Proposed Rules on Qualified Financial Contracts and Stays, and Related ISDA Protocols and Bankruptcy Issues

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Overview

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II. The Experience of Lehman Brothers
III. FDIC Stay Provisions For Banks
IV. Title II of Dodd-Frank (Orderly Liquidation Authority)
V. Prudential Regulators' Proposed Rules
VI. Alternative Compliance with ISDA Protocols

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The Existing Bankruptcy and Bank Regulatory Regimes

- Bankruptcy Code
  - Automatic stay
  - Ipso facto clauses unenforceable
  - Avoidance provisions

- Safe harbors
  - Permit ipso facto termination
  - Protect netting, setoff rights
  - Protection from avoidance
  - Section 562/timing of valuation
  - Concern about “domino effect” and systemic risk
  - Absent safe harbor provisions, counterparties run risk of postpetition market moves, cherrypicking of transactions
  - Steady expansion of protections 1978-2006

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Lehman Brothers

- At time of filing, approximately 1.2 million derivative transactions with approximately 6500 counterparties
- "Free fall" bankruptcy
- Lehman trading book could not be maintained due to bankruptcy default
- Close-outs and resulting litigation viewed as negatively impacting value of Lehman's trading book
- Legislative response to Lehman and the financial crisis was Title II of Dodd-Frank/Orderly Liquidation Authority

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Special Resolution Regimes

The Prudential Regulators' Proposed Rules are intended to enhance the orderly resolution of failed global systemically important banks ("GSIBs") by restricting certain rights of counterparties to qualified financial contracts ("QFCs") to the same extent as would be required under the U.S. "special resolution regimes." The U.S. special resolution regimes, generally, are the insolvency and receivership processes as codified in:

I. **the Federal Deposit Insurance Act ("FDI Act"); and**

II. **Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")**

I. FDIC Stay Provisions for Banks

- **The FDIC and FDI Act**: Bank insolvencies are administered by the Federal Deposit Insurance Corporation ("FDIC"). The insolvency of a bank, which is specifically exempted from the Bankruptcy Code, is governed by the Federal Deposit Insurance Act ("FDI Act").

- **The FDIC Receivership:** Under the FDI Act, an institution may enter a receivership administered by the FDIC. During the receivership process, the FDIC succeeds to all rights, powers, and interests of the failed institution and is given plenary power to administer its affairs.

- While the FDIC's receivership process is, in many respects, analogous to that of bankruptcy, unlike a proceeding under the Bankruptcy Code, there are no creditors' committees, no trustees, and no court overseeing the FDIC's activities. Any claims against the failed institution must first be submitted to the FDIC for its own administrative determination.

- **QFCs in Receivership:** As in bankruptcy, QFCs are a special class of contract that receives special treatment in FDIC receivership. The FDI Act contains a <u>one business day</u> cooling-off period before a bank's direct counterparties may exercise early termination rights and other remedies. 12 U.S.C. § 1821(e)(9)-(12).

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I. FDIC Stay Provisions for Banks, continued

- Under the FDI Act, during the stay, the FDIC has the right to transfer all (but not less than all) of the QFCs with a particular counterparty to a single third-party financial institution.

- If the FDIC exercises this option, the counterparty is not permitted to terminate or exercise certain other remedies under the QFC on account of the resolution or insolvency proceedings.

- The primary obligors on many QFCs entered into by GSIBs are the material operating subsidiaries of their parent, rather than the parent itself.

- **SPOE Resolution Strategy:** The Prudential Regulators believe that defaults by affiliates of GSIBs based on a GSIB parent's insolvency can be solved by a single-point-of-entry (SPOE) strategy.

- Under the SPOE strategy, the material operating subsidiaries of a GSIB are kept out of insolvency proceedings and from otherwise defaulting on their financial contracts.

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II. Title II of Dodd Frank – Orderly Liquidation Authority

- Title II of Dodd-Frank establishes the **Orderly Liquidation Authority ("OLA").** The OLA, largely modeled on Sections 11 and 13 of the FDI Act, is an alternative to bankruptcy. It permits the U.S. Government to invoke a new form of resolution authority for non-bank financial institutions instead of the Bankruptcy Code if the Treasury Secretary makes certain financial distress and systemic risk determinations.

- **Rationale**: The central purpose of the OLA is to provide a system for the resolution of a failing systemically important "non-bank" financial institution without the need for a "bailout." It is designed to provide systemic protection and also to preserve creditors' rights.

- A financial company will be designated a "Covered Financial Company" and the FDIC will be appointed as receiver under Title II of Dodd-Frank if the Treasury Secretary, in consultation with the President, finds:

  – (i) the financial company is "in default or in danger of default;"
  – (ii) use of normal insolvency to resolve the entity "would have serious adverse effects on financial stability in the United States";
  – (iii) no viable private sector alternative is available to prevent the default;
  – (iv) the effect on creditors is "appropriate" in light of the dangers to financial stability.; and
  – (v) an orderly liquidation would avoid or mitigate adverse effects.

