The Delta Report

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At a glance

CFTC Chairman Co-Authors White Paper on Swaps Regulation Version 2.0

CFTC Chairman J. Christopher Giancarlo published a white paper, "Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps," co-authored with CFTC Chief Economist Bruce Tuckman. The White Paper is intended as an agenda for the CFTC's ongoing improvement of its regulatory framework and assesses the successes and deficiencies of swaps reform in five key areas: central counterparties; reporting rules; execution rules; swap dealer capital; and end-user exceptions.

Prudential Regulation Authority (PRA) Consultation Paper CP12/18 of 22 May 2018: "Securitisation: The new EU framework and Significant Risk Transfer" (the CP)

The PRA has published a new CP regarding (i) proposals on its approach to the European Union's Securitisation Regulation and certain aspects of the revised Capital Requirements Regulation banking securitisation capital framework and (ii) its expectations with regard to Significant Risk Transfer (relevant for PRA-authorised CRD IV firms only).

Securitisation Derivatives and the Margin Exemption

This article discusses the current works to expand the current margin exemption for covered bond issuers to certain derivatives entered into in the context of simple, transparent and standardised securitisations.

US Resolution Stay Final Rules

US Regulators have released final rules restricting the ability of parties to certain specified financial contracts (including derivatives, repos, and securities lending and borrowing transactions) from exercising specific insolvency-related default rights against their counterparties that have been designated as a global systemically important banking organisation. The final rules achieve this by requiring the insertion of restrictions and prohibitions directly into such financial contracts.

CFTC Chairman Co-Authors White Paper on Swaps Regulation Version 2.0

Ian Cuillerier, Erin Choo

On 26 April 2018, Chairman J. Christopher Giancarlo of the US Commodity Futures Trading Commission (the **CFTC**), with CFTC Chief Economist Bruce Tuckman, published a white paper entitled "Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps" (the **White Paper**)[1]. Drawing from academic research, market activity and CFTC experience, the White Paper assesses the successes and deficiencies of the CFTC's implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank**) in five areas: central counterparty clearing; trade reporting; trade execution; swap dealer capital; and the end-user exception. The version referenced in the title of the White Paper is purposely included to underscore the CFTC's responsibility to continuously pursue improvements and upgrades to the CFTC's first round of swaps reform. The authors intend the White Paper to contribute to the process of swaps reform to produce a regulatory framework consistent with congressional intent, and that balances market durability and systemic risk mitigation with liquidity and economic growth. The White Paper offers high-level recommendations, not detailed modifications to specific CFTC regulations and refrains from giving specific timetables for implementation.[2]

A summary of the White Paper's assessments and recommendations for each of the five areas is presented below:

Swaps Clearing and Central Counterparties

The White Paper states that the clearing mandate has had the most far-reaching and consequential effects and has successfully moved large quantities of over-the-counter derivatives to central clearing counterparties (**CCPs**). While acknowledging the successes, particularly with respect to daily risk management and recovery planning, the authors identify three main remaining challenges: CCP risk mitigation; CCP recovery; and CCP resolution.

CCP Risk and Risk Mitigants

The key challenge for CCPs is to mitigate risk and remain safe and sound under extreme but plausible scenarios. The White Paper considers the following issues related to CCP risk mitigation:

