

Federal Reserve's Proposed Rule on QFCs with U.S. G-SIBs and the U.S. Operations of Foreign G-SIBs

Visual Memorandum

May 25, 2016

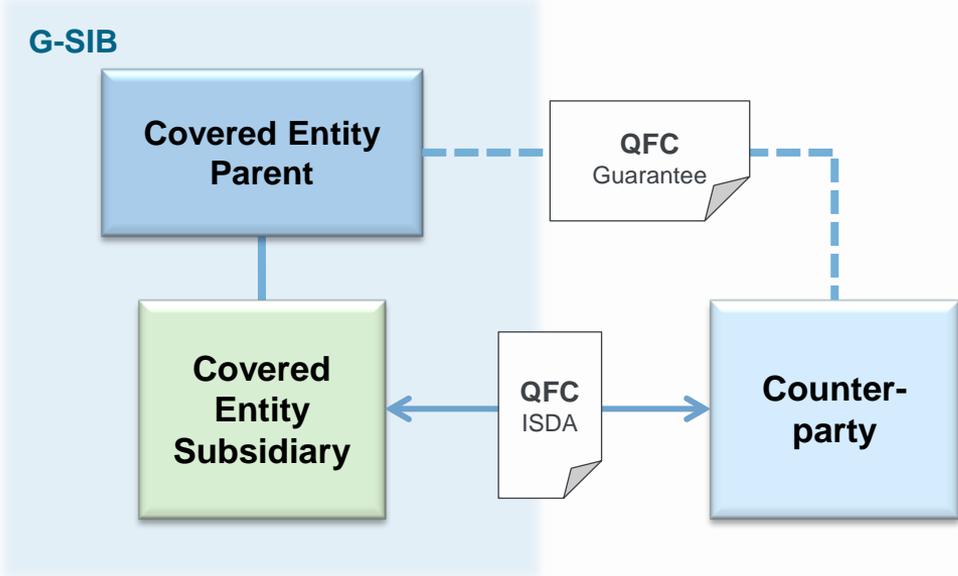


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Introduction

Overview of Proposed Rule

- The Board of Governors of the Federal Reserve System (**Federal Reserve**) has issued a **proposed rule** designed to **eliminate** what the Federal Reserve and the Federal Deposit Insurance Corporation (**FDIC**) consider to be a **material impediment to the orderly resolution** of a U.S. global systemically important banking organization (**G-SIB**) and the U.S. operations of a foreign G-SIB.
 - The perceived impediment is the ability of **counterparties to certain financial contracts to terminate those contracts based on a cross-default** to a parent or other affiliate of the direct G-SIB party becoming subject to insolvency proceedings, even when the direct party is performing on the contracts.
- The proposed rule would attempt to eliminate this perceived impediment by prohibiting a **covered entity** (see definition [page 15](#)) from becoming party to a **new qualified financial contract (QFC)**, and requiring the covered entity to amend any **existing QFCs** with a particular counterparty if a **triggering event** occurs, unless the new and existing QFCs reflect the following requirements and restrictions:
 - The exercise of cross-default rights is **expressly limited**, and transfers of parent guarantees are **expressly made effective**, to the same extent as provided under Title II of the **Dodd-Frank Act**; and
 - Cross-default rights related to a covered entity's affiliate becoming subject to insolvency proceedings are **not permitted**, and transfers of a parent guarantee or other affiliate credit enhancement are **not restricted** upon the parent or other affiliate becoming subject to insolvency proceedings, subject to certain exceptions.

By **triggering event**, we mean that the covered entity or any of its covered affiliates becomes a party to a new QFC with the same counterparty or any of its affiliates after the proposed rule becomes effective.

