ALERT MEMORANDUM

New Requirements for Financial Contracts Limit Exercise of Default Rights to Support GSIB Resolution

December 7, 2017

US banking regulators have introduced rules imposing new requirements on the terms of certain swaps, repos and other qualified financial contracts (**QFCs**) of global systemically important banking organizations (**GSIBs**). In an effort to support the ability of failing GSIBs to be recapitalized on a going-concern basis or otherwise resolved, these rules require contractual provisions limiting the ability of counterparties to exercise default rights arising in the context of a GSIB resolution and ensure that actions taken under US resolution regimes are enforceable on a cross-border basis.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

Seth Grosshandler
+1 212 225 2542
sgrosshandler@cgsh.com

Knox McIlwain
+44 20 7614 2204
+1 212 225 2245
kmcilwain@cgsh.com

Igor Kleyman
+1 212 225 2996
ikleyman@cgsh.com

Lauren Gilbert
+1 212 225 2624
lgilbert@cgsh.com

Alessandro Forzani
+44 7614 2291
aforzani@cgsh.com

Introduced in parallel by the Federal Reserve (**Board**), the Federal Deposit Insurance Corporation (**FDIC**) and the Office of the Comptroller of the Currency (**OCC**, and together with the Board and the FDIC, the **US Regulators**), the final rules (**Final Rules**)[1] require US GSIBs and the US operations of non-US GSIBs to ensure that, unless excluded or exempted, their QFCs satisfy the following conditions:

(1) Such QFCs are subject to existing limits on the exercise of default rights by counterparties under the Orderly Liquidation Authority (**OLA**) provisions of Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act (**FDIA**); and

(2) Such QFCs limit the ability of counterparties to exercise default rights related, directly or indirectly, to an affiliate of the Covered Entity (defined below) entering into insolvency proceedings.

Complying with these requirements will require amendments to a significant portion of existing QFC documentation, imposing compliance burdens on both GSIBs and their counterparties. QFCs can be conformed individually or through protocols, such as the ISDA 2015 Universal Resolution Stay Protocol (**ISDA Universal Protocol**).

[1] See, 82 Fed. Reg. 42882 (Sept. 12, 2017) (the **Board Rule**), 82 Fed. Reg. 50228 (Oct. 30, 2017) (the **FDIC Rule**), and 82 Fed. Reg. 56630 (Nov. 29, 2017) (the **OCC Rule**).

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Quick Reference

Covered Entities:

- US GSIBs: The parent holding company and each of its US and non-US subsidiaries
- Non-US GSIBs: Each US subsidiary, US branch and US agency
- National banks and federal savings associations with more than $700 billion in assets
- Exclusions: Certain subsidiaries held under merchant banking, DPC and related authorities

Covered QFCs: All QFCs a Covered Entity enters into, executes or otherwise becomes a party to on or after January 1, 2019 (regardless of any later compliance date for the counterparty) and, if any such QFC is entered into, all existing QFCs (other than excluded QFCs) between the GSIB group and the counterparty group

- QFC: Certain swap agreements, repurchase agreements, securities contracts, forward contracts and commodities contracts, together with related master agreements and credit support agreements
- Exclusions: (1) QFCs that do not contain default rights or transfer restrictions; (2) QFCs governed by US law entered into with "on-shore" counterparties that do not contain cross defaults or credit enhancement transfer restrictions; (3) certain retail investment advisory contracts; (4) certain existing warrants and warrants issued shortly after introduction of the Final Rules and (5) QFCs to which a CCP or other FMU is a party
- GSIB groups: Defined using Bank Holding Company Act definition of affiliate
- Counterparty groups: Defined using GAAP financial consolidation definition of affiliate

Compliance Dates: For Covered Entity QFCs with:

- Other Covered Entities: January 1, 2019
- "Financial counterparties" other than small banks: July 1, 2019
- All other counterparties: January 1, 2020

Means of Compliance:

- Adherence to the ISDA Universal Protocol
- Adherence to a "US protocol" based on the terms of the ISDA Universal Protocol but with certain minor deviations specified under the Final Rules
    - It is anticipated that ISDA will publish documentation satisfying this definition
- Conformance of QFC terms to the requirements of the Final Rules, which contain fewer protections for creditors than the protocol approaches
- An alternative means of complying approved by the US Regulators

Requirements of the Final Rules: Unless subject to a protocol or alternative means of compliance, Covered QFCs must conform to the following requirements:

- Explicitly provide that, if the Covered Entity or its affiliate becomes subject to resolution under OLA or the FDIA, its counterparty can only exercise default rights and enforce transfer restrictions as permitted under such regimes
- Limit a counterparty's ability to:
    - Exercise default rights related, directly or indirectly, to an affiliate of the Covered Entity becoming subject to a resolution or insolvency proceeding, including under the Bankruptcy Code; and
    - Enforce transfer restrictions with respect to credit enhancements provided by an affiliate of the Covered Entity;
    - Except that counterparties retain the right to exercise default rights that: (i) are unrelated to the affiliate becoming subject to proceedings, (ii) arise if the Covered Entity itself becomes subject to proceedings, (iii) arise if the Covered Entity or credit enhancement provider fails to satisfy a payment or delivery obligation or (iv) arise if certain creditor protections are not satisfied after a stay period (the longer of one business day and 48-hours)
- **Default Rights:** Defined broadly to include rights to terminate, suspend or delay performance or request additional collateral, but exclude same-day payment netting and increased margin requirements that arise solely from a change in value of collateral or the amount of economic exposure under the QFC

Background

The Final Rules are the culmination of efforts by the US Regulators to require the use of contractual means to address a potential impediment to the orderly resolution of GSIBs.

Following the financial crisis of 2008, regulators and market participants began to develop new strategies to resolve systemically important financial institutions, with a focus on ensuring the continuity of a distressed financial institution's operations throughout resolution, but doing so in a manner that does not impose losses on taxpayers. Many jurisdictions adopted "special resolution regimes" (**SRRs**) specifically designed to facilitate the resolution of global, systemically important banking groups by granting resolution authorities new powers.[2]

The SPOE Resolution Strategy

One of the key new strategies developed by regulators and market participants to address a distressed GSIB is the "single-point-of-entry" (**SPOE**) strategy. In an SPOE resolution, losses experienced in a banking group, including those of operating subsidiaries, would be upstreamed to the top-most parent entity that would enter resolution proceedings—the "resolution entity." The shareholders and creditors of the resolution entity would bear the losses of the entire group (according to their order of priority), while the remainder of the group's operations would continue as a going concern during the resolution.

