

New ISDA Protocol Will Limit Buy-Side Remedies in a Financial Institution Failure

The ISDA 2014 Resolution Stay Protocol, published on November 12, 2014, by the International Swaps and Derivatives Association, Inc. (ISDA),¹ represents a significant shift in the terms of the over-the-counter derivatives market. It will require adhering parties to relinquish termination rights that have long been part of bankruptcy “safe harbors” for derivatives contracts under bankruptcy and insolvency regimes in many jurisdictions. While buy-side market participants are not required to adhere to the Protocol at this time, future regulations will likely have the effect of compelling market participants to agree to its terms. This change will impact institutional investors, hedge funds, mutual funds, sovereign wealth funds, and other buy-side market participants who enter into over-the-counter derivatives transactions with financial institutions.

Among the key features of the Protocol are the following:

- **Special Resolution Regimes.** In the wake of the 2008 financial crisis, regulators in several jurisdictions have adopted “special resolution regimes,” which are designed to enable regulators to direct an orderly resolution of a distressed financial institution, including the institution’s derivatives transactions. These regimes, including Title II of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, generally impose a one or two business day stay on the exercise of default rights (such as termination rights and rights to net collateral), to give the receiver or regulatory body time to transfer the failing or failed financial institution’s rights and obligations to another entity. Following such a transfer, the non-defaulting party’s right to exercise default rights as a result of its counterparty entering the proceedings is eliminated. The cross-border enforceability of these special resolution regimes is unclear under current law. The Protocol seeks to provide clarity, by introducing the provisions from certain eligible regimes by contract to ISDA Master Agreements and related credit support arrangements. *In effect, Protocol adherents will agree to be bound by the special resolution regimes, even in situations where they might not otherwise apply.*
- **U.S. Bankruptcy Code Proceedings.** Particularly troubling is that the Protocol includes provisions requiring an adhering party to agree to limit (and in certain cases, eliminate) its rights to exercise remedies under ISDA Master Agreements and related credit support arrangements when an affiliate of its counterparty, such as a bank holding company, enters U.S. Bankruptcy Code or certain other U.S. insolvency proceedings. *Coupled with the anticipated regulatory pressure to compel all market participants to adhere to the Protocol, these provisions will have the practical effect of amending and limiting long-standing “safe harbor” protections for derivatives contracts under the U.S. Bankruptcy Code and other U.S. law, without action by Congress.*
- **Timing.** The special resolution regime section of the Protocol becomes effective on **January 1, 2015**, for ISDA Master Agreements between voluntary adherents to the Protocol who are financial institutions covered by an eligible special resolution regime. The provisions of the Protocol that relate to proceedings under the U.S. Bankruptcy Code and other U.S. insolvency regimes (other than special resolution regimes) apply only after U.S. regulations enter into force limiting the ability of financial institutions to enter into derivatives transactions under ISDA Master Agreements that do not include provisions like those in the Protocol. Those regulations are expected to be adopted by the Federal Reserve and other U.S. regulators in the next couple of years. So far, eighteen major global banks have voluntarily adhered to the Protocol. ***Buy-side entities are not expected to adhere at this time.*** The Protocol by its terms anticipates that regulators in various jurisdictions will adopt

¹ ISDA 2014 Resolution Stay Protocol, available [here](#).

regulations in the coming years that will prohibit financial institutions from entering into derivatives transactions with counterparties who have not adhered to the terms of the Protocol or otherwise agreed to similar terms.

A more detailed explanation of the changes to ISDA Master Agreements and related credit support arrangements made by the Protocol is included in [Annex A](#) to this Alert.

