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US Resolution Stay Final Rules

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Introduction

The Board of Governors of the Federal Reserve System (the **Federal Reserve**), the Federal Deposit Insurance Corporation (the **FDIC**) and the Office of the Comptroller of the Currency (the **OCC**, and together with the Federal Reserve and the FDIC, the **US Regulators**) each adopted final rules and accompanying interpretive guidance setting forth limitations to be placed on parties to certain financial contracts exercising insolvency-related default rights against their counterparties that have been designated as a global systemically important banking organization (**GSIB**).

Due to the significant harmonization undertaken by the US Regulators, this article provides a broad overview of the important concepts and consequences of the final rules adopted by the Federal Reserve¹ (the **Federal Reserve Final Rules**), the FDIC² (the **FDIC Final Rules**) and the OCC³ (the **OCC Final Rules**). References to the **Final Rules** indicate that the concept being discussed is applicable to each of the Federal Reserve Final Rules, the FDIC Final Rules and the OCC Final Rules. Material differences have been highlighted, as applicable.

Background

One of the key regulatory reforms contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank Act**) was protecting the financial stability

of the US by addressing the “too-big-to-fail” problem. Part of the strategy undertaken by the US Regulators has been to help ensure that a US insolvency proceeding of a GSIB is as orderly as possible in an effort to help mitigate the destabilizing effects on the financial system.

The Final Rules form part of this strategy by limiting disruptions to a failed GSIB by restricting counterparties to certain specified financial contracts (e.g., derivatives, repurchase agreements and securities lending and borrowing transactions) from exercising certain specified insolvency-related default and cross-default rights against GSIBs by requiring the insertion of restrictions and prohibitions directly into such financial contracts.⁴

Scope of the Final Rules

Covered Entities

Broadly, the Final Rules are intended to apply to banking groups that have been identified as GSIBs by the Federal Reserve (each, a **Covered Entity**). Covered Entities include the following types of entities:⁵

- With respect to US GSIBs,⁶ all US and non-US subsidiaries and
- With respect to foreign GSIBs,⁷ US subsidiaries, US branches and US agencies

1 Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 82 FR 42882 (13 November 2017), available at <https://www.federalregister.gov/d/2017-19053>

2 Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 82 FR 50228 (30 October 2017), available at <https://www.federalregister.gov/d/2017-21951>; Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definition, 82 FR 61443 (28 December 2017), available at <https://www.federalregister.gov/d/2017-27971>

3 Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 82 FR 56630 (29 November 2017), available at <https://www.federalregister.gov/d/2017-25529>

4 Commenters had requested that the US Regulators clarify that amending swaps pursuant to these rules would not cause a legacy swap that was previously exempt from the swap margin requirements for non-cleared swaps to be subject to such requirements. The US Regulators noted that they do “not expect that compliance with [the Final Rules] would trigger the swap margin requirements for non-cleared swaps”. Following the release of the Final Rules, the US Prudential Regulators and the Commodity Futures Trading Commission each issued proposed rules to amend the swap margin requirements for non-cleared swaps to conform to the Final Rules. Under the proposal, legacy swaps would not become subject to the swap margin requirements for non-cleared swaps as a result of being amended solely to comply with the requirements of the Final Rules (Margin and Capital Requirements for Covered Entities; Proposed Rule, 83 FR 7413 (21 February 2018), available at <https://www.federalregister.gov/d/2018-02560>; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Proposed Rule, 83 FR 23842 (23 May 2018) <https://www.federalregister.gov/d/2018-10995>). For information on the swap margin requirements for non-cleared swaps, please see our client alert available [here](#).

5 Whether an entity is regulated by the Federal Reserve, the FDIC or the OCC will depend on whether such entity will be subject to the Federal Reserve Final Rules, the FDIC Final Rules or the OCC Final Rules, as the case may be. Each entity subject to the Federal Reserve Final Rules is termed a “covered entity”. Each entity subject to the FDIC Final Rules is termed a “covered FSI”. Each entity subject to the OCC Final Rules is termed a “covered bank”. The OCC Final Rules also apply to national banks and federal savings associations with more than US\$700 billion in total assets.

6 As of the date of this article, there were eight US GSIBs: Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc., Goldman Sachs, Inc., JPMorgan Chase & Co., Morgan Stanley Inc., State Street Corporation and Wells Fargo & Company.

