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ISDA 2018 U.S. Resolution Stay Protocol: Should Fund Managers Adhere or Not?

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Many fund managers have already received notices from their swap dealer counterparties regarding the implementation of "contractual stay rules" adopted by the U.S. federal banking authorities (QFC Rules). Swap dealers are now urging their counterparties to adhere to the ISDA 2018 U.S. Resolution Stay Protocol (Protocol). Fund managers that do not adhere to the Protocol or take other steps to bring their trading documentation into compliance may not be able to trade certain qualifying financial contracts (QFCs) with their counterparties after January 1, 2019.

This article provides an overview of the Protocol and related QFC Rules, with an emphasis on issues that fund managers need to consider in assessing whether to adhere to the Protocol or opt for bilateral amendments to their trading documentation. The relative merits of the two approaches strongly suggest that fund managers should, in almost all cases, choose to adhere to the Protocol.

For more on the QFC Rules and Protocol, see "Steps Fund Managers Should Take Now to Ensure Their Trading of Swap, Repo and Securities Lending Transactions Continues Uninterrupted After January 1, 2019" (Oct. 18, 2018).

Overview of QFC Rules

As part of macro-prudential efforts to mitigate systemic risk in the wake of the financial crisis, the three primary federal banking authorities – i.e., the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC) – adopted the QFC Rules to facilitate the orderly resolution of financially distressed global systemically important U.S. bank holding companies (U.S. GSIBs) and their affiliates, as well as the U.S. operations of systemically important foreign banks (non-U.S. GSIBs). These financial institutions are referred to as "covered entities" under the QFC Rules and as "Regulated Entities" under the Protocol.

The QFC Rules require that certain QFCs be amended to:

1. ensure cross-border enforcement of the U.S. special resolution regimes – i.e., the Orderly Liquidation Authority under Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act (FDIA); and
2. prohibit counterparties from exercising certain default rights related to an affiliate of a covered entity entering any kind of bankruptcy or insolvency proceedings.

In the latter respect, the QFC Rules provide that a "covered QFC" cannot allow the exercise of any default right directly or indirectly related to an affiliate insolvency, nor prohibit the transfer of any relevant credit support arrangement to a transferee in connection with such insolvency. This permanent stay on the exercise of cross-default rights and restrictions on transfer may only be lifted if certain conditions occur that are detrimental to the rights of creditors.

While the QFC Rules apply only to covered entities, they require those covered entities to amend their counterparty QFCs to comply with the QFC Rules in order to continue trading with their counterparties.

See "Treatment of a Hedge Fund's Claims Against and Other Exposures to a Covered Financial Company Under the Orderly Liquidation Authority Created by the Dodd-Frank Act" (May 6, 2011).

Qualifying Financial Contracts

The QFC Rules apply to a broad range of contracts defined as "qualifying financial contracts" under the Dodd-Frank Act. These include swaps; repurchase (repo) and reverse repo transactions; securities lending and borrowing transactions; commodity contracts; and forwards. For purposes of the QFC Rules, a QFC is considered to be "in scope" if it includes either (1) express transfer restrictions, including with respect to any interest or obligation in or under the QFC, or property securing the QFC; or (2) explicit "default rights" that can be exercised against the covered entity. An in-scope QFC becomes a covered QFC if it is entered into by a covered entity after January 1, 2019.

The broad definition of "in scope" means that most industry-standard master agreements for swaps, repo and securities lending arrangements will be covered by the QFC Rules. Spot FX transactions and other trades that do not include express terms limiting transfers or providing default rights will not be in scope, however.

Phase-In of the QFC Rules – January 1, 2019 Deadline

The QFC Rules included a phased implementation timeline that was ostensibly designed to give covered entities time to amend their QFCs. The phase-in under the QFC Rules provides for a January 1, 2019, deadline for QFCs between covered entities; a July 1, 2019, deadline for QFCs between covered entities and "financial counterparties" (including investment funds); and a January 1, 2020, deadline for QFCs between covered entities and all other counterparties.

