The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 30879

September 21, 2017

Member Call Rescheduled on Final Rules Issued by Board of Governors of the Federal Reserve System on Stays in Qualified Financial Contracts of Global Systemically Important Banks

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September 21, 2017 TO: Derivatives Markets Advisory Committee
Money Market Funds Advisory Committee RE: Member Call Rescheduled on Final Rules Issued by Board of Governors of the Federal Reserve System on Stays in Qualified Financial Contracts of Global Systemically Important Banks

The Board of Governors of the Federal Reserve System ("Board") recently issued final rules ("Final Rules") that require US global systemically important banking organizations (GSIBs), certain subsidiaries of US GSIBs, and certain US operations of foreign GSIBs to include restrictions in their qualified financial contracts (QFCs), such as OTC swaps, repo and reverse repo transactions, and securities lending transactions.[1] Although the Final Rules are largely similar to the rules the Board proposed in 2016 ("Proposal"),[2] the Board made several changes in response to comments, including those of ICI.[3] We provide a summary of the Final Rules below, focusing on relevant changes from the Proposal.

ICI has rescheduled our member conference call on the Final Rules – it will now take place on Tuesday, September 26th, from 2-3 pm ET. The dial-in information for the call is the same:

Dial-in number: 1-888-701-8647 Passcode: 24165
On this call, we would like to discuss member views on the "US protocol" permitted under § 252.85 of the Final Rules, along with your views and questions regarding the Final Rules. If you would like to participate in the member call, please RSVP to Jennifer Odom at jodom@ici.org or (202) 326-5833.

Background

The Final Rules are part of the Board's efforts to address the systemic implications of the failure of a major financial firm, such as Lehman Brothers' failure in September 2008.[4] The Board explains that the Final Rules, consistent with the Dodd-Frank Wall Street Reform

and Consumer Protection Act ("Dodd-Frank Act"), are intended to help ensure that if a GSIB fails, its passage through a resolution proceeding would be more orderly, thereby helping to mitigate destabilizing effects on the financial system. The Final Rules seek to achieve this goal by limiting the ability of a failed GSIB's counterparties to terminate their QFCs with the GSIB immediately upon the GSIB's (or an affiliate's) entry into resolution.

The Final Rules require QFCs entered into by certain entities to contain contractual provisions that recognize the automatic stay of termination and transfer provisions applicable in resolution proceedings under the Orderly Liquidation Authority (OLA) provisions of Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act (FDIA). The Final Rules also generally require QFCs entered into by certain entities to prohibit the QFC counterparty from exercising default rights based on an affiliate of the covered entity entering resolution or insolvency proceedings (i.e., prohibit the exercise of cross-default rights). This provision covers not only proceedings under OLA, the FDIA, and the US Bankruptcy Code, but state and foreign resolution and insolvency proceedings.

Covered Entities and Contracts under the Final Rules

Covered Entities

The Final Rules apply to "covered entities," which are defined in a substantially similar manner as under the Proposal. Covered entities include: (1) any US GSIB bank holding company; (2) any subsidiary of such a bank holding company that is not an "excluded bank;"[5] and (3) the US operations of any foreign GSIB with the exception of any "excluded bank." Whether an entity is a US GSIB bank holding company will be determined pursuant to the Board's rule which establishes the criteria for identifying a GSIB and the methods that those firms must use to calculate a risk-based capital surcharge (i.e., the GSIB surcharge rule).[6]

Covered entities also include all US operations of foreign GSIBs that are not excluded banks, including US subsidiaries, US branches, and US agencies. The Final Rules define a "global systemically important foreign banking organization" (i.e., a foreign GSIB) to include any foreign banking organization that would be designated as a GSIB under the Board's GSIB surcharge rule or would be designated as a GSIB under the global methodology for identifying GSIBs adopted by the Basel Committee on Banking Supervision (BCBS).[7]

Covered Contracts

The Final Rules define "qualified financial contract" broadly, consistent with section 210(c)(8)(D) of Title II of the Dodd-Frank Act. In response to comments, however, the Final Rules exclude QFCs that have no explicit transfer restrictions or default rights, as such QFCs have no provisions that the rules are intended to address. The Final Rules also exclude investment advisory contracts with retail advisory customers of a covered entity that only contain the transfer restrictions required by section 205(a) of the Investment Advisers Act of 1940,[8] and existing warrants that evidence a right to subscribe or otherwise acquire a security of a covered entity or its affiliate. In addition, the Board can exempt other QFCs from the Final Rules, based on consideration of enumerated factors. While the Final Rules retained the proposed exclusion for QFCs to which a CCP is a party, the Board specifically declined to extend that exclusion to the client-facing leg of a cleared swap.[9]