7 A “foreign GSIB” is a foreign banking organization that would be designated as a GSIB if it were subject to the Federal Reserve’s jurisdiction or would be a GSIB under the methodology for identifying GSIBs adopted by the Basel Committee on Banking Supervision. See “Global systemically important banks: Updated assessment methodology and the higher loss absorbency requirement”, available [here](#).

In November 2017, the Financial Stability Board and the Basel Committee on Banking Supervision published an updated list of banking organizations that are GSIBs under the assessment methodology. The list includes the eight US GSIBs (see below) and the following 22 foreign banking organizations: Agricultural Bank of China, Bank of China, Barclays, BNP Paribas, China Construction Bank, Credit Suisse, Deutsche Bank, Royal Bank of Canada, Groupe Cr dit Agricole, Industrial and Commercial Bank of China Limited, HSBC, ING Bank, Mitsubishi UFJ FG, Mizuho FG, Nordea, Royal Bank of Scotland, Santander, Soci t  G n rale, Standard Chartered, Sumitomo Mitsui FG, UBS, and UniCredit Group. See FSB, “2017 update of list of global systemically important banks” (21 November 2017), available [here](#).

Covered QFCs

A “qualified financial contract” (**QFC**) is defined to have the same meaning as in the Dodd-Frank Act and would include, among others, derivatives, repos, securities lending and borrowing transactions, commodity contracts and forward agreements.⁸ This definition would also include master agreements that apply to QFCs (e.g., an ISDA Master Agreement). However, under the Federal Reserve Final Rules and the OCC Final Rules,⁹ if a master agreement with a foreign GSIB permits transactions to be entered into at one or more US branches or US agencies of the foreign GSIB, then the master agreement will only be subject to such rules with respect to QFCs that are booked at a US branch or US agency of the foreign GSIB (i.e., are booked at a Covered Entity).

The Final Rules would apply to each QFC (1) that explicitly restricts the transfer of a QFC from a Covered Entity or explicitly provides default rights (see below) that may be exercised against a Covered Entity, (2) to which a Covered Entity is a party¹⁰ and (3) that is entered into either on or after 1 January 2019 (or, if later, the date an entity becomes a Covered Entity). However, if the Covered Entity or any of its affiliates that are also Covered Entities enter into a new QFC (irrespective of whether or not it contains any default rights or transfer restrictions) with the Covered Entity’s counterparty or any affiliate of its counterparty after 1 January 2019, then all existing Covered QFCs it has entered into, executed or otherwise become a party to prior to 1 January 2019 will be subject to the Final Rules (i.e., the Final Rules have a retrospective effective with respect to these QFCs). The Final Rules would cover QFCs with sovereigns and central banks. The Final Rules do not, however, apply to certain investment advisory contracts, to certain existing warrants, to QFCs that are cleared through a central counterparty (but not the client-facing leg of a cleared transaction) and to QFCs that are solely with one or more financial market utilities (broadly, entities that manage or operate certain multilateral systems that enable the transfer, clearing or settling of financial transactions).¹¹

For the purposes of this article, each QFC subject to the Final Rules is referred to as a **Covered QFC**.

Default Rights

The Final Rules apply to “default rights” included in a Covered QFC, which are broadly defined to include:

- 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, exercise remedies in respect of collateral or other credit support or property, demand payment or delivery, suspend, delay, or defer payment or performance, or modify the obligations of a party, or any similar rights and
- rights to alter the amount of collateral or margin that must be provided with respect to an exposure under the QFC, or any similar rights

The following rights are specifically excluded from the definition of “default rights” and are therefore not subject to the restrictions imposed by the Final Rules:

- same-day payment netting that occurs during the life of a QFC in order to reduce the number and amount of payments each party to that QFC owes the other
- contractual margin requirements that arise solely from the change in value of the collateral or margin or a change in the amount of an economic exposure, except changes due to counterparty credit risk (e.g., credit rating downgrades) and
- with respect to the Final Rules’ restriction on cross-default rights only (see below), contractual rights to terminate without the need to show cause, including rights to terminate on demand and rights to terminate at contractually specified intervals

These rights are excluded on the basis that they are part of a party’s “business-as-usual” interactions under a QFC and/or are not related to the entry into an insolvency proceeding of a Covered Entity.