Notwithstanding this timeline, the QFC Rules provide that if a covered entity enters into any QFC, regardless of whether it is in scope, with any counterparty after December 31, 2018, then all outstanding in-scope QFCs with that counterparty must be amended to comply with the rules. Thus, the phase-in period is effectively negated and covered entities will face regulatory risk if they do not amend their outstanding QFCs by January 1, 2019.

ISDA 2018 U.S. Resolution Stay Protocol

The Protocol opened for adherence on August 22, 2018.[1] Regulated Entities – i.e., covered entities under the QFC Rules – are expected to rely on the Protocol to comply with their obligations under the QFC Rules. The Protocol will cover all QFCs that are in scope under the QFC Rules, including swaps, repos, securities lending transactions and forward transactions that are documented under industry-standard master agreements, such as the ISDA Master Agreement, Master Repurchase Agreement (MRA), Global MRA, Master Securities Lending Agreement (MSLA), Global MSLA and Master Securities Forward Transaction Agreement (MSFTA).

Adherence to the Protocol will result in the amendment of all existing transactions under the relevant master agreement, as well as transactions governed by that master agreement that are executed in the future. Counterparties of Regulated Entities that adhere to the Protocol will be "Adhering Parties" under the Protocol.

See our three-part series on best practices for fund managers when entering into ISDAs: "Negotiation Process and Tactics" (Jan. 12, 2017); "Negotiating Event of Default and Termination Event Provisions" (Jan. 19, 2017); and "Negotiating Collateral Arrangements" (Jan. 26, 2017).

QFC Amendments Under the Protocol

Adhering to the Protocol will result in the relevant QFCs being amended in two distinct ways.

Opting In to Identified Regimes

First, Adhering Parties will be "opting in" to certain identified regimes, which are the principal bank resolution regimes of the U.S., U.K., Germany, France, Switzerland and Japan (Identified Regimes). This means that an Adhering Party will be subject to the provisions of those regimes that relate to transfers of the amended QFCs, as well as to stay periods that will restrict the exercise of default rights under those QFCs.

In effect, this amendment is a choice of law clause that ensures cross-border enforceability of the Identified Regimes. For example, if an offshore fund that is an Adhering Party is trading with a Regulated Entity under an English law-governed ISDA Master Agreement, and the Regulated Entity becomes subject to resolution under the FDIA, this amendment results in the fund's agreement to be bound by the actions of the FDIC under the FDIA, without concern as to whether an English court would enforce the FDIA under the English law-governed ISDA Master Agreement.

Contractual Stay on Cross-Default Rights

Second, Adhering Parties will be subject to a contractual stay on exercising certain cross-default rights under the amended QFCs that are directly or indirectly related to an affiliate of the Regulated Entity entering into insolvency proceedings, such as Chapter 11 of the U.S. Bankruptcy Code. This effectively overrides the Chapter 11 safe harbor from the automatic stay, although the amendment is limited to default rights that are the result of the insolvency of the Regulated Entity's affiliate. The Protocol amendment does not affect "direct default rights" that are safe harbored and that are exercised as a result of the Regulated Entity itself becoming insolvent.

Contractual Stays Under the Protocol and Creditor Protections

The Protocol provides that the exercise of cross-default remedies in connection with the affiliate of a Regulated Entity becoming subject to insolvency or resolution proceedings is stayed for 48 hours or one business day, whichever is longer. This is modeled on the FDIC/FDIA "weekend resolution" model that has long been employed with respect to banking institutions in the U.S.

Under the Protocol, this "short-term" stay period can be extended in certain circumstances. For example, the stay is permanent if the affiliate is not a credit support provider for the Regulated Entity – *i.e.*, if the affiliate is merely a "Specified Entity" of the Regulated Entity under an ISDA Master Agreement. If the affiliate is a credit support provider, however, the stay may only be extended if certain specific "creditor protection" conditions described in the Protocol are satisfied.

