+44 (0)20 3405 0201

contact@abderivs.com

ISDA 2018 U.S. Resolution Stay Protocol

03 - Sep - 2018

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Do You Need to Take Action?

Yes, you will need to sign up to the ISDA 2018 U.S. Resolution Stay Protocol (the "US Protocol") in order to trade with applicable entities with a United States ("US") nexus (see below). We expect broadly all of our buy side clients to sign up to the US Protocol.

How Soon Will You Need to Take Action?

The relevant US resolution stay rules (defined below as the "QFC Rule") come into effect from 1 January 2019 and, although the applicable phase-in date for the majority of the buy side is 1 July 2019, it is likely that in-scope dealers (which is likely to mean the vast majority of dealers) will request adherence by the end of this year.

What is it?

On 31 July 2018, the International Swaps and Derivatives Association, Inc. ("ISDA") published the US Protocol[1]. The US Protocol is now open for adherence and ISDA has also published accompanying frequently asked questions ("FAQs")[2].

Background to Resolution Stay Protocols

Following the financial crisis of 2008, a number of jurisdictions have implemented laws or regulations requiring market participants falling under their legal or regulatory supervision to amend certain agreements to recognise stays or overrides of certain early termination rights under the applicable jurisdiction's statutory regimes. For example, a New York law-governed agreement may not recognise EU laws and regulations, hence a regulator may require a supervised EU-based entity to ensure that the agreement is amended to recognise applicable EU laws and regulations, notwithstanding the governing law of the agreement. If the other party refuses to agree to such amendment, the supervised entity must cease doing business with that party.

In terms of other (prior) resolution stay protocols, ISDA most recently published the ISDA Resolution Stay Jurisdictional Modular Protocol (the "Stay Jurisdictional Protocol"), which enables a regulated entity to comply with its own regulatory obligations to amend relevant agreements to include contractual recognition of stays on or overrides of termination rights under the home country special resolution regime of such regulated entity. Adherents to the Stay Jurisdictional Protocol choose to apply one or more jurisdictional modules which relate to particular stay regulations in particular jurisdictions[3].

ISDA had previously published the ISDA 2015 Universal Resolution Stay Protocol (the "2015 Universal Stay Protocol"), which had broadly the same aims, but was developed in advance of stay regulations being finalised and received few adherents (those adherents being almost entirely sell side entities). The relevant US resolution stay rules (defined below as the "QFC Rule") provide a safe harbour for compliance via the 2015 Universal Stay Protocol, in other words parties may choose to adhere to the 2015 Universal Stay Protocol instead of the US Protocol. However, important provisions differ between these two protocols, and it is expected that market participants will predominantly choose to adhere to the US Protocol.

Why is the US Protocol Needed?

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (together, the "US Agencies") have each adopted final rules (collectively, the "QFC Rule")[4] intended to promote US financial stability by improving the resolvability and resilience of systemically important US banking organisations and systemically important foreign banking organisations (together, "G-SIBs"). The QFC Rule is one part of a suite of measures to address the spectre of 'too big to fail'.

The QFC Rule requires (i) US G-SIBs and their US and non-US subsidiaries and (ii) the US operations of non-US G-SIBs (i.e., their US subsidiaries, US branches and US agencies) (each, a "Covered Entity"), to amend their in-scope qualified financial contracts ("QFCs") to ensure the contractual recognition of certain 'stay' aspects of the US special resolution regimes (i.e., a contractual 'opt-in' to the relevant regimes). The rationale for contractual recognition is that a foreign court may not enforce relevant stay provisions of such regimes, in which case a contractual opt-in is necessary to ensure that such stays are recognised, and enforced.

What is a QFC?

A QFC is broadly defined to include any securities contract, commodity contract, forward contract, repurchase agreement or swap agreement (i.e., a QFC, and therefore the coverage of the US Protocol, extends beyond derivative transactions). However, certain QFCs are excluded from the ambit of certain of the contractual stay provisions of the QFC Rule (and hence from certain of the provisions of the US Protocol). For example: (i) the provisions of Section 1 of the US Protocol (see below) exclude QFCs governed by US law and entered into with a counterparty that is domiciled, incorporated, organised or has a principal place of business in the US; and (ii) the provisions of Section 2 of the US Protocol (see below) exclude QFCs that do not include default rights related directly or indirectly to certain of the Covered Entity's affiliates becoming subject to insolvency proceedings and do not prohibit the transfer of a credit enhancement (for example, a guarantee or collateral arrangement) provided by an affiliate of a Covered Entity upon or following the affiliate becoming subject to insolvency proceedings.