Background: From the 2008 Financial Crisis to the Protocol

Following the financial crisis in 2008 and widespread concerns about taxpayer support of financial institutions that are deemed to be “too big to fail,” many jurisdictions adopted special resolution regimes. These special resolution regimes generally give regulators sweeping powers in the event a systemically important financial institution becomes distressed, with the goal of stabilizing or liquidating a failing or failed institution without severe disruption to the financial system or losses to taxpayers.²

One of the key issues regulators have sought to address in implementing special resolution regimes is termination rights in respect of a failing or failed financial institution’s derivatives contracts. The special resolution regimes seek to address this issue by imposing a temporary pause—or “stay”—on the ability of counterparties to exercise direct default or cross-default rights. A temporary stay is designed to give regulators time, among other things, to oversee the transfer of derivatives contracts to a more financially sound entity or to take other actions to preserve the financial institution’s contracts. Termination of derivatives contracts and the resulting capital calls made on Lehman Brothers were widely viewed as complicating the firm’s resolution. Since that time, regulators have sought to implement measures to avoid wholesale terminations of a financial institution’s derivatives contracts by its counterparties during a time of severe financial stress.

Addressing these issues in a cross-border context has proven challenging. Whether and how the different rules apply in the case of a global financial institution with counterparties in (and contracts governed by the laws of) multiple jurisdictions is complex and uncertain under current law.³ As a result, some counterparties of a failing or failed financial institution may be able to terminate derivatives contracts with the financial institution, while others may not, depending on each party’s jurisdiction (and the governing law of the contract). As regulators grappled with these issues, they have called upon ISDA, the primary trade association for the over-the-counter derivatives market, to implement a contractual solution.

The Protocol addresses the cross-border problem by contractually binding all adherents to the resolution laws governing a financial institution that enters an eligible special resolution regime, including any stays on the exercise of default remedies. Since special resolution regimes generally override the exercise of termination rights based on direct defaults or cross-defaults, the effect of the Protocol is to impose a contractual stay on termination of the financial institution’s derivatives contracts by counterparties once the financial institution enters a special resolution regime, no matter where the financial institution or its

² For more information about special resolution regimes, please see Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011), available [here](#).

³ A report published in the Federal Reserve Bank of New York’s Economic Policy Review notes that Lehman Brothers Holdings Inc. was party to more than 900,000 derivatives contracts at the time of its bankruptcy, and that the U.S. Bankruptcy Code, the Securities Investor Protection Act, the Federal Deposit Insurance Act, U.S. state insurance laws, and more than eighty jurisdictions’ insolvency laws were implicated in the Lehman bankruptcy. See Michael Fleming and Asani Sarkar, *The Failure Resolution of Lehman Brothers*, Federal Reserve Bank of New York, Economic Policy Review, Special Issue: Large and Complex Banks, Vol. 20, Number 2 (March 2014), available [here](#).

counterparty is located (or the governing law of the contract). In addition, if the financial institution's rights and obligations under a derivatives contract are transferred to a successor as part of the resolution process, the right of the non-defaulting party to exercise termination rights as a result of its original counterparty's entering resolution proceedings is eliminated.

The Protocol also incorporates provisions relating to a proceeding under the U.S. Bankruptcy Code, including restrictions on creditor rights that otherwise would apply in a U.S. Bankruptcy Code proceeding. These include the removal of any ability to exercise cross-default rights because an affiliate of a financial institution counterparty that is listed as a "specified entity" in an ISDA Master Agreement enters a U.S. Bankruptcy Code proceeding. The Protocol also limits the ability of a non-defaulting party to exercise remedies in the event that a guarantor of a financial institution's obligations under an ISDA Master Agreement enters U.S. Bankruptcy Code proceedings. Unlike the rules applicable to an eligible special resolution proceeding, the Protocol does not limit a non-defaulting counterparty's right to terminate derivatives transactions in the event that its direct counterparty enters U.S. Bankruptcy Code proceedings—although, in fact, it seems likely that most major U.S. swap dealers will be subject to special resolution proceedings.⁴

Implications of the Protocol and Considerations for the Buy Side

As noted above, eighteen major global banks have voluntarily adhered to the Protocol, which is to become effective with respect to those banks and eligible special resolution regimes on January 1, 2015. It is expected that regulators will adopt regulations in 2015 and beyond that will prohibit financial institutions from entering into derivatives transactions with counterparties who have not agreed to terms like those in the Protocol. Regulations will have the effect of requiring more entities—including members of the buy side—to give up termination rights (*i.e.*, adhere to the Protocol) in order to continue trading with financial institutions in these jurisdictions. Adherence to the Protocol will cause an adhering party to agree to these terms for all of its outstanding derivatives contracts under ISDA Master Agreements with other adhering parties.