A covered QFC, for purposes of the Final Rules, includes master agreements that apply to

QFCs.[10] However, in response to comments, a foreign bank multi-branch master agreement that is a covered QFC because it permits QFCs to be entered into at US branches or US agencies of a foreign GSIB will be subject to the Final Rules only if such QFCs are actually booked at the US branch or agency.

The Final Rules also provide explicitly that a covered entity does not become a party to a QFC solely by acting as agent with respect to a QFC. Thus, a covered entity acting as agent in a securities lending arrangement would be excluded, but it may be covered if it serves in other roles, such as guarantor.[11]

QFC Restrictions Relating to US Special Resolution Regimes

§ 252.83 resembles section 1 of the 2015 version of the Universal Resolution Stay Protocol ("2015 Protocol").[12] § 252.83 requires that a covered QFC explicitly provide that: (1) in the event the covered entity becomes subject to a proceeding under a US special resolution regime (SSR), the transfer of the QFC (and any interest or obligation in or under it and any property securing it) from the covered entity will be effective to the same extent as the transfer would be effective if the covered QFC were governed by the laws of the United States or of a state; and (2) in the event the covered entity, or an affiliate of the covered entity, becomes subject to a proceeding under a US SSR, default rights with respect to the covered QFC that may be exercised against a covered entity could be exercised to no greater extent than they could be exercised under the US SRR if the covered QFC were governed by the laws of the United States or of a state.

The Final Rules define "US special resolution regimes" to mean the FDIA and the OLA provisions of Title II of the Dodd-Frank Act, as well as the regulations issued under those statutes. In an important change from the Proposal, the Final Rules exclude from the requirements of § 252.83 QFCs that are governed by US or state law, if the QFC counterparty is organized under US or state law, has its principal place of business in the United States, or is a US branch or agency, and certain conditions are satisfied. This exclusion, which was added in response to comments, recognizes that QFCs that meet these requirements would be directly subject to the stay and transfer provisions of the US SRRs, and thus there is no need to subject them to the requirements of § 252.83.

The definition of "default right" is unchanged under the Final Rules. That definition excludes certain business as usual payments associated with a QFC, such as same-day payment netting, as well as contractual margin requirements that arise solely from the change in the value of the collateral or margin, or the amount of an economic exposure. In response to comments, the Board clarified that the exception includes changes in margin due to changes in market price, but does not include changes due to counterparty credit risk (e.g., credit rating downgrades).[13]

Proposed QFC Restrictions Relating to Insolvency Proceedings

§ 252.84 resembles section 2 of the 2015 Protocol, and generally prohibits a covered entity from being party to a covered QFC that: (1) allows the exercise of any default right that is related to the entry into resolution of an affiliate of the covered entity (i.e., prohibition against cross-default rights); and (2) prohibits the transfer of a credit enhancement applicable to the QFC (a guarantee, for example) from an affiliate to a transferee upon the entry into resolution of the affiliate. As proposed, these provisions in the Final Rules apply to defaults triggered by an affiliate of the covered entity that is a GSIB entering into a receivership, insolvency, liquidation, resolution, or similar proceeding, including not only US federal resolution and insolvency proceedings, but state and foreign resolution and

insolvency proceedings. Similar to the Board's change to final § 252.83, § 252.84 excludes covered QFCs that do not explicitly include cross-default rights or restrictions on the transfer of credit enhancements.

As proposed, the Final Rules include a series of creditor exceptions intended to allow creditors to exercise both direct and cross-default rights not related to an orderly resolution of a GSIB.[14] These creditor protections reflect the Board's recognition that the rules' restrictions may limit the ability of covered entities' QFC counterparties to include certain protections in covered QFCs. The Board was unwilling, however, to expand creditor protections, as commenters requested.[15] The Board also declined to eliminate or shift the burden of proof required for a QFC counterparty to demonstrate that its exercise of a covered QFC is permitted.

