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Newly Adopted Fed Rules: Limiting Buy-Side Remedies in Financial Institutions

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The Board of Governors of the Federal Reserve System (the "Board") has adopted final rules[1] that represent a significant shift in the terms of over-the-counter 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 many jurisdictions in order to continue trading with large financial institutions. The new rules 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, these 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 (or an affiliate 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[2] 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 have been adopted in Germany, Japan and the United Kingdom, and are being adopted in other jurisdictions.

[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; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, which is available here.

[2] The term "U.S. special resolution regimes," as used in the final rules, means the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act and related regulations.

Under comparable regulations in certain jurisdictions, contracts are only required to include provisions "opting into" the applicable stay if the contract is governed by the law of a different jurisdiction (therefore increasing the risk that the stay would not otherwise be enforceable). The Board included a narrower exemption in the final rules, exempting contracts from the "opt in" requirement if the contract is governed by the laws of the United States or a U.S. state and each party to the contract (other than the covered financial institution) is an individual domiciled in the U.S., a company organized in the U.S., a company with a principal place of business in the U.S., or a U.S. branch or U.S. agency.

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 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.

The final rules are largely similar to the rules proposed by the Board in 2016. For a detailed description of the proposed rules, please see our previous Alert.

ISDA Resolution Stay Jurisdictional Modular Protocol and Next Steps

Generally speaking, the rules require global financial institutions that are "covered entities"[3] to incorporate certain provisions into their "qualified financial contracts" ("QFCs"), including contracts with buy-side firms. The International Swaps and Derivatives Association (ISDA) has published the "ISDA Resolution Stay Jurisdictional Modular Protocol" (the "Modular Protocol"), 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"), which addresses the same policy goals as the Modular Protocol. Whereas the 2015 Protocol was developed in advance of regulations requiring parties to agree to provisions such as those required by the rules with their counterparties, the Modular Protocol has

[3] The term "covered entity" includes (i) U.S. global systemically important banking organization ("GSIB") top-tier bank holding companies, (ii) any subsidiary of such a bank holding company that is not an "excluded bank," and (iii) the U.S. operations of a foreign GSIB that is not an excluded bank. Excluded banks generally are national banks and other entities that are supervised by the Office of the Comptroller of the Currency or the Federal Deposit Insurance Corporation, which are expected to issue substantially similar rules.

The following entities are identified as U.S. GSIBs in the adopting release for the rules: 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 final rules also cover the U.S. operations of foreign GSIBs that are not excluded banks. The adopting release notes that, as of November 2016, this group includes the following 22 foreign banking organizations: 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.

been developed to facilitate compliance with specific legislative or regulatory requirements in different jurisdictions (*i.e.*, each jurisdiction will have its own "module"). As of the date of this post, ISDA has published modules for Japan, Germany and the United Kingdom. It is expected that ISDA will publish a module for the United States (and other jurisdictions, as new rules are adopted in those jurisdictions).

The adopting release relating to the final rules specifically states that covered entities may comply with the final 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 rules. The final rules also provide that covered entities may comply by adhering to a "U.S. protocol," which is defined as "a protocol that is the same as the universal protocol" (*i.e.*, the 2015 Protocol), except for certain differences that are described in the rules. In the adopting release for the rules, the Board reiterates statements made in the proposing release noting 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, and as a result 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 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 rules. In the final release, the Board clarified that incorporating the terms of a protocol into an agreement by reference is treated the same as adhering to a protocol for this purpose.

It is expected that ISDA will publish a jurisdictional module for a particular jurisdiction (including the United States) once regulations in the jurisdiction are finalized. The scope of agreements covered under each jurisdictional module typically tracks 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.

Covered QFCs between a financial institution that is a "covered entity" 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**. As a practical matter, this means that buy-side firms entering into over-the-counter derivatives, repurchase or reverse repurchase agreements or securities loans with covered entities will be required to agree to the applicable provisions contemplated by the rules (*e.g.*, by adherence to the U.S. module of the Modular Protocol—which has not yet been published—or otherwise) by the applicable compliance date.