While members of the buy side are not required to adhere to the Protocol at this time, they should begin thinking about the Protocol and its potential effect on their derivatives trading. Members of the buy side should understand the extent to which their financial institution counterparties are potentially within the scope of eligible special resolution regimes and the effect such proceedings would have on the terms of their ISDA Master Agreements, depending on the jurisdictions of the counterparties and any "specified entities" or guarantor entities of such counterparties, to determine how the Protocol would apply.

Notably, the Protocol is limited to ISDA Master Agreements and related credit support arrangements. Other types of trades, such as repurchase agreements, securities lending transactions, and derivatives that are not traded under an ISDA Master Agreement are not directly covered by the Protocol. It is not clear if and when these types of transactions might become subject to a similar industry-wide solution.

Please contact the Ropes & Gray attorney who usually advises you with any questions.

⁴ This highlights the asymmetry of the Protocol. The Protocol's "stay" will not limit the rights of a financial institution, including one in an insolvency proceeding, from exercising any and all rights it may have against a non-financial counterparty.

Annex A: New ISDA Protocol Will Limit Buy-Side Remedies in a Financial Institution Failure

Below is a summary of some of the key terms in the Protocol. The terms of the Protocol are complex and vary depending on the relationship between the parties and the terms of the documentation, as described in more detail below.

The Protocol does not apply to an ISDA Master Agreement or any credit support document unless both of the parties to the ISDA Master Agreement or both of the parties to (or both the provider and the beneficiary of) the credit support document adhere to the Protocol.

Special Resolution Regimes (“SRRs”) Covered by the Protocol

- The Protocol initially covers the existing resolution regimes in France, Germany, Japan, Switzerland, the United States (both Title II of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the U.S. Federal Deposit Insurance Act) and the United Kingdom. The resolution regimes of France, Germany and the United Kingdom will automatically be amended and updated to reflect these jurisdictions’ implementation of the EU’s Bank Recovery and Resolution Directive. Resolution regimes of other countries that are members of the Financial Stability Board will be covered in the future, as they are developed, to the extent they meet certain requirements (*e.g.*, equal treatment of creditors, no temporary stay exceeding two business days, protection of netting and set-off rights, and either suspension of payment and delivery obligations under the master agreement with respect to both parties during the stay or a requirement that the failing or failed financial institution perform its payment and delivery obligations under the master agreement during the stay).
- If an adhering party is not subject to regulations by January 1, 2018, that prohibit such adhering party from entering into any transactions documented under ISDA Master Agreements that do not include provisions similar to those in the Protocol, the Protocol includes a mechanism for any other adhering party to opt out of the Protocol with respect to that particular counterparty and SRR.

Opt-in to Eligible Special Resolution Regimes

- Through the Protocol, an adhering party opts in to the resolution laws governing its counterparty, and certain of its counterparty’s related entities, that enter an SRR in a covered jurisdiction. In particular, this means that parties in many cases will give up the right to terminate trades governed by an ISDA Master Agreement and to claim under a related guarantee if the counterparty (or any of certain related entities of the counterparty) becomes subject to an SRR.
- *If a direct counterparty becomes subject to an eligible SRR (the “Party in Resolution”):*
 - The non-defaulting party is entitled to exercise default rights under the relevant ISDA Master Agreement or a related credit support document, such as a guarantee (including a credit support document provided by a related entity⁵ of the Party in Resolution, as long as the related entity has adhered to the Protocol) only to the same extent it would be able to do so under such SRR if the

⁵ A related entity of an adhering party includes certain of its parent companies and any of its other affiliates that has either provided a credit support document in relation to the adhering party’s obligations under the relevant ISDA Master Agreement or been listed as a “specified entity” in that ISDA Master Agreement.

