

CAPITAL MARKETS
QUALIFIED FINANCIAL CONTRACTS

All in order

The US Federal Reserve has aligned its latest rules for a number of G-Sibs' contractual requirements to the resolution regimes applicable to these entities

1 MINUTE READ

The board of governors of the Federal Reserve System has issued Final Rules that will require many market participants to amend their qualified financial contracts, a term that includes over-the-counter derivatives, repurchase and reverse repurchase agreements, securities lending and borrowing transactions, commodity contracts and forward agreements.

The Final Rules will significantly limit counterparty default rights in many such contracts. They are largely similar to rules proposed last year but contain a number of provisions intended to lessen their burden, including exceptions for certain types of contracts and a phase-in period that provides for compliance starting in January 2019.

On September 12 2017, the board of governors of the Federal Reserve System published in the Federal Register final rules (the Final Rules) intended to reduce the potential risks posed to the US financial system by banks deemed too big to fail. The Final Rules will impose restrictions on certain non-cleared financial contracts entered into by US global systemically important banking organisations (G-Sibs) and their subsidiaries, as well as the US operations of foreign G-Sibs (collectively, the covered entities). Subsidiaries or operations subject to regulation by another banking regulator are not covered. These restrictions will significantly limit counterparty default rights in over-the-counter derivatives, repurchase and reverse repurchase agreements, securities lending and borrowing transactions, commodity contracts and forward agreements (collectively, qualified financial contracts or QFCs).

The Final Rules are largely similar to the rules proposed by the Board in May 2016 (the Proposed Rules), but with a few significant differences, discussed below, primarily intended to alleviate their burden. The Federal Deposit Insurance Corporation (FDIC) also recently approved final rules that are substantively identical to the board's Final Rules for entities that are subject to regulation by the FDIC, and the Office of the Comptroller of the Currency (OCC) is expected soon to finalise similar rules for entities subject to its supervision. The Final Rules are scheduled to become effective on November 13 2017.

Goals of the Final Rules

The Proposed Rules had two primary goals aimed at facilitating the orderly liquidation of systemically important financial institutions, including under the orderly liquidation process created under title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Final Rules seek to effectuate these same goals.

The first goal is to assure the application of US special resolution regimes to certain cross-border transactions between covered entities and their counterparties outside of the US. While existing US special

resolution regimes provide the US regulatory agencies with the powers to prevent counterparties from exercising contractual termination rights in certain circumstances, it is not entirely clear what might happen if a court outside of the US were to disregard such powers. The Final Rules will require covered entities to add to their QFCs provisions that will make clear that the US special resolution regimes will apply to cross-border transactions and will thus bind authorities and parties outside of the US.

large, interconnected financial companies. OLA provides the FDIC with the authority to serve as receiver for large financial companies whose failure would pose a significant risk to the financial stability of the US. The second is the Federal Deposit Insurance Act (FDI Act) which, even prior to the Dodd-Frank Act, gave the FDIC receivership authority with respect to federally insured banks and thrift institutions.

Both of the US special resolution regimes in certain circumstances limit the contractual

number of modifications to the rules as adopted that are largely intended to lessen their burden.

Among other differences from the Proposed Rules, the Final Rules exclude from scope of the Final Rules certain types of G-Sib affiliates, including certain portfolio companies. In addition, the Final Rules clarify that certain contracts are not required to be conformed to the requirements of the final rules, including:

- QFCs that contain no relevant transfer restriction or default rights;
- certain retail investment advisory agreements and warrants;
- QFCs to which each party is a financial market utility;
- certain QFCs to which the application of non-US law is unlikely; and
- with respect to non-US G-Sibs, certain transactions not involving a US branch or agency.

As further detailed below, the Final Rules also provide for a phased-in implementation schedule, with compliance for QFCs with non-financial counterparties or small financial institutions not required until January 1 2020.

The Final Rules will require parties facing covered entities in QFCs expressly to relinquish certain of their contractual rights

The board's second goal is to facilitate the resolution of a G-Sib, whether under a single point of entry (SPoE) strategy, in which only the top-tier holding company would enter into resolution proceedings while its subsidiaries continue to operate and meet their financial obligations, or a multiple point of entry (MPoE) strategy in which multiple entities affiliated with a G-Sib might enter separate resolution proceedings in different regions. The board takes the view that, to facilitate such resolutions, it must ensure that operating subsidiaries of a G-Sib are not parties to contracts containing cross-default rights that their counterparties could exercise based on the entry into resolution of an affiliate of such operating subsidiaries.

To achieve these goals, the Final Rules will require parties facing covered entities in QFCs expressly to relinquish certain of their contractual rights. However, as detailed below, the Final Rules are in certain respects less burdensome than the Proposed Rules would have been.

