

# ClientAlert

## Capital Markets/Derivatives

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### New Termination and Liquidation Regime for Certain Swap Counterparties Under Dodd-Frank

On January 20, 2011, the CFTC proposed rules requiring swap dealers and major swap participants to include certain consents and confirmations with respect to the new orderly liquidation authority under Title II of the Dodd-Frank Act (the "Act") and the existing resolution process of insured depository institutions under the Federal Deposit Insurance Act ("FDIA").<sup>1</sup> The new resolution process under Title II provides for an orderly liquidation under a Federal Deposit Insurance Corporation ("FDIC") administered receivership of certain non-bank financial companies whose failure could adversely affect the financial stability of the United States. As further discussed below, under the new Title II liquidation authority, counterparties' swap agreements will be subject to a temporary stay in order to permit the FDIC to transfer the swaps and other assets of an insolvent financial company to a third party. The CFTC's proposed rules require parties to make certain acknowledgements and consents with respect to such an FDIC-administered receivership and puts parties on notice of the potential effect that the new liquidation authority may have on counterparties' uncleared, bilateral trades. The proposed regulation does not apply to swaps cleared by a derivatives clearing organization.<sup>2</sup>

#### The New Orderly Liquidation Authority

Title II of the Act establishes an orderly liquidation authority for the wind-down and liquidation of certain large financial companies. The CFTC notes in the proposed rules that the lack of such a resolution mechanism has been sighted as the reason why the recent government bail-out of certain financial companies that were "too big to fail" was necessary. Title II of the Act seeks to address the need for an orderly liquidation process for large financial companies, in particular, those that are not insured depository institutions subject to the current FDIA resolution process, and where the bankruptcy process may be too slow to effectively mitigate risk. To this end, Title II establishes a process whereby upon recommendation of the Federal Deposit Insurance Corporation ("FDIC") and the Board of Governors of the Federal Reserve System ("Board of Governors") and after consultation with the President, the FDIC would be appointed as receiver to wind down and liquidate the assets of a financial company in default or in danger of default, which has been determined to pose systemic risk to the financial markets. A swap counterparty facing a swap dealer or major swap participant in receivership under the FDIC would not be allowed to terminate, liquidate or net its open swap positions (and other qualified financial contracts as further discussed below) with the failing financial



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<sup>1</sup> A copy of the proposed rule can be found [here](#). A copy of our previous client alert with respect to the proposed swap documentation requirements can be found [here](#).

<sup>2</sup> While cleared swaps under the Act are addressed under section 210(c)(8)(G), the CFTC did seek comment as to whether to also include cleared swaps in the proposed rules.

company until the earlier of the following business day at 5:00 p.m. (Eastern time) and such time as the FDIC is able to make the requisite transfer of the open swap positions of the financial company in receivership to a third party (either a private acquirer or a bridge bank).<sup>3</sup> Since the regulation applies to a termination solely by reason of the appointment of the FDIC as receiver or the financial condition of the financial company, the regulation does not affect the ability of a party to a swap to terminate a swap by reason of another event of default, such as a failure to pay.

## Swap Dealers and Major Swap Participants May Be Subject to Liquidation Under Title II of the Act

The liquidation and resolution authority of the FDIC under Title II will apply to “covered financial companies.” The term under the Act includes swap dealers and major swap participants (which are not insured depository institutions) that have been designated by the Financial Stability Oversight Council created pursuant to the Act (the “FSOC”) as being systemically important financial institutions (a “SIFI”) under Title I of the Act.<sup>4</sup> A swap dealer or a major swap participant might also be deemed to be a covered financial company independent of Title I’s FSOC designation process. Under Title II, such company could be deemed to be a “financial company” if the entity is (i) predominantly engaged in financial activities and (ii) those financial activities generate 85 percent or more of the company’s revenues. A “covered financial company,” to which the orderly liquidation provisions would apply, is a financial company for which a determination has been made under section 203(b) of the Act by the Secretary of the Treasury. A prerequisite to that determination process is the written recommendation of both the FDIC and the Board of Governors of the Federal Reserve System (“Board of Governors”).<sup>5</sup> Subsidiaries of such covered financial companies may also be deemed to be a covered financial company. In making a determination to act under Title II, the Secretary of the Treasury (in consultation with the President) must determine that, among other things, (i) the financial company is in default or in danger of default, (2) the default of the financial company would have a serious adverse effect on the financial stability of the United States and (3) no viable private sector alternative is available

to prevent the default. The Secretary of the Treasury must make a specific determination that any effect on the claims or interests of creditors, counterparties and shareholders is appropriate.