Dodd-Frank Act means the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Introduction *(cont.)*

Overview of Proposed Rule *(cont.)*

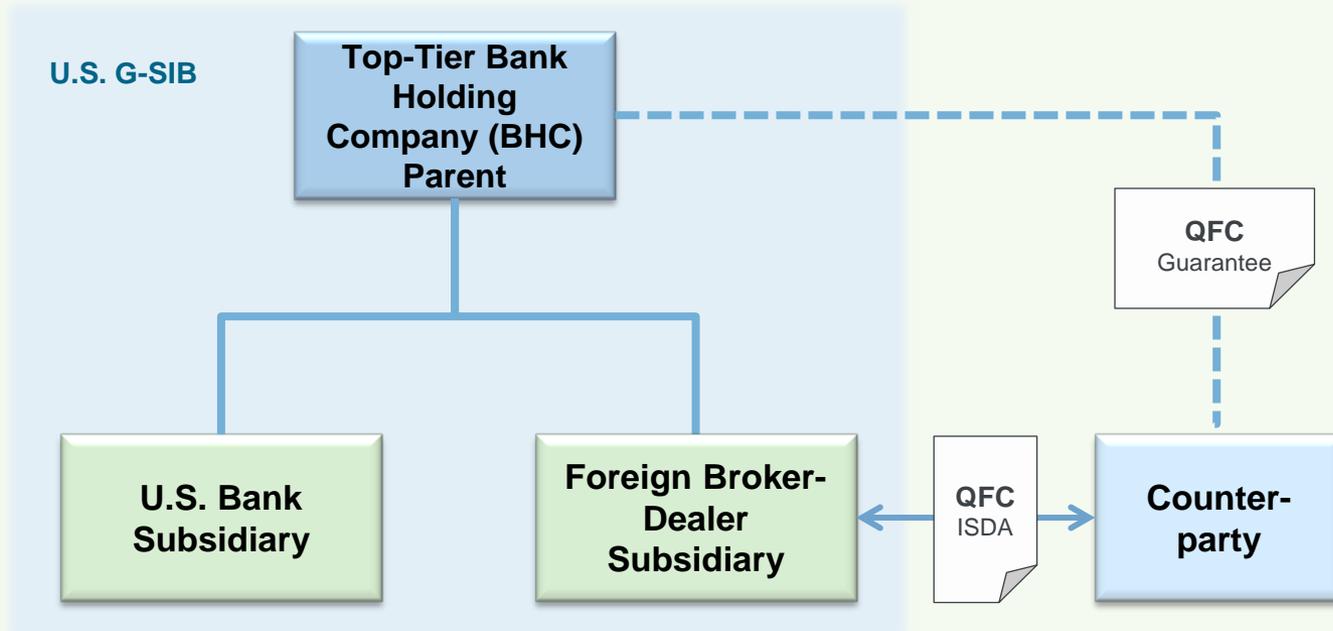
- The **effect** of the proposed rule on **counterparties** that are **not covered entities** is to eliminate the practical ability of those counterparties and any of their affiliates to enter into any new QFCs with any major dealer in derivatives that is a covered entity or any of its covered affiliates unless the proposed rule is complied with.
- The Federal Reserve is issuing the proposed rule under the **statutory authority** provided by **Section 165 of the Dodd-Frank Act**, which instructs it to impose enhanced prudential standards on BHCs with total consolidated assets of \$50 billion or more to prevent or mitigate risks to the financial stability of the United States.
- The **effective date** of the proposed rule would be the first day of the calendar quarter that starts at least one year after the final rule has been issued.
- The comment period ends on **August 5, 2016**.
- A copy of the proposed rule (including an explanatory preamble) is available [here](#) and a copy of a memorandum about the proposed rule written by the Federal Reserve staff is available [here](#).

Example. This would include putting on a new derivatives trade under an existing master agreement.

A covered affiliate is an affiliate of a covered entity that is itself a covered entity or a covered bank. See [page 15](#) and [page 16](#) for additional detail.