Background: the US special resolution regimes

The Final Rules designate two special US special resolution regimes, whose cross-border application the Final Rules seek to assure. The first is title II of the Dodd-Frank Act (titled Orderly Liquidation Authority and known in short as OLA), the enactment of which enhanced the federal government's receivership authorities by expanding them to

rights of counterparties facing certain bank entities. Under the OLA, after a determination is made that a financial company should be placed in receivership, the FDIC takes over as receiver, and the bank's counterparties are prohibited, or stayed, from terminating certain contracts until 5pm of the business day after the receivership is commenced. Similarly, under the FDI Act, after a resolution is initiated and the FDIC becomes a bank's receiver, the bank's counterparties are prohibited from terminating certain contracts until 5pm of the business day following the day on which the receiver was appointed. Under both its OLA authority and the FDI Act, the FDIC has the right, among other things, to transfer certain contracts to a bridge financial company, which, as contemplated by the special resolution regimes, will be capable of performing under the transferred contracts.

These provisions of the US special resolution regimes are generally in accordance with recommendations of the Financial Stability Board (FSB). After the financial crisis of 2007/09, the FSB recommended that countries put in place special resolution regimes to address failing financial institutions, especially those whose collapse could have systemic consequences.

Key differences between the Final and Proposed Rules

While the Final Rules are substantially similar to the Proposed Rules, the board made a

Provisions of the Final Rules

Entities and contracts concerned

The Final Rules apply to covered QFCs, that is, contracts that constitute qualified financial contracts to which a covered entity is a party.

For these purposes, covered entities include:

- any US bank holding company that is identified as a G-Sib holding company under the board's rule establishing risk-based capital surcharges for G-Sibs;
- any subsidiary of a US G-Sib described in the preceding bullet point that is not, among other things, an entity subject to regulation by the OCC, such as a national bank, a federal savings association, a federal branch or federal agency, or an entity subject to regulation by the FDIC, such as a state savings association or a state nonmember bank; and
- a US subsidiary, US branch, or US agency of a non-US G-Sib (other than, among other things, entities subject to regulation by the OCC or the FDIC).

Unlike the Proposed Rules, the Final Rules exclude from the covered entity definition certain (i) companies held under specified

provisions of the Bank Holding Company Act; (ii) portfolio companies held under the Small Business Investment Act of 1956; and (iii) companies engaged in the business of making public welfare investments.

The Final Rules define the term qualified financial contracts in accordance with section 210(c)(8)(D) of the Dodd-Frank Act. Accordingly, QFCs include many swaps, repurchase (and reverse repurchase) transactions, forward contracts, commodity contracts and securities sale, lending and borrowing transactions. The QFC definition also generally includes any master agreement that governs QFCs between relevant parties.

QFCs entered into before January 1 2019 must be conformed to the Final Rules' requirements if the covered entity (or certain types of affiliates of the covered entity) enters into a QFC with the same counterparty or with a consolidated affiliate of the same counterparty on or after January 1 2019. In a significant change from the Proposed Rules, for these purposes, affiliation with respect to the counterparty is defined by reference to financial consolidation rules, and not under the definition in the Bank Holding Company Act of 1956. This may lessen the burden of the Final Rules by reducing the number of parties with which QFCs must be conformed.

QFCs excluded

Similar to the Proposed Rules, the Final Rules expressly exclude from their scope centrally cleared QFCs (that is, transactions to which a central counterparty is a party). In addition, unlike the Proposed Rules, the Final Rules also exclude:

- QFCs that do not expressly provide one or more default rights that may be exercised against a covered entity or restrict the transfer of the QFC from a covered entity;
- certain warrants, and certain investment advisory contracts with retail customers;
- contracts to which each party is a financial market utility, as defined in section 803(6) of the Dodd-Frank Act;
- QFCs that are (i) governed by US law, and (ii) involve only parties (other than the covered entity) that are domiciled in, incorporated in, organised under, or whose principal place of business is located in the US; and
- with respect to non-US G-Sibs, certain transactions booked in such entities' non-US offices.

The Final Rules further provide that by

order the Board may, after consideration, exempt one or more covered entities from the requirements of the Final Rules.

Provisions required to be added to QFCs

The Final Rules will require covered entities to add two distinct provisions to their QFCs. One such provision will limit the exercise of default rights under covered QFCs, and the other will facilitate transfers of QFCs to bridge entities as contemplated by the special resolution regimes.

Limitations on default rights under covered QFCs

To clarify the cross-border application of the US special resolution regimes, the Final Rules will require each covered QFC to expressly provide that, if the covered entity or an affiliate of the covered entity becomes subject to a proceeding under a US special resolution regime, default rights under 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 US special resolution regime if the covered QFC were governed by the laws of the United States or a state of the United States'. Such a provision will make clear that the covered entity's counterparty, regardless of its jurisdiction, will have no right

delivery; suspend, delay, or defer payment or performance; or modify the obligations of a party, including, among other things, altering the amount of required collateral or margin. The default right definition does not generally prevent, however, the exercise of rights to (i) net same-day payments; (ii) demand delivery of collateral based on a change in the value of relevant transactions or (iii) terminate a contract based on a provision that allows termination at a party's option without the need to show cause.

In addition, the Final Rules provide that a covered QFC must require, after an affiliate of a party to the QFC has become subject to a receivership, resolution or similar proceeding, that the party seeking to exercise a default right bears the burden of proof that the exercise is permitted under the covered QFC. The QFC must also contain at least clear and convincing evidence or similar burden of proof to exercise such a default right.