ISDA Master Agreement or credit support document were governed by the law of the home jurisdiction of the SRR. Thus, for example, if the applicable SRR imposes a stay on the termination of derivatives contracts, the non-defaulting party will be subject to the same stay, even if the relevant ISDA Master Agreement is governed by the law of a different jurisdiction.

- If the Party in Resolution's rights and obligations under the relevant ISDA Master Agreement, or a credit support document entered in connection with the ISDA Master Agreement (including a credit support document provided by a related entity of the non-defaulting party, as long as the related entity has adhered to the Protocol), are transferred to a successor of the Party in Resolution pursuant to such SRR, the transfer will be effective to the same extent that a transfer of an ISDA Master Agreement or a credit support document governed by the law of the home jurisdiction of the SRR would be effective under the applicable SRR. Such a transfer is binding on the non-defaulting party (or its related entity), notwithstanding any provision of the ISDA Master Agreement or credit support document that would otherwise prohibit the transfer.
- *If a related entity of an adhering party becomes subject to an eligible SRR (the "Related Entity in Resolution"):*
 - Under the ISDA Master Agreement, a party has the ability to exercise default rights if an entity listed in the ISDA Master Agreement as a "specified entity" or "credit support provider" of its counterparty enters insolvency proceedings or defaults under certain other obligations. The Protocol limits these rights. Under the Protocol, if a related entity of an adhering party enters an eligible SRR, the non-defaulting party is entitled to exercise default rights under the ISDA Master Agreement with the adhering party or a related credit support document (including a credit support document provided by the Related Entity in Resolution or any other related entity of the adhering party, in either case, as long as the related entity has adhered to the Protocol) only to the same extent it would be able to do so under such SRR, if the ISDA Master Agreement or credit support document were governed by the law of the home jurisdiction of the SRR.
 - If the Related Entity in Resolution's rights and obligations under a credit support document entered into by the Related Entity in Resolution in connection with the ISDA Master Agreement with the adhering party are transferred to a successor of the Related Entity in Resolution pursuant to such SRR, then, as long as the Related Entity in Resolution has adhered to the Protocol, the transfer will be effective to the same extent that both a transfer of a credit support document governed by the law of the home jurisdiction of the SRR, and a transfer of a credit support document governed by the law of the home jurisdiction of the SRR that supports an ISDA Master Agreement governed by the law of the home jurisdiction of the SRR, would be effective under the applicable SRR.
 - For as long as a default right is not exercisable under an ISDA Master Agreement covered by the Protocol or a related credit support document as a result of these provisions, any event of default or similar event specified in the ISDA Master Agreement or credit support document that gave rise to the default right shall be deemed not to be occurring or continuing for purposes of determining whether an event of default or a similar event under any other agreement has occurred or is continuing, to the extent that such cross-default rights would be unenforceable if the ISDA Master Agreement or related credit support document were governed by the law of the home jurisdiction of the SRR. As a result, a non-defaulting party is potentially stayed from exercising both direct default rights under the relevant ISDA Master Agreement and any related credit support document, and cross-default rights under any other agreement, if its financial institution counterparty (or a related entity) is subject to an eligible SRR.

- For example, if a bank (“Bank A”) defaults under an ISDA Master Agreement with a fund (“Fund B”) due to Bank A entering an eligible SRR, but Fund B is prohibited by the Protocol from terminating trades under the ISDA Master Agreement, Fund B also will not be able to call a default under other agreements (*e.g.*, Master Repurchase Agreements, securities lending agreements, or any other trading agreements) between Bank A (or any related entity of Bank A) and Fund B as a result of the provision in the ISDA Master Agreement that provides that Bank A entering into the SRR is an event of default. However, if the other agreements have independent terms identifying entering an SRR as an event of default, Fund B may be able to call a default under those terms.

