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US Resolution Stay: Covered Entity Compliance

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The first of three compliance deadlines for US regulations requiring resolution-related amendments to qualified financial contracts is January 1, 2019, and delaying compliance until the subsequent deadlines creates additional risk. Compliance programs may not be able to eliminate this risk due to the scope of contracts to be remediated and the staggered compliance period that looks back to the first compliance date. Therefore, risk-based plans for addressing non-conforming contracts and related communications with bank regulatory agency staff during the compliance period could be useful aspects of a compliance program.

Background

In late 2017, the Board of Governors of the Federal Reserve System (the **Board**), the Federal Deposit Insurance Corporation (the **FDIC**) and the Office of the Comptroller of the Currency (together with the Board and FDIC, the **US Regulators**) finalized substantially-similar regulations (together, the **Final Rules**) intended to improve the resolvability and resiliency of US global, systemically important banks (**GSIBs**) and the US operations of non-US GSIBs by requiring them to amend many of their derivatives, securities financing transactions, and other qualified financial contracts (**QFCs**). The Final Rules are intended to limit the ability of a GSIB's financial counterparties to disrupt its orderly resolution by exercising their contractual default rights and remedies *en masse* and thereby limit the risk to US financial stability posed by the disorderly resolution of a GSIB.

For more detail on the Final Rules, please refer to our client alert "US Resolution Stay Final Rules" available here.

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Scope of resolution regimes and contracts

The Final Rules address a GSIB's resolution under US law designed to resolve banks and certain financial companies—namely, the Federal Deposit Insurance Act and Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (together, the **US Special Resolution Regimes**)—as well as ordinary insolvency law such as the US Bankruptcy Code.

- US Special Resolution Regimes: The Final Rules seek to reduce the risk that a court outside the United States would disregard the provisions of the US Special Resolution Regimes that allow the FDIC to stay default rights and transfer QFCs to another entity by requiring the QFCs to explicitly provide that these provisions apply to the same extent they would if the contract were governed by US law.[1]

- Cross-defaults under insolvency law: The Final Rules seek to further limit the disruption to an orderly resolution by restricting QFC counterparties' rights to exercise default rights that are directly or indirectly related to an affiliate becoming subject to the Bankruptcy Code or any other US or non-US resolution regime other than Title II of the Dodd-Frank Act.[2]

- Scope of entities and contracts: As noted, the Final Rules apply to most types of QFCs with top-tier US GSIBs, their subsidiaries and the US subsidiaries, branches and agencies for non-US GSIBs (each a **Covered Entity**).[3] The definition of QFC is broad.[4] In addition to derivatives, securities financing transactions, commodity contracts and forward agreements, it includes, but is not limited to, margin loans, cash market securities transactions, loans with equity collars, and certain intraday extensions of credit. This definition also includes master agreements that apply to QFCs (*e.g.*, an ISDA Master Agreement) and guarantees of QFCs.[5]

Conformance methods

Currently, Covered Entities and their counterparties generally have three methods to conform their QFCs to the Final Rules.

- Universal Protocol: QFCs amended by the ISDA 2015 Universal Resolution Stay Protocol (**Universal Protocol**) are deemed to comply with the Final Rules even though they do not conform to every requirement of the Final Rules. Most notably, the Universal Protocol's ordinary insolvency stay provisions provide creditor protections to guaranteed counterparties that the Final Rules do not otherwise permit.[6] The US Regulators provided this "safe harbor" primarily because the Universal Protocol is generally responsive to the concerns of the Final Rules and amends a greater scope of contracts than the Final Rules may otherwise require (*i.e.*, contracts among all adherents).

- US protocol: The Final Rules provide the same safe harbor to a "US protocol," which is required to be the same as the Universal Protocol but for identified differences. The US Regulators safe harbored the US protocol primarily to allow the buyside to receive the benefits of adhering to the Universal Protocol without some of the detriments the buyside identified. For example, the US protocol may not amend contracts exclusively between the buyside but must continue to amend contracts with all Covered Entities. The 2018 ISDA US Resolution Stay Protocol was specifically drafted to conform to "US protocol" as defined in the Final Rules.

- Bilateral amendments: Parties to a QFC may agree to amend the contract to the requirements of the Final Rules. This option does not permit parties to receive the additional creditor protections of the Universal Protocol or US protocol. However, it may allow counterparties to avoid amending QFCs with all Covered Entities.

For more detail regarding the conformance methods, please see our client alert "US Resolution Stay: End-User Compliance Options" available here.