- *Liquidity of Prefunded Resources*. The CFTC requires that CCPs hold margin in safe and liquid assets, restricting both the securities that members post as margin and the CCP's investments of cash posted as margin. Nevertheless, CCPs are exposed to the risk of a depository or repo counterparty's failure. As a consequence of such a failure, a CCP may be unable to convert investments to cash as contractually stipulated. The White Paper stresses the importance of preserving the liquidity of prefunded resources by diversifying exposures to depositories and repo counterparties and monitoring liquidity risk of securities holdings. The White Paper also argues that the measure by which CCPs that are designated as systemically important are allowed to deposit money directly with the Federal Reserve may have the unintended consequence of further concentrating the CCP field, or raising barriers to entry for smaller CCPs.
- *Correlated Defaults and Network Effects*. The White Paper recommends using new methodologies to study and analyze correlated defaults and network effects. Suggested approaches include looking at correlations across positions at various financial institutions, or studying networks of relationships that may spread defaults across the system.
- *Liquidation of Defaulted Swaps Positions*. The White Paper notes the difficulty of quantifying liquidation costs and suggests applying more scrutiny to the margin charge collected by CCPs for protection against liquidation costs. Before accepting new, less liquid products for clearing, the liquidation cost of these products and the ability of CCPs to guarantee this cost should be considered.
- *Design of the Waterfall*. The White Paper notes that while current regulations dictate the total quantity of prefunded resources (margin, default fund contributions and skin-in-the-game), they do not dictate the respective portions of such resources from members (in the form of default contributions) and CCPs (in the form of skin-in-the-game). The White Paper asks that consideration be given to how the incentive structure should be adjusted so that CCP incentives are aligned with the optimal level of risk tolerance.

1 J. Christopher Giancarlo and Bruce Tuckman, Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps (April 26, 2018), available at: https://www.cftc.gov/sites/default/files/2018-04/oce_chairman_swapregversion2whitepaper_042618.pdf

2 Press Release Number 7719-18, CFTC, "CFTC Chairman Unveils Reg Reform 2.0 Agenda" (April 26, 2018), available at: https://www.cftc.gov/PressRoom/PressReleases/7719-18

CCP Recovery

In preparation for adverse scenarios where CCPs cannot cover all their losses, large and important CCPs must have reliable recovery plans in place to maintain viability without government assistance. One presented approach is combining gains-based haircuts (**GBH**) with partial "tear-ups." GBH reduce variation margin payments due to clearing members and customers pro rata until the payables no longer exceed resources available, ensuring that a CCP does not owe more in variation margin than it can pay. However, GBH do not ensure that a CCP has enough funds to replace defaulted positions. Tear-ups are a strategy to restore a matched book by tearing up a selection of offsetting, non-defaulted positions according to an ex ante formula when the CCP does not have enough resources to replace defaulted positions. However, the GBH/tear-up strategy is not perfect and the authors note remaining issues, such as improving the transparency and predictability of the recovery plans and reducing the uncertainty of knowing who will (or will not) honor levied assessments. The White Paper also warns against regulators being exceedingly prescriptive about the workings of the recovery plans.

CCP Resolution

In the event that recovery plans prove inadequate, Title II of Dodd-Frank provides for the resolution of a CCP where government authorities intervene and make resources from the orderly liquidation fund available to ensure continuity of clearing services. According to the White Paper, the CFTC is working closely with the Federal Deposit Insurance Corporation to coordinate the planning and execution of a CCP resolution and to provide the market with more transparency in the process.

Swaps Reporting Rules

Since the publication of the CFTC's swap data reporting requirements in 2012, the CFTC, reporting counterparties and Swap Data Repositories (**SDRs**) have collaborated to improve swap data collection and integrity. However, still, the reporting structure is incomplete and does not provide regulators with a complete and accurate picture of counterparty credit risk. Sufficient technical specifications on the information to be reported have been missing since the initial implementation of the reporting regulations. Standardized data standards, schema and templates would make the reported information more consistent and, hence, usable. The CFTC has prepared an outline for changing reporting regulations (including Parts 43, 45 and 49) in its 2017 Roadmap to Achieve High Quality Swaps Data (the **Roadmap**).[3] The White Paper recommends the following as next steps in the Roadmap process in order to improve the quality, accuracy and completeness of data available to the CFTC and the public:

