US Resolution Stay: End-User Compliance Options

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With the implementation of the US Resolution Stay Final Rules, end-users will be required to amend certain of their derivative and other financial contracts with global systemically important banking organizations (GSIBs). How these amendments are effected, whether through an industry protocol or bilateral arrangement, can result in material differences in the ability of end-users to exercise their insolvency-related default rights.

Introduction

One of the key regulatory reforms contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") was protecting the financial stability of the US by addressing the "too-big-to-fail" problem. Part of the strategy undertaken by the US Regulators[1] has been to help ensure that a US insolvency proceeding of a global systemically important banking organization (a "**GSIB**") is as orderly as possible in an effort to help mitigate the destabilizing effects on the financial system.

As part of this strategy each of the US Regulators adopted substantially similar final rules (together, the "**Final Rules**")[2] setting forth limitations to be placed on parties to certain "qualified financial contracts" (a "**QFC**")[3] exercising insolvency-related default rights against their dealer counterparties that have been designated as GSIBs (each, a "**Covered Entity**").[4]

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1 The Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Federal Deposit Insurance Corporation (the "**FDIC**") and the Office of the Comptroller of the Currency (the "**OCC**", and together with the Federal Reserve and the FDIC, the "**US Regulators**").

2 Federal Reserve Final Rules: Restrictions on Qualified Financial Contracts of Systemically Important US Banking Organizations and the US Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 82 FR 42882 (13 November 2017), available at https://www.federalregister.gov/d/2017-19053; FDIC Final Rules: Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 82 FR 50228 (30 October 2017), available at https://www.federalregister.gov/d/2017-21951; Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definition, 82 FR 61443 (28 December 2017), available at https://www.federalregister.gov/d/2017-27971; OCC Final Rules: Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 82 FR 56630 (29 November 2017), available at https://www.federalregister.gov/d/2017-25529.

3 A "qualified financial contract" is defined to have the same meaning as in the Dodd-Frank Act and would include, among others, derivatives, repos, securities lending and borrowing transactions, commodity contracts and forward agreements. This definition would also include master agreements that apply to QFCs (e.g., an ISDA Master Agreement).

4 Whether an entity is regulated by the Federal Reserve, the FDIC or the OCC will depend on whether such entity will be subject to the Final Rules of each such respective regulator. Each entity subject to the Federal Reserve's Final Rules is termed a "covered entity" under that rule. Each entity subject to the FDIC's Final Rules is termed a "covered

The Final Rules achieve this outcome by requiring Covered Entities to insert restrictions and prohibitions directly into each of their covered QFCs. This will necessarily require end-users that are counterparties to a covered QFC to amend such contracts to limit their termination rights related to the resolution and bankruptcy proceedings of a Covered Entity.

For end-users, there are two compliance options available, the scope and requirements of which differ, as further described below.

For a more detailed explanation of the Final Rules, please see our client alert available here.

Compliance Options

End-users that are parties to a covered QFC can implement the required amendments in one of two ways:

a) adherence to a safe-harbored protocol; or

b) entering into a bilateral amendment agreement complying with the requirements of the Final Rules.

ISDA Protocols

Background

The Final Rules provide a safe-harbor for those covered QFCs that are amended by the ISDA 2015 Universal Stay Protocol ("**Universal Protocol**")[5] or the ISDA 2018 US Resolution Stay Protocol ("**2018 Protocol**")[6] by deeming those covered QFCs to be in compliance with the Final Rules. As discussed further below, there are material differences between the Final Rules and the protocols that end-users should consider.

The Universal Protocol was implemented prior to the Final Rules for use by dealer entities to address certain concerns of regulatory authorities in Germany, France, Japan, Switzerland, the UK and the US until such time as comprehensive statutory regimes could be developed and adopted. For example, adherents to the Universal Protocol agree to "opt-in" and be bound by stays applicable to all other adhering parties as well as certain other identified and eligible resolution regimes in order to provide a contractual approach to cross-border recognition of such regimes.[7]

As mentioned above, the safe-harbor provisions in the Final Rules also permit compliance with its requirements through the use of a new US-specific protocol, provided that such protocol has the same terms as the Universal Protocol except where the Final Rules explicitly permit otherwise. The 2018 Protocol was developed by the International Swaps and Derivatives Association, Inc. ("**ISDA**") and a working group composed of dealer and buy-side member firms to comply with these safe-harbor provisions. The Universal Protocol was not necessarily intended to be used by end-users; it was prepared for compliance by and among dealers. Given this focus of the Universal Protocol, this article will consider more particularly compliance with the Final Rules via the 2018 Protocol.