January 1, 2019 trigger date

Unless the QFC is exempt, the Final Rules require Covered Entities to conform a QFC that the Covered Entity:

- Enters on or after January 1, 2019, or
- Entered before that date, if the Covered Entity or its affiliate[7] that also is a Covered Entity (together, a **Covered Entity Group**) enters into any QFC after January 1, 2019, with the same counterparty or a GAAP-consolidated[8] affiliate of that counterparty (together, a **Counterparty Group**).

Therefore, if a Covered Entity Group enters into any QFC with any Counterparty Group after January 1, 2019, the Covered Entity Group will be required to conform all existing non-exempt QFCs with that Counterparty Group. This "look-back" requirement will be triggered regardless of whether the new QFC is itself exempt from the Final Rules or whether the QFC is only a new transaction under an existing QFC master agreement. The remainder of this article will refer to a QFC that the Final Rules require to be amended in at least one respect as a "Covered QFC."[9]

Staggered compliance period

Although conformance requirements will be determined based on QFC activity as of January 1, 2019, the Final Rules provide additional time to conform Covered QFCs with most types of counterparties. Only Covered QFCs that are between Covered Entities must be conformed by January 1, 2019. The Final Rules provide another six months (July 1, 2019) to conform Covered QFCs with "financial counterparties" and one year (January 1, 2020) to conform Covered QFCs with all other types of counterparties.[10]

Risk created by the later compliance dates

So long as the Covered QFCs are not between two Covered Entities, the Final Rules essentially permit Covered Entities to create Covered QFCs without immediately conforming them. A Covered Entity may enter into a Covered QFC with a non-Covered Entity counterparty for six months or one year after January 1, 2019 (depending on counterparty), without immediately conforming the new QFC or any other existing Covered QFC with the counterparty or its Counterparty Group. However, if any member of the Counterparty Group does not agree to conform its Covered QFCs with any member of the Covered Entity Group by the applicable compliance date, the Covered Entity Group may not be fully compliant with the Final Rules because it will not be able to unilaterally amend the Covered QFCs. In other words, a Covered Entity Group that uses the staggered compliance dates (*i.e.*, that intentionally or inadvertently enters a QFC with a non-Covered Entity counterparty between January 1, 2019 and the later, applicable compliance date) may become subject to the US Regulators' enforcement discretion.

US Regulators' intent

This risk appears to be the result of the Final Rules trying to address two competing concerns: commenters' requests to allow more time to conform QFCs and US Regulators' concern about the increasing "back book" of Covered Entities (*i.e.*, the number of QFCs not automatically subject to the Final Rules). The Final Rules address the former with the staggered compliance dates and the latter by prohibiting QFCs entered after 2018 to remain non-conformed.

The US Regulators have not publicly indicated how they expect Covered Entities to manage this risk. To eliminate this risk entirely, Covered Entities may have to cease entering QFCs after January 1, 2019, with any Counterparty Group that has not amended all its Covered QFCs with the Covered Entity Group—*i.e.*, treating all counterparties as if they were Covered Entities. This practice would appear to make the benefits of the staggered compliance dates illusory and to contradict the US Regulators' statements. The preambles to the

Final Rules explain that the US Regulators expected "a relatively small number of counterparties [] would need to modify their QFCs" by January 1, 2019.[11] Moreover, the US Regulators stated that the subsequent compliance periods "will allow market participants time to adjust to the new requirements and make required changes to QFCs in an orderly manner."[12] Chairman (then Governor) Jerome Powell reiterated this rationale in his opening statement at the meeting that approved the Board's regulation: "In particular, because this final rule requires GSIBs to amend a large number of their contracts, we modified the timeline from the proposal to adopt a phased-in approach to give more time to conform contracts with less complex and less risky counterparties, such as community banks, pension funds, and insurance companies."[13]

Risk-based compliance program

A Covered Entity Group may unilaterally eliminate the risk of non-conformed Covered QFCs by entering any QFC with any member of a Counterparty Group as of January 1, 2019, *only if* the Counterparty Group conforms all Covered QFCs with the Covered Entity Group no later than the time it enters into the new QFC. This approach depends on, among other things, identifying the transactions that are part of the broad definition of QFC, identifying the entities that comprise Counterparty Groups, the familiarity of the Counterparty Groups with the available conformance methods, the method or methods the Counterparty Groups have used (and/or are willing to use) to amend its Covered QFCs, and whether those compliance methods have conformed all Covered QFCs between the relevant Covered Entity Group and Counterparty Group.