In addition to the Final Rules, regulators have introduced a variety of regulatory requirements to facilitate this strategy, including requirements for minimum "total loss-absorbing capacity," resolution planning requirements and enhanced prudential standards.

Global financial regulators identified that a potential impediment to the orderly resolution of financial institutions under these new strategies is the ability of counterparties to exercise default rights under financial contracts, particularly over-the-counter (**OTC**) derivative contracts, once entities within a banking group enter resolution proceedings. In a typical OTC derivative contract, a party has the right to terminate and close out once the counterparty enters insolvency or resolution proceedings (**direct default rights**), and, in some cases, the party may also have the right to terminate and close out once an affiliate of the counterparty enters insolvency or resolution proceedings (**cross-default rights**), even if the counterparty itself is not in proceedings and continues to perform its obligations. Regulators were concerned that large-scale exercise of such default rights could undermine the ability of the banking group to continue operations during resolution and could have negative secondary effects on other markets (*e.g.*, for collateral), leading to systemic risk.

SRRs address this issue by granting resolution authorities the power to temporarily stay the ability of a counterparty to exercise default rights based on the entry into resolution proceedings and, if certain creditor protections are satisfied, to permanently override such default rights.

Notwithstanding these new powers, regulators were concerned about whether these powers would be enforced in a cross-border context in circumstances where contracts were governed by a law other than the law of the SRR (*e.g.*, a resolution under OLA, but where contracts were governed by English law).

The Final Rules' origin is in efforts undertaken by regulators to require the use of contractual means to eliminate uncertainty about the extraterritorial application of local law. In 2013, regulators from Germany, Japan, Switzerland, the United Kingdom and the United States asked the International Swaps and Derivatives Association, Inc. (**ISDA**) to develop contractual documentation that addressed this concern. ISDA formed a working group comprised of the major derivatives dealers in those jurisdictions and major buyside entities to address the issue. The working group, in consultation with the regulators, developed the ISDA 2014 Resolution Stay Protocol (**ISDA 2014 Protocol**), a contractual arrangement that amends

[2] The Financial Stability Board (**FSB**) developed the "Key Attributes of Effective Resolution Regimes for Financial Institutions" (**Key Attributes**) that outline the core features for SRRs.

ISDA Master Agreements between adhering parties and related credit enhancements. **Section 1** of the ISDA 2014 Protocol clarifies that if a party becomes subject to a resolution under an SRR, other adhering parties could exercise default rights only to the extent permitted under the SRR, and any transfers of covered agreements would be enforceable to the same extent as provided under the SRR, in each case regardless of the law governing those agreements.

The ISDA 2014 Protocol also addresses a separate, but related, concern of the US Regulators and US GSIBs that in the event a US GSIB enters proceedings in the United States but is not resolved under OLA, regulators would not have the ability to stay or override the exercise of counterparties' cross-default rights. This would occur, for example, if a US GSIB enters proceedings under the US Bankruptcy Code. Although Bankruptcy Code proceedings impose an "automatic stay" on termination of contracts (other than QFCs) with a debtor, there are no restrictions on the ability of counterparties to contracts with the debtor's subsidiaries and affiliates to exercise cross-default rights. The same is true under the FDIA. As a result, there are no stays for parties to "opt-in" to, as parties do under Section 1 of the ISDA 2014 Protocol.

As required under the US resolution planning regime, US GSIBs developed strategies to be resolved in an orderly fashion under the Bankruptcy Code that depend in part on preserving the continuity of their operating subsidiaries and keeping them out of bankruptcy or other proceedings. These strategies could be undermined if counterparties to operating subsidiaries could exercise cross-default rights based on the parent entity entering bankruptcy proceedings.

Section 2 of the ISDA 2014 Protocol creates a contractual stay regime that parallels the stay regime under OLA, but that applies where affiliates of adhering parties enter proceedings under the Bankruptcy Code, the Securities Investor Protection Act (**SIPA**) or the FDIA. Under these provisions, adhering parties agree that default rights based, directly or indirectly, on an affiliate of an adhering counterparty entering such proceedings cannot be exercised. In cases where the affiliate is a guarantor or otherwise supports the credit of the ISDA Master Agreement between the parties, certain conditions must be satisfied in order for default rights to be overridden. These conditions parallel those applicable under OLA.

In 2015, the ISDA working group, in coordination with the regulators, developed the ISDA Universal Protocol. Among other things, this protocol expanded the scope of the ISDA 2014 Protocol to include agreements governing securities finance transactions.

US Special Resolution Regimes

In the United States, the primary SRR is OLA, a resolution framework intended to be used only if resolution under the Bankruptcy Code would give rise to system risk. OLA empowers the FDIC, as receiver for a "covered financial company," to transfer QFCs of the covered financial company to a bridge company or other transferee not in resolution proceedings. To facilitate this transfer, counterparties are stayed for one business day from exercising close-out rights that arise "solely by reason of or incidental to" the entity's resolution, its insolvency or its financial condition. If a counterparty's QFCs (and those of its affiliates) have been transferred before the expiration of the stay period, the exercise of such rights is permanently overridden; otherwise, the counterparty may immediately exercise such rights.

OLA also addresses cross-default rights. The FDIC can enforce contracts that a subsidiary or affiliate of a covered financial company is a party to that are "linked to" or "guaranteed or otherwise supported by" the covered financial company, notwithstanding any cross-default rights. If a contract is "guaranteed or otherwise supported by" the covered financial company, the FDIC must satisfy by the end of the one business day stay period certain conditions that preserve the benefit of the credit support. If the contract is solely "linked to" the covered financial company, the contract is automatically enforced, meaning counterparties cannot exercise, *e.g.*, "Specified Entity" cross-default rights under an ISDA Master Agreement related to resolution of the Specified Entities. Notably, these provision apply to all contracts, not just QFCs.

The other SRR in the United States is the FDIA, which applies to insured depository institutions. The FDIA and OLA are substantially similar regimes, although the FDIA does not include the OLA cross-default provisions.

Adherence to the ISDA protocols was voluntary and not the subject of formal rules. These protocols were primarily adhered to by GSIBs, although adherence by other parties is possible. However, unless a party benefits from adherence to the protocol, it may not be in a party's interest to adhere. For example, buyside entities generally would not be eligible for resolution under SRRs, so Section 1 of the protocols would not benefit them, and under Section 2, they may limit or give up certain bargained-for rights.