For further information on the Universal Protocol, please refer to our client alert available here.

2018 Protocol

The 2018 Protocol will apply to all "in scope" QFCs under the Final Rules, which will include most derivatives, repos, securities lending and borrowing transactions, commodity contracts and forward agreements as well as industry-standard master agreements, (e.g., an ISDA Master Agreement), subject to certain limited exceptions

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FSI" under that rule. Each entity subject to the OCC's Final Rules is termed a "covered bank" under that rule. This article will refer to each of these entities as a "**Covered Entity**".

5 The Universal Protocol was published by ISDA and is available on its website.

6 The 2018 Protocol was published by ISDA and is available on its website.

7 The Universal Protocol specifies six "Identified Regimes", being the resolution regimes in Germany, France, Japan, Switzerland, the UK and the US. In additional, the Universal Protocol permits the inclusion of "Protocol-Eligible Regimes," which are not specified but may subsequently qualify as such under the Universal Protocol (including via publication of new "Country Annexes").

set out in the Final Rules. If an ISDA Master Agreement is amended by the 2018 Protocol, then all legacy and future transactions entered into thereunder will be subject to such amendments.

An entity that adheres to the 2018 Protocol is referred to as an "**Adhering Party**". If an Adhering Party is a Covered Entity (i.e., a US GSIB[8] (or any of its subsidiaries) or a US subsidiary, branch or agency of a foreign GSIB[9]), then it is a "**Regulated Entity**" for the purposes of the 2018 Protocol. End-users will be Adhering Parties, but not Regulated Entities.

The 2018 Protocol will amend covered QFCs in the following two ways:

Opt-in with respect to certain specified US and non-US bank resolution regimes (Section 1)

In order to ensure cross-border enforcement of such resolution regimes, Section 1 of the 2018 Protocol includes explicit terms in covered QFCs pursuant to which end-users agree to only exercise their direct default rights and transfer restrictions against their Regulated Entity counterparties to the same extent as provided under the applicable resolution regime (irrespective of whether or not such regime was enforceable in the applicable foreign jurisdiction). That is, end-users are effectively "opting-in" to the applicable resolution regimes by contractual agreement. The applicable regimes are the specified resolution regimes in Germany, France, Japan, Switzerland, the UK and the US. Unlike the Universal Protocol, the 2018 Protocol does not include an opt-in to any additional regimes.

Limitations on certain cross-default rights (Section 2)

Section 2 of the 2018 Protocol includes explicit terms in covered QFCs that prohibit an end-user from exercising a range of cross-default rights that are related to the entry into proceedings by an affiliate of their Regulated Entity counterparty under Chapter 11 of the Bankruptcy Code or the Federal Deposit Insurance Act ("**FDIA**"). These restrictions do not apply to default rights that occur with respect to the Regulated Entity directly. For completeness, we note that, with respect to credit enhancements (e.g., guarantees, collateral arrangements and letters of credit) provided by an affiliate that supports a covered QFC, the restrictions in Section 2 only apply during the stay period (which is the longer of one business day and 48 hours), although this may be extended or become permanent in certain circumstances. For instance, the stay period will become permanent where, very broadly, the applicable affiliate credit enhancement as well certain assets of the affiliate are successfully transferred to a third party and such third party continues to satisfy its obligations under the credit enhancement. Section 2 also permits a Regulated Entity to transfer a credit enhancement and overrides any restrictions on such a transfer, assuming certain creditor protections are satisfied.

Adherence to the 2018 Protocol opened on August 22, 2018. The text of the 2018 Protocol as well as further information on the 2018 Protocol, including frequently asked questions, is available on the ISDA Website.

Bilateral Agreement

As an alternative to adhering to the 2018 Protocol, end-users are also entitled to enter into a bilateral amendment agreement with individual Covered Entities complying with the requirements of the Final Rules. We understand that ISDA is developing template bilateral agreements, which will be available on the ISDA Website.

For information on the Final Rules, please see our client alert available here.

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8 As of the date of this article, there were eight US GSIBs: Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc., Goldman Sachs, Inc., JPMorgan Chase & Co., Morgan Stanley Inc., State Street Corporation and Wells Fargo & Company.