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II. Title II of Dodd Frank – Orderly Liquidation Authority, continued

- **OLA Procedure**: Once invoked, the FDIC is appointed as receiver and any existing bankruptcy is superseded and future bankruptcy is precluded.

- **Powers of the FDIC**: The FDIC has the discretion to act as a receiver of subsidiaries (other than a bank subsidiary – although the FDIC may so act with respect to a bank under the FDI Act). The FDIC assumes complete financial and operational control of the institution and has the authority to manage, sell, transfer or merge all of the assets of the firm, as well as provide the funds needed for an orderly liquidation.

- **QFCs in an OLA**: The FDIC may transfer all the QFCs with a particular counterparty and its affiliates of a failed financial company to a bridge financial company or some other company that is not in a resolution proceeding and that should be capable of performing under the QFCs. No contract-by-contract cherry-picking is allowed.

- **The OLA Stay**: To give the FDIC time to effect this transfer, Title II temporarily stays QFC counterparties of the failed entities until 5pm eastern time on the business day following the appointment of the FDIC as receiver. The stay prevents a counterparty from exercising termination, netting and collateral liquidation rights by reason of the failed entities' entry into OLA resolution, or its financial condition. Once the QFCs are transferred, OLA permanently stays the exercise of default rights for such reasons.

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II. Title II of Dodd Frank – Orderly Liquidation Authority, continued

- **Damages on Repudiated QFCs**: During the stay, the FDIC may repudiate the QFCs and pay the counterparty compensatory damages. Damages are calculated on the date of repudiation, rather than the earlier date of the FDIC's appointment and may include the cost of cover.

- **Cross-Default Rights:** While the stay largely parallels the one provided the FDIC in the FDI Act, OLA provides additional authority to the FDIC to enforce QFCs entered into with subsidiaries or affiliates of a Covered Financial Company that are "guaranteed by" or "linked to" the Covered Financial Company. The FDIC in an OLA FDIC resolution can void "cross-default" rights related to the insolvency of a counterparty's affiliated credit support provider.

- The most common case is that of a parent guarantee. Where a counterparty's QFCs are guaranteed by the parent, the temporary stay will become permanent if the FDIC transfers the guarantee to a third party (including a bridge financial company) or otherwise provides "adequate protection" to the counterparty, before the end of the temporary stay period. Otherwise, the temporary stay will automatically terminate.

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III. The Prudential Regulators' Proposed Rules

- **Rationale**: The Proposed Rules, as articulated by the Prudential Regulators, aim "to support U.S. financial stability by enhancing the resolvability of very large and complex financial firms."
  - Statement on Federal Reserve Board's Proposed Rule by Gov. Daniel K. Tarullo.
  - Discussion of rationale by Prudential Regulators in preamble to the Proposed Rules.

- Generally, by preventing the immediate cancellation of QFCs of GSIBs and by supporting a "single point of entry," the Prudential Regulators are attempting to reduce the risk of a run on the solvent subsidiaries of a failed GSIB caused by a large number of firms terminating their financial contracts at the same time.

- The Proposed Rules are also aimed at ensuring that U.S. special resolution regimes – the FDI Act and Title II of Dodd-Frank – apply to transactions between GSIBs and non-U.S. counterparties.

- To the extent that the Proposed Rules are adopted and go into effect, they will likely require parties in transactions with GSIBs to relinquish certain of their contractual rights.

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III. The Prudential Regulators' Proposed Rules, continued

- **General Application***:* The Proposed Rules apply to "**covered QFCs**", that is, contracts that constitute "qualified financial contracts" (as defined in Dodd-Frank) to which a "**covered entity**" is a party.

- **"Covered QFCs"** (as in Dodd-Frank) include:
  - Swaps, repo transactions, reverse repo transactions, securities lending and borrowing transactions, commodity contracts, forward agreements and guarantees of or credit enhancements related to the foregoing.

- "**Covered Entities**" include:
  - A U.S. bank holding company that is identified as a global systemically important banking organization ("GSIB"), and any subsidiary of such a holding company.
  - A U.S. subsidiary, U.S. branch or U.S. agency of a foreign GSIB.

- **"Covered Banks" or "Covered FSIs"** include:
  - A national bank, federal savings association (including a subsidiary thereof) that is a subsidiary of a designated GSIB bank holding company or foreign bank.
  - A federal branch or agency (including a subsidiary thereof) of a designated global systemically important foreign bank.
  - State savings associations or state non-Federal Reserve member banks that are subsidiaries of designated global systemically important bank holding companies or foreign banks.

- The Proposed Rules would apply to **new QFCs** that a covered entity becomes a party to after the rules become effective and **existing QFCs**, if the covered entity or any of its affiliates becomes a party to a QFC with the same counterparty or its affiliates after the rules become effective.

III. The Prudential Regulators' Proposed Rules, continued

- The Proposed Rules pertain to direct default rights and cross-default rights.
  - **Direct default** – Entry of direct counterparty into insolvency proceedings.
  - **Cross-default** – Entry of an affiliate into insolvency proceedings.

- The SPOE resolution strategy is intended to address the direct default problem. The special resolution regimes (FDI Act and Dodd-Frank) address both types of defaults by imposing temporary stays, including as part of the SPOE resolution strategy.