However, the goal of the regulators was for the approaches taken under the ISDA protocols to apply generally to financial documentation on a market-wide basis. In 2015, the FSB published the Principles for Cross-border Effectiveness of Resolution Actions, articulating its preferred approach to ensuring the cross-border enforceability of stays on close-out.[3] While emphasizing the importance of implementing comprehensive statutory recognition frameworks, the FSB also supported contractual approaches to cross-border recognition, which the FSB noted were critical pending the adoption of such statutory frameworks and which may also complement such regimes once they are in place. The members of the FSB committed to introduce regulatory requirements for contractual recognition of stays under relevant agreements. As of the date of this client alert, in addition to the Final Rules, such regulations have been introduced in Germany,[4] Japan,[5] Switzerland[6] and the United Kingdom.[7] To facilitate compliance with these regulatory requirements by all market participants, ISDA developed the ISDA Jurisdictional Modular Resolution Stay Protocol.[8]

Although regulators in other jurisdictions may have preferred that market participants comply with their regulatory requirements by adhering to the ISDA Universal Protocol, such adherence was not required. By contrast, the Final Rules were designed to strongly encourage either adherence to the ISDA Universal Protocol or to another protocol on substantially similar terms. The Final Rules consist of two primary requirements that mirror the mechanics of Section 1 and Section 2 of the ISDA Universal Protocol, although these requirements are stricter and contain fewer protections for creditors than the ISDA Universal Protocol. However, the Final Rules permit parties to comply by adhering to the ISDA Universal Protocol or a similar protocol, thereby benefitting from the additional creditor protections, particularly under Section 2. Adherence to such protocols would be on a "universal" basis, meaning Covered QFCs with any counterparty subject to the Final Rules that also adheres would be amended. Buyside entities will need to carefully consider these compliance options.

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3 FSB, Principles for Cross-border Effectiveness of Resolution Actions (Nov. 3, 2015) (available at http://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf).

4 Section 60a of the German Recovery and Resolution Act.

5 The "Comprehensive Guidelines for Supervision of Major Banks, etc.," the "Comprehensive Guidelines for Supervision of Small- and Medium-Sized Enterprises and Regional Financial Institutions," the "Comprehensive Guidelines for Supervision of Insurance Companies" and the "Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc." rulebooks of the Financial Services Agency of Japan.

6 Article 12 para. 2bis of the Banking Ordinance of the Swiss Federal Council of 30 April 2014, as supplemented by Chapter 5 Article 56 and 61a of the Ordinance of the Swiss Financial Market Supervisory Authority on the Insolvency of Banks and Securities Dealers.

7 The Stay in Resolution section of the PRA Rulebook.

8 https://www.isda.org/protocol/isda-resolution-stay-jurisdictional-modular-protocol/.

Scope and Requirements of the Final Rules

Default Rights Permitted under Covered QFCs

- If subject to the Final Rules, Covered QFCs of Covered Entities must satisfy the following requirements:
- "**Part 1**" Requirements. Covered QFCs must provide that, if the Covered Entity or any of its affiliates become subject to resolution under OLA or the FDIA, the counterparty can only exercise default rights and enforce transfer restrictions to the extent permitted under such regimes.
- "**Part 2**" Requirements.
  - Covered QFCs must not permit the counterparty to:
    - Exercise default rights related, directly or indirectly, to an affiliate of the Covered Entity becoming subject to receivership, insolvency, liquidation, resolution or similar proceedings, other than the permitted default rights described below; or
    - Enforce transfer restrictions with respect to a guarantee or other credit support provided by an affiliate of the Covered Entity that is also itself a Covered Entity or property securing any such credit support (a **covered affiliate credit enhancement**).
  - *Default rights permitted under the Part 2 requirements.* Counterparties retain the ability to exercise default rights that:
    - Are unrelated to the affiliate becoming subject to proceedings;
    - Arise if the Covered Entity itself becomes subject to proceedings;
    - Arise if the Covered Entity or credit enhancement provider fails to satisfy a payment or delivery obligation; or
    - Arise based on the failure of certain creditor protection conditions to be satisfied (see the summary of the Part 2 requirements at the end of this client alert for more detail on these protections).
  - The Covered QFC must provide that the counterparty exercising a default right bears the burden of proving, by clear and convincing evidence, that such exercise is permitted.
  - *Expanded limitations on transfer restrictions*. The limitations on the enforcement of transfer restrictions in Part 2 of the Final Rules were expanded to align with the approach proposed by the FDIC.
    - In the FDIC's proposed rule, the limitation on transfer restrictions under the Part 2 provisions went further than the Board's or OCC's proposed rules by preventing the enforcement of transfer restrictions "upon or following" the entry into proceedings by a Covered Entity's affiliate.
    - Each of the Final Rules adopts this broader construction, without explanation. This change creates uncertainty regarding when, if ever, transfer restrictions could be enforced following an insolvency event with respect to an entity within a Covered Entity group.
- At the end of this client alert is a comparison of the requirements of the Final Rules, including permitted creditor protections, and the provisions of the ISDA Universal Protocol.

Scope of Default Rights

- The term "default rights" under the Final Rules aligns with the definition under the ISDA Universal Protocol, and is defined broadly to include:
  - Rights of a party to terminate, set off or net, exercise remedies in respect of collateral, demand payment or delivery, suspend or delay payment or performance, or modify the obligations of a party.

    - Rights related to same-day payment netting are excluded from the definition of default rights.
  - Rights that alter the amount of collateral or margin that must be provided, that entitle a party to demand the return of any transferred collateral or margin or that modify a transferee's right to reuse collateral or margin.
    - Rights or operations of a contractual provision that arise solely from a change in the value of collateral or margin or a change in the amount of an economic exposure are excluded from the definition of default right.
- Rights that allow a party to terminate a Covered QFC on demand or at its option at a specified time, or from time to time, without the need to show cause are not considered default rights for purposes of Part 2 of the Final Rules.

