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ISDA Publishes 2018 U.S. Resolution Stay Protocol: Considerations for the Buy Side

ISDA recently published the ISDA 2018 U.S. Resolution Stay Protocol (the "Protocol"), which is now open for adherence. This Client Alert provides further information about the Protocol and considerations for buy-side entities in respect of the Protocol and the applicable rules to which the Protocol relates.

Rules Underlying the Protocol

U.S. federal banking regulators have adopted rules that represent a significant shift in the terms of "qualified financial contracts" (such as derivatives, repurchase and reverse repurchase transactions and securities lending transactions). These rules will require 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 order to continue trading with large financial institutions. The rules will apply to derivatives transactions, repurchase and reverse repurchase transactions and securities lending transactions with large financial institutions. As a result, institutional investors, hedge funds, mutual funds, sovereign wealth funds and other buy-side market participants who enter into these transactions after January 1, 2019 will need to bring their covered qualified financial contracts (including, but not limited to, ISDA Master Agreements, Master Repurchase Agreements, and securities lending agreements) with large covered financial institutions into compliance with the rules.

The 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. 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 rules seek to provide clarity with respect to the enforceability of the U.S. special resolution regimes by requiring parties to covered qualified financial contracts to "opt into" the applicability of these regimes by contract. In effect, parties to covered qualified 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 have been adopted in Germany, Japan, Switzerland and the United Kingdom, and are expected to be adopted in other jurisdictions.

In addition, the 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 qualified 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 qualified 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.

For additional details about the rules, please see our previous Client Alert.

Timing

Qualified financial contracts between a financial institution that is a "covered entity"[1] on the effective date of the rules and a counterparty that is a "financial counterparty" (including private funds, mutual funds, and commodity pools) must be in compliance by July 1, 2019; if the counterparty is not a financial counterparty, compliance is required by January 1, 2020.

However, the rules provide that if a covered entity enters into any qualified financial contract with a counterparty (or any of its consolidated affiliates) on or after January 1, 2019, then all of the qualified financial contracts between such covered entity and such counterparty must include the relevant provisions by the relevant compliance date. Therefore, we expect that covered entities will be reluctant to enter into new qualified financial contracts after **January 1, 2019** with any counterparty whose qualified financial contracts do not include the relevant provisions.

Protocol or Bilateral Amendments

Existing qualified financial contracts can be amended to include the relevant provisions either through adherence to the Protocol or by executing bilateral amendments with all relevant counterparties. There are advantages and disadvantages to each approach. Parties who adhere to the Protocol agree to somewhat different provisions than would be required to be included in bilateral amendments. This is the case because the U.S. banking regulators provided a safe harbor with respect to compliance with the rules for contracts between parties who are adherents to the ISDA 2015 Universal Resolution Stay Protocol (the "Universal Stay Protocol") (a protocol published by ISDA in 2015 and used to amend qualified financial contracts between dealers), which had been published before the rules were finalized, as well as for parties who are adherents to the Protocol (which the safe harbor describes as a future protocol to be published by ISDA that would be substantially the same as the Universal Stay Protocol with certain specified changes). Therefore, the Protocol tracks the terms of the prior Universal Stay Protocol (and, accordingly, the terms of the safe harbor), rather than tracking the terms otherwise required by the rules. Bilateral amendments between parties who have not adhered to the Protocol would need to track the terms required by the rules, since they would not satisfy the safe harbor.

Advantages of Bilateral Amendments

By adhering to the Protocol, an adhering entity opts into not only the stays under Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act, as amended ("FDIA") but also the comparable stays under the regimes of France, Germany, Japan, Switzerland and the United Kingdom. Therefore, parties adhering to the Protocol are required to "opt into" the stays under the laws of the United States and all jurisdictions listed above with respect to their existing contracts with counterparties in the applicable jurisdiction(s), and do not have the option to opt into some, but not all,

[1] A "covered entity" includes U.S. global systemically important banking organization ("GSIB") top-tier bank holding companies, certain subsidiaries of such bank holding companies, and certain U.S. operations of foreign GSIBs. The following U.S. banking institutions have been identified as GSIBs: 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 following foreign banking institutions have been identified as GSIBs: 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.

of the stay regimes of those jurisdictions. A party using bilateral amendments could do so, however, by (1) not entering into any new contracts with counterparties in that jurisdiction, and (2) using bilateral amendments to opt into the stays under the other jurisdictions.[2]

No bilateral amendment would be required with respect to a qualified financial contract that does not need to be amended to be in compliance with the rules. The qualified financial contract would need (1) to be explicitly governed by U.S. law (with no exclusion of U.S. special resolution regimes), (2) to have only counterparties that are incorporated or organized in, domiciled in, or have a principal place of business in the U.S., (3) not to include any default right that is related, directly or indirectly, to an affiliate of the direct "covered entity" party becoming subject to any receivership, insolvency, liquidation, resolution or similar proceedings and (4) not to prohibit the transfer of any guaranty or other credit enhancement provided by an affiliate of the "covered entity" party being transferred upon such affiliate becoming subject to any receivership, insolvency, liquidation, resolution or similar proceeding.

Advantages of the Protocol

Parties adhering to the Protocol would not need to undertake the time and effort to negotiate bilateral amendments with each of their "covered entity" counterparties. Also, parties adhering to the Protocol benefit from certain "creditor protections" provided under the terms of the Protocol (and therefore permitted under the safe harbor) that are not otherwise permitted under the terms of the rules. These include the following:

- Adherents to the Protocol waive their right to exercise remedies under a contract due to an affiliate of their direct counterparty entering insolvency proceedings, only if those insolvency proceedings are under Chapter 7 or Chapter 11 of the U.S. Bankruptcy Code or proceedings under the Securities Investor Protection Act, as amended, or the FDIA. Under a bilateral amendment, a party would have to waive such rights if the affiliate of the direct counterparty enters into any insolvency proceedings (including non-U.S. insolvency proceedings).
- The creditor protections under the Protocol apply regardless of whether the affiliate of the direct counterparty that is providing credit support is a "covered entity" under the rules (see footnote 1). However, under the rules, the creditor protections apply only if the affiliate providing credit support is a "covered entity" under the rules (for example, if the credit support is provided by a foreign GSIB or a non-U.S. affiliate of a foreign GSIB, which would not be a covered entity under the rules, the creditor protections would not apply).

ISDA published a chart comparing creditor protections in the Protocol to those in the rules (available here).

Questions

Please feel free to contact Leigh Fraser, Molly Moore, Lindsey Jones or any member of your regular Ropes & Gray team with any questions about the matters discussed in this Client Alert.

[2] ISDA also has published the ISDA Resolution Stay Jurisdictional Modular Protocol, which enables parties to opt into stay regimes in specific jurisdictions ("modules"). ISDA has published modules covering Germany, Japan, Switzerland and the United Kingdom; however, a U.S. module is not expected to be published and the ISDA Resolution Stay Jurisdictional Modular Protocol is not within the scope of the safe harbor available under the U.S. rules.