- The two gaps that remain are the:
  - **Extraterritorial gap**: stay of default rights may not be recognized outside of the United States
  - **Bankruptcy gap**: the Bankruptcy Code does not address cross-default issues.

- The Proposed Rules attempt to bridge these gaps and to contractually protect existing special regime resolution rights by requiring certain provisions in QFCs.

- The Rules require the addition of two main contractual provisions in covered QFCs: **(1)** limitations on default rights; and **(2)** allowance of stays and transfers of QFCs to bridge entities.

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III. The Prudential Regulators' Proposed Rules, continued

- **Limitations on Default Rights**
  - Requires QFCs of GSIBs to contain contractual provisions that recognize the automatic stay and transfer provisions of Dodd-Frank and the FDI Act.
  - Specifically requires each covered QFC to expressly provide that "default rights" under the contract "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 regimes. "
  - The contractual provision is designed to make clear that the covered entity's counterparty, regardless of its jurisdiction, will have no right to terminate a covered QFC to the extent it would not have such right under the applicable U.S. special resolution regime.
  - The goal is to ensure that all QFCs, including those that are governed by foreign law or entered into with a foreign party or for which collateral is held outside the United States, would be treated the same way.

III. The Prudential Regulators' Proposed Rules, continued

- **Allowance of QFC Transfers**
  - Cross-default rights based on Chapter 11 bankruptcy of a GSIB entity as guarantor would be stayed for 48 hours and overriden if, within that 48 hours, the guarantee and substantially all assets of the entity are transferred to a bridge company or third party, or the guarantee receives administrative priority status in bankruptcy.
  - This does not affect counterparty rights based on direct counterparty's insolvency or payment or performance defaults.
  - The provisions are intended to support the SPOE resolutions of banking organizations, in which only a single legal entity, the GSIB's top bank holding company, is to enter a resolution proceeding.
  - The SPOE strategy attempts to ensure that the operating subsidiaries remain adequately capitalized and able to meet their financial obligations without defaulting or entering the resolution process.
  - A GSIB may enter into QFCs through operating subsidiaries, and, to the extent that such QFCs cause losses, the losses would be passed up through the operating subsidiaries to the holding company's equity holders and unsecured creditors.

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IV. ISDA Universal Resolution Stay Protocol

- The Prudential Regulators have indicated that GSIBs may also comply with the Proposed Rules by utilizing QFCs that are modified by ISDA's 2015 Universal Stay Resolution Protocol (the "2015 Universal Stay Protocol").

- The 2015 Universal Stay Protocol was developed by market participants that are members of ISDA, in coordination with the Federal Reserve Board, the FDIC, the Office of the Comptroller of the Currency, and certain foreign regulators.

- Like any other ISDA protocol, by adhering to the 2015 Universal Stay Protocol, parties agree that their contracts with other adhering parties are amended in accordance with the terms of the protocol.

IV. ISDA Universal Resolution Stay Protocol, continued

- **Rationale:** The 2015 Universal Resolution Stay Protocol has the same objective as the Proposed Rules, which is to make U.S. and foreign GSIBs more resolvable by amending their contracts to recognize the applicability of U.S. special resolution regimes and to restrict cross-default provisions to facilitate orderly resolution.

- **Terms of the Protocol**: Provides that if one adhering party is subject to certain special resolution regimes, then the other adhering party may exercise default rights under an ISDA or other credit support arrangement only to the extent it would be able to do so under the special resolution regime.

- **Cross-default rights** are stayed in accordance with the FDI Act or, for Chapter 11 entities, for 48 hours (or until 5 pm on next Business Day, if later) and overriden if, within that period, the relevant credit enhancement is transferred.

- **QFCs Covered**: The 2015 Stay Protocol covers OTC derivatives transactions documented under ISDA Master Agreements, as well as repurchase agreement transactions and securities lending transactions under industry standard master agreements. It also provides for an optional Other Agreements Annex that would cover all other QFCs between adhering parties.

- **Identified Regimes**: Automatic opt-in to special resolution regimes of France, Germany, Japan, Switzerland, the U.K. and the U.S. (FDIA and OLA)
- **Protocol-eligible regimes** must first meet certain creditor protections and Country Annexes are being added to confirm that a regime meets these standards. So far Spain, Italy and the Netherlands have been added.

- **Exception** for non-insolvency-related default rights.

- **Exception** for certain cleared transactions and clearing organizations.

- **Other ISDA Protocols:** Contemporaneously with the release of the new rules, ISDA published the ISDA Resolution Stay Jurisdictional Modular Protocol **("ISDA JMP")**. The ISDA JMP is designed to enable parties to amend the terms of Protocol Covered Agreements to aid compliance with the stay or override of termination rights in various jurisdictions. It is composed of boilerplate provisions of particular stay regulations in various jurisdictions.

Counterparty Concerns

- Transfer to a “bridge financial company” and status of parent guarantee.
- What is “adequate protection?”
- Volatility concerns.
- Asset management concerns.

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Conclusion

Thank you for your attention.

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