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Proposed U.S. Federal Reserve Board Rule's Impact on Buy-Side Remedies in QFCs with Global Systemically Important Banking Organizations and their Affiliates

A legal update from Dechert's Financial Services Group

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Proposed U.S. Federal Reserve Board Rule's Impact on Buy-Side Remedies in QFCs with Global Systemically Important Banking Organizations and their Affiliates

The Board of Governors of the U.S. Federal Reserve System (Board) recently proposed a rule (Proposed Rule) that will impact parties to any "qualified financial contract" (QFC), as described below, with a global systemically important banking organization (GSIB) or a GSIB affiliate (together, a covered entity). The Proposed Rule will eliminate certain contractual rights with respect to the QFC when:

- the covered entity counterparty is placed in a Federal Deposit Insurance Corporation (FDIC) receivership; or
- an affiliate of the covered entity counterparty is placed in a receivership, insolvency, liquidation, resolution or similar proceeding.[1]

The contractual rights impacted under the Proposed Rule are standard contractual provisions that permit a party facing an insolvent covered entity counterparty, or benefiting from credit support provided by an insolvent affiliate of the covered entity counterparty, to *immediately*: (i) terminate the transaction; (ii) set off and net payment obligations owed between the parties; and (iii) liquidate the counterparty's collateral.

If the Proposed Rule is adopted, such buy-side QFC parties – including many registered investment companies (registered funds) as well as hedge funds and other private funds (together with registered funds, funds) – will be required by their counterparties to amend existing and new QFCs to reflect the requirements of the Proposed Rule. Accordingly, these buy-side QFC parties will need to consider how they will be impacted from a credit risk and regulatory compliance perspective if the Proposed Rule is adopted.

This *OnPoint* describes the scope of the Proposed Rule, provides an overview of the applicable bankruptcy and receivership regimes and the impact of the proposed changes on buy-side parties, summarizes the key components of the Proposed Rule, and discusses certain issues under the Proposed Rule that buy-side QFC parties may wish to consider.

Comments on the Proposed Rule must be submitted by August 5, 2016.

Scope of the Proposed Rule

As noted above, the Proposed Rule applies to QFCs of covered entities (covered QFCs).[2]

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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. 29169 (May 11, 2016) (Proposing Release).

2 *See* Proposed Rule § 253.83(a) and § 253.84(a).

- The term "qualified financial contract" includes securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements, as well as related master agreements, security agreements, guarantees, credit enhancements and reimbursement obligations.[3]

- The term "covered entity" would mean: (i) any U.S. top-tier bank holding company identified as a U.S. GSIB; (ii) any subsidiary of a U.S. GSIB (other than a subsidiary that is a covered bank); and (iii) any U.S. subsidiary, U.S. branch or U.S. agency of a foreign GSIB.[4]

Current Insolvency and U.S. Special Resolution Regimes and Proposed Changes

Bankruptcy Code. The U.S. Bankruptcy Code (Bankruptcy Code) contains "safe harbor" provisions that permit certain non-defaulting QFC parties to exercise contractual remedies *immediately* upon the insolvency of their counterparties, or their counterparties' credit support providers, notwithstanding the Bankruptcy Code's general imposition of an automatic stay of creditors' claims on the assets of the insolvent party.

These safe harbor protected remedies include a contractual right to immediately: (i) terminate the transaction; (ii) set off and net obligations owed between the parties; and (iii) liquidate the insolvent party's collateral.

