

MEMO# 28418

October 1, 2014

FSB Issues Consultative Document on Cross-Border Recognition of Resolution Action; Stay on Early Termination Rights

[28418]

October 1, 2014

TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 64-14

ICI GLOBAL MEMBERS No. 37-14

INTERNATIONAL COMMITTEE No. 31-14 RE: FSB ISSUES CONSULTATIVE DOCUMENT ON CROSS-BORDER RECOGNITION OF RESOLUTION ACTION; STAY ON EARLY TERMINATION RIGHTS

On September 29, 2014, the Financial Stability Board (“FSB”) proposed a package of policy measures and guidance consisting of: (1) a set of elements that jurisdictions should consider including in their statutory cross-border recognition frameworks and (2) contractual approaches to cross-border recognition that focus on two particular cases where achieving cross-border recognition is considered to be a critical prerequisite for orderly resolution, including a stay on early termination rights in derivatives contracts. [\[1\]](#) Comments are due on the Consultative Document by December 1.

Background

Previously, the FSB identified legal uncertainties regarding the cross-border effectiveness of resolution measures as one of the main obstacles to the resolution of systemically important financial institutions (“SIFIs”) that operate across borders. [\[2\]](#) The FSB was concerned that, unless resolution action can be given prompt effect in relation to assets that are located in, or liabilities or contracts that are governed by the law of a foreign jurisdiction, authorities are likely to face obstacles in implementing group-wide resolution plans effectively for cross-border groups. Most jurisdictions currently do not have statutory powers to recognize, enforce, or give legal effect to foreign resolution measures.

Although statutory cross-border frameworks are the preferred goal of the FSB, the FSB has been working to implement contractual arrangements that could be an interim solution until comprehensive statutory regimes have been adopted in all relevant jurisdictions. Under a contractual approach, counterparties would agree to be bound by specified resolution actions taken by a foreign resolution authority. FSB members have agreed to pursue the rapid implementation of contractual solutions with regard to two particular

cases. The first is the temporary restriction or stay on early termination rights (including with respect to cross-defaults) in financial contracts. The second is the write-down, cancellation or conversion of debt instruments in resolution where the instruments are governed by the laws of a jurisdiction other than that of the issuing entity.

The FSB has been working with the International Swaps and Derivatives Association (“ISDA”) to develop a protocol that, if adopted by both counterparties to an ISDA Master Agreement, would support the cross-border enforcement of a temporary stay of early termination rights in relation to resolution-based defaults. The FSB contemplates that such a contractual approach should be supported by either a regulation or other enforceable measure that could be implemented by resolution authorities, supervisors, or other regulators.

Statutory Frameworks for Cross-Border Recognition

According to the Consultative Document, the statutory processes for giving effect to foreign resolution measures may take the form of a recognition procedure or the taking of measures under the domestic legal framework that support and are consistent with the resolution measures taken by the foreign home resolution authority. Under a recognition procedure, a jurisdiction would accept the commencement of a foreign resolution proceeding domestically and empower the relevant domestic authority to enforce the foreign resolution measure or grant other forms of domestic relief, such as a stay on domestic creditor proceedings. Supportive measures would involve the domestic resolution authority taking resolution measures that help implement and support resolution measures taken by the foreign home resolution authority.

The Consultative Document sets forth seven elements that jurisdictions should consider including in their frameworks to enhance the effectiveness of cross-border resolution. These elements are as follows:

- The legal framework should confer to a domestic authority or authorities legal capacity to give effect to foreign resolution measures and clearly establish which actions may be taken by these authorities.
- The legal framework should clearly establish the process and conditions for giving effect to foreign resolution actions and provide clarity about the extent to which the effect is automatic or subject to a discretionary decision by an authority.
- The legal framework should clearly identify the grounds for granting recognition of foreign resolution proceedings or adopting measures to support foreign resolution actions.
- The process for giving effect to foreign resolution measures should be guided by the principle of equitable treatment of creditors.
- In giving effect to foreign resolution actions, national authorities should take account of the need for speed in resolution.
- The capacity to give effect to foreign resolution actions should be complemented by the necessary legal protections for authorities and their officials and other measures such as limitations on actions that could constrain or reverse resolution decisions to give effect to foreign resolution actions.
- Authorities should require firms, or provide incentives for firms, to adopt contractual approaches, where appropriate, to reinforce the legal certainty and predictability of recognition under the statutory frameworks already in place and to fill the gap for statutory approaches until these have been fully implemented.