- *Validation of Data Accuracy and Completeness*. The White Paper recommends that both SDRs and swap counterparties be required to verify the swap data that has been reported to the SDR, as they do with portfolio reconciliation. SDRs could regularly provide swap data reports to the relevant reporting counterparties, and the reporting counterparties would respond to the SDR with a confirmation or correction.
- *Validation of Incoming Data*. The White Paper suggests requiring SDRs to validate swap data upon receipt, similar to what the European Securities and Markets Authority (**ESMA**) already has in place. In this connection, reporting entities would need to correct and resubmit data that fails validation in a timely manner.
- *Changes to Part 45 Regulatory Reporting*. The White Paper believes fewer, yet better defined and standardized, data fields would improve both the quality of swaps reporting and regulators' ability to utilize swaps data. The authors specifically suggest considering giving more time to market participants to submit fewer, more defined data fields, adjusting the reporting requirement to a T+1 timeframe that matches overseas regulatory counterparts, and implementing swaps reporting data standards that CPMI-IOSCO published.
- *Real-Time Public Reporting*. A pilot program to study the effects of varying cap sizes, block sizes and time delays potentially across different Swap Execution Facilities (**SEFs**), asset classes and/or specific products is suggested.
- *Distributed Ledger Technology* (**DLT**). The authors see great promise in the use of DLT for trade reporting. DLT contributes to increasing the speed and quality of reporting, permitting more timely oversight of the swaps markets, all at a lower cost and with less or no intervention from humans or intermediaries. The White Paper calls for the CFTC to cultivate "regulator nodes" on distributed ledgers and have a long-term plan to take advantage of DLT and other new technologies, while ensuring standardization, interoperability and security. The White Paper proposes that the CFTC ensure that its regulations are technologically neutral by not prescribing how principles or parameters must be met.

3 CFTC Division of Market Oversight, Roadmap to Achieve High Quality Swaps Data (July 10, 2017), available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/dmo_swapdataplan071017.pdf

Swaps Execution Rules

Consistent with the observations Giancarlo made in his 2015 White Paper,[4] the authors express criticism about the way in which the CFTC promulgated the Dodd-Frank trade execution requirement. Dodd-Frank requires that swaps subject to the clearing requirement be executed on an SEF or designated contract market (**DCM**) unless no SEF or DCM makes the swap available to trade. While Dodd-Frank does not require that SEFs use any particular method of trading or execution, the CFTC implemented the mandate by prescribing specific execution methods. The authors argue that the current CFTC rules are a flawed and ad hoc implementation of congressional intent, and that the better approach would be to focus on shepherding the professional conduct of swaps execution through licensure, testing and adoption of codes of conduct. The White Paper details numerous studies that link the current regulations to fragmenting the market, stunting swaps trading and price discovery on SEFs, reducing liquidity and hindering technological innovation.

The White Paper recommends:

- *Eliminating prescriptive execution methods*. Despite Congress's directive that SEFs operate by "any means of interstate commerce," CFTC regulations currently specify that swaps subject to the trade execution requirement be executed on an SEF either through an order book or a request-for-quote system involving three unaffiliated participants (**RFQ-to-3**). CFTC regulations also require that an SEF offer an order book for all swaps it lists. The authors believe these rules impose significant costs to SEFs and market participants and burden the markets from organically innovating and becoming more efficient. The White Paper urges the CFTC to move away from the prescriptive order book and RFQ-to-3 requirements and permit flexible methods of execution.

- *Eliminating the Made Available to Trade (**MAT**) process*. Under current CFTC regulations, the process of determining which swap is "made available to trade" is initiated by SEFs and DCMs, which submit a determination that a swap is MAT to the CFTC. The CFTC may then deny or approve such MAT determination. The White Paper recommends aligning the MAT determination process with the clearing determination so that all swaps subject to the clearing mandate are MAT. This would promote swaps trading on SEFs and accomplish increased market transparency by expanding the range of products, increasing liquidity and encouraging price discovery on SEFs.

Swap Dealer Capital

As around half of the 100 swap dealers registered with the CFTC are banks, and another 30 percent are subsidiaries of bank holding companies, the bank capital regime is extremely relevant to the swaps market. The White Paper discusses how some components of the bank capital regime overestimate the risk of swaps. In particular, the standardized models required by regulators fail to recognize that the notional amount is not representative of credit risk and does not account for posted margin or offsetting swap positions. The authors see many benefits to using internal models developed by the banks instead, as they are customized for the business of that firm and better able to capture the relevant risks. The authors recommend that regulators improve their capabilities to approve and monitor internal models used by firms. They note that refining standardized models is also an option, but that would by necessity create further complications.

