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ALERT

Asset Management

May 9, 2016

Update: Proposed Rules Will Limit Buy-Side Remedies in a Financial Institution Failure

The Board of Governors of the Federal Reserve System (the "Board") has proposed rules (the "Proposed Rules")[1] that represent a significant shift in the terms of over-the-counter derivatives, repurchase and reverse repurchase transactions and securities lending transactions. If adopted, the Proposed Rules would have the effect of compelling buy-side firms to relinquish certain termination rights that have long been part of bankruptcy "safe harbors" for these types of contracts under bankruptcy and insolvency regimes in many jurisdictions in order to continue trading with large financial institutions. 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, repurchase and reverse repurchase transactions and securities lending transactions with large financial institutions.

From a policy perspective, the Proposed Rules are part of post-financial crisis efforts by regulators in various jurisdictions to create a framework for directing an orderly resolution of a distressed systemically important 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 (the "Dodd-Frank Act"), generally impose a one or two business day stay on the exercise of default rights (such as termination rights and rights to net collateral) by creditors of a distressed financial institution, to give the applicable receiver or regulatory body time to transfer the 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 extinguished.

The cross-border enforceability of these special resolution regimes is unclear under current law. The Proposed Rules seek to provide clarity with respect to the enforceability of the U.S. special resolution regimes, by requiring parties to covered financial contracts to "opt into" the applicability of these regimes by contract. In effect, parties to covered financial contracts will agree to be bound by the U.S. special resolution regimes, even in situations where the regimes might not otherwise apply. Comparable regulations are being adopted in other jurisdictions.

In addition, the Proposed Rules are designed to facilitate an insolvency proceeding of a failing or failed financial institution under the U.S. Bankruptcy Code, by prohibiting a covered financial institution from entering into covered financial contracts that allow a counterparty to exercise default remedies with respect to such financial institution because an affiliate of such financial institution – including, without limitation, an affiliate who has provided a guaranty with respect to such covered financial contract – enters into resolution or bankruptcy proceedings. This restriction is in part designed to facilitate "single point of entry" resolutions of financial institutions, under which the parent holding company of a financial institution enters bankruptcy proceedings, with the intention that the subsidiaries of such parent company continue to operate outside of bankruptcy.

The goal of these changes is to increase the likelihood of an orderly and controlled resolution of a troubled global financial institution and to limit the destabilizing effects on the global financial system as a whole.

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[1] Board of Governors of the Federal Reserve System, Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations, a draft of which is available here.

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Impact of Proposed Rules

Generally speaking, the Proposed Rules require global financial institutions that are "covered entities"[2] to incorporate certain provisions into their "qualified financial contracts" ("QFCs"), including contracts with buy-side firms. The term "qualified financial contract" generally includes over-the-counter derivatives, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions. Centrally cleared derivatives are not covered by the Proposed Rules.

The Proposed Rules will generally apply to existing QFCs as well as any new QFCs entered into by covered entities after the Proposed Rules are effective. However, to the extent parties to a QFC (or any of their respective affiliates) do not enter into any new QFCs between them after the final rules become effective, the parties will not be required to amend their preexisting QFC(s) to incorporate the required provisions. Upon entry into any new QFC by the parties (or any of their respective affiliates), the parties will be required to comply with the Proposed Rules with respect to the new QFC, along with all preexisting QFCs.

Subject to certain conditions and exceptions, among other things, the Proposed Rules generally will have the effect of:

- Requiring buy-side firms to agree, by contract, to "opt into" the U.S. special resolution regimes,[3] which, among other things, generally impose a one business day stay[4] on the exercise of default rights under covered QFCs (*e.g.*, over-the-counter derivatives, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions) with a covered entity if the covered entity becomes subject to a special resolution proceeding. Following the stay, the non-defaulting party will lose its right to terminate the QFC based on the commencement of the special resolution proceeding if the covered entity's obligations are transferred to a successor entity pursuant to the resolution proceeding (and the successor entity performs its obligations under the QFC). Buy-side firms will not be required to give up default rights based on the covered entity's (or transferee's) failure to perform under the QFC following the stay period.

- Requiring buy-side entities to "opt into" provisions under the U.S. special resolution regimes that allow the transfer of a QFC from the covered entity to another entity in connection with proceedings under such regimes, notwithstanding the typical restrictions on transfer included in derivatives, repurchase agreement and securities lending documentation.

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[2] The Proposed Rules apply to "covered entities", which consist of (i) any U.S. global systemically important banking organization ("GSIB") top-tier bank holding company, (ii) any subsidiary of such a bank holding company that is not a covered bank, and (iii) a U.S. subsidiary, U.S. branch, or U.S. agency of a foreign GSIB that is not a covered bank. The term "covered bank" means national banks and certain other entities that are supervised by the Office of the Comptroller of the Currency ("OCC"). The OCC is expected to issue substantially similar rules governing covered banks.

The following entities are identified as U.S. GSIBs in the proposing release: Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc., Goldman Sachs Group, Inc., JPMorgan Chase & Co., Morgan Stanley Inc., State Street Corporation, and Wells Fargo & Company.

