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ISDA introduces protocol to address upcoming rules related to qualified financial contracts in the orderly resolution of systemically important financial institutions

September 17, 2018

U.S. federal banking regulations that go into effect next year require certain major financial institutions to ensure that their qualified financial contracts (QFCs), such as swaps and repurchase agreements, are subject to temporary or permanent limitations on counterparties' legal abilities to exercise default rights in the event that the financial institution becomes subject to a resolution regime as a result of financial distress, such as that which may result from capital or liquidity problems.[1] Many QFCs contain termination rights that are triggered upon the insolvency of a counterparty or an affiliate of a counterparty. These rights are ordinarily not subject to the U.S. Bankruptcy Code's automatic stay on proceedings against a debtor[2] and are ordinarily not affected by the appointment of the Federal Deposit Insurance Corporation as receiver of an insured depository institution.[3]

In lieu of requiring each QFC to be amended on a bilateral basis to comply with the new federal regulations, covered financial institutions are allowed a regulatory "safe harbor," allowing counterparties to QFCs to adhere to a uniform protocol that would have the effect of amending each QFC.[4] The federal regulations were issued by the prudential banking regulators, namely the Board of Governors of the Federal Reserve System (the Fed), the Federal Deposit Insurance Corporation (the FDIC), and the Office of the Comptroller of the Currency (the OCC, and together with the Fed and the FDIC, the Prudential Regulators) and are substantively similar to each other, with certain differences to account for the nature of the regulated institutions. The protocol would override QFC participants' usual contractual rights to exercise default rights as a result of a bankruptcy or insolvency event and would also override the exceptions to the U.S. Bankruptcy Code's and Federal Deposit Insurance Act's automatic stays. Although the federal statutes governing resolution regimes have such override provisions, the protocol would constitute an express contractual consent to the overrides. This summer, the International Swaps and Derivatives Association (ISDA) introduced the ISDA 2018 U.S. Resolution Stay Protocol (the U.S. Stay Protocol), and market participants have commenced the adherence process.[5] In the coming

[1] *See* 12 C.F.R. §§ 47.1-8, 252.81-88, 382.1-7
[2] *See* 11 U.S.C. § 362(b)(17).
[3] *See* 12 U.S.C. § 1821(e)(8)(A).
[4] *See* 12 C.F.R. §§ 47.6, 252.85(a), 382.5(a).
[5] The US Stay Protocol is available at https://www.isda.org/protocol/isda-2018-us-resolution-stay-protocol/.

months, swap participants, including funds and commercial end users, may be asked by their bank counterparties to adhere to this protocol via the ISDA website.

Who should read further?

Market participants that enter into QFCs, such as swaps, options, forwards, and repurchase agreements, with certain systematically important non-U.S. financial institutions and their U.S. branches, agencies, and affiliates, regardless of the underlying governing law of the QFC, and market participants that enter into QFCs with affiliates of systemically important financial institutions both in the United States and outside the United States that are not governed by the laws of the United States or a U.S. state are likely to be asked to adhere to the U.S. Stay Protocol. QFCs with commercial end users are not exempt from the federal regulations addressed by the U.S. Stay Protocol.

Do I have to adhere to this protocol?

By their terms, the federal regulations (the Stay Regulations) apply only to a subset of those entities that are regulated by the Prudential Regulators.[6] Not all financial institutions are subject to the Stay Regulations. Rather, only entities that are designated as global systemically important banks (G-SIBs), along with U.S.-based subsidiaries and branches of G-SIBs, are required to comply with the Stay Regulations. As of the present date, thirty banks have been designated as G-SIBs, including JP Morgan Chase, Bank of America, Citigroup, Goldman Sachs, Wells Fargo, and Morgan Stanley. Furthermore, numerous non-U.S. G-SIBs, such as Barclays and ING Bank, have swap and/or repo operations in the United States.

The Stay Regulations are not directly applicable to entities that are neither G-SIBs nor affiliated with G-SIBs, such as end users, hedge funds, corporates, and sovereigns, and accordingly, there is no affirmative legal obligation for any such entity to enter into the U.S. Stay Protocol.[7] However, financial institutions are likely to decline to enter into any new transactions after the applicable compliance date under existing master swap and repo agreements with non-adhering counterparties. Some financial institutions may be willing to negotiate bilateral amendments with certain counterparties in lieu of entering into the U.S. Stay Protocol. While the U.S. Stay Protocol is a pre-approved method of complying with federal regulations, bilateral amendments are not.