End-User Exception

Recognizing the cost of clearing and uncleared margin requirements, Dodd-Frank made certain accommodations for end-users. The White Paper considers further improvements that can be made to reduce the burden for end-users that are unlikely to be sources of systemic risk. The White Paper distinguishes commercial end-users, small banks and financial institutions with simple business models and balance sheets as unlikely sources of systemic risk, different from financial institutions with complex businesses. The authors make the following recommendations:

- *Codifying the existing clearing no-action relief for small banks*. The CFTC currently has in place no-action relief from clearing requirements available to bank holding companies and savings and loan holding companies holding consolidated assets of no more than US$10 billion. The White Paper recommends the CFTC codify this relief and consider additional, incremental rule changes to reduce the burden for such small banks.

- *Reconsidering the definition of "financial entity."* The White Paper asks the CFTC to consider narrowing the definition of "financial entity" to bring clarity and relief to a variety of end-users, such as treasury affiliates, certain special purpose vehicles and energy firms.

4 J. Christopher Giancarlo, Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank (Jan 29, 2015), available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf

- *Reworking the determination and application of "material swaps exposure" (**MSE**) threshold*. Financial end-users that are below the MSE threshold are excepted from initial margin requirements. The authors urge regulators to set the MSE threshold using better metrics than the notional amount (which inappropriately adds offsetting long and short positions together). The authors offer Entity-Netted Notionals (**ENNs**), which nets longs and shorts within pairs of legal counterparties, product classes and currencies, as an alternative that better captures actual risk. The White Paper also recommends a relative, rather than absolute, MSE threshold, based on the ratio of ENNs to assets, and that the MSE threshold except end-users from variation margin requirements.
- *Reworking uncleared initial margin calculations*. The authors argue that the current uncleared margin rule is overly prescriptive and produces a bias in favor of cleared products. The White Paper references Chairman Giancarlo's previous statements about the 2016 final rule on margin requirements for uncleared swaps, in which he asserted that there is nothing in Dodd-Frank directing regulators to set punitive margin levels on uncleared products to drive end-users to cleared products, and that such punitive margin levels may have the unintended consequence of driving market participants to inadequately hedge exposure. The authors point to the ten-day margin period of risk (**MPOR**) requirement for uncleared products compared to the five-day MPOR for clearinghouses as a prime example of a standard favoring cleared swaps. The standard, they argue, is an overstatement of the risk of uncleared swaps and a broad and imprecise model for a wide variety of uncleared swaps. The White Paper recommends a non-prescriptive regulatory standard, which covers a 99 percentile adverse event, and then permits market participants to elect customized models that are approved by regulators or simple and conservative models offered by the regulators.

Prudential Regulation Authority (PRA) Consultation Paper CP12/18 of 22 May 2018: "Securitisation: The new EU framework and Significant Risk Transfer" (the CP)

Richard Blackburn

Introduction

The PRA's new CP comes ahead of the incoming EU Securitisation Regulation[5], due to come into effect on 1 January 2019 and the incoming securitisation capital framework implementing revisions to the Basel securitisation capital framework, introduced via amendments[6] to the CRR[7].

In summary, the CP sets out the proposals relating to the following:

- **Part 1 – The New Securitisation Framework** – the Prudential Regulation Authority's (**PRA**) proposals on its approach to the European Union's Securitisation Regulation and certain aspects of the revised Capital Requirements Regulation (**CRR**) banking securitisation capital framework (relevant for all PRA-authorised CRD IV[8] firms and all PRA-authorised Solvency II firms and potentially other firms pending HM Treasury discretions) and
- **Part 2 – Significant Risk Transfer (SRT)** – the PRA's expectations with regard to SRT (relevant for PRA-authorised CRD IV firms only)

Part 1 – The New Securitisation Framework

The proposals relating to the Securitisation Regulation aim to communicate the PRA's approach to supervising certain aspects of the new securitisation framework.

The proposals relating to CRR amendments primarily clarify the PRA's proposed approach to exercising its discretions in relation to the methods used to calculate risk weights on their securitisation exposures.