Introduction *(cont.)*

Hypothetical QFC Transaction With a U.S. G-SIB

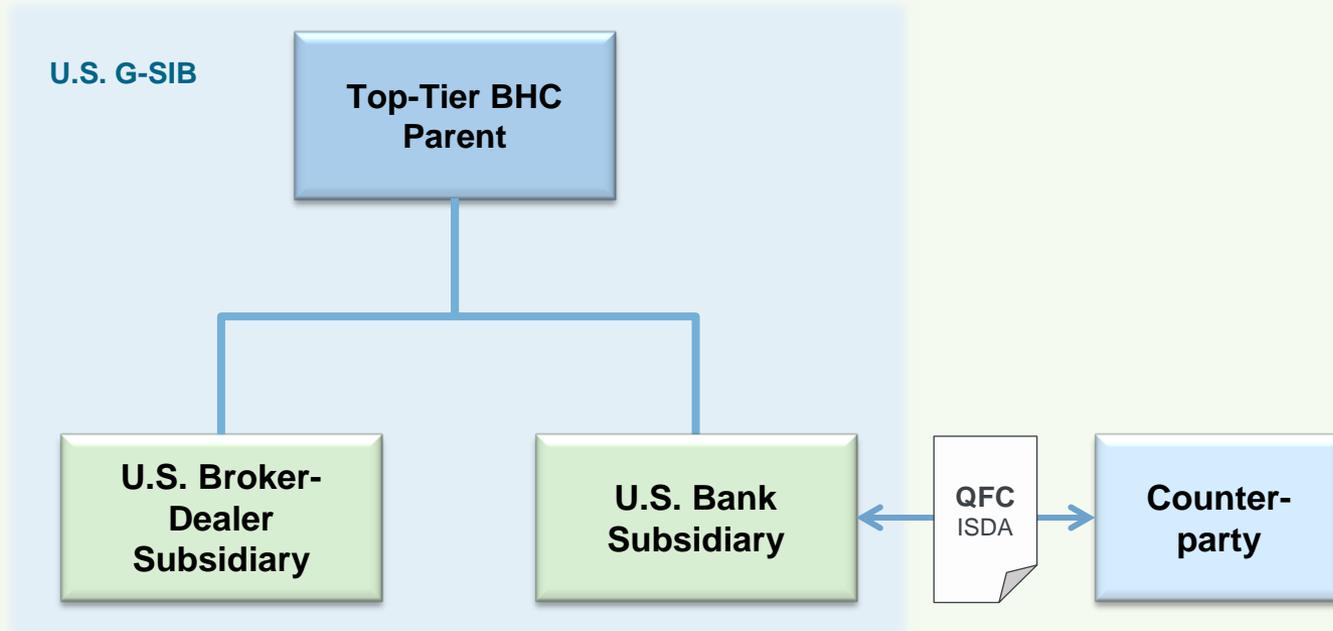


QFC Events of Default:

- (1) **Direct default:** Entry of the foreign broker-dealer subsidiary into an insolvency proceeding.
- (2) **Cross-default:** Commencement of proceeding under the Bankruptcy Code with respect to the top-tier BHC parent.

Introduction *(cont.)*

Hypothetical QFC Transaction With a U.S. G-SIB *(cont.)*



QFC Events of Default:

- (1) **Direct default:** Entry of the U.S. bank subsidiary into an FDIC receivership under the Federal Deposit Insurance Act (**FDI Act**).
- (2) **Cross-default:** Commencement of proceeding under the Securities Investor Protection Act with respect to the U.S. broker-dealer affiliate.

Introduction *(cont.)*

Backdrop: The Lehman Problem

- **Lehman problem.** The perceived impediment to the orderly resolution of a U.S. G-SIB is illustrated by what may be called the Lehman problem. One of the destabilizing features of the Lehman Brothers bankruptcy was **the sudden termination of Lehman's financial contracts** arising initially on the counterparties' exercise of **cross-defaults** based on the bankruptcy of the Lehman parent and subsequently on the counterparties' exercise of **direct defaults** against Lehman's material operating subsidiaries, including when the subsidiaries commenced their own bankruptcy or similar proceedings.
 - This resulted in **substantial losses on Lehman's derivatives book**.
 - Counterparties calculated the amounts due to them under certain terminated contracts in a manner that was favorable to them.
 - Many counterparties withheld payment on contracts on which they owed money to Lehman.
 - This resulted in a significant **outflow of cash from Lehman's material operating subsidiaries to counterparties** as Lehman's subsidiaries attempted to satisfy their obligations under terminated contracts and respond to increased collateral demands under open contracts.
 - In order to generate cash, this led to **fire sales of collateral** that secured the terminated financial contracts as well as **fire sales of assets** by Lehman's subsidiaries.