By when should I adhere to the protocol?

Only QFCs entered into on or after January 1, 2019 are subject to the Stay Regulations, regardless of whether the master agreement, if any, covering such QFC was executed before this date. The regulators have allowed a staggered roll-out for compliance dates. The compliance date for any QFCs between two G-SIBs or subsidiaries of G-SIBs is January 1, 2019.[8] The next compliance date, July 1, 2019, applies to QFCs with "financial counterparties" (a regulatory category that includes banks, private funds, commodity pool operators, and employee benefit plans, among others), with the exception of small financial institutions (a regulatory category that generally applies to banking entities that have assets of US$10 billion or less).[9] The last compliance date, applying to all other QFCs, including those with non-financial end users, is January 1, 2020.[10] The U.S. Stay Protocol will not amend any master agreements that are entered into following the day that the last of the two counterparties adheres to the protocol. However, post-adherence QFCs entered into pursuant to the terms of pre-adherence master agreements will be deemed amended by the terms of the U.S. Stay Protocol. ISDA has published language that may be

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[6] *See* 12 C.F.R. §§§ 47.3(b), 252.82(b), 382.2(b).
[7] *See id.*
[8] *See* 12.C.F.R. §§ 47.3(f)(1)(i), 252.82(f)(1)(i), 382.2(f)(1)(i).
[9] *See* 12.C.F.R. §§ 47.3(f)(1)(ii), 252.82(f)(1)(ii), 382.2(f)(1)(ii).
[10] *See* 12.C.F.R. §§ 47.3(f)(1)(iii), 252.82(f)(1)(iii), 382.2(f)(1)(iii).

included in post-adherence master agreements for purposes of compliance with resolution regime requirements.

Which regulations does the protocol address?

Bank resolution regimes typically include prohibitions (known as automatic stays) that have the effect of disallowing market participants from exercising default rights against their direct bank counterparties and against affiliates of the entities in resolution.[11] Derivatives and repurchase transactions are subject to a safe harbor under the U.S. Bankruptcy Court, the Federal Deposit Insurance Act, and other federal banking statutes, and as a result, an automatic stay is not applied, allowing parties to close out of net transactions and apply collateral rights. Numerous counterparties to Lehman Brothers exercised these rights during the Lehman bankruptcy, which led to the seizure of collateral and cross-defaults to other agreements, exacerbating the nascent financial crisis. The purpose of the U.S. Stay Protocol is to ensure that there is no contractual uncertainty regarding whether an automatic stay can be enforced by courts, especially courts outside the United States. In essence, the U.S. Stay Protocol applies the automatic stay to derivatives transactions and contractually overrides the U.S. Bankruptcy Code safe harbor. The result is an even playing field between counterparties whose QFCs are governed by U.S. law and those whose QFCs are governed by the law of a different jurisdiction.

Stay Regulations are intended to assist banking regulators in the orderly resolution of failing banking institutions.[12] More specifically, the U.S. Stay Protocol provides that counterparties expressly acknowledge their own limits on the exercise of default rights, as stipulated by Title II of the Dodd-Frank Act (known as the Orderly Liquidation Authority) and the Federal Deposit Insurance Act, as well as the FDIC's power to transfer QFCs to other institutions without the counterparties' prior consent.[13] Furthermore, the U.S. Stay Protocol limits a QFC counterparty's ability to declare a default and exercise related default rights under the QFC as a result of the direct client-facing bank counterparty's affiliate entering into insolvency proceedings and permits the transfer of credit support (such as a bank parent guaranty) to another entity.[14]

Under the Stay Regulations, covered entities are U.S. bank holding companies identified as G-SIBs along with all U.S. and non-U.S. subsidiaries of such bank holding companies, along with U.S. subsidiaries, U.S. branches, and U.S. agencies of a non-U.S. G-SIB.[15] QFCs are contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and any similar agreements that the FDIC determines by regulation, resolution, or order to be a qualified financial contract.[16] A guarantee of a swap agreement is generally deemed to be a QFC. For purposes of the Stay Regulations, in-scope QFCs are generally those entered into on or after January 1, 2019 along with those entered into prior to such date by a covered entity (or any affiliate that is a covered entity) with another entity or consolidated affiliate of such other entity if they also enter into another QFC on or after January 1, 2019.[17] Multi-branch QFCs that permit transactions to be booked via a U.S. branch or agency of a foreign G-SIB may be viewed as in-scope QFCs by federal regulators.