Scope of Covered Entities

- The Final Rules generally apply only to banking groups that have been designated as GSIBs under the Board's Regulation YY,[9] although each of the Final Rules applies to a different set of entities within such banking groups.[10] Taken as a whole, the Final Rules apply to the following entities (**Covered Entities**):
  - With respect to US GSIBs, all US and non-US subsidiaries;
  - With respect to non-US GSIBs, all US subsidiaries, US branches and US agencies.
- The term "subsidiary" is defined under the Final Rules by reference to the definition of "affiliate" in the Bank Holding Company Act and therefore incorporates the act's standard of "control." The US Regulators rejected commenters' requests to narrow the scope of entities covered by the Final Rules by using a definition of "subsidiary" based on consolidation principles under US Generally Accepted Accounting Principles (**GAAP**) or equivalent principles. (However, as discussed below, the US Regulators did take this approach to defining the scope of counterparty groups.)
- Certain types of entities are specifically excluded from the definition of Covered Entity:
  - Bank-owned debt previously contracted (**DPC**) subsidiaries;
  - Merchant banking portfolio companies;
  - Portfolio companies held under 4(k)(4)(I) of the Bank Holding Company Act (investment authority for insurance companies);
  - Portfolio companies held under the Small Business Investment Act of 1958;
  - Certain companies engaged in the business of making public welfare investments; and
  - For non-US GSIBs only:
    - Section 2(h)(2) subsidiaries; and
    - DPC branch subsidiaries.

[9] The OCC Rule also applies to a national bank or federal savings association that has more than $700 billion in total assets. We understand that there are currently no such national banks or federal savings associations that are not otherwise part of a GSIB group subject to the OCC Rule.

[10] The OCC Rule covers national banks, federal savings associations, federal branches and federal agencies, as well as subsidiaries of the same. The FDIC Rule covers state savings associations and state non-member banks, as well as subsidiaries of the same. The Board Rule covers bank holding companies and all subsidiaries other than those covered under the OCC Rule and FDIC Rule.

Scope of Covered Agreements

- The requirements of the Final Rules apply to all QFCs a Covered Entity enters into, executes or otherwise becomes a party to on or after January 1, 2019, unless such QFCs fall within one of the exclusions below (**Covered QFCs**).
  - The term QFC is defined by cross referencing the definition provided under OLA and includes certain swap agreements, repurchase agreements, securities contracts, forward contracts and commodities contracts, together with related master agreements and credit support agreements.
  - This definition is very broad and goes beyond derivatives and securities financing arrangements. In particular, the definition of securities contract includes all contracts for the "purchase, sale or loan" of securities and certain other assets, including debt securities and mortgage loans.
- Excluded QFCs. The following types of QFCs are excluded from the requirements of the Final Rule:
  - QFCs that contain neither default rights nor transfer restrictions;
  - A Covered Entity is not required to conform to the Part 1 requirements of the Final Rules (addressing "opt-ins" to OLA and the FDIA, discussed further below) any QFC that: (1) explicitly provides that it is governed by the laws of the United States or a state of the United States (and does not explicitly provide that one or both of the US SRRs is excluded from the law governing the QFC) and (2) is entered into with a counterparty that is organized, domiciled or has a principal place of business in the United States (an **on-shore** counterparty);
  - A Covered Entity is not required to conform to the Part 2 requirements of the Final Rules (addressing defaults arising because of Bankruptcy Code or other proceedings in respect of an affiliate of the Covered Entity) any QFC that (1) does not explicitly provide any default right related "directly or indirectly" to an affiliate of the Covered Entity becoming subject to insolvency or resolution proceedings and (2) does not explicitly prohibit the transfer of a covered affiliate credit enhancement were the covered entity affiliate to become subject to insolvency or resolution proceedings;[11]
  - Certain retail investment advisory contracts; and
  - Warrants in respect of shares of a Covered Entity issued shortly after publication of the Final Rules.[12]

Rights Linked "Directly or Indirectly" to an Affiliate

The Part 2 provisions of the Final Rules apply to any default rights related "directly or indirectly" to an affiliate of the Covered Entity becoming subject to insolvency or resolution proceedings. In addition to capturing "Specified Entity" default rights under an ISDA Master Agreement and other default rights that specifically identify affiliates of the Covered Entity, the Part 2 provisions also capture default rights where the linkage to such affiliates is "indirect." For example, as discussed in the preamble to each of the Final Rules, a direct default right based on the rating of the Covered Entity could be "indirectly" linked to the insolvency or resolution of the Covered Entity's affiliate, *e.g.*, if the rating is lowered, suspended or withdrawn based on the insolvency of the Covered Entity's affiliate.

Therefore, even for QFCs that do not contain cross defaults with explicit "direct" linkages to an affiliate, market participants will need to consider whether any direct default rights could be "indirectly" linked to the insolvency or resolution of an affiliate of the Covered Entity before relying on the exclusion from the Part 2 provisions.

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[11] Such transfers may be prohibited only in circumstances where the transfer would result in the supported party being the beneficiary of the credit enhancement in violation of law applicable to the supported party.

[12] The exclusion under the Board Rule applies to warrants issued before November 13, 2017, whereas the exclusions under the FDIC Rule and OCC Rule apply to warrants issued before January 1, 2018.

- Exclusion for QFCs with Central Counterparties (**CCPs**). QFC transactions "to which a CCP is a party" are excluded from the Final Rules.
  - Under the European, principal-to-principal clearing model, a Covered Entity that acts as a clearing member is a party to both the client-facing leg and the CCP-facing leg of the cleared transaction. However, because the CCP is not a party to the client-facing leg of the transaction, the Board clarified that the client-facing leg would be subject to the Final Rules.
    - The treatment under the Final Rules of the client-facing leg of a cleared trade in a principal-to-principal clearing model is different than under the ISDA Universal Protocol, which under Section 2 would allow the customer to exercise default rights against the clearing member if the CCP exercised default rights against the clearing member (to ensure both legs of the cleared transaction were either both terminated or both continued).
    - The preambles to the Final Rules did not provide clear guidance on the application of the Final Rules to the US agency approach to clearing.
- Financial Market Utilities (**FMUs**). Transactions to which "each party (other than the Covered Entity) is an FMU" are also excluded from the Final Rules.
  - The definition of FMU is based on the definition of FMU under the Dodd-Frank Act and does not include depository institutions acting under custodial agreements.
- Additional Exclusions. The Final Rules include a process by which the US Regulators may exempt other QFCs from the scope of the Final Rules.