The proposal also would cover the U.S. operations of foreign GSIBs that are not covered banks. The following foreign banking institutions are identified as GSIBs in the proposing release: Agricultural Bank of China, Bank of China, Barclays, BNP Paribas, China Construction Bank, Credit Suisse, Deutsche Bank, Groupe BPCE, Groupe Crédit Agricole, Industrial and Commercial Bank of China Limited, HSBC, ING Bank, Mitsubishi UFJ FG, Mizuho FG, Nordea, Royal Bank of Scotland, Santander, Société Générale, Standard Chartered, Sumitomo Mitsui FG, UBS, and Unicredit Group.

[3] The term "U.S. special resolution regimes" is defined in the Proposed Rules to mean the Federal Deposit Insurance Act and related regulations and Title II of the Dodd-Frank Act and related regulations.

[4] The temporary stay generally lasts until 5:00 p.m. (Eastern time) on the business day following the appointment of the receiver. *See* 12 U.S.C. 1821(e)(10)(B)(I) and 12 U.S.C. 5390(c)(10)(B)(i)(I).

- Prohibiting covered entities from entering into QFCs that allow a counterparty (such as a buy-side entity) to exercise default rights under a covered QFC with a covered entity based on the commencement of a U.S. special resolution regime proceeding or another receivership, insolvency, liquidation, resolution or similar proceeding (such as a proceeding under the U.S. Bankruptcy Code) with respect to an ***affiliate*** (such as a parent bank holding company) of the direct counterparty to the QFC. Buy-side entities often have the right under ISDA Master Agreements to terminate derivatives if a "specified entity" or a "credit support provider" of the entity's direct counterparty enters insolvency or defaults under certain other obligations. Under the Proposed Rules, buy-side entities would not have the ability to exercise such rights as a result of the "specified entity" or "credit support provider" entering into a receivership, insolvency, liquidation, resolution or similar proceeding (including, but not limited to, a U.S. special resolution regime proceeding or a U.S. Bankruptcy Code proceeding).[5]

- Prohibiting covered entities from entering into QFCs that prohibit the transfer of a guaranty (or other credit enhancement) of the covered entity's obligations under the QFC provided by an affiliate of the covered entity upon an affiliate of the covered entity entering into a receivership, insolvency, liquidation, resolution or similar proceeding (including, but not limited to, a U.S. special resolution regime proceeding or a U.S. Bankruptcy Code proceeding).

Buy-side firms will continue to have the following rights (among others) following implementation of the Proposed Rules:

- The right to exercise default rights in the event that a covered entity that is the ***direct counterparty*** to the covered QFC becomes subject to a resolution proceeding other than a U.S. special resolution regime proceeding or a comparable foreign proceeding.[6] For example, if the direct counterparty to a covered QFC becomes subject to a proceeding under the U.S. Bankruptcy Code, the non-defaulting party would not be stayed from exercising default rights under the covered QFC as a result of the commencement of the U.S. Bankruptcy Code proceeding.

- The right to exercise default rights in covered QFCs that are triggered by (i) the failure of the direct counterparty, an affiliate guarantor, or a transferee that assumes a credit enhancement (such as a guaranty) to satisfy its payment obligations under the covered QFC or credit enhancement or (ii) the failure of the direct counterparty to satisfy its payment or delivery obligations under another contract between the parties that gives rise to a default right in the covered QFC.

- For QFCs that are guaranteed (or otherwise subject to a credit enhancement) by a covered entity who is an affiliate of the direct party to the QFC, after a stay period,[7] the right to exercise default rights if (i) the guarantor that remains obligated under the guaranty becomes subject to a receivership, insolvency, liquidation, resolution or similar proceeding, other than a proceeding under Chapter 11 of the U.S. Bankruptcy Code; (ii) the transferee, if any, of the obligations under the guaranty becomes subject to a receivership, insolvency, liquidation, resolution or similar proceeding; (iii) the guarantor does not continue to

[5] Under the Proposed Rules, the term "default right," for this purpose, includes, among other rights, rights to terminate, set off, net, realize on collateral, call for extra collateral, suspend or delay payments or modify the rights of a party. It does not include daily payment netting or any contractual rights in the covered QFC to terminate the QFC on demand (such as an "optional early termination" provision) or at a party's option at a specified time, or from time to time, without the need to show cause.
[6] Update: The final rules adopted by the Board on September 1, 2017, removed the proposed exemption of a U.S. special resolution regime proceeding or a comparable foreign proceeding from this provision. As a result, counterparties to a covered QFC will not be prohibited by the final rules from exercising default rights in the event that a covered entity that is the direct counterparty to the covered QFC becomes subject to any receivership, insolvency, liquidation, resolution or similar proceeding
[7] For this purpose, the stay period ends at the later of 5:00 p.m. (Eastern time) on the business day following the commencement of the proceeding and 48 hours after the commencement of the proceeding.

guarantee all QFCs supported by the guaranty before the proceeding (this provision is designed to prevent "cherry picking"); or (iv) if the guaranty is transferred to a transferee, all of the ownership interests of the direct party directly or indirectly held by the guarantor are not transferred to the transferee (or reasonable assurances are not provided that such transfer will occur).