5 Regulation (EU) 2017/2402 of the European Parliament and Council of 12 December 2017, laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402&from=EN

6 Regulation (EU) 2017/2401 of the European Parliament and Council of 12 December 2017, amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2401&from=EN

7 Capital Requirements Regulation (575/2013), available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN

8 The Capital Requirements Directive (2013/36/EU) (CRD) and the Capital Requirements Regulation (575/2013) (CRR) (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=EN), are referred to together as "**CRD IV**".

The proposals also include an updated mapping of External Credit Assessment Institutions (**ECAI**) ratings to the Credit Quality Steps (**CQS**) used in the SEC-ERBA, as an interim measure before an updated Implementing Technical Standard (**ITS**) is adopted.

In summary, the topics covered are as follows:

- General requirements
  - Securitiser requirements
  - Investor requirements
- Sponsors of STS and ABCP programmes
- CRR securitisation capital framework

Part 2 – Significant Risk Transfer

The PRA intends to provide clarity on the PRA's expectations for firms undertaking SRT securitisations that incorporate excess spread features or use standardised approach (SA) portfolios and clarify the accountability of senior management in relation to these transactions.

In summary, the topics covered are as follows:

- SRT in the presence of excess spread
- Assessing CRT for securitisations of SA portfolios
- Senior management engagement in SRT securitisation
- The consultation closes on Wednesday 22 August 2018.

Securitisation Derivatives and the Margin Exemption

Eduardo Barrachina

Background

On 4 May 2018, the Joint Committee of the European Supervisory Authorities (**ESAs**) published a consultation paper on the draft regulatory technical standards (the **Draft RTS**) amending Delegated Regulation (EU) 2016/2251 on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP (the **Margin Rules**)[9] in the context of simple, transparent and standardised securitisations (**STS Securitisations**) (the **Consultation**)[10].

The Draft RTS purports to align and ensure the consistency of the treatment of derivatives entered into by covered bond entities in connection with covered bond issuances, or by a securitisation special purpose entity (**SSPE**) in connection with an STS Securitisation.

Article 42(2) of the Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 (the **STS Regulation**)[11] amended Article 4 of Regulation No 648/2012 of the European Parliament and of the Council (**EMIR**) by adding paragraph (5), which excludes both STS Securitisations and covered bond issuers from the EMIR clearing obligation, subject to specific requirements. In particular, the scope of the new paragraph (5) states that:

"Paragraph 1 of this Article shall not apply with respect to OTC derivative contracts that are concluded by covered bond entities in connection with a covered bond, or by a securitisation special purpose entity in connection with a securitisation, within the meaning of Regulation (EU) 2017/2402 of the European Parliament and of the Council provided that (…)"

ESAs have to develop draft RTSs to determine the level and type of collateral required with respect to OTC derivative contracts entered into by SSPEs and covered bond entities in connection with STS Securitisations and covered bonds respectively, taking into account any impediments faced in exchanging collateral with respect to existing collateral arrangements under the covered bond or securitisation issuances.

Main Proposed Changes

Largely the amendments proposed in the Consultation are aimed to align the regulatory treatment of STS Securitisations and covered bond issuances by extending the existing exemption applicable to covered bonds issuers and cover pools to STS Securitisations. Under Article 30 of the Margin Rules, covered bond issuers and cover pools are exempted from posting any initial margin (**IM**) and variation margin (**VM**). This special treatment has been justified due to the legal impediments that covered bond issuers or cover pools may encounter when providing collateral. Please see for further details our Delta Report.

However, no equivalent exemption exists currently under EMIR for securitisations. The Consultation considers that SSPEs have similar collateral arrangements to those of

9 Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN

10 Available at: https://www.eba.europa.eu/news-press/calendar?p_p_id=8&_8_struts_action=%2Fcalendar%2Fview_event&_8_eventId=2205968

11 Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402&from=EN

the covered bond issuances, which would justify a similar exemption arrangement, although fewer requirements would be needed.

