right bears the burden of proof that the exercise is permitted under the covered QFC, and the QFC must contain at least a "clear and convincing evidence" or similar burden of proof in order to exercise such a default right. Final Rules at § 252.84(i), 82 Fed. Reg. at 42,924.
[16] Final Rules at § 252.83(b)(1), 82 Fed. Reg. at 42,923.
[17] Id. at § 252.84(b)(2), 82 Fed. Reg. at 42,923.
[18] Final Rules, 82 Fed. Reg. at 42,885.

company going into resolution or a resolution plan that calls for a GSIB's U.S. insured depository institution to enter resolution.[19]

To facilitate these resolution strategies, in which operating affiliates 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.[20] Accordingly, the Final Rules 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 the covered entity that is a party to the WFC becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding.[21]

However, a covered QFC may 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.[22]

Compliance Schedule

The Final Rules contain a phased-in compliance schedule, under which a covered entity must conform its QFCs to the requirements of the Final Rules no later than:

- January 1, 2019, if the covered entity's counterparty is either another covered entity or a similar entity likely to be subject to rules similar to the Final Rules promulgated by another U.S. regulatory agency;
- July 1, 2019, if the covered entity's counterparty is not an entity described in the preceding bullet point but is a "financial counterparty," a term broadly defined to include, among other things, certain bank holding companies and their affiliates, savings and loan holding companies, depository institutions, entities that are state-licensed as credit or lending entities or money services businesses, swap dealers, brokers, dealers, investment advisers, commodity pools and employee benefit plans; and
- January 1, 2020, if the covered entity's counterparty is a non-financial counterparty or a small financial institution, a term defined to include certain banks and similar entities with total assets of $10 billion or less.[23]

Importance of ISDA Protocols

The Final Rules contemplate that covered entities may conform their QFCs to the Final Rules' requirements by means of protocols published (or to be published) by the International Swaps and Derivatives Association, Inc. ("ISDA"). Specifically, the Final Rules provide that, unless the Board determines otherwise based on specific facts and circumstances, a covered QFC will comply with the requirements of the Final Rules if it is amended by the ISDA 2015 Universal Resolution Stay Protocol. Under the terms of that protocol, adhering parties, among other things, opt in to numerous special resolution regimes of the U.S. and other countries. In addition, the Final Rules permit compliance by means of what they call the "U.S. protocol," a protocol not yet created by ISDA, which must conform to requirements set out in the Final Rules.[24]

[19] Id. at 42,886.
[20] See id. at 42,885.
[21] Final Rules at § 252.84(b)(1), 82 Fed. Reg. at 42,923.
[22] Id. at § 252.84(d), 82 Fed. Reg. at 42,923-24.
[23] Id. at § 252.82(f), 82 Fed. Reg. at 42,922-23.
[24] Id. at § 252.85, 82 Fed. Reg. at 42,924-25.

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