Implementation

Under the Final Rules, each Covered Entity would need to conform each of its Covered QFCs (1) with other Covered Entities, by 1 January 2019, (2) with certain other financial entities,¹² by 1 July 2019 and (3) with all remaining counterparties, by 1 January 2020.

⁸ See section 210(c)(8)(D) of Title II of the Dodd-Frank Act.

⁹ The FDIC Final Rules did not include any special provisions relating to multi-branch master agreement as such provisions were not relevant to entities subject to these rules (i.e., covered FSIs).

¹⁰ The Final Rules also state that a Covered Entity does not become a party to a QFC solely by acting as an agent with respect to the QFC.

¹¹ The definition of “financial market utilities” is based on the definition in the Dodd-Frank Act, but has been amended for the purposes of the Final Rules to include a broader set of entities.

¹² The definition of “financial counterparty” is similar to the definition of “financial end user” under the swap margin requirements for non-cleared swaps of the US Prudential Regulators. For information on these rules, please see our client alert available [here](#).

Overview of the Final Rules

The Final Rules are designed to achieve the following regulatory outcomes:

- restrict counterparties from utilizing direct default rights against Covered Entities that are subject to a resolution under the Federal Deposit Insurance Act (**FDIA**) (which governs the resolution of FDIC-insured depository institutions) or Title II of the Dodd-Frank Act as administered by the Orderly Liquidation Authority (which governs certain systemically important financial institutions) (collectively referred to as the **US Special Resolution Regimes**) and
- restrict counterparties from utilizing cross-default rights against Covered Entities subject to a resolution under any US or non-US insolvency regime, including the Bankruptcy Code and the FDIA¹³

In order to achieve these regulatory outcomes, the Final Rules (1) ensure cross-border enforcement of the US Special Resolution Regimes by requiring Covered Entities to include explicit terms in their Covered QFCs (subject to certain limited exemptions) pursuant to which the Covered Entity's counterparties agree to only exercise their direct default rights to the same extent as provided under the US Special Resolution Regimes (irrespective of whether or not such regime was enforceable in the applicable foreign jurisdiction) and (2) address concerns of the US Regulators with respect to how certain insolvency regimes deal with cross-default rights by requiring Covered Entities to include explicit terms in certain of their Covered QFCs that prohibit the Covered Entity's counterparties from exercising a range of cross-default rights that are related, directly or indirectly, to the entry into a receivership, insolvency, liquidation, resolution or similar proceeding of an affiliate of the Covered Entity.

Required Contractual Provisions relating to the US Special Resolution Regimes

Under the US Special Resolution Regimes, the FDIC is, subject to certain conditions, empowered to transfer QFCs of an entity that is in a resolution proceeding under such regimes. In order to give the FDIC sufficient time to effect such a transfer, the applicable regimes temporarily stay QFC counterparties of the failed entity from exercising termination, netting and collateral liquidation rights solely as a result of the entity's entry into resolution proceedings, the fact of its insolvency or its financial condition.

We note, however, that while Title II of the Dodd-Frank Act stays direct default and cross-default rights, the FDIA only stays direct default rights.

The concern of the US Regulators is that the FDIC may be unable to effect such a transfer under the US Special Resolution Regimes in circumstances where a court in a foreign jurisdiction does not enforce the rights of the FDIC. In order to address this concern, the Final Rules require that the terms of a Covered QFC explicitly provide that:

- in the event the Covered Entity becomes subject to a proceeding under a US Special Resolution Regime, the transfer of a Covered QFC from the Covered Entity to a transferee would be effective to the same extent as it would be under the US Special Resolution Regimes if the Covered QFC were governed by the laws of the US or a US state and
- in the event the Covered Entity or any of its affiliates become subject to a proceeding under a US Special Resolution Regime, default rights with respect to a Covered QFC that could be exercised against the Covered Entity could be exercised to no greater extent than they could be exercised under the US Special Resolution Regimes if the Covered QFC were governed by the laws of the US or a US state

This requirement does not, however, apply to a Covered QFC that (1) states that it is governed by the laws of the US or a US state and (2) the counterparty to the QFC is domiciled in the US (in the case of an individual) or organized under the laws of the US or a US state, has its principal place of business in the US or is a US branch or US agency (in the case of all other entities). This exemption reflects the fact that the US Special Resolution Regimes should already apply to such Covered QFCs and that, therefore, no additional wording is required.