Impediment. Unless solved, the regulators believe that the Lehman problem would be a material impediment to the orderly resolution of U.S. G-SIBs and the U.S. operations of foreign G-SIBs.



Proposed Rule. The proposed rule attempts to eliminate this perceived impediment by restricting the ability of U.S. G-SIBs and the U.S. operations of foreign G-SIBs from entering into new QFCs unless they contain, and all prior QFCs with the counterparty are amended to contain, certain provisions.

Introduction *(cont.)*

The Cross-Default and Direct Default Problems

- **Automatic Stays.**
 - **Bankruptcy Code.** Attempts by creditors of a bankrupt entity to enforce their debts outside of bankruptcy proceedings (e.g., by seizing collateral) are generally blocked by the imposition of an **automatic stay**.
 - **U.S. Special Resolution Regimes.** In receivership proceedings under Title II of the Dodd-Frank Act or the bank resolution provisions of the FDI Act, and their implementing regulations (**U.S. Special Resolution Regimes**), the FDIC has a similar power to block any attempts by creditors of the institution to enforce their debts outside of the receivership proceedings.
- **Safe Harbor for QFCs.** The Bankruptcy Code and the U.S. Special Resolution Regimes, however, generally exempt **QFCs** from these automatic stays through special “**safe harbor**” provisions. QFC counterparties are permitted to exercise their:
 - **Cross-default rights** based on a parent or other affiliate of a direct party entering into an insolvency proceeding.*
 - **Direct default rights** based on the direct party’s entry into an insolvency proceeding.**

* **Except that** under regulations promulgated under **Title II of the Dodd-Frank Act** (but **not** the Bankruptcy Code or the FDI Act), the exercise of those rights is subject to a **temporary (one business day) stay**, and those rights may be exercised after the expiration of the temporary stay **only if** the FDIC fails to transfer any guarantees of the underlying QFCs by the parent to a third party, including a bridge financial company, or otherwise provide adequate protection to the counterparty, before the end of the temporary stay period. Under the Bankruptcy Code, the automatic stay does not extend to cross-default rights under QFCs or other types of contracts.

** **Except that** under the **U.S. Special Resolution Regimes** (but **not** the Bankruptcy Code), the exercise of those rights is subject to a **temporary (one business day) stay**, and those rights may be exercised after the expiration of the temporary stay **only if** the FDIC fails to transfer QFCs to a third party, including a bridge bank or bridge financial company, before the end of the temporary stay period.

Introduction *(cont.)*

The Cross-Default and Direct Default Problems *(cont.)*

To summarize:

By **insolvency proceeding**, we mean a receivership, insolvency, liquidation, resolution or similar proceeding.

Cross-Default Problem

This problem arises when a QFC contains an event of default based on a parent or other affiliate of the direct party becoming subject to an **insolvency proceeding** (cross-default), giving the counterparty to the QFC a contractual right to terminate the QFC or exercise other default rights, even though the direct party is performing on the QFC and a direct default on the QFC has not occurred.

Direct Default Problem

This problem occurs when a QFC contains an event of default based on the direct party becoming subject to an insolvency proceeding (direct default), giving the counterparty to the QFC a contractual right to terminate the QFC or exercise other default rights.