Limitation on Exercise of Default Rights upon Other U.S. Insolvency Proceedings

- The Protocol also incorporates provisions that restrict important creditor rights that otherwise would be available to a counterparty of a financial institution that becomes subject to a U.S. Bankruptcy Code proceeding, or certain other U.S. insolvency proceedings other than SRRs.⁶
- *If a direct counterparty becomes subject to a U.S. insolvency proceeding that is not an SRR:* Notably, unlike in the event of a direct counterparty entering an SRR, the Protocol would not limit a non-defaulting counterparty’s right to exercise default rights in the event that its direct counterparty enters other U.S. insolvency proceedings. For example, if Bank A enters a U.S. insolvency proceeding when Fund B has outstanding transactions with Bank A under an ISDA Master Agreement, the Protocol would not prohibit Fund B from exercising default rights with respect to those transactions.
- *If an affiliate⁷ of the direct counterparty becomes subject to a U.S. insolvency proceeding that is not an SRR:*
 - As noted above, under the ISDA Master Agreement, a party has the ability to exercise default rights if an entity listed in the ISDA Master Agreement as a “specified entity” of its counterparty enters insolvency proceedings or defaults under certain other obligations. The Protocol limits such rights in the event that a “specified entity” enters U.S. insolvency proceedings. If the “specified entity” is not a credit support provider of the direct counterparty, the non-defaulting party can only exercise default rights under the ISDA Master Agreement or a related credit support document that are “Performance Default Rights” and “Unrelated Default Rights,” which may be exercised at any time. All other rights to exercise default rights are suspended.
 - “Performance Default Rights” generally include default rights that arise due to (i) the direct counterparty entering insolvency proceedings; (ii) the direct counterparty’s failure to satisfy payment or delivery obligations under the ISDA Master Agreement, credit support document, or certain other types of transactions (including, for example, “specified transactions” and “specified indebtedness” as defined in the ISDA Master Agreement); or (iii) the failure by a credit support provider to satisfy a payment or delivery obligation.
 - “Unrelated Default Rights” generally include (i) default rights that are not based solely on the affiliate entering into U.S. insolvency proceedings and that can be shown “by clear and

⁶ The term “U.S. insolvency proceeding” includes bankruptcy proceedings under Chapter 7 or Chapter 11 of the U.S. Bankruptcy Code, proceedings under the Federal Deposit Insurance Act that commence upon the Federal Deposit Insurance Corporation being appointed as a receiver, and proceedings under the Securities Investor Protection Act.

⁷ In this context, the term “affiliate” generally includes any other entity that is controlled (directly or indirectly by the direct counterparty, any entity that controls (directly or indirectly) the direct counterparty, or any entity directly or indirectly under common control with the direct counterparty.

convincing evidence” to be unrelated to the affiliate entering into U.S. insolvency proceedings; and (ii) default rights based solely on an affiliate of the direct counterparty becoming subject to insolvency or resolution proceedings (other than U.S. insolvency proceedings), as long as a U.S. parent of such direct counterparty is not subject to a U.S. insolvency proceeding. This standard may be hard to meet if the parent and the affiliate default at the same time.

