# Application of U.S. QFC stay rules to underwriting agreements

In 2017, U.S. federal banking regulators adopted regulations requiring that certain financial institutions provide that their qualified financial contracts (**QFCs**) are subject to limitations on a counterparty's ability to exercise certain default rights.

Beginning in 2019, the U.S. QFC Stay Rules (the **Rules**) now require that certain major financial institutions (U.S. global systemically important banking organizations, or **GSIBs**) and the U.S. operations of foreign GSIBs (together, **Covered Entities**) include new language in certain of their underwriting agreements and similar agreements.

## Background

When Covered Entities become subject to a resolution regime as a result of financial distress, such as that which may result from capital or liquidity constraints, certain provisions in their QFCs may grant their counterparties default rights such as the right to terminate, liquidate, accelerate, demand payment or delivery, among other remedies. The exercise of default rights against a Covered Entity in connection with the termination of a contract could potentially destabilize the entity, thus undermining a key goal of the post-financial crisis regulatory framework of ensuring the resilience of GSIBs in order to avoid future shocks to the financial markets.

Both the Federal Deposit Insurance Act (**FDI Act**) and the Orderly Liquidation Authority under Title II of the Dodd Frank Act (**OLA**) provide that a counterparty may exercise default rights after a temporary stay of one business day and such rights are ordinarily not subject to the U.S. Bankruptcy Code's automatic stay on proceedings against a debtor and are typically not affected by the appointment of the Federal Deposit Insurance Corporation as receiver of an insured depository institution.

In 2017, U.S. banking regulators issued the Rules to address this uncertainty by requiring language in applicable covered QFCs expressly recognizing the U.S. Special Resolution Regime (as defined below) to stay the (i) exercise of default rights under the contracts and (ii) transfer of such contracts away from the Covered Entity. The Rules provide a uniform protocol under a regulatory "safe harbor" that allows QFC counterparties opting into the protocol to amend the QFC accordingly.

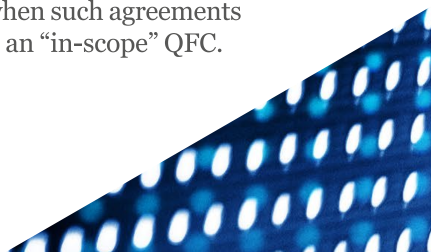
## In-Scope Qualified Financial Contracts

QFCs include "securities contracts," or contracts for the purchase, sale or loan of a security or option on a security, such as swaps, repurchase agreements and securities lending agreements. For a QFC to be "in-scope" and thus covered under the Rules it must explicitly either (a) provide one or more default rights exercisable against a Covered Entity, or (b) include a provision that limits the ability of one party to assign its rights or obligations under the agreement or provides that assignments are subject to the other party's consent (a **transfer restriction**).

## Remediation of Underwriting Agreements

Whereas underwriting and similar agreements were not traditionally considered QFCs under the Rules, starting in 2019 and provided they are "in-scope," such agreements must be remediated under the Rules by the underwriter Covered Entity.

The underwriting agreement, however, is not covered if both (1) (a) it is governed by the laws of the United States or any state and (b) it does not explicitly exclude the applicability of Title II of the Dodd-Frank Act or the Federal Deposit Insurance Act (or a broader set of laws that includes these laws); and (2) each party to the agreement other than the Covered Entity is (a) an individual domiciled in the United States, (b) a company incorporated in or organized under the laws of the United States or any state of the United States, (c) a company which has its principal place of business in the United States, or (d) a U.S. branch or U.S. agency of a foreign banking organization. Underwriting and similar agreements, including standard bank forms used for debt capital markets offerings under Rule 144A and Regulation S, entered into with foreign private issuers (as defined in Rule 405 of the Securities Act of 1933, as amended), could, therefore, potentially be subject to the Rules if they contain the rights and provisions necessary to qualify as an "in-scope" QFC. As a result, financial institutions are increasingly requesting the inclusion of boilerplate QFC stay language in underwriting and similar agreements even when such agreements would not otherwise qualify as an "in-scope" QFC.



The Rules establish three compliance dates for remediating new and certain pre-existing “in-scope” QFCs: (i) if all parties to the “in-scope” QFC are Covered Entities, then the date for remediation was January 1, 2019; (ii) if all parties are either Covered Entities or “financial counterparties,” as defined under the Rules, then the remediation must be completed by July 1, 2019; and (iii) if at least one party is neither a Covered Entity nor a “financial counterparty,” then remediation must be completed by January 1, 2020.

## The Model Language

In a memorandum published on December 13, 2018, the Security Industry and Financial Markets Association (**SIFMA**) proposed the model language for inclusion in “in-scope” underwriting agreements set forth below (which has been slightly modified for purposes of this article to include in-text definitions of relevant terms). Many Financial institutions are requesting the inclusion of such language in underwriting agreements:

**x) Recognition of the U.S. Special Resolution Regimes**

(a) In the event that any [Underwriter] that is a covered entity under 12 C.F.R. § 252.82(b), 12 C.F.R. § 47.3(b) or 12 C.F.R. § 382.2(b) (a *"Covered Entity"*) becomes subject to a proceeding under either (i) the Federal Deposit Insurance Act and the regulations promulgated thereunder or (ii) Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the regulations promulgated thereunder (each, a *"U.S. Special Resolution Regime")*, the transfer from such [Underwriter] of [this Agreement], and any interest and obligation in or under [this Agreement], will be effective to the same extent as the transfer would be effective under the U.S. Special Resolution Regime if [this Agreement], and any such interest and obligation, were governed by the laws of the United States or a state of the United States.

(b) In the event that the [Underwriter] that is a Covered Entity or an affiliate under 12 U.S.C. § 1841(k) (a *"BHC Act Affiliate"*) of such [Underwriter] becomes subject to a proceeding under a U.S. Special Resolution Regime, default rights under 12 C.F.R. §§ 252.81, 47.2 or 382.1, as applicable (the "Default Rights") under [this Agreement] that may be exercised against such [Underwriter] are permitted to be exercised to no greater extent than such Default Rights could be exercised under the U.S. Special Resolution Regime if [this Agreement] were governed by the laws of the United States or a state of the United States.

## Final thoughts

Despite the fact that the model language becomes operative only to the extent that a specific, identifiable set of facts (that can be readily determined by the parties) makes it applicable to a particular offering, we have found that the language is becoming increasingly prevalent in bank form underwriting and similar agreements and it is becoming accepted market practice to include such language.

For a more comprehensive discussion of the rules relating to QFCs, with a particular focus in the context of derivatives, please see our alert: [ISDA introduces protocol to address upcoming rules related to qualified contracts in the orderly resolution of systemically important financial institutions US QFC stay rules.]

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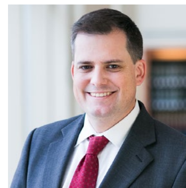

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