Due to these variables, it is possible that Covered Entities may inadvertently create non-conformed Covered QFCs. Covered Entities should consider compliance programs and related communications to US Regulator staff that focus on efforts to avoid non-compliance (*e.g.*, identification of QFCs and counterparties, counterparty outreach) as well as efforts to remediate non-conformed Covered QFCs. Moreover, both aspects may be tailored to address the concerns of the underlying Final Rules. Risk-based compliance programs could be prioritized based on, among other options, (1) exposure under the contract, which would be responsive to the risk of the contract being terminated in resolution; (2) total exposure to the Counterparty Group, which would be responsive to the risk that the FDIC could not transfer the QFCs;[14] or (3) Covered QFCs entered after 2018, which would be responsive to the "back-book" concern discussed above. Considering factors such as contract term and counterparty, for example, during initial conformance and later remediation efforts could help minimize resolution-related risks.

Heightened relevance due to overlapping authorities of US Regulators

Developed compliance programs and related communications to US Regulator staff may be particularly relevant for the Final Rules because multiple US Regulators may monitor compliance starting in January 1, 2019,[15] and use a variety of methods to do so. Many Covered Entity Groups will be subject to examination for compliance with the Final Rules by more than one US Regulator. In addition, the Board and FDIC may jointly evaluate the risk of QFC closeouts as part of the resolution plans of Covered Entity Groups.

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1 Under the US Special Resolution Regimes, the FDIC may, subject to certain conditions, transfer QFCs of an entity that is in a resolution proceeding. 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 that are triggered by the entity's entry into resolution proceedings, its insolvency or its financial condition. Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) also allows the FDIC to stay default rights of counterparties against a resolving entity's affiliates that are triggered by the FDIC's resolution proceedings.

2 Most guarantees and other credit enhancements provided by a Covered Entity to its affiliate generally must also permit their transfer upon the resolution of the Covered Entity.

3 Certain subsidiaries, such as those acquired under merchant banking authority or as part of a debt previously contracted in good faith, are not Covered Entities. See, e.g., 12 CFR 252.82(b).

4 The Final Rules define QFC by reference to Title II of the Dodd-Frank Act. See 12 U.S.C. § 5390(c)(8)(D) (defining QFC).

5 As discussed in more detail in the US Resolution Stay Final Rules client alert, the Final Rules exempt some types of QFCs that do not present the risks that the rules are intended to address.

6 These additional creditor protections include the condition that either the guarantee be transferred to a third party that meets certain requirements or the guarantee claim be elevated to administrative priority status under the Bankruptcy Code.

7 With respect to the Covered Entity Group, the Final Rules refer to the definitions of "affiliate" and "control" under the Bank Holding Company Act. These definitions generally are broader than financial accounting standards and may include companies that are commonly "controlled" by a company that owns 25 percent or less of the voting securities of each "affiliate." 12 U.S.C. § 1841.

8 For counterparties that do not prepare financial statements in accordance with US Generally Accepted Accounting Principles (GAAP), the Final Rules define affiliate based on the "International Financial Reporting Standards or other similar standards." E.g., 12 CFR 252.81.

9 The article adopts this definition of "Covered QFC" for simplicity. It is different than the Final Rules' definition of Covered QFC, which includes certain types of QFCs that the Final Rules exempt from conformance. See, e.g., 12 CFR 252.82(c) and 252.88(a), (c).

10 See, e.g., 12 CFR 252.81 (defining "financial counterparty").

11 82 Fed. Reg. 42882, 42912 (Sept. 12, 2017) (Board Preamble); 82 Fed. Reg. 50228, 50255 (Oct. 30, 2017) (FDIC Preamble); 82 Fed. Reg. 56630, 56658 (Nov. 29, 2017) (OCC Preamble).

12 Board Preamble at 42913; FDIC Preamble at 50255; OCC Preamble at 56658.

13 Opening Statement on the Consideration of a Final Rule Restricting Qualified Financial Contracts by Governor Jerome H. Powell (Sept. 1, 2017) available at https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20170901.htm.

14 In general, the FDIC is able to transfer a QFC from the entity in resolution under a US Special Resolution Regimes only if the FDIC transfers all QFCs that the entity has with the counterparty and its affiliates. 12 U.S.C. §§ 1821(e)(9), 5390(c)(9).

15 Examiners will be able to cite violations of the Final Rules—non-conforming Covered QFCs—as of the compliance date applicable to the Covered QFC. For example, an examiner may identify a non-conformed Covered QFC as a violation of the regulation as of January 1, 2019, if the Covered QFC is with a Covered Entity, but no earlier than January 1, 2020, if the Covered QFC is with a small bank. Nonetheless, examiners will be able to examine a Covered Entity's compliance program before July 1, 2019, or January 1, 2020.