Adherence to Protocols Under Final Rules

The Final Rules provide that, as an alternative to complying with § 252.83 and § 252.84, a covered entity may instead, as a safe harbor, adhere to the 2015 Protocol. In response to concerns raised by commenters, including ICI, about the ability of some market participants to adhere to the 2015 Protocol, the Board expanded the safe harbor to provide that covered QFCs amended through adherence to a new, yet to be developed, "US protocol" also will be deemed to satisfy the requirements of the Final Rules.

The Board explained that the US protocol may differ from the 2015 Protocol in certain respects, but otherwise must be substantively identical.[16] Under the Final Rules, the US protocol, among other things:

- May limit the application of the provisions the 2015 Protocol identifies as Section 1 and Section 2 to only covered entities and excluded banks;
- Must include the US SRRs and the other "Identified Regimes" under the 2015 Protocol, but is not required to include "Protocol-eligible Regimes;"[17]
- May include the "opt-out" provisions of the 2015 Protocol, as long as the covered QFCs otherwise conform to the requirements of the Final Rules;[18]
- Must not include the exemption in the 2015 Protocol for the client-facing leg of a cleared transaction; and
- Must not permit parties to adhere on a firm-by-firm or entity-by-entity basis, or permit adherence to a "static list" of all current covered entities.[19]

The Final Rules further provide that the US protocol may include minor and technical differences from the 2015 Protocol. In amending covered QFCs to conform to either the 2015 Protocol or the US protocol, the Final Rules provide that amendments through incorporation of the terms of the protocol (by reference or otherwise) are acceptable.

Transition Periods

In response to comments, the Board extended the proposed compliance periods. Under the Final Rules, an entity that is a covered entity on November 13, 2017 must conform its covered QFCs with its counterparties as follows:

- With other covered entities or excluded banks, by January 1, 2019;
- With "financial counterparties" (such as registered funds, private funds, and commodity pools) that are not covered entities or excluded banks, by July 1, 2019; and
- With community banks and other non-financial counterparties (including "small financial institutions"), by July 1, 2020.

The Final Rules provide similar compliance periods (i.e., one year, 18 months, two years) for entities that subsequently become covered entities to conform their pre-existing covered QFCs.

The Board modified the definition of "covered QFC" to address commenters' concerns about the overly broad implications of the Proposal for pre-existing QFCs. ICI had argued that one fund entering into a new QFC should not cause the other funds in the fund complex to be required to conform their pre-existing QFCs to the rules' requirements. The Final Rules somewhat limit the scope of the rules' applicability to pre-existing QFCs by including only QFCs with the same person or a ''consolidated affiliate,'' a term defined by reference to financial consolidation principles, rather than the broader term "affiliate," which was used in the Proposal.[20]

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endnotes

[1] *Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions,* 82 Fed. Reg. 42882 (Sept. 12, 2017), *available at* https://www.gpo.gov/fdsys/pkg/FR-2017-09-12/pdf/2017-19053.pdf ("Adopting Release").

[2] For a summary of the Proposal, please see ICI Memorandum No. 29916 (May 16, 2016), *available at* https://www.ici.org/my_ici/memorandum/memo29916.

[3] *See* Letter to Mr. Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, from David W. Blass, General Counsel, Investment Company Institute, dated August 5, 2016, *available at* https://www.ici.org/pdf/30119.pdf.

[4] Adopting Release, *supra* note 1, at 42883.

[5] "Excluded bank" is defined generally as a national bank, a federal savings association, federal branch, or other entities supervised by the Office of the Comptroller of the Currency (OCC) or Federal Deposit Insurance Corporation (FDIC). The Board states that the OCC and FDIC are expected to shortly issue final rules that are substantially similar to the Board's Final Rules.

[6] *See* 12 CFR 217.402. Under the methodology of this rule, there currently are eight US GSIBs: 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. The Board notes that this list may change in the future in light of changes to the relevant attributes of the current US GSIBs and of other large US bank holding companies.