The requirement to conform the terms of QFCs to the Stay Regulations do not apply if the QFC (a) explicitly provides that it is governed by the laws of the United States or a U.S. state; (b) does not explicitly provide that one or both of the U.S. special resolution regimes (Orderly Liquidation Authority and the Federal Deposit Insurance Act), or a broader set of laws that includes a U.S.

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[11] *See, e.g.*, 12 C.F.R. § 47.5.
[12] *See, e.g.*, 12 C.F.R. § 47.1(b).
[13] Attachment to US Stay Protocol, §§ 1-3.
[14] *Id.*, § 2.
[15] *See* 12 C.F.R. §§ 47.3(b), 252.82(b), 382.2(b).
[16] 12 U.S.C. § 5390(c)(8)(D)).
[17] *See* 12.C.F.R. §§ 47.3(c), 252.82(c), 382.2(c).

special resolution regime, is excluded from governing law; and (c) the counterparty to the covered entity is an individual domiciled in the United States, a company that is incorporated in or organized under the laws of the Unite States or a U.S. state, a company the principal place of business of which is located in the United States, or a U.S. branch or U.S. agency.[18] Accordingly, QFCs strictly between U.S. persons that enter into swaps under a New York-law governed ISDA Master Agreement or repos under a Master Repurchase Agreement should not be subject to the U.S. Stay Protocol. There are certain additional limited exclusions from the requirement to conform QFCs, such as for QFCs that do not expressly provide default rights that are related, directly or indirectly, to a counterparty's affiliate becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding and that do not expressly prohibit the transfer of the QFC if such circumstances were to arise.[19] Furthermore, QFCs that are executed with a central clearinghouse as a counterparty,[20] certain retail investment advisory contracts,[21] as well as warrants issued prior to November 13, 2017 that evidence a right to subscribe to or otherwise acquire a security of the covered entity or its affiliate[22] are not required to be conformed to the Stay Regulations.

To the extent the Stay Regulations do apply, the in-scope QFC must explicitly state that (a) in the event the covered entity becomes subject to a proceeding under a U.S. special resolution regime, the transfer of the covered QFC (and any interest and obligation in or under, and any property securing, the covered QFC) from the covered entity will be effective to the same extent as the transfer would be effective under the U.S. special resolution regime if the covered QFC (and any interest and obligation in or under, and any property securing, the covered QFC) were governed by the laws of the United States or a U.S. state; and (b) in the event the covered entity or its affiliate becomes subject to a proceeding under a U.S. special resolution regime, default rights with respect to the covered QFC that may be exercised against the covered entity are permitted to be exercised to no greater extent than the default rights could be exercised under the U.S. special resolution regime if the covered QFC were governed by the laws of the United States or a U.S. state.[23] In lieu of having each QFC contain such language, the Stay Regulations allow covered entities to implement protocols with their counterparties that are deemed to amend existing agreements.[24]

What does the protocol provide?

The U.S. Stay Protocol is broadly divided into two operative sections. Section 1 addresses proceedings under U.S. special resolution regimes, while Section 2 addresses proceedings under U.S. federal insolvency rules such as the U.S. Bankruptcy Code and federal banking statutes. Under Section 1, the adhering parties opt in to special resolution regimes in the United States, the United Kingdom, France, Germany, Japan, and Switzerland.[25] As a result, they will agree to the automatic stay on default exercise rights with respect to both contractual agreements (such as an ISDA Master Agreement or a Master Repurchase Agreement) as well as credit enhancements (such as collateral arrangements under an ISDA Credit Support Annex and parent guarantees) if the counterparty or affiliate of the counterparty is subject to a special resolution regime.[26] The automatic stay will last until the end of the following business day under the U.S. regimes and up to two business days under the other jurisdictions' regimes. Automatic Early Termination under Section 6(a) ISDA Master Agreement, which, if activated via the ISDA Schedule, results in