The US Protocol covers in-scope QFCs entered into between adhering parties on or before the relevant compliance date (see below) unless the parties choose to expressly override this in the QFC. In respect of in-scope QFCs entered into after the relevant compliance date, the US Protocol can be incorporated by reference in the QFC itself[5], as long as the parties have previously adhered to the US Protocol.

What Does the US Protocol Do?

Broadly, the US Protocol enables parties to amend their in-scope QFCs to give contractual recognition to the stays on insolvency-related default and cross-default rights required by the QFC Rule. An adhering party cannot select which Covered Entities the amendments will be made in relation to, as the US Protocol operates on a 'universal' basis (although the US Protocol will not apply if neither adhering party is a Covered Entity and no such amendment is required under the QFC Rule).

More specifically, the US Protocol provides for the following contractual amendments:

1. Section 1 of the US Protocol (resolution regime 'opt-in'): if the Covered Entity, its parent company or any other affiliate of the Covered

Entity which is identified in the QFC as a "Credit Support Provider" or a "Specified Entity" becomes subject to a special resolution regime in France, Germany, the United Kingdom, Japan, Switzerland or the US[6], then its counterparty may only exercise its default and cross-default rights (which, in this context, also include enforcement of collateral rights) to the extent allowed under the relevant identified special resolution regime (which could mean a stay of up to two business days[7] – and if the resolution action is 'successful', then such stay may become permanent).

2. Section 2 of the US Protocol (cross default rights restrictions): if an affiliate of the Covered Entity becomes subject to certain insolvency proceedings under the U.S. Bankruptcy Code, Federal Deposit Insurance Act ("FDIA") or the Securities Investor Protection Act, but the Covered Entity does not become subject to similar insolvency proceedings, and is still performing and meeting its obligations under the in-scope QFC, then, very broadly, such Covered Entity's counterparty may only exercise default rights against the Covered Entity which are unconnected to the affiliate's insolvency. For example, were an affiliate of the Covered Entity to be designated as a "Specified Entity" for the purposes of 'Bankruptcy' under an ISDA Master Agreement between the Covered Entity and its counterparty, the insolvency of the affiliate of the Covered Entity would not allow the counterparty to declare an Event of Default under that ISDA Master Agreement. However, a failure to pay by the Covered Entity under that ISDA Master Agreement would allow the Covered Entity's counterparty to declare an Event of Default. This stay on rights will last the longer of one business day or 48 hours following the commencement of the applicable insolvency proceedings – and if the resolution action is 'successful', then such stays may become permanent.

When is the Compliance Date?

The contractual recognition requirements of the QFC Rule are phased-in, such that they initially apply from 1 January 2019 for QFCs in respect of which both parties are Covered Entities (the "First Compliance Date"). However, the majority of buy side entities such as hedge funds and other investment vehicles will be required to comply by 1 July 2019. For completeness, we should add that the remainder of in-scope counterparties will have until 1 January 2020 to comply.

An industry body letter[8] has highlighted a potential issue with this phase-in process. The QFC Rule currently requires that a Covered Entity entering into a new QFC after the First Compliance Date must ensure that both the new QFC and all pre-existing QFCs are then compliant with the QFC Rule requirements, which is inconsistent with the notion of phase-in periods. If Covered Entities were to go along with this interpretation of the QFC Rule, then they would need to adhere to the US Protocol by the end of this year (2018). However, if a party were to adhere to the US Protocol before 1 January 2019, the provisions of the US Protocol would not begin to apply until the relevant phase-in date applicable to that party (for example, 1 July 2019, being the applicable phase-in date for most buy side entities), in which case early adherence to the US Protocol may not be a remedy to this apparent conflict.

Notwithstanding the above, Covered Entities are likely to want their buy side counterparties to adhere to the US Protocol (or achieve compliance in another manner) before the 2018 year-end to ensure that they can comply with the QFC Rule in respect of in-scope QFCs entered into after the First Compliance Date and before 1 July 2019.

AB Trading Advisors View and Comment

Compliance with the QFC Rule can realistically be achieved in two ways[9]: (1) bilateral amendments to each relevant QFC to incorporate language complying with the relevant contractual stay provisions[10]; or (2) taking advantage of a safe harbour in the QFC Rule which provides that adherence to the 2015 Universal Stay Protocol or the US Protocol (each, a "Complying Protocol") will be deemed to comply with the requirements.