There are two key creditor protections worth highlighting in this context. First, if credit support is not transferred where an affiliate credit support provider is in Chapter 11 proceedings, the stay is extended only if the bankruptcy court enters an order providing increased creditor priority for the beneficiary parties in the bankruptcy proceeding. Second, if the credit support is transferred to a bridge entity or other transferee, the stay is extended only if there is an order of the bankruptcy court confirming that the transferee meets certain conditions protective of creditors and that the assets and credit support obligations of the bankrupt affiliate have been transferred. In each case, the bankruptcy court must enter the order before the short-term stay expires – providing a very brief window of time before the QFCs of the Regulated Entity might become subject to market-wide termination. As noted above, the Protocol does not limit a counterparty's right to exercise remedies in the event the Regulated Entity itself is bankrupt and becomes subject to Chapter 11 proceedings, preserving the bankruptcy safe harbors for QFCs in the event of a "direct" default.

Using the Protocol Versus Bilateral Amendment

Compliance with the QFC Rules can be accomplished by bilateral amendment of in-scope QFCs, or by adhering to the Protocol. Under the QFC Rules, however, the required amendments are different depending on which approach is taken. Looking at the principal distinctions side-by-side provides a good sense of the relative merits of each approach.

As the summary in the table on the following page shows, a fund that benefits from any type of credit support arrangement will have better creditor protections under the Protocol. The principal advantage of the bilateral approach, on the other hand, is the ability to enter into amendments with each dealer, theoretically allowing a fund manager to exclude a relationship that involves a credit support provider that presents a credit risk.

Where the credit risk of credit support providers is a salient concern, however, pursuing a bilateral approach would only make sense if there were a particular credit support provider that is deemed so risky, from a credit standpoint, that the fund manager is willing to

Protocol	Bilateral Amendment
All in-scope QFCs are amended with every adhering Regulated Entity, including those that may adhere in the future.	Can be agreed on a dealer-by-dealer basis for each QFC.
Requires opting in to all the Identified Regimes.	Limits cross-border "opt-in" to the U.S. special resolution regimes and bankruptcy cross-default limitations.
Cross-default limitations operate only with respect to Chapter 11 and FDIA.	Cross-default limitations extend to a generically and broadly described range of affiliate insolvency proceedings or regimes.
Extension of short-term stay is conditioned on certain creditor protections being in place by order of bankruptcy court.	Stay is permanent unless certain conditions detrimental to creditors occur. The standards for maintaining the stay – *i.e.*, creditor protections – do not require bankruptcy court involvement and are not as robust as those under the Protocol.
Protocol creditor protections available even if affiliate credit support provider is not a Regulated Entity.	Creditor protections available only if affiliate credit support provider is a Regulated Entity.

forego the Protocol's creditor protections for every other counterparty relationship just to be able to silo the risky relationship and cease trading with that counterparty in anticipation of the default or insolvency of the credit support provider. Of course, a fund manager can always decide to arrange additional credit support; cease trading with a counterparty; or either reduce or move that exposure, limiting whatever marginal advantage is gained by using a bilateral approach in that circumstance.

The Protocol also requires the cross-border opt-in to the Identified Regimes, whereas the bilateral approach does not. Fund managers whose funds are trading with non-U.S. GSIBs or the offshore affiliates of U.S. GSIBs, however, are likely already familiar with the various bank resolution regimes in those jurisdictions, as those funds have most likely already adhered to or incorporated into their QFCs the relevant jurisdictional module of the ISDA Resolution Stay Jurisdictional Modular Protocol.

The QFC Rules were designed to incentivize the market to use the Protocol as the primary means of compliance. The distinctions between these approaches may not matter as much in the absence of credit support arrangements or where trading is limited to U.S. GSIBs and their domestic affiliates. Even so, the Protocol may provide a cost-effective means to have all relevant QFCs come into compliance with every Regulated Entity, allowing fund managers to avoid the additional time and expense – or the risk of overlooking an important QFC arrangement – that could result from using a bilateral approach.

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[1] ISDA has issued a list of frequently asked questions providing additional information on the Protocol.