Retrospective Effect of the Final Rules

- The requirements under the Final Rules to conform Covered QFCs are triggered any time one member of a Covered Entity's corporate group enters into *any* QFC with any member of a counterparty group after January 1, 2019.
  - Once such a QFC is entered into, the Final Rules require the Covered Entity group to conform all existing Covered QFCs it has entered, executed or otherwise become a party to prior to January 1, 2019 with the counterparty corporate group.
  - Covered Entity groups are defined based on the Bank Holding Company Act definition of "affiliate," subject to the exclusions for certain affiliates discussed above.
  - Counterparty corporate groups are defined based on US GAAP principles of financial consolidation.

Any QFC Triggers Retrospective Effect

While only Covered QFCs must be conformed to the requirements of the Final Rules, entry into any QFC, including a QFC excluded from the scope of the Final Rules (*e.g.*, because it does not contain any default rights or transfer restrictions), triggers the retrospective effect of the Final Rules and the requirement to conform all existing Covered QFCs between the corporate groups.

Compliance Dates

- As requested by industry, the Final Rules include a staggered compliance schedule based on the type of counterparty. A Covered Entity must conform Covered QFCs as follows:
  - January 1, 2019: Covered QFCs with other Covered Entities.
  - July 1, 2019: Covered QFCs with "financial counterparties."

    - The term "financial counterparty" is tied to registration under different US federal and state financial regimes. The term is similar to the term "financial end user" in the prudential regulators' margin rules for uncleared swaps and security-based swaps, but it does not include a catch-all provision in the financial end user definition for collective investment vehicles.

  - January 1, 2020: Covered QFCs with all other counterparties, including small financial institutions (banking entities with $10 billion or less in assets), even if such institutions fall within the definition of financial counterparty.

- Transition Periods for new Covered Entities. The Final Rules provide a one-year transition period for any Covered Entity that is not a Covered Entity shortly after publication of the Final Rules.[13]
  - This transition period would apply, for example, to a corporate group that is newly designated as a GSIB in the future. Under the plain language of the Final Rules, the transition period would also apply to any other entity that becomes a Covered Entity in the future.

Requirements Apply to All Covered QFCs Beginning Jan. 1, 2019, Notwithstanding Compliance Deadlines

While Covered Entities may have extended periods after January 1, 2019 to conform Covered QFCs with certain counterparty types (discussed below), all Covered QFCs a Covered Entity enters into, executes or otherwise becomes a party to must be conformed to the requirements of the Final Rules. For example, if a Covered Entity enters into a Covered QFC with a "financial counterparty" on January 2, 2019, the QFC must be conformed to the requirements of the Final Rules by July 1, 2019 and triggers the "retrospective" requirements of the Final Rules, meaning that all other QFCs between the Covered Entity corporate group and the financial counterparty corporate group must also be conformed by July 1, 2019.

Compliance Options

- The Final Rules permit parties to comply with their requirements in a number of ways, including by taking advantage of certain safe harbors for adherence to protocols.
- Bilateral Amendments to Covered QFCs. Covered Entities can bilaterally amend their Covered QFCs in accordance with the requirements of Part 1 and Part 2 of the Final Rules.
  - This approach offers fewer protections for creditors than the safe-harbored ISDA Universal Protocol or US protocol, particularly in the context of a bankruptcy proceeding of an affiliate of a Covered Entity.
  - However, it would allow parties to comply with the narrower Part 1 provisions, which results in an "opt-in" to only OLA and the FDIA, rather than the broader scope of SRRs covered by the protocols discussed below. Likewise, it would permit counterparties to be more selective with respect to which GSIB groups it amends Covered QFCs with, rather than amending all Covered QFCs on a "universal" basis with all Covered Entities that adhere to the protocols discussed below—so long as no entity in a counterparty group enters into any QFC with any entity in a Covered Entity corporate group after January 1, 2019, the requirement to amend existing Covered QFCs with that Covered Entity group would not arise.
- Safe harbor: adherence to the ISDA Universal Protocol. Any Covered QFCs amended by the ISDA Universal Protocol are deemed to comply with the requirements of the Final Rules.

[13] The Board deadline is November 13, 2017, whereas the FDIC and the OCC deadlines are January 1, 2018.

- For purposes of the Final Rules, the ISDA Universal Protocol is defined to include the SFT Annex and the Other Agreements Annex.
  - As a result, the ISDA Universal Protocol covers the following agreements:
    - For purposes of Section 1, all agreements within the scope of the Final Rules; and
    - For purposes of Section 2, all QFCs.
  - Adherence to Country Annexes that expand the scope of jurisdictions covered by the ISDA Universal Protocol is permitted but not required.

Safe Harbors Subject to Discretion of the Regulators

The US Regulators appear to have reserved for themselves ongoing discretion with respect to the availability of the protocol safe harbors. The provisions of the Final Rules establishing the safe harbors for protocol adherence begin "[u]nless the [applicable US Regulator] determines otherwise based on the specific facts and circumstances…" The preambles to the Final Rules do not provide any discussion of how the US Regulators might exercise this discretion.

- Safe harbor: adherence to a "US protocol." Any Covered QFCs amended by a US protocol are deemed to comply with the requirements of the Final Rules. A US protocol is defined in the Final Rules as a protocol that has the same terms as the ISDA Universal Protocol, except that:
  - Under Section 1, it must provide for an opt-in to all Identified Regimes (SRRs in France, Germany, Japan, Switzerland and the United Kingdom, in addition to OLA and the FDIA), but need not provide for opt-in to "Protocol-eligible Regimes" (as defined in the ISDA Universal Protocol);
  - Section 1 provisions may be limited so that they apply only with respect to Covered Entities (the Section 2 provisions are already so limited);
  - The provision of Section 2 excluding from coverage the client-facing leg of a cleared transaction may not be included (meaning such transactions would be subject to the terms of the US protocol);
  - Certain opt-out provisions of the ISDA Universal Protocol must be limited in scope or application; and
  - Other "minor and technical" differences may be included to conform to the requirements above.[14]
- Board Approval. The US Regulators may approve an alternative means of compliance, including additional, enhanced creditor protections.
  - However, the Final Rules include a burdensome process for approval of enhanced creditor protections, including requiring a detailed written analysis of how the proposed means of compliance satisfies a series

Incorporation by Reference of a Protocol

Industry commenters requested that parties be able to comply with the Final Rules by incorporating by reference the ISDA Universal Protocol or other protocol into Covered QFCs. As is standard for ISDA protocols, the ISDA Universal Protocol only amends agreements in existence at the time the relevant parties adhere. Following adherence to ISDA protocols, market practice is for parties to either incorporate by reference the terms of the applicable protocol into new agreements or otherwise conform such agreements to the requirements of applicable rules.