Introduction *(cont.)*

Existing Solutions to Direct Default Problem

SPOE Resolution Strategy

- **Primary Solution.** The Federal Reserve and the FDIC believe that the direct default problem is solved by the single-point-of-entry (**SPOE**) resolution strategy and the Federal Reserve's proposed rule on total loss-absorbing capacity (**TLAC**). A step-by-step illustration of an SPOE strategy is available [here](#).
 - The primary obligors on the vast majority of QFCs entered into by U.S. G-SIBs are the **material operating subsidiaries** of their parent BHCs, rather than the parent BHCs themselves.
 - Under the SPOE strategy, the material operating subsidiaries of a U.S. G-SIB would be **kept out of insolvency proceedings** and from otherwise **directly defaulting** on their financial contracts.
 - The Federal Reserve's proposed TLAC rule would reinforce this solution by prohibiting the top-tier parent BHCs of U.S. G-SIBs from entering into QFCs with third parties.

FDI Act

- **Back-up Solution for IDIs.** The bank resolution provisions of the FDI Act provide a back-up solution to the direct default problem for QFCs with insured depository institutions (**IDIs**) by:
 - Imposing a temporary (one business day) stay on the ability of QFC counterparties to exercise direct default rights based on the entry of an IDI into an FDIC receivership; and
 - Authorizing the FDIC to transfer the QFCs of the failed institution to a third party or bridge bank without the consent of the counterparties.

The temporary stay becomes **permanent** if the transfer is effected before the end of the **temporary stay period**.

Title II of the Dodd-Frank Act (Title II)

- **Back-up Solution for Covered Title II Financial Companies.** Title II of the Dodd-Frank Act establishes the **Orderly Liquidation Authority**, an alternative to the Bankruptcy Code that is applicable to financial companies (other than IDIs and certain other excluded financial companies) if certain conditions are satisfied. It provides a nearly identical back-up solution to the direct default problem for QFCs with financial companies subject to Title II, by:
 - Imposing a temporary (one business day) stay on the ability of QFC counterparties to exercise direct default rights based on the entry of a covered financial company into a Title II receivership; and
 - Authorizing the FDIC to transfer the QFCs of the failed covered financial company to a third party or bridge financial company without the consent of the counterparties.

Introduction *(cont.)*

Existing Solutions to Cross-Default Problem and Gaps

Title II

- **Section 210(c)(16) of Title II** provides a **solution to the cross-default problem** for QFCs with a direct G-SIB party based on the entry of a parent of the direct G-SIB party into Title II proceedings.
 - FDIC regulations promulgated under this section impose a temporary (one business day stay) on the ability of counterparties to terminate their QFCs based on a cross-default to a parent's entry into Title II proceedings, subject to certain creditor protections.
 - Where a counterparty's QFCs are guaranteed by the parent, this temporary stay will become permanent if the FDIC transfers the guarantee to a third party, including a bridge financial company, or otherwise provides adequate protection to the counterparty, before the end of the temporary stay period. Otherwise, the temporary stay will automatically terminate.
 - If there is no guarantee, the cross-default is permanently overridden from the start.

Example. The parent BHC of a foreign broker-dealer subsidiary might guarantee a QFC entered into by the foreign broker-dealer. The QFC may contain a cross-default that would permit the counterparty to terminate the QFC based on the parent BHC becoming subject to an insolvency proceeding, even though the foreign broker-dealer subsidiary is still solvent and performing on the QFC.

Remaining Gaps Addressed By Proposed Rule

- **SPOE Alone Not a Solution.** An SPOE resolution strategy alone does not solve the cross-default problem because the parent BHC enters into a bankruptcy or other similar proceeding under an SPOE strategy.
- **Extraterritorial Gap.** The prohibition in the FDIC's regulations on QFC counterparties' exercising cross-default rights **may not be recognized and given effect outside the United States**. This problem could arise, for example, if a QFC with a foreign subsidiary is governed by foreign law or is with a foreign counterparty.
- **Bankruptcy Code Gap.** The Bankruptcy Code does not contain a provision like Section 210(c)(16) of Title II addressing the cross-default problem.*

* A bill that has passed the House but not the Senate would add a similar provision to the Bankruptcy Code. A copy of the bill is [here](#).

Introduction *(cont.)*

Resolving Gaps in Solutions to Cross-Default Problem

Extraterritorial Gap

- Title II's prohibition on exercising cross-default rights based on a parent's entry into Title II proceedings, and its related stay-and-transfer provisions, may not be recognized outside the United States.