Adhering to a Complying Protocol has three distinct advantages over a bilateral approach: (1) the provisions of each Complying Protocol are less stringent than the exact requirements of the QFC Rule in certain respects, such as a narrower restriction on cross default; (2) adherents to a Complying Protocol benefit from enhanced creditor protections compared to those who take a bilateral approach[11]; and (3) once a Complying Protocol is adhered to, the provisions of that Complying Protocol can be incorporated into future QFCs with another Complying Protocol adherent (which is not possible if a Complying Protocol has not been adhered to), which will make ongoing compliance far easier.

Seeing as adherence to the 2015 Universal Stay Protocol was (and remains) unpopular with the buy side, adherence to the US Protocol would be the preferred compliance option (even though the US Protocol is substantially similar to the 2015 Universal Stay Protocol other than where differences are required or permitted by the QFC Rule). We and ISDA expect that the US Protocol will be the most common method used by the buy side to achieve regulatory compliance.

However, to end on a note of caution, the US Protocol (in common with the 2015 Universal Stay Protocol and the Stay Jurisdictional Protocol) is complicated and very detailed (by necessity, since it closely tracks the QFC Rule). Whilst adhering to the US Protocol would satisfy the requirements under the QFC Rule (and keep the US Agencies happy), there is a wider market issue here. Given the complexity of the circumstances in which contractual stay recognitions apply, together with their interaction with other jurisdictions' resolution regimes and stay requirements, market participants are likely to find it difficult to fully appreciate the impact of the applicable stay measures and which of their counterparties they apply to (and in what way they apply to those counterparties) and thus accurately evaluate risk.

What can be said for sure is that almost all buy side entities will need to adhere to one of the Complying Protocols in due course in order to continue their trading activity with any counterparty with a US nexus (which means, most likely, almost all of the usual names).

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[1] Available at: https://www.isda.org/protocol/isda-2018-us-resolution-stay-protocol/

[2] Available at: https://www.isda.org/a/8FjEE/ISDA-2018-U.S.-Protocol-FAQs-Final.pdf

[3] See our August 2016 Briefs for the Buy side on the Stay Jurisdictional Protocol, available at: https://abderivs.com/client-news/isda-resolution-stay-jurisdictional-modular-protocol/

[4] The rules of the three US Agencies are substantially similar but will apply to different entities within a G-SIB's organisation depending on such entity's activities. They are: 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, 82 Fed. Reg. 42882 (Sept. 12, 2017), available at https://www.gpo.gov/fdsys/pkg/FR-2017-09-12/pdf/2017-19053.pdf; Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 82 Fed. Reg. 50228 (Oct. 30, 2017), available at https://www.fdic.gov/news/board/2017/2017-09-27-notice-sum-b-fr.pdf; and Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 82 Fed. Reg. 56630 (Nov. 29, 2017), available at: https://www.occ.treas.gov/news-issuances/federal-register/82fr56630.pdf; and related rulemakings.

[5] The FAQs provide template language for this on page 9 thereof.

[6] In the context of US special resolution regimes, this applies to the regimes under the Federal Deposit Insurance Act ("FDIA") and the

Orderly Liquidation Authority provisions of Title II of the Dodd-Frank Act (“OLA”).

[7] Under FDIA and OLA, the stay lasts until the end of the following business day.

[8] From SIFMA AMG and the Investment Company Institute to the US Agencies, available at: https://www.sifma.org/wp-content/uploads/2018/04/SIFMA-AMG-and-ICI-Request-the-U.S.-Banking-Agencies-align-the-Applicability-Dates-with-Phased-In-Compliance-Schedule-Under-the-Qualified-Financial-Contract-%E2%80%9CQFC%E2%80%9D-Stay-Rules.pdf.

[9] A third way is for the US Agencies to approve an alternative proposal; however, this approach requires in-depth policy consideration analysis and a legal opinion as to validity and enforceability.

[10] ISDA has produced template language for such a bilateral amendment approach that certain counterparties could use in some circumstances, available at: https://www.isda.org/a/gZjEE/Standard-Language-Part-I-of-US-Stay-Regulations.pdf

[11] ISDA has produced a comparison of creditor protections, available at: https://www.isda.org/a/EZjEE/Comparison-of-Creditor-Protections-ISDA-2018-U.S.-Resolution-Stay-Protocol-versus-Bilateral-Agreement.pdf