9 A "foreign GSIB" is a foreign banking organization that would be designated as a GSIB if it were subject to the Federal Reserve's jurisdiction or would be a GSIB under the methodology for identifying GSIBs adopted by the Basel Committee on Banking Supervision. See "Global systemically important banks: Updated assessment methodology and the higher loss absorbency requirement", available here.

In November 2017, the Financial Stability Board and the Basel Committee on Banking Supervision published an updated list of banking organizations that are GSIBs under the assessment methodology. The list includes the eight US GSIBs and the following 22 foreign banking organizations: Agricultural Bank of China, Bank of China, Barclays, BNP Paribas, China Construction Bank, Credit Suisse, Deutsche Bank, Royal Bank of Canada, 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. See FSB, ''2017 update of list of global systemically important banks'' (21 November 2017), available here.

End-User Considerations

Given that the scope and requirements of the 2018 Protocol and the Final Rules differ, end-users need to determine which compliance method best suits their particular circumstances.

We set out below some points that end-users may wish to consider in deciding which compliance option to use.

Universal adherence versus dealer-by-dealer compliance

End-users that adhere to the 2018 Protocol are adhering on a universal basis, not on a dealer-by-dealer basis. That is, by adhering to the 2018 Protocol, an end-user is agreeing to amend its covered QFCs with all its Regulated Entity counterparties, including Regulated Entities that will adhere after the end-user itself has adhered. The primary benefit of this approach is that it provides end-users with a cost-effective and administratively efficient way to amend its agreements to bring them into compliance. However, an end-user loses its ability to choose the Regulated Entities with which it will amend its covered QFCs.

End-users that adhere by bilateral agreement amend their covered QFCs individually with each of their Covered Entity counterparties in accordance with the requirements of the Final Rules. While this provides an end-user with more flexibility around its compliance, it is much more administratively burdensome as it requires individual amendment agreements to be negotiated and entered into with each of its Covered Entity counterparties.

Creditor protections

Taken as a whole, the creditor protections provided under the 2018 Protocol are greater than those under the Final Rules. As such, end-users that adhere to the 2018 Protocol will have greater creditor protections in their covered QFCs than if they amended their covered QFCs by entering into a bilateral agreement complying with the Final Rules (i.e., end-users will generally have greater rights to terminate under the 2018 Protocol).

We set out below some of the main differences between the creditor protections in the 2018 Protocol and those in the Final Rules (as would apply if using a bilateral amendment agreement):

Restricted cross-default rights

Under the 2018 Protocol, the types of restricted cross-default rights are those in respect of the entry into proceedings of an affiliate of the end-user's Regulated Entity counterparty under Chapter 11 of the Bankruptcy Code or the FDIA. Under a bilateral agreement in compliance with the creditor protections under the Final Rules, the universe of restricted cross-default rights is more expansive as it encompasses any default rights related, directly or indirectly, to the entry into a receivership, insolvency, liquidation, resolution or similar proceeding of an affiliate of the Covered Entity under any US or non-US insolvency regime.

Credit enhancements

Under both the 2018 Protocol and the Final Rules, cross-default rights are permitted with respect to certain insolvency proceedings entered into by an affiliate credit enhancement provider. However, the requirements for what constitutes an affiliate credit enhancement provider varies between the 2018 Protocol and the Final Rules. Under the 2018 Protocol, the applicable definition is "credit enhancement provider" which requires that the applicable credit enhancement be provided by an affiliate of the Regulated Entity irrespective of whether that affiliate is subject to the Final Rules or not (i.e., is a Covered Entity or not). However, under the Final Rules, the applicable definition is "covered affiliate support providers" which requires that the affiliate also be a Covered Entity. Therefore, end-users that utilize the 2018 Protocol rather than a bilateral agreement that complies with the Final Rules will have greater creditor protections.

Credit enhancement stay period extension

Under both the 2018 Protocol and the Final Rules, the restriction on use of cross-default rights with respect to affiliate credit enhancement providers ends following the expiration of the stay period (i.e., the longer of one business day and 48 hours) provided that certain conditions are satisfied, which differ between the 2018 Protocol and the Final Rules. The 2018 Protocol is generally more specific in its requirements including, for example, requiring the involvement of the bankruptcy court in determining whether the stay period will be extended. In contrast, the Final Rules are somewhat more general. The practical effect for end-users is that

there may be more latitude for the stay period to be extended under a bilateral agreement that complies with the Final Rules than under the 2018 Protocol. The longer the stay period runs, the longer an end-user will be restricted from exercising certain cross-default rights.

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