U.S. Special Resolution Regimes. The Proposed Rule addresses two alternative non-Bankruptcy Code resolution regimes (together, U.S. special resolution regimes): (i) Orderly Resolution Authority (OLA) FDIC receiverships established in Title II of the Dodd-Frank Act for certain non-bank financial companies under extreme conditions; and (ii) Federal Deposit Insurance Act (FDIA) FDIC receiverships, which apply to all FDIC-insured depositary institutions.[5] The U.S. special resolution regimes impose more onerous, but temporary, stay requirements on QFCs than are provided for under the Bankruptcy Code. Specifically, the U.S. special resolution regimes:

- impose a "temporary stay period" during which QFC counterparties of a failed entity that is placed in an FDIC receivership are temporarily stayed from exercising termination, set off and netting, and collateral liquidation rights under QFCs solely by reason of, or incidental to, the placing of the failed entity into OLA or FDIA FDIC resolution, insolvency, or financial condition – the stay continues until 5:00 PM (Eastern time) on the business day following the appointment of a receiver; and

- permit the FDIC to transfer the QFCs of the failed entity that is in FDIC receivership to another financial institution that is not in an insolvency proceeding during the temporary stay period.

In addition, the OLA permits the FDIC to enforce contracts of subsidiaries or affiliates of a failed covered financial company that are ''guaranteed or otherwise supported by or linked to the covered financial company, notwithstanding any contractual rights based solely on the insolvency, financial condition, or receivership of'' the failed subsidiary or affiliate. Accordingly, in an OLA FDIC resolution, the FDIC can avoid what the Proposing Release calls "cross-default"

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3 The term "qualified financial contract" would be defined by reference to the meaning of the term under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). *See* Proposed Rule § 252.81.

4 *See* Proposed Rule § 252.82(a); *see also* Proposing Release at n. 54 (providing a list of covered entities). A covered bank is an entity supervised by the Office of the Comptroller of Currency (OCC). The Proposing Release indicates that OCC is expected to issue a substantively identical proposal applicable to covered banks. A state chartered bank is treated as a covered subsidiary under the Proposed Rule.

5 Receiverships under either of the U.S. special resolution regimes are referred to as FDIC receiverships.

rights related to the insolvency of a counterparty's affiliated credit support provider. The FDIA, in contrast, does not contain a similar provision.

Impact of the Proposed Changes on Buy-Side Parties. As described in more detail below, the Proposed Rule: (i) has the effect of requiring QFC counterparties to covered entities to contractually agree that their termination rights will be temporarily limited under the OLA and FDIA regimes if their counterparties are placed in FDIC receivership and the QFC is transferred to another counterparty; and (ii) extends the OLA prohibition on the exercise of cross-default rights against all covered entities in the context of any resolution regime.

Below are high-level depictions of how the rights of a buy-side entity that is a party to a QFC with different categories of covered entity counterparties would change as a result of the application of each element of the Proposed Rule:

Stay-and-Transfer Requirement

Counterparty	Existing Regime	Buy-Side Rights Under Proposed Rule
Covered entity placed in an FDIC receivership under the OLA	Subject to temporary stay on the exercise of default rights based on OLA FDIC receivership	**Same**, plus the restrictions are contractually memorialized
Covered entity placed in a proceeding under the Bankruptcy Code	Not prevented from immediately exercising default rights arising from the counterparty's insolvency	**Same**
State chartered insured depository institution subsidiary of a GSIB placed in an FDIA receivership under the FDIA	Subject to temporary stay on the exercise of default rights based on FDIA FDIC receivership	**Same**, plus the restrictions are contractually memorialized

Prohibition on Cross-Default

Counterparty	Existing Regime	Buy-Side Rights Under Proposed Rule
Covered entity (including a state chartered insured depository institution) with credit support from an affiliate placed in an FDIC receivership under the OLA	FDIC may prevent party from exercising cross-default rights relating to affiliate's insolvency	**Same**, plus contractually prohibited from exercising cross-default relating to affiliate's insolvency
Covered entity (including an insured depository institution) with credit support from an affiliate placed in a proceeding under the Bankruptcy Code	May immediately exercise cross-default rights arising from affiliate's insolvency	**Change**, in that the party is prohibited by the terms of the QFC from exercising cross-default rights arising from affiliate's insolvency

