DERIVATIVES - USA

Final rule issued on qualified financial contracts: what you need to know

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Introduction

On September 1 2017 the Board of Governors of the Federal Reserve System adopted a final rule requiring US global systemically important banking institutions (GSIBs), their subsidiaries and the US operations of foreign GSIBs (covered entities) to amend many of their qualified financial contracts (QFCs) in order to restrict their counterparties' ability to immediately terminate such contracts in the event that the covered entity or an affiliate enters into bankruptcy or resolution proceedings.

The final rule was first proposed in May 2016(1) and is intended to prevent the destabilising contagion effects of the failure of a large, interconnected financial institution (eg, Lehman Brothers). Similar requirements have been implemented, or are being implemented, in other jurisdictions. It is expected that other US banking regulators (including the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC)) will adopt substantially similar rules for GSIB subsidiaries under their jurisdictions.

The final rule contains two key provisions. First, each covered entity must amend its QFCs in order to add certain restrictions on the close out of such QFCs to be consistent with the stay and transfer provisions of the Federal Deposit Insurance Act and Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These provisions are intended to mitigate the threat posed by QFC default rights, but allow appropriate protections for QFC counterparties of the failed entity. Second, the QFCs of covered entities and their affiliates are generally prohibited from containing a cross-default based on an insolvency or resolution of an affiliate.

Covered entities

The covered entities under the final rule are as follows:

- US GSIBs,(2) as identified by the Federal Reserve pursuant to Section 165 of the Dodd-Frank Act, are covered.
- Certain subsidiaries of a US GSIB, which generally includes any 'subsidiary' (as defined in the Bank Holding Company (BHC) Act) that is not a national bank, federal savings association, federal branch, federal agency, state savings association or state non-member bank (excluded banks). These entities are excluded from the final rule because the FDIC and the OCC have jurisdiction over them. In addition, this category of covered entity excludes certain other types of subsidiary, such as debt previously contracted (DPC) subsidiaries, merchant banking portfolio companies and portfolio companies held under Section 4(k)(4)(I) of the BHC Act, and certain public welfare investments.
- Almost all US operations of a foreign GSIB, which generally includes US subsidiaries, US

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branches and US agencies of a foreign GSIB. For this purpose, a foreign GSIB includes:

- any foreign banking organisation that the Federal Reserve determines has the characteristics of a GSIB under the methodology adopted by the Basel Committee on Banking Supervision; or
- a foreign banking organisation or intermediate holding company required to be formed under the Federal Reserve's Regulation YY (IHC) that would be a GSIB if the organisation were subject to the Federal Reserve's GSIB surcharge rule.(3)

Subsidiaries of foreign GSIBs not held under an IHC per a Federal Reserve order are not exempt from the final rule. Not encompassed within the definition of 'US operations of a foreign GSIB' are national banks, federal savings associations, federal branches, federal agencies, state savings associations and state non-member banks, which are expected to be subject to substantially similar OCC or FDIC rules, and certain other types of subsidiary.

Covered QFCs

Covered QFCs subject to the final rule are generally co-extensive with the scope of such term under the Federal Deposit Insurance Act and Title II of the Dodd-Frank Act. 'Covered QFCs' is defined broadly to include, among other things, swaps, repurchase and reverse repurchase transactions, securities lending and borrowing transactions, commodity contracts, and forward agreements,(4) as well as guarantees and security arrangements relating to the foregoing.

Scope of required amendments

The final rule requires that a covered entity conform its QFCs to provide expressly that if the covered entity becomes subject to a US special resolution regime (ie, the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act):

- default rights may be exercised only by the counterparty to the extent permitted under the special resolution regime; and
- any transfer of the QFC from the covered entity will be effective to the extent it would be effective under the special resolution regime.

Amendments are not required if the QFC is governed by US law and the counterparty is a US person.

In addition, the final rule requires that the QFC not permit the exercise of any default right relating to the insolvency or resolution of an affiliate of the covered entity. The QFC also generally may not prohibit the transfer of any security or credit enhancement provided by the affiliate on the insolvency or resolution of the affiliate. Covered entities need not amend QFCs that have no transfer restrictions, direct default rights or cross-default rights.

The restrictions do not prohibit exercise of default rights where the relevant party has failed to perform a payment or delivery obligation. Certain other credit protection provisions may apply after the defined stay period.