The Final Rules provide that adherents to the ISDA Universal Protocol or "US protocol" may comply with the requirements of the Final Rules by incorporating by reference the relevant protocol. As a result, incorporation by reference would appear to be available only for adherents to the ISDA Universal Protocol or US protocol.

[14] In a comment letter submitted by ISDA, a set of compromise provisions based on the ISDA Universal Protocol provisions was proposed that included features important to the buyside but that sufficiently supported the resolvability of GSIBs (such as limiting universal adherence to a "static list" of initial adhering covered entities, followed by entity-by-entity adherence for any new covered entities). The Final Rules generally do not reflect the requested compromise terms.

of specific policy considerations and an opinion with respect to "applicable law of the relevant jurisdictions." Further, approval would need to be obtained individually from each of the applicable US Regulators depending on the scope of Covered Entities for which approval was sought.

Multi-Branch Master Agreements

- With respect to Covered QFCs that are multi-branch master agreements of US branches or agencies of non-US GSIBs, the Board Rule and OCC Rule only apply to the transactions that are booked at the US branches or agencies (the FDIC Rule does not apply to any branches or agencies of non-US GSIBs).
  - In response to industry comments, these rules eliminate the part of the proposed multi-branch master agreement provision that brought within scope agreements "for which a payment or delivery may be made at such US branches or US agencies."
- Implementing the requirements of the Board Rule or OCC Rule literally, and conforming to the rules only those transactions booked to a US branch or agency, could raise concerns about the effectiveness of netting provisions, including for purposes of calculating exposures upon closeout and determining applicable margin requirements. Likewise, such an approach could raise interpretive issues with respect to contractual provisions written based on the assumption that they would apply to all transactions under the agreement, unless the governing documentation is modified to accommodate this treatment.

Agency Transactions

- The Final Rules provide that a Covered Entity does not become party to a QFC solely by acting as agent with respect to the QFC.
  - However, if the Covered Entity also acts in other capacities under the QFC, such as by providing a guarantee or indemnity to underlying principals, the agreement presumably would fall within the scope of the Final Rules and need to be conformed to their requirements.

Interactions with Other Regulations

- The US Regulators each stated in the preambles to the Final Rules that they are considering with the other relevant regulators whether amendments made to comply with the Final Rules would be viewed as amendments that would make swaps lose legacy status under the uncleared swaps margin rules. However, each US Regulator stated that it "does not expect that compliance with this final rule [would] trigger the swap margin requirements for non-cleared swaps."

Comparison of Final Rules to ISDA Universal Protocol

Although Part 1 and Part 2 of the Final Rules are based on Section 1 and Section 2, respectively, of the ISDA Universal Protocol, the scope and requirements of these provisions differ in material ways. This section analyzes certain key differences between these provisions, focusing on scope issues and the creditor protections available to counterparties. Except where explicitly noted below, a US protocol would generally track the provisions of the ISDA Universal Protocol in order to fit within the safe harbor in the Final Rules.

Scope of Adherence

In the preamble to the Board Rule, the Board identified that a "primary benefit" (from the perspective of the US Regulators) of the ISDA Universal Protocol as compared to the provisions of Part 1 and Part 2 of the Final Rules, and one of the reasons why the additional creditor protections in the ISDA Universal Protocol as compared to the Final Rules are acceptable to the US Regulators, is "universal adherence."

- ISDA Universal Protocol: Under the ISDA Universal Protocol, an adhering party agrees to amend its covered agreements with all other adhering parties. Therefore, once a party adheres, it agrees to amend covered agreements "universally" with all other adherents, including future adherents.
- US Protocol: These universal mechanics are a required element of a US protocol, but may be limited to Covered Entities.
- Final Rules: A Covered Entity is permitted to amend Covered QFCs consistent with the terms in Part 1 and Part 2 of the Final Rules on a bilateral basis, subject to the requirement that all Covered QFCs between the Covered Entity group and counterparty group comply with the requirements of the Final Rules. As a result, a counterparty group could choose to amend Covered QFCs only with certain Covered Entity groups so long as they do not enter into any QFCs with the other Covered Entity groups.

SRRs Covered under Section 1 of the ISDA Universal Protocol and Part 1 of the Final Rule

Each of Part 1 of the Final Rules, Section 1 of the ISDA Universal Protocol and Section 1 of a US protocol require a Covered Entity's counterparty to "opt in" to certain SRRs, but the scope of regimes opted into is different.

- ISDA Universal Protocol: Adhering parties agree to opt in to:
  - Identified Regimes, *i.e.*, the SRRs in France, Germany, Japan, Switzerland and the United Kingdom, in addition to OLA and the FDIC.
  - SRRs in "Protocol-eligible Jurisdictions"[15] that meet the requirements of the definition of "Protocol-eligible Regime," which are modeled on the requirements of the FSB's Key Attributes.
- US Protocol: Adhering parties must opt in to Identified Regimes, as described above, but need not opt in to Protocol-eligible Regimes.
- Final Rules Part 1: Counterparties are only required to opt in to OLA and the FDIA.

[15] Protocol-eligible Jurisdictions include Argentina, Australia, Brazil, Canada, China, Hong Kong, India, Indonesia, Italy, Mexico, the Netherlands, Republic of Korea, Russia, Saudi Arabia, Singapore, South Africa, Spain and Turkey, as well as any other jurisdiction that is the home jurisdiction of a GSIB.

Creditor Protections Available under Section 2 of the ISDA Universal Protocol and Part 2 of the Final Rule

Section 2 of the ISDA Universal Protocol

Section 2 of the ISDA Universal Protocol was developed in direct response to US resolution planning requirements under Title I of the Dodd-Frank Act, which require large financial institutions to plan for resolution under insolvency regimes, such as the Bankruptcy Code and the FDIA, and not under OLA. The Bankruptcy Code and the FDIA do not impose a stay on, and do not override, the exercise of cross-default rights in QFCs of subsidiaries or affiliates of the entity in resolution. To facilitate orderly resolution under these regimes, Section 2 of the ISDA Universal Protocol creates a contractual stay regime that parallels the cross-default override provisions of OLA.