Transfers of covered QFCs

The Final Rules also require each covered QFC to support the US special resolution regimes by permitting transfers of such QFCs to bridge entities as contemplated by such resolution regimes. Specifically, the Final Rules require covered QFCs expressly to provide that, if the covered entity becomes subject to a proceeding under a US special resolution regime, the transfer of the covered

The Final Rules expressly exclude from their scope centrally cleared QFCs - transactions to which a central counterparty is a party

to terminate a covered QFC to the extent it would not have such right under the applicable US special resolution regime.

The Proposed Rules define broadly the default rights to which this mandatory provision applies. Default rights include, among other things, a right of a party, whether contractual or otherwise, to liquidate, terminate, cancel, rescind, or accelerate an agreement or transactions thereunder; set off or net amounts owing; exercise remedies in respect of collateral or other credit support or related property; demand payment or

QFC (and any interest and obligation in, or property securing, the covered QFC) from the covered entity will be effective to the same extent as the transfer would be effective under the US special resolution regime if the covered QFC were governed by US law.

The Final Rules also generally provide that no covered QFC may prohibit the transfer of a credit enhancement supporting such QFC provided by an affiliate of the covered entity upon an affiliate of the covered entity becoming subject to a receivership, insolvency, liquidation, resolution or similar proceeding.

Support for SPoE and MPoE resolutions

The Proposed Rules also contain provisions limiting the exercise of cross-default rights against a covered entity. The board intends those provisions to support both SPoE and MPoE resolutions of banking organisations.

rights based on the entry into resolution or insolvency proceedings of the operating subsidiaries' affiliates. Accordingly, the Final Rules provide that a covered QFC may not permit the exercise of any default right with respect to the covered QFC that is related, directly or indirectly, to an affiliate of the covered entity that is a party to the QFC

depository institutions, entities that are state-licensed as credit or lending entities or money services businesses, swap dealers, brokers, dealers, investment advisers, commodity pools and employee benefit plans; and

- January 1 2020, if the covered entity's counterparty is a non-financial counterparty or a small financial institution, a term defined to include certain banks and similar entities with total assets of \$10 billion or less.

The SPoE strategy ensures that the operating subsidiaries remain adequately capitalised and able to meet their financial obligations

In a SPoE resolution, only a single legal entity, the G-Sib's top-tier bank holding company, will enter into a resolution proceeding. The board contemplates that a G-Sib may enter into QFCs through operating subsidiaries, and, to the extent that such QFCs cause losses, those losses will be passed up from the operating subsidiaries that incurred them to the holding company, where, by means of the resolution process, the losses will be imposed on the holding company's equity holders and unsecured creditors. The SPoE strategy is intended to ensure that the operating subsidiaries will remain adequately capitalised and able to meet their financial obligations without defaulting or entering resolution. In contrast, in a MPoE resolution, more than one entity or part of banking group may be subject to resolution, potentially under different resolution regimes. Such a resolution could involve, for example, a foreign G-Sib's US intermediate holding company going into resolution or a resolution plan that calls for a G-Sib's US insured depository institution to enter resolution.

To facilitate these resolution strategies, in which operating affiliates are expected to remain continuously in operation and out of resolution, the board believes that it must prevent counterparties facing operating subsidiaries of G-Sibs from exercising default

becoming subject to a receivership, insolvency, liquidation, resolution or similar proceedings.

However, a covered QFC may permit the exercise of default rights based on (i) a covered entity itself becoming subject to receivership, insolvency, liquidation, resolution, or similar proceeding, other than under a special resolution regime; or (ii) a party to a QFC, or an affiliated credit support provider, failing to meet a payment or delivery obligation under the covered QFC.

Compliance schedule

The Final Rules contain a phased-in compliance schedule, under which a covered entity must conform its QFCs to the requirements of the Final Rules no later than:

- January 1 2019, if the covered entity's counterparty is either another covered entity or a similar entity likely to be subject to rules similar to the Final Rules promulgated by another US regulatory agency;
- July 1 2019, if the covered entity's counterparty is not an entity described in the preceding bullet point but is a financial counterparty, a term broadly defined to include, among other things, certain bank holding companies and their affiliates, savings and loan holding companies,

Significance of Isda Protocols

The Final Rules contemplate that covered entities may conform their QFCs to the Final Rules' requirements by means of protocols published (or to be published) by the International Swaps and Derivatives Association (Isda). Specifically, the Final Rules provide that, unless the board determines otherwise based on specific facts and circumstances, a covered QFC will comply with the requirements of the Final Rules if it is amended by the Isda 2015 Universal Resolution Stay Protocol (the Universal Protocol). Under the terms of that protocol, adhering parties, among other things, opt in to numerous special resolution regimes of the US and other countries.

In addition, the Final Rules permit compliance by means of what they call the US protocol, a protocol not yet created by Isda, which must conform to requirements set out in the Final Rules. The Final Rules state that, except as specified by them, the US protocol must be the same as the Universal Protocol.



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