Bankruptcy Code Gap

- The Bankruptcy Code does not contain any provisions limiting the exercise of cross-default rights in a QFC based on the parent or other affiliate of the direct G-SIB party becoming subject to a bankruptcy proceeding.

Contractual Requirements

New QFCs must include a provision pursuant to which the counterparty contractually agrees that:

- Any cross-default rights are subject to the limits on the exercise of such rights under Title II; and
- Any transfer of a parent guarantee of the new QFCs to a third party, including a bridge financial company, will be effective to the same extent as it would be under Title II.

Contractual Restrictions

Subject to certain creditor protection conditions, covered QFCs must not:

- Permit the counterparty to exercise any cross-default rights related, directly or indirectly, to a parent or other affiliate of the direct party to the covered QFCs becoming subject to insolvency proceedings; or
- Prohibit the transfer of a parent guarantee or other affiliate credit enhancement upon the parent or other affiliate becoming subject to insolvency proceedings, subject to certain exceptions.

Existing QFCs. The proposed rule would also require all existing covered QFCs with a covered entity to reflect these requirements and restrictions **if, but only if**, the covered entity or any of its covered affiliates becomes a party to a new QFC with the same counterparty or any of its affiliates after the proposed rule becomes effective.

OR

New QFCs and Existing QFCs must comply with the ISDA Protocol

Introduction *(cont.)*

Resolving Gaps in the Back-up Solutions to Direct Default Problem

MPOE Resolution Strategy

- As noted above, the **primary solution** to the direct default problem for U.S. G-SIBs is the **SPOE resolution strategy** since most QFCs are issued by U.S. G-SIB operating subsidiaries and SPOE keeps them out of their own insolvency proceedings. The proposed rule nevertheless contains a back-up solution for direct defaults based on the covered entity entering into Title II or FDI Act proceedings pursuant to a multiple point of entry (**MPOE**) resolution strategy.

Under an MPOE strategy, one or more of a G-SIB's operating subsidiaries or intermediate holding companies enters into an insolvency proceeding.

Extraterritorial Gap

- The temporary stay on exercising direct default rights based on a direct party's entry into Title II or FDI Act proceedings, and the related transfer provisions, may not be recognized outside the United States.

Contractual Provisions

- New QFCs must include a provision pursuant to which the counterparty contractually agrees that:
 - Any direct default rights are subject to the limits on the exercise of such rights under Title II and the FDI Act; and
 - Any transfer of the new QFCs to a third party, including a bridge bank or bridge financial company, will be effective to the same extent as it would be under Title II or the FDI Act.

OR

New QFCs and Existing QFCs must comply with the ISDA Protocol

Existing QFCs. The proposed rule would also require all existing covered QFCs with a covered entity to reflect these requirements **if, but only if**, the covered entity or any of its covered affiliates becomes a party to a new QFC with the same counterparty or any of its affiliates after the proposed rule becomes effective.

Introduction *(cont.)*

Relationship to the ISDA Protocol

- **Background.** The ISDA 2015 Universal Resolution Stay Protocol (**ISDA Protocol**) was developed by a working group of ISDA members (including representatives of dealers and buy-side institutions) in coordination with the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency (**OCC**), as well as regulatory agencies from other jurisdictions.
- **Current Adherents.** To date, 23 G-SIBs as defined by the Financial Stability Board have adhered to the ISDA Protocol.
- **QFCs Covered.** The ISDA Protocol covers OTC derivatives transactions documented under ISDA Master Agreements, as well as repurchase agreement (**repo**) transactions and securities lending transactions under industry standard master agreements. It also provides for an optional Other Agreements Annex that would cover all other QFCs between adhering parties.
- **Relationship to the Proposed Rule.** The Federal Reserve appears to expect that most counterparties will agree to be bound by the ISDA Protocol with respect to existing QFCs (or a separate **Jurisdictional Modular Protocol** containing substantially identical terms, see [page 44](#)), and to ensure that any new QFCs comply with the terms of the ISDA Protocol, in order to be able to continue entering into new QFCs with the covered entities and enjoy the greater creditor protections contained in the ISDA Protocol. See [page 45 – page 46](#) for examples of the **superior creditor protections** that the ISDA Protocol offers compared to the proposed rule.
- **Other Similar Rules.** There have been efforts by regulators in other jurisdictions to promulgate rules to solve similar issues.
 - For example, the Prudential Regulatory Authority in the U.K. recently released its own final rules, which can be found [here](#).