- *If an affiliate that is a credit support provider of the direct counterparty becomes subject to a proceeding under Chapter 11 of the U.S. Bankruptcy Code:*
 - If the affiliate is a credit support provider of the direct counterparty and the affiliate becomes subject to proceedings under Chapter 11 of the U.S. Bankruptcy Code, the non-defaulting party will be able to exercise only Performance Default Rights and Unrelated Default Rights. The Protocol will suspend the non-defaulting party’s right to call a default on any other basis during a temporary stay period, which is the longer of 48 hours and one business day. Following the temporary stay period, the non-defaulting party may not exercise default rights (other than Performance Default Rights and Unrelated Default Rights) if certain conditions are met. Generally, these conditions include that the party in Chapter 11 proceedings either (i) transfers the guarantee to a transferee (including a bridge institution) that meets certain qualifications; or (ii) remains obligated under the guarantee as a “debtor in possession” and satisfies certain conditions, including that the party in Chapter 11 proceedings files an order with the bankruptcy court that would give priority to any payments due under affected credit support arrangements over payments due to other creditors.
 - In such a scenario, both parties must continue to perform under the ISDA Master Agreement. If the direct counterparty fails to perform under the ISDA Master Agreement, the non-defaulting party can exercise default remedies.
 - Similarly, if the affiliate is a credit support provider of the direct counterparty and the affiliate becomes subject to proceedings under the U.S. Federal Deposit Insurance Act (FDIA), the non-defaulting party will be able to exercise only Performance Default Rights and Unrelated Default Rights. The Protocol will suspend the non-defaulting party’s right to call a default under the ISDA Master Agreement on any other basis during a temporary stay period, which is the amount of time that a stay would apply to a “qualified financial contract” under FDIA Section 11(e). The non-defaulting party will be prohibited from terminating the contract following the stay period if the contract has been properly transferred to a successor by the Federal Deposit Insurance Corporation.

Tables summarizing the matters described above are included on the following pages.

Summary of Changes: Eligible SRRs

	Direct Counterparty in SRR	Related Entity of Direct Counterparty in SRR
Default rights under ISDA Master Agreement and Credit Support Document	Subject to same stay that applies under law of the SRR.	Subject to same stay that applies under law of the SRR.
Transfer of ISDA Master Agreement	Binding on non-defaulting party if transfer is effective under law of the SRR.	Not applicable to ISDA Master Agreements, but ownership of direct counterparty may change if related entity is a parent.
Transfer of related Credit Support Document	Transfer of rights and obligations of direct counterparty under Credit Support Document binding on non-defaulting party if transfer is effective under law of the SRR.	Transfer of rights and obligations of related entity of direct counterparty under Credit Support Document binding on non-defaulting party if transfer is effective under law of the SRR.
Cross-default rights under ISDA Master Agreement arising from defaults under other agreements	Subject to same stay that applies under law of the SRR.	Subject to same stay that applies under law of the SRR.
Cross-default rights under other agreements arising from events of default (or similar) under ISDA Master Agreement	Subject to same stay that applies under law of the SRR.	Subject to same stay that applies under law of the SRR.

Summary of Changes: U.S. Bankruptcy Code Proceedings

	Direct Counterparty in Proceedings	Affiliate who is a Specified Entity in Proceedings (not Credit Support Provider)	Affiliate who is a Credit Support Provider in Proceedings
Default rights under ISDA Master Agreement and Credit Support Document	No change.	Default rights based on specified entity clauses are suspended indefinitely.	Non-performance default rights suspended for up to two business days, then permitted unless Credit Support Provider assumes credit support agreement (DIP Motion) or assigns it to eligible third party.
Transfer of ISDA Master Agreement	No change.	Not applicable, but ownership of direct counterparty may be transferred if affiliate in proceedings is a parent.	Not applicable, but ownership of direct counterparty may be transferred if affiliate in proceedings is a parent.
Transfer of related Credit Support Document	No change.	Credit Support Document can be transferred subject to certain conditions.	Credit Support Document can be transferred subject to certain conditions.
Cross-default rights under ISDA Master Agreement arising from defaults under other agreements	No change.	Can exercise default rights only if non-defaulting party can show cross-default is unrelated to default of affiliate by clear and convincing evidence.	Can exercise default rights only if non-defaulting party can show cross-default is unrelated to default of affiliate by clear and convincing evidence.
Cross-default rights under other agreements arising from events of default (or similar) under ISDA Master Agreement	No change.	Event of default under ISDA deemed not occurring for purposes of other agreements as long as ISDA default rights are suspended.	Event of default under ISDA deemed not occurring for purposes of other agreements as long as ISDA default rights are suspended.