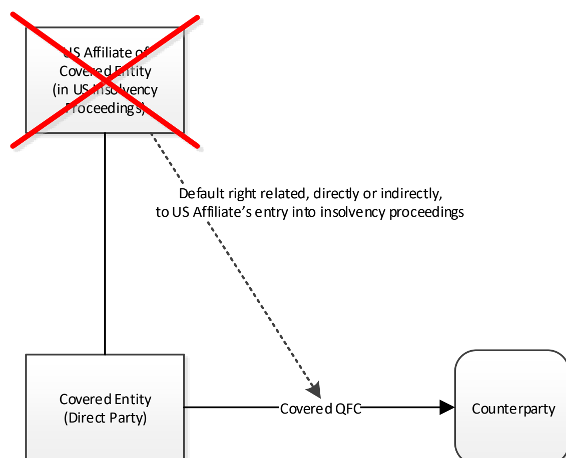
Interaction With Bankruptcy Code Safe Harbors

Section 2 of the ISDA Universal Protocol (and Part 2 of the Final Rules) do not affect the rights safe harbored under the Bankruptcy Code that permit a party to close out immediately upon its Covered Entity counterparty itself becoming subject to proceedings under the Bankruptcy Code. Rather, Section 2 addresses situations where an affiliate of the Covered Entity becomes subject to such proceedings.

Notwithstanding the other provisions of Section 2, nothing in Section 2 limits the ability of a counterparty to exercise the following default rights:

- Unrelated Default Rights: Default rights that:
  - Are not based solely on an affiliate of the Covered Entity becoming subject to US insolvency proceedings; and
  - Can be shown by clear and convincing evidence to be not related, directly or indirectly, to an affiliate of the Covered Entity becoming subject to US insolvency proceedings, to any transfers to a transferee by a transfer motion or to a DIP motion (as defined below).
- Performance Default Rights: Default rights that arise if:
  - The Covered Entity enters insolvency proceedings;
  - The Covered Entity fails to satisfy a payment or delivery obligation to the counterparty on the direct QFC or any other contract between the parties; or
  - A credit enhancement provider, if any, fails to satisfy a payment or delivery obligation to the counterparty under a related credit enhancement.

Section 2 of the ISDA Universal Protocol applies in circumstances where the affiliate of a Covered Entity enters US insolvency proceedings. As under OLA, Section 2 limits the exercise of cross-default rights differently depending on whether the affiliate in proceedings provides any credit enhancements for the QFC with the counterparty.



For example, consider a Covered QFC that contains a cross-default right triggered by the entry into insolvency proceedings of an affiliate of the Covered Entity. In this case, the affiliate is not a credit enhancement provider to the counterparty. Under Section 2 of the ISDA Universal Protocol, upon the affiliate's entry into proceedings, the counterparty agrees not to exercise its cross-default right. Note that this override applies if the affiliate enters proceedings under the Bankruptcy Code (under either chapter 7 or 11), the FDIA or SIPA (together, **US Insolvency Proceedings**).

If the Covered QFC benefits from a credit enhancement from the Covered Entity's affiliate, Section 2 stays and overrides the

exercise of a counterparty's default rights in more limited circumstances. If the affiliate is a credit enhancement provider, Section 2 imposes a temporary stay on the exercise of cross-default rights, during a temporary "stay period" that lasts for the longer of one business day and 48 hours; following this period, the exercise of related default rights is permanently overridden if certain creditor protections are satisfied. Notably, these provisions only apply if the affiliate in proceedings is in proceedings under chapter 11 of the Bankruptcy Code or the FDIA.

Section 2 contemplates that if the affiliate enters into chapter 11 proceedings, it will pursue one of two SPOE resolution strategies:

- The affiliate will remain a debtor-in-possession and file a "DIP motion" at the start of the stay period (**DIP Strategy**);
  - This strategy only applies if the affiliate is a "US Parent"[16] of the direct party; or
- The assets of the affiliate, together with the relevant creditor enhancements, will be transferred to a bridge holding company or other third-party transferee and the affiliate will file a "transfer motion" at the start of the stay period (**Transfer Strategy**).

Section 2 includes several creditor protection conditions designed to ensure that the counterparty retains the benefit of its credit enhancement after the affiliate of the Covered Entity emerges from the stay period. If those conditions are not satisfied, the stayed party can exercise its default rights that were stayed by Section 2. Set out below is a summary of the creditor protections for each of the DIP strategy and the transfer strategy under Section 2 of the ISDA Universal Protocol.

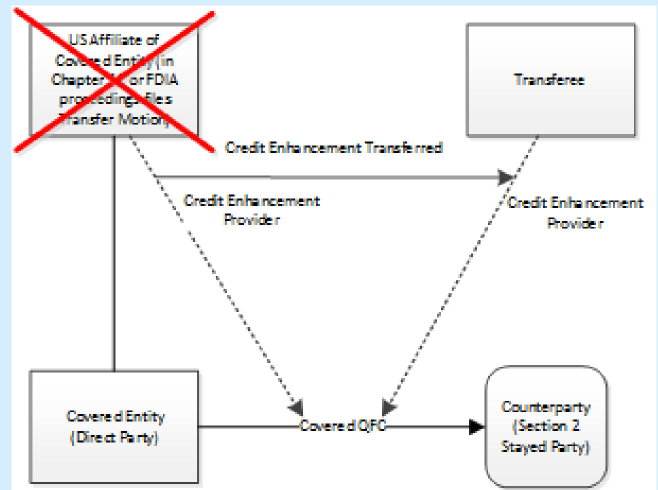
[16] "US Parent" means, with respect to a party adhering to the ISDA Universal Protocol, the ultimate parent entity organized under the laws of the United States or any state or territory thereof having direct or indirect control of such party.