Article 30a of the Draft RTS establishes that:

- *With respect to OTC derivatives contracts that are concluded by a securitization special purpose entity in connection with a securitization within the meaning of Regulation (EU) 2017/2402 and meeting the conditions of Article 4(5) of this Regulation (EU) 648/2012, by way of derogation from Article 2(2), where the conditions set out in paragraph 2 of this Article are met, counterparties may provide in their risk management procedures the following:*
  - that variation margin is not posted by the securitisation special purpose entity but that it is collected from its counterparty in cash and returned to its counterparty when due
  - *that initial margin is not posted or collected*

Article 30a of the Draft RTS sets out the following conditions that must apply in order to benefit from the exemption:

- the counterparty to the OTC derivative concluded with the SSPE ranks at least pari passu with the holders of the most senior securitisation note. This condition applies only where the counterparty to the OTC derivative contract is neither the defaulting nor the affected party
- the establishment of a level of credit enhancement of the most senior securitisation note of at least 2 per cent of the outstanding notes on an ongoing basis and
- the netting set does not include OTC derivative contracts unrelated to the STS Securitisation

In principle it is understood that the requirement set out in Article 30(2)(d) of the Margin Rules that the relevant OTC derivative contract is used only to hedge interest rate or currency mismatches will not need to be included since it is already covered in EMIR itself.

The benefit of this exemption is limited to OTC derivative contracts that rank at least pari passu with the most senior class of notes under an STS securitisation so this will limit the practical benefit of the exemption in the context of STS securitisations. This may result that hedging arrangements in respect of subordinated classes of notes may be subject to VM and IM obligations.

Another limitation that will have a practical impact is that the Draft RTS is very clear that this exemption will only apply for OTC derivative contracts entered into in respect of STS securitisations thus leaving outside this regime any non-STS securitisations. It is very unlikely that this will change since Article 42 of the Securitisation Regulation has a very strict scope of application (please see above).

In any case, the above is relevant now that it has been confirmed that the European Commission's 2016 Regulatory Fitness and Performance (the **EMIR Review**) will not amend the definition of "financial counterparty" (**FC**) to include SSPEs, who will typically be "non-financial counterparties" (**NFC**) Therefore, VM and IM requirements would only apply where the SSPE has exceeded the relevant thresholds, thus becoming an NFC+.

Next steps

The Draft RTS will be submitted to the European Commission for endorsement by 18 July 2018. This will be followed by scrutiny by the European Parliament and the Council, before being published in the Official Journal of the European Union.

Conclusions

Subject to the above limitations, the Draft RTS should be welcome by both the derivative and the securitisation market. However, as explained above, the exclusions of non-STS securitisations will limit the practical impact of this exemption.

The proposed changes are made with the same purpose of those under the ongoing EMIR Review, which aim to reduce unnecessary burdens for NFCs. This is also in line with the recent position clarifying that SSPEs will not be included within the definition of FCs as was anticipated. For more details on the EMIR Review, please see the Delta Report.

US Resolution Stay Final Rules

Ian Cuillerier, Rhys Bortignon

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 Reserve[12] (the **Federal Reserve Final Rules**), the FDIC[13] (the **FDIC Final Rules**) and the OCC[14] (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.[15]

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:[16]

- With respect to US GSIBs,[17] all US and non-US subsidiaries and
- With respect to foreign GSIBs,[18] US subsidiaries, US branches and US agencies

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.[19] 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,[20] 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

12 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

13 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

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

15 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.

16 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.

17 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.

18 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 Crédit Agricole, Industrial and Commercial Bank of China Limited, HSBC, ING Bank, Mitsubishi UFJ FG, Mizuho FG, Nordea, Royal Bank of Scotland, Santander, Société Générale, 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.

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

20 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).

exercised against a Covered Entity, (2) to which a Covered Entity is a party[21] 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).[22]

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,[23] by 1 July 2019 and (3) with all remaining counterparties, by 1 January 2020.

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 FDIA[24]

21 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.

22 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.

23 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.

24 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.

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.

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.[25]

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 Protocol[26] 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 bests 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.

25 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.

26 The ISDA 2015 Universal Resolution Stay Protocol is available here.

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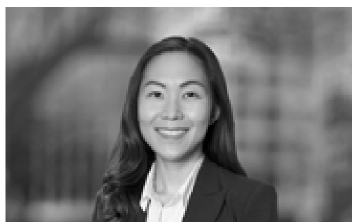

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