[7] In November 2016, the FSB and the BCBS published an updated list of banking organizations that are GSIBs under the global methodology. The list includes the eight US GSIBs and the following 22 foreign banking organizations: Agricultural Bank of China, Bank

of China, Barclays, BNP Paribas, China Construction Bank, Credit Suisse, Deutsche Bank, Groupe BPCE, Groupe Crédit Agricole, Industrial and Commercial Bank of China Limited, HSBC, ING Bank, Mitsubishi UFJ FG, Mizuho FG, Nordea, Royal Bank of Scotland, Santander, Société Générale, Standard Chartered, Sumitomo Mitsui FG, UBS, and Unicredit Group.

[8] Retail customer or counterparty is defined by reference to the Board's Regulation WW. *See* 12 CFR 249.3.

[9] The Board explained that it declined to extend the exclusion "because bilateral trades between a GSIB and a non-CCP counterparty are the types of transactions that the final rule intends to address and because nothing in the final rule would prohibit a covered entity clearing member and a client from agreeing to terminate or novate a trade to balance the clearing member's exposure." Adopting Release, *supra* note 1, at 42897.

[10] Under the Dodd-Frank Act's definition of QFC, which the Final Rules reference, master agreements for QFCs, together with all supplements to the master agreement (including underlying transactions), are considered to a single QFC.

[11] *See* Adopting Release, *supra* note 1, at 42908.

[12] The 2015 Protocol was developed by the International Swaps and Derivatives Association (ISDA), in coordination with the Financial Stability Board. It enables parties to amend the terms of covered agreements to recognize contractually the cross-border application of special resolution regimes applicable to certain financial companies and supports the resolution of certain financial companies under the US Bankruptcy Code. The Final Rules are necessary to implement the insolvency provisions of the 2015 Protocol.

[13] See Adopting Release, *supra* note 1, at 42900.

[14] For purposes of exercising default rights, the stay period, under the Final Rules, with respect to a receivership, insolvency, liquidation, resolution, or similar proceeding, is the period of time beginning on the commencement of the proceeding and ending at the later of 5:00 p.m. (eastern time) on the business day following the date of the commencement of the proceeding and 48 hours after the commencement of the proceeding. This stay period is similar to the stay periods that that would be imposed in a resolution under the OLA provisions of Title II of the Dodd-Frank Act or the FDIA, although it could run longer than those stay periods under some circumstances. It is also similar to the stay period under the 2015 Protocol (the longer of one business day or 48 hours following the commencement of insolvency proceedings).

[15] The Final Rules, like the Proposal, include an exclusion to prevent transfers that would result in the supported party under a covered affiliate credit enhancement violating the law, such as a transfer to an entity that would cause a fund to violate section 12(d)(3) of the Investment Company Act of 1940. The Board was unwilling, however, to extend the exclusion, as ICI requested, to prevent the transfer of such an interest to an entity that would cause a fund to exceed the concentration threshold permitted by Regulation M of the Internal Revenue Code of 1986. *See* Adopting Release, *supra* note 1, at n.171.

[16] It is possible that the US protocol the Board contemplates may be similar to the ISDA jurisdictional modular protocol (JMP). The JMP is intended to achieve the same policy goals as the 2015 Protocol with respect to the orderly resolution of GSIBs, but was developed to facilitate compliance with the stay regulations in different jurisdictions. *See ISDA Resolution*

Stay Jurisdictional Modular Protocol, available at https://www2.isda.org/functional-areas/protocol-management/protocol/24.

[17] The 2015 Protocol defines "Identified Regimes" as the SRRs of France, Germany, Japan, Switzerland, the UK, and the United States. The 2015 Protocol defines "Protocol-eligible Jurisdiction" as (i) each member jurisdiction, as of January 1, 2014, of the Financial Stability Board that is not a jurisdiction with an Identified Regime (such member jurisdictions being 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), (ii) with respect to only bankruptcy law, the United States, and (iii) any other jurisdiction that is the jurisdiction of organization of the ultimate parent entity within a banking group that has been designated by the Financial Stability Board as a "global systemically important bank."

[18] An adherent could rely on the US protocol with respect to Section 2, for example, but "opt-out" of Section 1, and instead comply with § 252.83 of the Final Rules.

[19] In other words, the US protocol must have universal adherence.

[20] The Final Rules provide that a covered QFC includes a QFC that the covered entity entered, executed, or otherwise became a party to before January 1, 2019, if the covered entity or any affiliate that is a covered entity or excluded bank also enters, executes, or otherwise becomes a party to a QFC with the same person or a consolidated affiliate of the same person on or after January 1, 2019.