In adopting the final rule, the Federal Reserve rejected requests to exempt QFCs involving physical commodities and QFCs with sovereign entities and central banks. The final rule has special provisions addressing foreign GSIB multi-branch master agreements permitting QFCs to be entered into by one or more US branches or agencies.(5)

The final rule exempts certain categories of QFC, including:

- QFCs that are centrally cleared (although the final rule would apply to the client-facing leg of a cleared transaction);
- QFCs where the only counterparty is a financial market utility;
- investment advisory contracts with retail advisory customers; and
- existing warrants providing the right to acquire a security of a covered entity or its subsidiary.

In addition, the final rule provides that the Federal Reserve may exempt one or more covered entities from conforming certain QFCs or types of QFC to the final rule after considering, among other

factors that the Federal Reserve deems relevant, the relief of burden and the potential impact of the exemption on the resolvability of the covered entity or its affiliates.

Compliance with final rule and timing

Covered entities must amend their QFCs to comply with the final rule in accordance with the phase-in schedule detailed below.

As with other amendments required by US regulators, it is anticipated that covered entities will rely on industry protocols. Specifically, the final rule states that covered entities may comply with the final rule by adhering to the International Swaps and Derivatives Association (ISDA) 2015 Universal Resolution Stay Protocol (the Universal Protocol). At present, the Universal Protocol covers ISDA Master Agreements and certain other master agreements, including the Global Master Repurchase Agreement, the Global Master Securities Lending Agreement, the Master Equity and Fixed Interest Stock Lending Agreement, the Master Gilt Edged Stock Lending Agreement, the Master Repurchase Agreement, the Master Securities Loan Agreement and the Overseas Securities Lender's Agreement.

In addition, the final rule outlines the requirements for a separate, US-specific protocol which may also be used to comply with the final rule.(6) It is anticipated that ISDA will develop a version of the Resolution Stay Jurisdictional Modular Protocol (US JMP) that will meet the requirements of the final rule. For all other agreements not covered by the Universal Protocol or the US JMP, or for parties that do not wish to adhere to either protocol, the parties will have to seek bilateral amendments to such QFCs to ensure compliance with the final rule.

There will be a phased-in approach to comply with the final rule in order to facilitate its implementation. Covered entities must conform covered QFCs to the requirements of the final rule by:

- January 1 2019 for QFCs where each party is a either a covered entity or an excluded bank;
- July 1 2019 for QFCs where each party (other than the covered entity) is a financial counterparty(7) that is not a covered entity or an excluded bank; and
- January 1 2020 for QFCs where each party (other than the covered entity) is a non-financial counterparty or a small financial institution.(8)

Comment

The final rule is largely consistent with the proposed rule. Although it is expected that covered entities (and their counterparties) will be able to comply in large part with the final rule through adherence to the Universal Protocol or the US JMP, the requirements may be burdensome for some parties. Market participants will also need to assess the extent to which the final rule will affect their potential rights and remedies in a default situation, as compared to existing documentation and law.

The final rule is available here.

For further information on this topic please contact Joel Moss, Geoffrey B Goldman or Reena Sahni at Shearman & Sterling LLP by telephone (+1 212 848 4000) or email (joel.moss@shearman.com geoffrey.goldman@shearman.com or reena.sahni@shearman.com). The Shearman & Sterling LLP website can be accessed at www.shearman.com.

Endnotes

(1) More information on the proposed rule is available here.

(2) According to the Federal Reserve's GSIB surcharge rule's methodology, the existing US GSIBs are Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc, Goldman Sachs Group, Inc, JPMorgan Chase & Co, Morgan Stanley Inc, State Street Corporation and Wells Fargo & Company. This list is subject to change.

(3) A complete list of foreign GSIBs is available here.

(4) As defined in Section 210(c)(8)(D) of the Dodd-Frank Act.

(5) Foreign GSIB multi-branch master agreements will not be covered merely because payment or delivery is made at a US branch or agency; however, such agreements will be considered QFCs with respect to such agreements or transactions booked in US branches.

(6) See Section 252.85(a)(3)(ii)(A)-(F) of the final rule.

(7) The definition of 'financial counterparty' includes a wide range of regulated financial institutions, including banks, other lenders, broker-dealers, swap dealers, futures commission merchants, investment advisers, investment companies, commodity pool operators and commodity trading advisers, as well as private funds and similar entities. See Section 252.81 of the final rule. This definition does not include counterparties that are sovereign entities, multilateral development banks or The Bank for International Settlements.

(8) 'Small financial institution' is defined as a company that is either organised as a bank, a savings association or an insured federal credit union or state-chartered credit union with total assets of $10 billion or less on the last day of the company's most recent fiscal year. See section 252.81 of the final rule.