[18] *See* 12 C.F.R. §§ 47.4(a), 252.83(a), 382.3(a).
[19] *See* 12 C.F.R. §§ 47.3(d), 252.82(d), 382.2(d).
[20] *See* 12 C.F.R. §§ 47.8(a)(1), 252.88(a)(1), 382.7(a)(1).
[21] *See* 12 C.F.R. §§ 47.8(c)(1), 252.88(c)(1), 382.7(c)(1).
[22] *See* 12 C.F.R. §§ 47.8(c)(2), 252.88(c)(2), 382.7(c)(2).
[23] *See* 12 C.F.R. §§ 47.4(b), 252.83(b), 382.3(b).
[24] *See* 12.C.F.R. §§ 47.6(a), 252.85(a), 382.5(a).
[25] Attachment to US Stay Protocol, § 1(b).
[26] *Id*.

transactions being automatically terminated immediately upon the occurrence of an event of default due to an insolvency, is overridden by the automatic stay activated via the U.S. Stay Protocol. If the resolution is successful (such as due to a transfer of all QFCs to another institution), the automatic stay will become permanent. If the resolution is unsuccessful, the automatic stay is likely to expire, thus reactivating default rights under the QFCs. Counterparties' rights to undertake or withhold actions under a covered QFC, such as suspending performance under the QFC, will be subject to the applicable special resolution regime. Furthermore, any suspended default will be deemed not to be occurring, existing, or continuing for purposes of determining whether a cross-default occurred under another agreement.[27]

Section 2 is intended to apply limitations on the ability of QFC counterparties to exercise certain rights triggered by the banking counterparty's affiliate's entry into resolution, insolvency, or receivership under Chapter 7 and Chapter 11 of the U.S. Bankruptcy Code, the Federal Deposit Insurance Act, and the Securities Investor Protection Act. Section 2 will not override the ability to close out a QFC as a result of the direct counterparty's performance failure or entry into insolvency proceedings (such as via the U.S. Bankruptcy Code safe harbor for swap agreements), unless a special resolution regime is activated, in which case the parties' rights are governed under Section 1.[28] If the affiliate subject to U.S. insolvency proceedings is not a credit enhancement provider (such as a parent guarantor), the Section 2 automatic stay is permanent.[29] If the affiliate subject to U.S. insolvency proceedings is a credit enhancement provider and is subject to Chapter 11 proceedings, then the Section 2 automatic stay is only applicable during a period that expires on the later of 5:00 p.m. Eastern Time on the next business day in the jurisdiction of the Chapter 11 proceedings and 48 hours after the commencement of the Chapter 11 proceedings.[30] The automatic stay period may be extended if the debtor files a motion before the expiration of the automatic stay period to transfer its assets to another entity or to remain obligated under its credit enhancement as a debtor in possession, subject to certain conditions.[31] As with Section 1, any default suspended under Section 2 will be deemed not to be occurring, existing or continuing for purposes of determining whether a cross-default occurred under another agreement.[32]

Are there any differences between the protocol and the regulations?

In certain respects, the U.S. Stay Protocol offers greater protections to G-SIBs than the Stay Regulations. For instance, while the U.S. Stay Protocol operates as an opt-in to numerous jurisdictions, the Stay Regulations require opt-in solely to the U.S. special resolution regimes, and while the U.S. Stay Protocol operates on a universal basis, the Stay Regulations allow group-by-group compliance.

In several other respects, the U.S. Stay Protocol may offer greater protections to counterparties to G-SIBs and affiliated entities. For example, Stay Regulations provide that covered QFCs are restricted from exercising default rights that arise as a result of an affiliate of the direct counterparty becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding, regardless of the jurisdiction of such proceeding.[33] In the U.S. Stay Protocol, these overrides over default rights are limited to rights arising out of U.S. insolvency proceedings, namely proceedings under Chapter 7 and Chapter 11 of the U.S. Bankruptcy Code as well as the Securities Investor Protection Act and the Federal Deposit Insurance Act.[34] Furthermore, the

[27] *Id.*, § 1(c).
[28] *Id.*, § 2(b)-(c).
[29] *Id.*, § 2(b).
[30] *Id.*, §§ 2(c), 6 (definition of "Stay Period").
[31] *Id.*, § 2(c)(i).
[32] *Id,* § 2(h).
[33] *See* 12 C.F.R. §§ 47.5(f), 252.84(f), 382.4(f0.
[34] Attachment to US Stay Protocol., §§ 2(b)-(c), 6 (definitions of "Performance Default Right" and "U.S. Insolvency Proceedings").