From the Preamble to the Proposed Rule:

Purpose of the ISDA Protocol. The ISDA Protocol has the “same general objective as the proposed rule,” which is to make U.S. G-SIBs and foreign G-SIBs “more resolvable by amending their contracts to . . . contractually recognize the applicability of U.S. special resolution regimes and to restrict cross-default provisions to facilitate orderly resolution under the U.S. Bankruptcy Code.”

Advantages of the ISDA Protocol. The Protocol’s additional creditor protections “appear to **meaningfully increase a [counterparty]’s assurance** that material payment and delivery obligations under its covered QFCs will continue to be performed and should meaningfully decrease the [counterparty]’s credit risk to its direct parties.”

Scope of the ISDA Protocol. “The scope of the stay and transfer provisions in the Protocol are narrower than” the scope of the proposed rule. Also, when one entity adheres to the Protocol, it necessarily adheres to the Protocol with respect “to **all covered entities that have also adhered** . . . rather than **one or a subset of covered entities**.” This allows the ISDA Protocol to address impediments “on an **industry-wide basis** and increase **certainty, transparency, and equitable treatment** with respect to default rights of non-defaulting parties.”

II. Covered Entities

Covered Entities

- The proposed rule would apply to **covered entities**, which would include all subsidiaries of a **U.S. G-SIB**, and the **U.S. operations of a foreign G-SIB**, other than the excluded entities listed below.

	Covered Entities	Excluded Entities
U.S. G-SIBs	<ul style="list-style-type: none"> BHCs identified as global systemically important BHCs under G-SIB surcharge rule All of their subsidiaries (other than excluded entities) 	<ul style="list-style-type: none"> Subsidiaries that are covered banks*
Foreign G-SIBs	<ul style="list-style-type: none"> U.S. subsidiaries (other than excluded entities) of foreign G-SIBs U.S. branches and agencies of foreign G-SIBs (other than federal branches or agencies) 	<ul style="list-style-type: none"> All foreign entities and offices U.S. subsidiaries that are <ul style="list-style-type: none"> Covered banks* Section 2(h)(2) companies DPC branch subsidiaries

* **Covered bank** means a national bank, Federal savings association, or federal branch or agency of a foreign bank. While covered banks would be exempted from the proposed rule, the OCC is expected to propose substantively identical requirements for covered banks in the near future.

Covered Entities *(cont.)*

Determination of G-SIB Status

U.S. G-SIBs

A U.S. BHC and its subsidiaries are considered to be a **U.S. G-SIB** if the BHC is determined to be a global systemically important BHC pursuant to the Federal Reserve's capital rules relating to G-SIB surcharges (**G-SIB surcharge rule**).

Foreign G-SIBs

A top-tier foreign banking organization (**FBO**) and its subsidiaries are considered to be a **foreign G-SIB**, for the purposes of this proposed rule, if the top-tier FBO is or controls:

- A nonbank financial company supervised by the Federal Reserve;
- Any BHC with \geq \$50 billion in total consolidated assets; **or**
- Any foreign bank or company that has \geq \$50 billion in total consolidated assets and that is a BHC or is treated as a BHC under Section 8 of the International Banking Act of 1978 (**IBA**);

and

- The **FBO determines** that its group has the characteristics of a foreign G-SIB under the assessment methodology and higher loss absorbency requirement for global systemically important banks issued by the Basel Committee on Banking Supervision (**BCBS methodology**); **or**
- The **Federal Reserve**, using information available to it, **determines** that
 - The FBO would be a G-SIB under the BCBS methodology;
 - The FBO would be a G-SIB under the G-SIB surcharge rule; **or**
 - Any U.S. intermediate holding company controlled by the FBO would be a G-SIB under the G-SIB surcharge rule.