Prohibition on Cross-Default		
Counterparty	**Existing Regime**	**Buy-Side Rights Under Proposed Rule**
Covered entity (including an insured depository institution) with credit support from an affiliate placed in an FDIC receivership under the FDIA	May immediately exercise cross-default rights arising from affiliate's insolvency	**Change**, in that the party is prohibited by the terms of the QFC from exercising cross-default rights arising from affiliate's insolvency

New Terms Required in QFCs with Covered Entities (Proposed Rule § 252.83)

The Proposed Rule requires that any covered QFC explicitly provide that:

- if the covered entity is placed into FDIC receivership under a U.S. special resolution regime, default rights under covered QFCs may be exercised against the covered entity to no greater extent than the rights could be exercised under the U.S. special resolution regime as if the covered QFC were governed by the laws of the United States or a state of the United States; and

- if the covered entity is placed into FDIC receivership under a U.S. special resolution regime, the transfer of a covered QFC from the covered entity would be effective to the same extent as would be the case under the U.S. special resolution regime as if the covered QFC were governed by the laws of the United States or a state of the United States.

In other words, the Proposed Rule would require a party to a transaction with a GSIB or another covered entity to contractually opt in to the application of the U.S. special resolution regimes upon the placement of the covered entity into an FDIC receivership. Accordingly, a party facing a covered entity that is placed in an FDIC receivership under the OLA or FDIA would by the terms of its QFC be subject to: (i) a temporary stay on the exercise of that party's default rights arising from the covered entity's entry into receivership; and (ii) the transfer of the covered QFC by the FDIC to another entity not subject to an insolvency or resolution proceeding during that period. After such a transfer, the non-insolvent party's default rights relating to this event would by the terms of its QFC be permanently stayed.

However, the Proposed Rule does not require QFC parties to give up default rights against covered entity counterparties in an FDIC receivership under the OLA or FDIA to the extent such rights are not inconsistent with the OLA or FDIA. Further, after the end of the stay period, the Proposed Rule would permit a non-insolvent QFC party to exercise its contractual rights if a transfer was not completed.

It is also important to note that this section of the Proposed Rule is expressly directed at covered entities that are placed in an FDIC receivership, as compared to those that are subject to a Bankruptcy Code proceeding or other type of resolution. The Proposed Rule does not require QFC parties to give up default rights against covered entity counterparties in proceedings other than the U.S. special resolution regimes (*e.g.*, under the Bankruptcy Code). In the Proposing Release, the Board indicated that the requirements of this section of are intended to address the Board's concern as to whether all covered QFCs "would be treated in the same way in the context of an FDIC

receivership" under the OLA or the FDIA.[6] The Board also noted in particular that requiring a party to contractually agree to terms that mirror the statutory "stay-and-transfer" provisions under the OLA or the FDIA would help ensure that a court outside the United States would enforce these provisions.[7]

Prohibition on Cross-Default Provisions (Proposed Rule § 252.84)

The Proposed Rule also provides that a covered entity may not enter into a covered QFC that would:

- allow its counterparty to exercise a "cross-default" right under the covered QFC – the term cross-default means any default right related to an affiliate of the direct party covered entity becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding; and

- prohibit the transfer of a covered affiliate credit enhancement (such as a payment guarantee) supporting the covered QFC to a transferee, upon an affiliate of the direct party covered entity becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding unless the transfer would result in the supported party being the beneficiary of the credit enhancement in violation of any law applicable to the supported party.

The prohibitions under this section of the Proposed Rule are designed to address the potential for disruption presented by such cross-default rights. The Proposing Release states that a primary purpose of these prohibitions is to facilitate the resolution of a GSIB outside of Title II, including pursuant to bankruptcy proceedings under the Bankruptcy Code.