## Current Regulation by the FDIC Under FDIA

Currently, the FDIC has similar resolution authority over an insured depository institution. Generally an insured depository institution under the FDIA is any FDIC-insured bank or savings association. The Title II orderly liquidation and resolution procedures are modeled after the FDIA and are in some cases identical. Title II of the Act has for all practical purposes extended the existing FDIC regime applicable to US banks to certain non-bank financial companies deemed to be systemically important to the financial stability of the US economy.

## The Resolution Process Under Title II of the Act

Swaps meeting the definition of “swap agreement” under the definition of “qualified financial contract” would be subject to transfer in any orderly liquidation under Title II.<sup>6</sup> “Swap Agreement” under the Act is broadly defined and seems to capture all “swaps” and “security-based swaps” under Title VII, including foreign exchange transactions which may be exempt from the definition of swap if determined by the Treasury Department. Far from clear as to the exact application of Title II to swaps under Title 7, the CFTC has recognized the potential for regulatory arbitrage even though it would appear that swaps subject to its jurisdiction under Title VII would be subject to either Title II or FDIA.<sup>8</sup> While making no specific mention of security-based swaps, the definition of “swap agreement” does include “an equity index or equity swap, option, future or forward agreement.” And, the definition of “securities contract” under the definition of “qualified financial contract” includes “any prepaid securities forward transaction, or any total return swap transaction coupled with a securities sale transaction” and any option to enter into any agreement referred to in the definition.<sup>9</sup> The CFTC further stresses in its proposed rule that if “the need for an orderly liquidation of any systemically important swap dealer or major swap participant arise[s], it would be most appropriate and practicable for all swaps held on the books of [such entity] to be considered part of a comprehensive and orderly resolution process.”

<sup>3</sup> While not the focus of this alert, the FDIC has recently proposed interim final rules with respect to the implementation of the resolution authority under Title II and can be found [here](#).

<sup>4</sup> Entities designated as systemically important under Section 113 of the Act are supervised by the Board of Governors, which satisfies sub-clause (ii) of the definition of “financial company” under Section 201(a)(11)(B).

<sup>5</sup> See Sections 201(a)(8) and (11).

<sup>6</sup> The Act defines “qualified financial contract” as any “securities contract, commodity contract, forward contract, repurchase agreement, swap agreement and any similar agreement as determined by the FDIC.”

<sup>7</sup> See Section 210(8)(D)(vi) for the definition of “swap agreement.”

<sup>8</sup> The definition of qualified financial contract is identical under both Title II and FDIA.

<sup>9</sup> See Section 210(8)(D)(ii) for the definition of “securities contract.”

## Proposed Regulation §23.504(b)(5)

The proposed regulation would require that parties include in their swap documentation a written agreement and consent to comply with the FDIC's transfer authority and specified resolution process under Title II of the Act and under the FDIA. Specifically, the written documentation shall provide an agreement by the parties that:

- In the event that the FDIC is appointed as a receiver for a covered financial company as defined by Title II of the Act or for an insured depository institution, the party not in receivership will not terminate, liquidate or net any swap solely by reason of the appointment of the FDIC as receiver for the counterparty until the earlier of (a) 5:00 p.m. (Eastern time) on the business day following the date of such appointment; and (b) after the counterparty not in receivership has received notice that the relevant swap has been transferred pursuant to Title II of the Act or the FDIA.
- A transfer under Title II of the Act may include all rights and obligations under a swap (including any and all claims, other than any claim which under the terms of the swap is subordinated to the claims of general unsecured creditors of such party in receivership, and any property securing the swap or any other credit enhancement) between the counterparty in receivership and the counterparty not in receivership or any of its affiliates.

Parties shall also be required to consent to any such transfer as a result of the exercise of the FDIC's resolution authority.

The CFTC has stated that such agreements could minimize potential litigation arising from the exercise of the orderly liquidation authority of the FDIC under Title II of the Act and the FDIA by putting parties on notice that their swaps positions, claims and any related credit support may be transferred to another financial entity or other solvent party as set forth under Title II and the FDIA and that there may be a brief stay on parties' ability to terminate a swap.

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