By requiring the inclusion of these provisions in the terms of such Covered QFCs, the Final Rules would help to ensure that a court in a foreign jurisdiction would enforce the effect of those provisions, regardless of whether the court would otherwise have decided to enforce the US statutory provisions themselves. As a result, the US regulatory regime is effectively exported to the foreign jurisdiction through the contractual provisions in order to establish a consistent regulatory outcome.

¹³ The US Regulators consider the Bankruptcy Code and the FDIA to be inadequate when compared to Title II of the Dodd-Frank Act as administered by the Orderly Liquidation Authority, as neither regime addresses stays of cross-default rights.

Prohibited Cross-Default Rights

General Prohibitions

Subject to the permitted creditor protections discussed below, the Final Rules prohibit a Covered Entity from entering into a Covered QFC that:

- allows for the exercise of any cross-default right that is related, directly or indirectly, to the entry into resolution of an affiliate of the Covered Entity or
- prohibits the transfer of any credit enhancement supporting a Covered QFC, along with associated interests, obligations or collateral, upon the entry into resolution of an affiliate of the Covered Entity, except where the transfer would result in the supported party being a beneficiary of the credit enhancement in violation of any law applicable to the supported party

The primary purpose of these restrictions is to facilitate the resolution of a GSIB under the Bankruptcy Code, the FDIA or a similar resolution regime. Unlike the stay and transfer provisions of Title II of the Dodd-Frank Act as administered by the Orderly Liquidation Authority, such regimes do not address one or both of the above requirements. In the case of the Bankruptcy Code, neither of the above requirements is addressed and, in the case of the FDIA, only stays of direct default rights are addressed while cross-default rights are not.¹⁴

Creditor Protections

The Final Rules also contain permitted creditor protections that permit creditors to exercise certain cross-default rights outside of an orderly resolution of a Covered Entity and would, therefore, not be expected to undermine such a resolution. These protections broadly include the following:

- exercise of default rights based on a Covered Entity's entry into a resolution proceeding and
- the failure of certain Covered Entities to satisfy their payment or delivery obligations under certain Covered QFCs, other contracts between the same parties to such a Covered QFC that give rise to a default under the Covered QFC or certain affiliate credit enhancements that support Covered QFCs

The Final Rules also allow for the inclusion and exercise of default rights, in limited circumstances, by a non-defaulting counterparty to certain Covered QFCs in connection with the resolution of the provider of certain affiliate credit enhancements that support such Covered QFCs, subject to various requirements (including, but not limited to, the expiration of a specified stay period).

Approval of Additional Creditor Protections

The Final Rules create a process by which Covered Entities seek approval from the US Regulators to include additional creditor protections that are not explicitly permitted by the Final Rules. The US Regulators noted that they expect to consult with each other when considering any such request and do not expect to arrive at different outcomes with respect to identical applications for approval of enhanced creditor protections.

ISDA Protocols

If a Covered QFC has been amended in accordance with the provisions of the ISDA 2015 Universal Resolution Stay Protocol¹⁵ or a new (and separate) US protocol that complies with the applicable requirements of the Final Rules, then the Covered QFC would be deemed to be compliant with the Final Rules. The scope and requirements of the protocols differ in certain respects from the Final Rules and Covered Entities and their counterparties should therefore determine which compliance method best suits their particular circumstances—adhering to a protocol or amending the Covered QFCs on a bilateral basis in accordance with the requirements of the Final Rules.

¹⁴ The Federal Reserve and the FDIC noted that none of the provisions in their respective final rules should be construed as being intended to modify or limit, in any manner, the rights and powers of the FDIC as receiver under Title II of the Dodd-Frank Act or the FDIA, including, without limitation, the rights of the FDIC as receiver to enforce provisions of Title II of the Dodd-Frank Act or the FDIA that limit the enforceability of certain contractual provisions. The FDIC Final Rules explicitly state that its cross-default rights prohibitions and associated creditor protection provisions do not apply to proceedings under Title II of the Dodd-Frank Act.

¹⁵ The ISDA 2015 Universal Resolution Stay Protocol is available [here](#).

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