However, the Proposed Rule includes a number of "substantial exceptions," including allowing a covered QFC to permit the exercise of default rights based on:

- the direct party to the transaction (as opposed to an affiliate) becoming subject to a receivership, insolvency, liquidation, resolution, or proceeding other than a U.S. special resolution regime or an equivalent foreign regime; and

- the failure of the direct party covered entity, a "covered affiliate support provider" (*i.e.*, another covered entity that is affiliated with the direct party) or a transferee, to satisfy its payment or delivery obligations under the transaction or credit enhancement (as applicable).

In addition, for credit enhancements of covered QFCs that are provided by another covered entity or a covered bank, the Proposed Rule would permit the exercise of all default rights after a "stay period" ending on the later of: (i) 5:00

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6 Note that the text of the Proposed Rule is somewhat ambiguous and might be read to apply the contractual requirements to resolutions other than those under OLA or the FDIA. This may be addressed in the final rule.

7 The Proposing Release specifically notes that the Proposed Rule is not intended to imply that the statutory stay-and-transfer provisions would not apply to a particular QFC. Instead, this element of the Proposed Rule appears to be intended to fill perceived potential gaps in the context of cross-border transactions – for example, where a covered entity transacts with a non-U.S. entity, the covered QFC is governed by non-U.S. law and the collateral securing the covered QFC is located outside of the United States. *See* Proposing Release at 29178. The Proposing Release also highlights that this element of the Proposed Rule is consistent with similar provisions under foreign jurisdictions' special resolution regimes, citing requirements in the UK, Germany and Switzerland.

p.m. (Eastern time) on the following business day; and (ii) 48 hours, in each case after the commencement of the proceeding, in specified circumstances.[8]

ISDA 2015 Universal Resolution Stay Protocol

The Proposed Rule provides that a covered entity could be deemed in compliance with Proposed Rule section 252.84, if the entity's QFCs are amended by the ISDA 2015 Universal Resolution Stay Protocol (including the Securities Financing Transactions Annex and the Other Agreements Annex) rather than by making specific amendments to the covered entity's QFC documentation.

Transition Periods

The effective date of the Proposed Rule would be the first day of the first calendar quarter beginning at least one year after the issuance of the final rule. The Proposed Rule would apply to covered QFCs entered into after the effective date. The Proposed Rule would also apply to all other currently existing QFCs with a counterparty that enters into a new QFC with the covered entity after the effective date.

Counterparty Credit Risk Issues

As discussed above, the Bankruptcy Code generally provides safe harbors that exempt QFC parties from the automatic stay provisions that would otherwise prohibit them from exercising contractual remedies (including termination, set off and netting, and liquidation of collateral) against a defaulting counterparty. These safe harbors serve to reduce a fund's exposure to the risk relating to the potential default of a QFC counterparty, particularly with respect to QFCs for which collateral is marked to market daily.

The imposition of even a temporary stay could increase the market risk faced upon a QFC party's deterioration. A delay in a QFC party's ability to liquidate collateral could expose the party to market risk for the duration of the stay. By way of example, on two separate trading days in 2008, the S&P 500 Index suffered one-day losses of approximately 9%. Certain rights available to a buy-side counterparty under the Proposed Rule may be either temporarily restricted or eliminated in the event that a covered entity counterparty or its affiliate is in FDIC receivership or another insolvency proceeding. Accordingly, a QFC party may be unable to mitigate such one-day losses caused by distressed markets, which are likely to coincide with the insolvency of a covered entity counterparty.

Buy-side QFC parties should assess the real impact of the Proposed Rule based on the status of their covered entity counterparties. To the extent that the Proposed Rule expands the number of potential delays a party could face in exercising its contractual rights (*e.g.*, by imposing the limit on cross-default in an FDIC receivership under FDIA or Bankruptcy Code insolvency), the party may need to be more mindful of its covered entity counterparty's financial condition. However, where the Proposed Rule requires contractual memorialization of an already extant and applicable statutory requirement, it is possible that the application of the Proposed Rule would not change a party's risk assessment framework.