U.S. Stay Protocol provides an evidentiary standard for what constitutes permitted "Unrelated Default Rights," which are those rights that "can be shown by clear and convincing evidence to be not related, directly or indirectly," to an affiliate of the bank counterparty becoming subject to U.S. insolvency proceedings and related motions.[35] It may be difficult to prove that a default right is an Unrelated Default Right. A credit rating downgrade in which the ratings agency expressly makes clear that the downgrade is not due to an insolvency may be interpreted as an Unrelated Default Right. Under the Stay Regulations, the "clear and convincing evidence" standard further extends to performance default rights, potentially resulting in a broader scope of scenarios where the heightened evidentiary standard may be applicable compared to the U.S. Stay Protocol.[36]

How do I adhere to the protocol?

Parties may adhere to the protocol by filling out an adherence letter on the ISDA website and paying a US$500 fee. Unlike the case with certain previous ISDA protocols, such as the Dodd-Frank protocols introduced in 2012 and 2013, there is no requirement to fill out a separate questionnaire. Rather, the counterparty will be required to answer on the ISDA website whether it is a covered entity for purposes of the Stay Regulations. Because the U.S. Stay Protocol operates on a universal basis, once a party adheres to the U.S. Stay Protocol, all of its QFCs with other adhering parties will be deemed to be amended per the terms of the protocol. It will not be possible to select separate sets of G-SIB affiliates or QFCs for purposes of the U.S. Stay Protocol. Accordingly, if a counterparty to a G-SIB does not intend its relationship to be subject to the U.S. Stay Protocol, it should not adhere to the U.S. Stay Protocol and should instead negotiate bilateral amendments to existing QFC documentation. Alternatively, the U.S. Stay Protocol does allow counterparties to expressly provide in their QFC that the U.S. Stay Protocol shall not apply to such QFC, which provision would override the U.S. Stay Protocol. According to ISDA, bilateral incorporation of the terms of the U.S. Stay Protocol by itself does not lead to compliance with the Stay Regulations.[37] The full list of adhering counterparties, along with conformed copies of each adherence letter, are available on the ISDA website.[38]

Should I ask for a bilateral agreement instead?

If a counterparty has QFCs with numerous G-SIBs and G-SIB affiliates and wishes to enter into bilateral amendments, it will need to do so with each banking counterparty individually. Because the U.S. Stay Protocol in certain respects offers greater protections to G-SIBs than the bilateral approach and allows for uniform treatment of QFC counterparties, banks are likely to insist on the protocol approach. However, the bilateral approach allows for parties to segregate netting sets in lieu of a uniform approach and does not require opting in to foreign jurisdictions. Accordingly, there may be advantages to asking for a bilateral agreement that conforms to the base compliance regime. The downside to the bilateral approach is that the U.S. Stay Protocol is a pre-approved regulatory safe harbor while bilateral amendments are not specifically addressed in the regulations and carry greater regulatory uncertainty, although the regulations provide for a formal process by which approval may be obtained from federal regulators with respect to a proposed bilateral amendment.[39] The ability of a counterparty to negotiate a bilateral agreement depends on the amount of leverage it has against a bank as well as the bank's administrative and operational capacity to comply with the Stay Regulations via bilateral documentation.

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35 *Id.*, § 6 (definition of "Unrelated Default Right").
36 *See* 12 C.F.R. §§ 47.5(i), 252.84(i), 382.4(i).
37 *See* https://www.isda.org/a/8FjEE/ISDA-2018-U.S.-Protocol-FAQs-Final.pdf, p. 17.
38 *See* https://www.isda.org/protocol/isda-2018-us-resolution-stay-protocol/adhering-parties.
39 *See* 12 C.F.R. §§ 47.6(c), 252.85(c), 382.5(c).

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