The Proposed Rules will not limit the rights of a covered entity, including a covered entity in an insolvency proceeding, from exercising any and all rights it may have against a buy-side (non-GSIB) counterparty.

ISDA Resolution Stay Jurisdictional Modular Protocol and Next Steps

The International Swaps and Derivatives Association (ISDA) has published the "ISDA Resolution Stay Jurisdictional Modular Protocol" (the "Modular Protocol"),[8] which will enable buy-side firms to incorporate the relevant provisions into their QFCs with covered entities.

The Modular Protocol is similar in many respects to the ISDA 2015 Universal Resolution Stay Protocol (the "2015 Protocol"),[9] which addresses the same policy goals as the Modular Protocol.[10] Whereas the 2015 Protocol was developed in advance of regulations requiring parties to agree to provisions such as those required by the Proposed Rules with their counterparties, the Modular Protocol has been developed to facilitate compliance with specific legislative or regulatory requirements in different jurisdictions (such as the Proposed Rules) (*i.e.*, each jurisdiction will have its own "module").

The proposing release accompanying the Proposed Rules specifically states that covered entities may comply with the Proposed Rules by adhering to the 2015 Protocol, even though the 2015 Protocol does not include all of the provisions required to be included in QFCs under the Proposed Rules. For example, as noted in the proposing release, the 2015 Protocol only requires a stay of default rights resulting from U.S. federal insolvency proceedings (*i.e.*, Chapters 7 and 11 of the U.S. Bankruptcy Code, the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act, and the Securities Investor Protection Act), whereas the stay required under the Proposed Rules would apply as a result of "any receivership, insolvency, liquidation, resolution or similar proceeding," which would include applicable state and foreign insolvency proceedings. The proposing release also implies that the provisions to be included in the U.S. module of the Modular Protocol will be sufficient to comply with the Proposed Rules, noting that "[a] jurisdictional module for the United States that is substantively identical to the [2015] Protocol in all respects aside from exempting QFCs between adherents that are not covered entities or covered banks would be consistent with the current proposal." The proposing release notes that there are certain advantages of market participants agreeing to the applicable provisions through a market-wide protocol rather than through bilateral agreements, such as increasing the chances that all counterparties to QFCs with a covered entity will be stayed to the same extent in the resolution of the covered entity, improving the chances that the covered entity will be resolved in an orderly manner. Therefore, the Board appears to be encouraging market participants to incorporate the provisions required by the Proposed Rules through a protocol, by allowing such participants to agree to somewhat narrower restrictions under the terms of the 2015 Protocol (or the Modular Protocol) than would be required under the Proposed Rules.

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[8] The Modular Protocol is available here.
[9] The 2015 Protocol is available here.
[10] In November 2014, ISDA released the ISDA 2014 Resolution Stay Protocol (the "2014 Protocol"), which included provisions that are substantially similar to those required by the Proposed Rules (but solely with respect to over-the-counter derivatives transactions) and was designed to accomplish the policy goals underlying special resolution regimes generally (*i.e.*, orderly liquidation of systemically important financial institutions). Eighteen major global banking institutions voluntarily adhered to the 2014 Protocol. The Protocol was updated and replaced in November 2015 with the 2015 Protocol, which added provisions governing securities financing and other transactions. It is not expected that buy-side firms will adhere to the 2015 Protocol. The Modular Protocol is designed to comply with specific laws and regulations of different jurisdictions, and it is expected that members of the buy-side will adhere to the Modular Protocol.

For a more detailed explanation of the 2014 Protocol, please see our previous Alert.

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It is expected that ISDA will publish a jurisdictional module for a particular jurisdiction once regulations in that jurisdiction are finalized.[11] Buy-side firms will be able to choose whether to adhere to specific jurisdictional modules. The scope of agreements that will be covered under each jurisdictional module will track the relevant definitions in the regulations adopted in the applicable jurisdiction. For example, it is expected that the U.S. jurisdictional module will cover all "QFCs" between the parties.[12]

Comments on the Proposed Rules are due by August 5, 2016. The final rules will become effective on the first day of the first calendar quarter that begins at least one year after the issuance of the final rules. As a practical matter, we expect that this means that buy-side firms entering into over-the-counter derivatives, repurchase agreements or securities loans with covered entities will be required to agree to the applicable provisions contemplated by the Proposed Rules (by adherence to the U.S. module of the Modular Protocol – which has not yet been published – or otherwise) by late 2017 or early 2018.

Please contact your usual Ropes & Gray attorney with any questions.

[11] Currently the only jurisdictional module that is open for adherence is the ISDA UK (PRA Rule) Jurisdictional Module, which enables entities subject to the UK Prudential Regulation Authority's final rule on contractual stays in financial contracts to comply with that rule.

[12] The 2015 Protocol covers the ISDA Master Agreement, Global Master Repurchase Agreement, Master Repurchase Agreement, Global Master Securities Lending Agreement, Master Equity and Fixed Interest Stock Lending Agreement, Master Gilt Edged Stock Lending Agreement, Master Securities Loan Agreement and the Overseas Securities Lender's Agreement, and parties may elect to cover other types of agreements.

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