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[8] These circumstances could include, for example, when: (i) a transfer is not effected; (ii) the transferee itself becomes subject to an insolvency or other resolution proceeding; or (iii) the transferee's obligations are not substantially the same as those of the affiliate prior to the affiliate's insolvency or other resolution proceeding. Notably, this stay period is deferent than that under the OLA or FDIA, which ends at 5:00 p.m. on the following business day.

Potential Issues for Registered Investment Companies

Registered funds and, in particular, registered money market funds (money market funds) transacting in QFCs may need to consider issues relating to whether the application of the Proposed Rule to repurchase agreements and other QFCs could impact such funds' ability to comply with certain substantive provisions of the Investment Company Act of 1940, as amended (1940 Act) and rules thereunder. This section identifies certain rules under which these issues could potentially arise.

Diversification Requirements. Section 5(b)(1) of the 1940 Act limits the extent to which a "diversified" registered fund may invest in the securities of a single issuer.[9] For purposes of this calculation, Rule 5b-3 (and, with respect to money market funds, Rule 2a-7) under the 1940 Act allows a fund to treat a repurchase agreement as an acquisition of the underlying securities (*e.g.*, government securities) rather than the securities of the counterparty, provided that the repurchase agreement is "collateralized fully." In order to be "collateralized fully," among other requirements, the repurchase agreement must "qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller" upon an insolvency event of the seller. The Proposed Rule would impose a temporary stay on a party's exercise of its default rights under a covered QFC, under certain circumstances.

Money Market Fund Disposition on Counterparty Insolvency Requirements. The Proposed Rule may also impact a money market fund's ability to comply with Rule 2a-7's requirement that a money market fund dispose of any security when an event of insolvency has occurred with respect to the issuer of the security (or the issuer of any related demand feature or guarantee).[10] Since a QFC generally includes limited transfer rights, a money market fund would ordinarily satisfy this requirement by exercising its termination rights under the QFC. As noted above, the Proposed Rule would temporarily prohibit a money market fund from exercising termination rights, under certain circumstances.

Money Market Fund Minimal Credit Risk Requirements. The Proposed Rule could also potentially impact a money market fund's ability to comply with the minimal credit risk requirements applicable to money market funds under Rule 2a-7.[11] The Proposed Rule: (i) requires a QFC with a covered entity to expressly permit the transfer of the QFC from the covered entity to another entity; and (ii) does not allow a QFC with a covered entity to prohibit the transfer of a credit enhancement. Therefore, a money market fund could be forced to acquire a new security (*i.e.*, a QFC that has been transferred to a different counterparty) without first being able to perform a meaningful minimal credit risk analysis, under certain circumstances.

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9 Specifically, in order to be classified as a "diversified" company, a registered fund must have at least 75 percent of the value of its total assets invested in: (i) cash and cash items (including receivables); (ii) government securities; (iii) securities of other investment companies; and (iv) other securities, for purposes of this calculation limited in respect of any one issuer to a maximum of five percent of the value of the total assets of the registered fund, and a maximum of ten percent of the outstanding voting securities of such issuer. Rule 2a-7 under the 1940 Act similarly restricts a money market fund from investing more than five percent of its total assets in a single issuer.

10 This requirement applies absent a finding by the money market fund's board that such disposal would not be in the best interests of the money market fund (taking into account, among other factors, market conditions that could affect orderly disposition).

11 Rule 2a-7 requires that a money market fund limit its investments to securities that, at the time of acquisition, are "eligible securities" – these are defined to include (in addition to government securities and shares of other money market funds) securities that the money market fund's board determines to present minimal credit risk. In addition, Rule 2a-7 requires a money market fund to dispose of any security that ceases to be an eligible security (*i.e.,* it no longer presents minimal credit risk).

If the Proposed Rule is adopted, it is uncertain whether the SEC and its staff would view registered funds as in compliance with the applicable rules described above. Funds with covered entity counterparties will need to carefully consider these issues that potentially may arise under Rules 2a-7 and 5b-3 in assessing the impact of the Proposed Rule if it is adopted.

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