Contractual Approaches to Cross-border Recognition

Given the time required to implement the necessary statutory frameworks (discussed above), the FSB agreed to develop contractual solutions with respect to (1) temporary stays on early termination rights and (2) contractual recognition of bail-in.

Temporary Stays on Early Termination Rights

The FSB is concerned that there is a risk that national courts may not enforce a restriction or temporary stay on the exercise of termination rights [\[3\]](#) imposed under a foreign resolution regime, where the contract is governed by their domestic law or where a court's enforcement would be unlikely to be sufficiently prompt to meet the needs of effective resolution. The FSB has been working with ISDA to draft a protocol to its Master Agreement, which could support the cross-border enforcement of a temporary stay of early termination rights with respect to OTC derivatives governed by the Master Agreement between such adopting parties upon specified resolution actions with respect to certain counterparties, relevant group companies or their credit support providers. [\[4\]](#) According to the Consultative Document, ISDA is expected to launch the protocol publicly in the near future with an initial set of global systemically important banks ("G-SIBs") and other large dealer banks to adhere to the protocol by November 2014 ahead of the meeting of the G20 countries. If adopted by the banks, the protocol would govern existing and new OTC derivatives contracts between the adopting banks from the beginning of 2015.

For prudentially regulated firms and firms within the scope of resolution regimes, the FSB recommends that G-SIBs and (where appropriate) other firms with significant derivatives exposures be subject to measures requiring the use of contractual language replicating statutory stays of early termination rights under derivatives and other similar financial contracts, particularly where they are trading with counterparts in jurisdictions that do not have statutory recognition regimes.

With respect to non-prudentially regulated firms, FBS recommends that jurisdictions keep under review the indirect impact of requirements on prudentially regulated entities on their counterparties and consider whether further measures are required, including the imposition of requirements through market conduct regulation, to promote use of appropriate contractual language on stays by market participants that are not prudentially regulated.

Contractual Recognition of Bail-in

Where an entity has issued debt governed by the law of a foreign jurisdiction, the FSB is concerned with the risk that the exercise of statutory bail-in powers (i.e., the write down or conversion of the debt by the resolution authority of the issuing entity) will not be recognized in the foreign jurisdiction. The FSB believes that contractual recognition clauses can help support the cross-border enforceability of such actions. The FSB states that prudential or resolution authorities should require entities issuing debt governed by the law of a foreign jurisdiction to include recognition clauses for statutory bail-in in those debt instruments.

Next Steps and Implementation Timelines

The Consultative Document sets forth the following timeline that authorities and firms should work toward in this area:

- By end of October 2014, G-SIBs and other large banks that engage in significant cross-

border trading activities to commit to adopt the ISDA protocol or equivalent contractual clauses, which will become effective from 2015.

- FSB to finalize guidance on key principles for recognition clauses by end-2015.
- FSB members to take official action to promote widespread adoption of contractual clauses recognizing stays on early termination rights and exercise of bail-in powers by end of 2015.

FSB to finalize guidance on core elements of statutory recognition frameworks by end of 2015.

Jennifer S. Choi
Senior Associate Counsel Securities Regulation

endnotes

[1] Cross-border Recognition of Resolution Action, September 29, 2014, available at http://www.financialstabilityboard.org/publications/c_140929.pdf ("Consultative Document").

[2] Progress and Next Steps Towards "Ending Too Big To Fail, September 2013, available at http://www.financialstabilityboard.org/publications/r_130902.pdf ("TBTF Report").

[3] FSB contemplates that the early termination rights would arise by reason of or in connection with a firm's entry into resolution, which would include early termination rights based on the direct default of the institution under resolution, cross default provisions, default of a specified reference entity, and defaults based on credit support.

[4] The Consultative Document also states that the protocol provides for a stay that would apply in the context of a US Bankruptcy Code proceeding in relation to a financial holding company, whereby a recapitalization occurs and the operating entities of the holding company remain viable going concerns.