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Federal Reserve Proposed Rule Imposes New Restrictions on Exercise of Default Rights Under Qualified Financial Contracts

By J.R. Smith and Nathan Kramer**

This article provides an overview of some of the key provisions in the Board of Governors of the Federal Reserve System's proposed rule that would significantly limit derivative counterparty remedies upon the insolvency of U.S. global systematically important banking organizations ("GSIB") and their affiliates and the U.S. operations of foreign GSIBs.

The Board of Governors of the Federal Reserve System (the "Federal Reserve") recently issued a proposed rule (the "Proposed Rule") that would significantly limit derivative counterparty remedies upon the insolvency of U.S. global systematically important banking organizations ("GSIB") and their affiliates and the U.S. operations of foreign GSIBs (collectively, "Covered Entities"). The Proposed Rule restricts the exercise of insolvency-triggered default rights against Covered Entities under swaps, repurchase transactions, reverse repurchase transactions, securities lending and borrowing transactions, commodity contracts, forward agreements and guarantees of or credit enhancements related to the foregoing (such agreements, "qualified financial contracts" or "QFCs"). If the Federal Reserve ultimately adopts the Proposed Rule, Covered Entities will need to amend many of their current QFCs to bring them into compliance and analyze the business impact on the buy-side derivative market, more than 80 percent of which are Covered Entities under the Proposed Rule.

THE PROPOSED RULE LIMITS DIRECT AND CROSS-DEFAULTS

Under the current regulatory scheme, counterparties can terminate safe harbored QFCs containing direct default or cross-default provisions when a GSIB or affiliate commences a bankruptcy or an analogous insolvency proceeding.[1] The Proposed Rule seeks to prevent runs on a failed GSIB/affiliate

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[1] Note, the Federal Deposit Insurance Act (the "FDIA") and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") currently impose a temporary stay on non-Covered Entity counterparty exercise of certain direct default rights, but do not

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and its solvent affiliates. The Proposed Rule requires Covered Entities to essentially "opt in" to specific contractual limitations under QFCs to limit traditionally safe harbored counterparty termination rights.[2]

The Proposed Rule identifies two goals: (1) reduce the risk that courts in foreign jurisdictions will disregard the temporary stays present in the FDIA and the Dodd-Frank Act[3] limiting the ability of the insolvent firm's QFC-counterparties to exercise termination rights upon entry into resolution; and (2) facilitate Covered Entity resolution under the Bankruptcy Code and similar resolution proceedings. The Proposed Rule addresses the first issue by requiring that Covered Entity-QFCs include provisions stating that default rights are limited to the same extent they are under the FDIA and the Dodd-Frank Act.[4] The Proposed Rule addresses the second issue by limiting a QFC counterparty's direct and cross-default rights.

Direct Default Rights

All Covered Entities' QFCs must contractually limit direct default rights and remove restrictions on the transfer of a QFC to the same extent as exists under the FDIA and the Dodd-Frank Act. The special resolution regimes under the FDIA and the Dodd-Frank Act impose a temporary stay on a counterparty's exercise of default rights to provide an opportunity for the transfer of the QFCs to a solvent affiliate or a third party. No similar temporary stay exists under the Bankruptcy Code. If an insolvent Covered Entity transfers a QFC to a financially viable entity during the stay period, the Proposed Rule prohibits the counterparty from exercising default rights. Importantly, default rights do not include mark-to-market or same-day netting provisions based on collateral value fluctuations.[5]

Cross-Default Rights

The Proposed Rule also requires Covered Entities to eliminate cross-default

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impede the exercise of cross-default rights. *See* note 3, *infra*.

[2] Generally, Covered Entities do not include national banks and federal savings associations that are GSIB subsidiaries; however, the Proposed Rule indicates such entities will be made subject to substantively identical regulations in the near future.

[3] Under the FDIA and the Dodd-Frank Act, this temporary stay generally lasts until 5:00 p.m. on the business day following the appointment of a receiver. *See* 12 U.S.C. §§ 1821(e)(10)(B)(I), 5390(c)(10)(B)(i)(I).

[4] Specifically Title II of the Dodd-Frank Act, which establishes the Orderly Liquidation Authority and is an alternative resolution regime.

[5] Furthermore, the Proposed Rule does not alter default rights unrelated to a Covered Entity's entering into a resolution proceeding, bankruptcy or an analogous insolvency proceeding (such as contractual rights to terminate on demand or at a specified time).

rights under QFCs triggered by the Covered Entity's entering into resolution under the FDIA, the Dodd-Frank Act, the Bankruptcy Code or an analogous insolvency proceeding. Similar to the right to transfer direct QFC obligations to solvent counterparties, QFCs also must permit the transfer of credit enhancements supporting QFCs to a transferee upon a Covered Entity insolvency trigger. For these guaranteed QFCs, after the temporary stay,[6] counterparties still are able to exercise certain default rights in limited situations.[7]

If a dispute arises over a counterparty's ability to exercise a default right against a Covered Entity under a QFC, the counterparty has the burden of proving the QFC permits exercise of the default right by clear and convincing evidence (or a similar more stringent standard).

THE PROPOSED RULE PROVIDES FOR ALTERNATIVE COMPLIANCE

As an alternative to complying with the Proposed Rule, Covered Entities can amend QFCs to conform to the International Swaps and Derivatives Association 2015 Universal Resolution Stay Protocol (the "ISDA Protocol").[8] The ISDA Protocol generally contains requirements similar to the Proposed Rule, albeit with narrower stay and transfer provisions that may provide greater flexibility for Covered Entities.[9]

Finally, the Proposed Rule provides a process by which a Covered Entity may seek approval from the Federal Reserve for otherwise impermissible additional creditor protections. The Federal Reserve will determine whether the additional protection mitigates risks to the financial stability of the United States,

[6] The temporary stay related to the transfer of credit enhancements begins to run once the Covered Entity enters the insolvency proceeding and ends upon the later of 5:00 p.m. EST on the following business day or 48 hours.

[7] These situations are: (1) the guarantor remaining obligated under the guaranty becomes subject to an insolvency proceeding other than Chapter 11 of the Bankruptcy Code; (2) the transferee of the obligations under the guarantee becomes subject to an insolvency proceeding; (3) the guarantor does not continue to guarantee all QFCs supported by the guaranty before the insolvency proceeding; or (4) if the guaranty is transferred to a transferee, all of the support provider's ownership interests in the direct party are not transferred to the transferee (or the guarantor has not provided reasonable assurances that such transfer will occur).

[8] While any entity may comply with the ISDA Protocol, generally, buy-side parties will be required to comply with the ISDA Resolution Stay Jurisdictional Modular Protocol, which the ISDA published on May 5, 2016.

[9] As of the date hereof, there are over 200 adhering parties to the ISDA Protocol. Many of the adhering parties, however, are affiliates of other adhering parties.

addressing many of the same issues prompting issuance of the Proposed Rule. If the Federal Reserve approves the additional protection, any other Covered Entity could use the protection.

PROPOSED RULE ENACTMENT

The Federal Reserve accepted comments on the Proposed Rule through August 5, 2016. The final rule becomes effective on the first day of the first calendar quarter that begins at least one year after issuance of the final rule. Any entity that is a Covered Entity on the date the final rule is issued would be required to comply with the final rule beginning on the effective date. An entity that does not become a Covered Entity until after the final rule is issued would be required to comply with the rule by the first day of the calendar quarter that begins at least one year after it became a Covered Entity.

CONCLUSION

The Proposed Rule will impact the QFC risk sharing between Covered Entities and counterparties, the ramifications of which could materially shift the QFC marketplace.