Section 2 of the ISDA Universal Protocol – DIP Strategy Creditor Protection Conditions[17]

Default Rights related, directly or indirectly, to an Affiliate Credit Enhancement Provider becoming subject to Chapter 11 Proceedings are permanently overridden if the Affiliate is a US Parent that files a "DIP Motion" and, after the stay period, the following DIP Conditions are satisfied:
• By the end of the Stay Period, a court order has been entered under which the US Parent remains obligated to the same extent as it was obligated immediately prior to becoming a Party in Chapter 11 Proceedings, with respect to:
    o The Covered Credit Enhancement;
    o All other Credit Enhancements it provides in support of Covered Agreements between the Direct Party and the Section 2 Stayed Party; and
    o All Credit Enhancements provided by the Affiliate in support of Covered Agreements between the Direct Party and each Affiliate of the Section 2 Stayed Party (*i.e.*, no "cherry-picking" between affiliates of the counterparty).
• By the end of the Stay Period, a "Creditor Protection Order" with respect to the Credit Enhancement has been entered by the court for the benefit of the Section 2 Stayed Party that states:
    o Claims under the Credit Enhancement are granted administrative priority status;
    o The Section 2 Stayed Party may terminate the Covered Agreement immediately and without seeking court approval if (i) the Direct Party fails to meet any of its material obligations under the Covered Agreement or (ii) the US Parent fails to meet any of its material obligations under the Credit Enhancement or any other Credit Enhancement in support of Covered Agreements between the Direct Party and the Section 2 Stayed Party; and
    o The Section 2 Stayed Party may terminate immediately and without seeking court approval if (i) the Direct Party fails to pay or deliver a Close-out Amount under any Covered Agreement between the Direct Party and another stayed counterparty or (ii) the US Parent fails to satisfy its obligations when due under any Credit Enhancement in respect of such Covered Agreement.
• Following the Stay Period, the Direct Party of the Section 2 Stayed Party remains registered with and licensed by its primary regulator(s) to continue its business.

[17] Capitalized terms used in these charts but not defined elsewhere have the meaning given in the ISDA Universal Protocol.

Section 2 of the ISDA Universal Protocol – Transfer Strategy Creditor Protection Conditions



Default Rights related, directly or indirectly, to an Affiliate becoming subject to Chapter 11 Proceedings are permanently overridden if the Affiliate files a "Transfer Motion" and, after the Stay Period, the following Transfer Conditions are satisfied:

- The Transferee is either a Bankruptcy Bridge Company or an unaffiliated third party that would be required to satisfy any ratings conditions or other financial covenants applicable to the Credit Enhancement Provider under the contract.
- During the Stay Period, the Transferee continues to satisfy its material payment and delivery obligations to each of its creditors and is not subject to insolvency or resolution proceedings.
- Upon the expiration of the Stay Period:
    - A court order has been entered transferring, as soon as practicably possible, all of the assets of the Affiliate in Chapter 11 Proceedings, excluding any assets retained for the costs and expenses of administration, to the Transferee;
    - All of the direct or indirect ownership interests held by the Affiliate in the Direct Party to a Covered Agreement are transferred to the Transferee by the end of the Stay Period; and
    - The Affiliate in Chapter 11 Proceedings has transferred all Credit Enhancements to a Covered Agreement between the Section 2 Stayed Party and the Direct Party and between the Section 2 Stayed Party's Affiliates and the Direct Party to the Transferee.
- Following the Stay Period:
    - The Direct Party of the Section 2 Stayed Party remains registered with and licensed by its primary regulator(s) to continue its business;
    - Only if the Transferee is a third party (not a Bankruptcy Bridge Company), the third-party Transferee continues to satisfy any financial covenants in the relevant Covered Agreement that were applicable to the Party in Chapter 11 Proceedings; and
    - If the transferred Credit Enhancements are secured, the Transferee continues to comply with all provisions regarding attachment, enforceability, perfection and priority of the security interest.

Part 2 of the Final Rules

Although Part 2 of the Final Rules is based on Section 2 of the ISDA Universal Protocol, the sections differ in scope as well as in the creditor protection conditions for counterparties:

- Scope of Relevant US Insolvency Regimes: Under Part 2 of the Final Rules, if a counterparty has default rights related directly or indirectly to an affiliate of the Covered Entity, but the affiliate is not a credit enhancement provider, its cross-default rights are overridden without condition (similar to Section 2 of the ISDA Universal Protocol and OLA). However, whereas this override in Section 2 of the ISDA Universal Protocol only arises if the affiliate enters US Insolvency Proceedings, the override in Part 2 of the Final Rules arises if the affiliate becomes subject to any receivership, insolvency, resolution or similar proceeding, including non-US proceedings.
- Burden of Proof: Similar to Section 2 of the ISDA Universal Protocol, Part 2 of the Final Rules permits a counterparty to exercise default rights unrelated to the affiliate's entry into proceedings or based on either the Covered Entity or its affiliate entering proceedings of failing to satisfy a payment or performance obligation. However, under Part 2 of the Final Rules, a counterparty must satisfy a "clear and convincing evidence" standard to exercise any such default right, including a performance default right (this burden of proof only applies to certain unrelated default right under Section 2 of the ISDA Universal Protocol).
- Creditor Protections: The other creditor protections available to counterparties under Part 2 of the Final Rules are, generally, not as robust or specific as the creditor protections available under Section 2 of the ISDA Universal Protocol. Parties should carefully review the creditor protections in Part 2 of the Final Rules.
  - Part 2 of the Final Rules allows Covered QFCs to permit counterparties to exercise default rights following a Covered Entity providing a covered affiliate credit enhancement becoming subject to insolvency or resolution proceedings and after the expiration of a stay period in any of the following circumstances:
    - The Covered Entity providing the covered affiliate credit enhancement becomes subject to insolvency or resolution proceedings other than under chapter 11 of the Bankruptcy Code;
    - If the covered affiliate credit enhancement is transferred, (i) the transferee becomes subject to insolvency or resolution proceedings or (ii) all of the Covered Entity affiliate's ownership interest in the Covered Entity is not transferred to the transferee (and reasonable assurances are not provided that all or substantially all of the assets of the Covered Entity affiliate will be transferred); and
    - Neither the Covered Entity affiliate nor a transferee remains liable substantially to the same extent as the Covered Entity affiliate was immediately before entering proceedings with respect to the covered affiliate credit enhancement and related credit enhancements.
  - In circumstances where the Covered Entity providing the covered affiliate credit enhancement is in proceedings under the FDIA, Covered QFCs may provide for the exercise of default rights in the following circumstances:
    - During the stay period provided under the FDIA, default rights may only be exercised so as to permit the party benefiting from credit support provided by the Covered Entity affiliate in FDIA proceedings to exercise contractual rights to suspend its performance under the supported Covered QFC to the same extent as the supported party would be entitled to do if the supported Covered QFC were a Covered QFC with the Covered Entity affiliate in FDIA proceedings that was treated in the same manner as the credit support provided by such Covered Entity affiliate.

- After the expiration of the stay period provided under the FDIA, default rights may be exercised if the credit support provided by the bank in FDIA proceedings is not transferred to a bridge bank or other transferee.

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