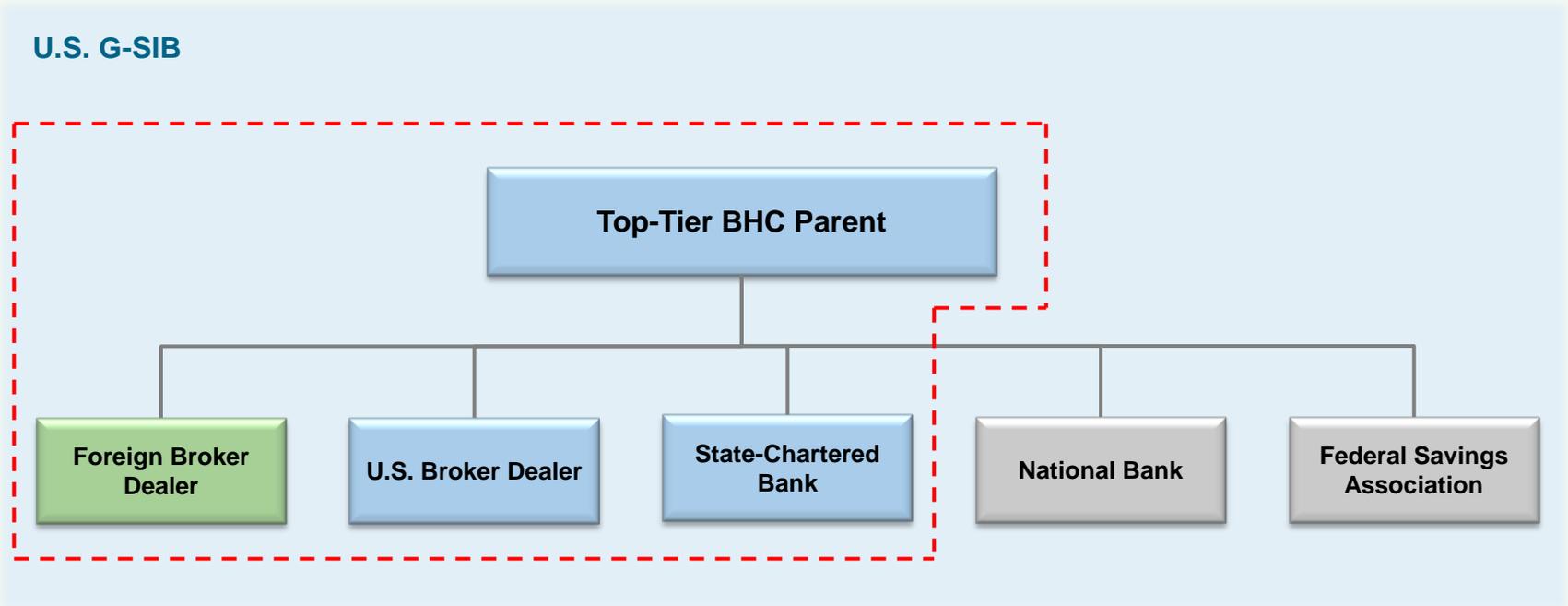
These are the categories of entities required by the Federal Reserve and the FDIC to submit resolution plans under Section 165(d) of the Dodd-Frank Act.

Both an **FBO** and a foreign company treated as a BHC under Section 8 of the IBA is a foreign bank or other company that is or controls a foreign bank that operates a branch, agency or commercial lending company subsidiary in the United States, or has a U.S. bank or Edge Act subsidiary.

The proposed rule would require each of these FBOs to provide, by January 1 of each year, notice to the Federal Reserve related to its G-SIB status.

Covered Entities (cont.)

U.S. G-SIBs*

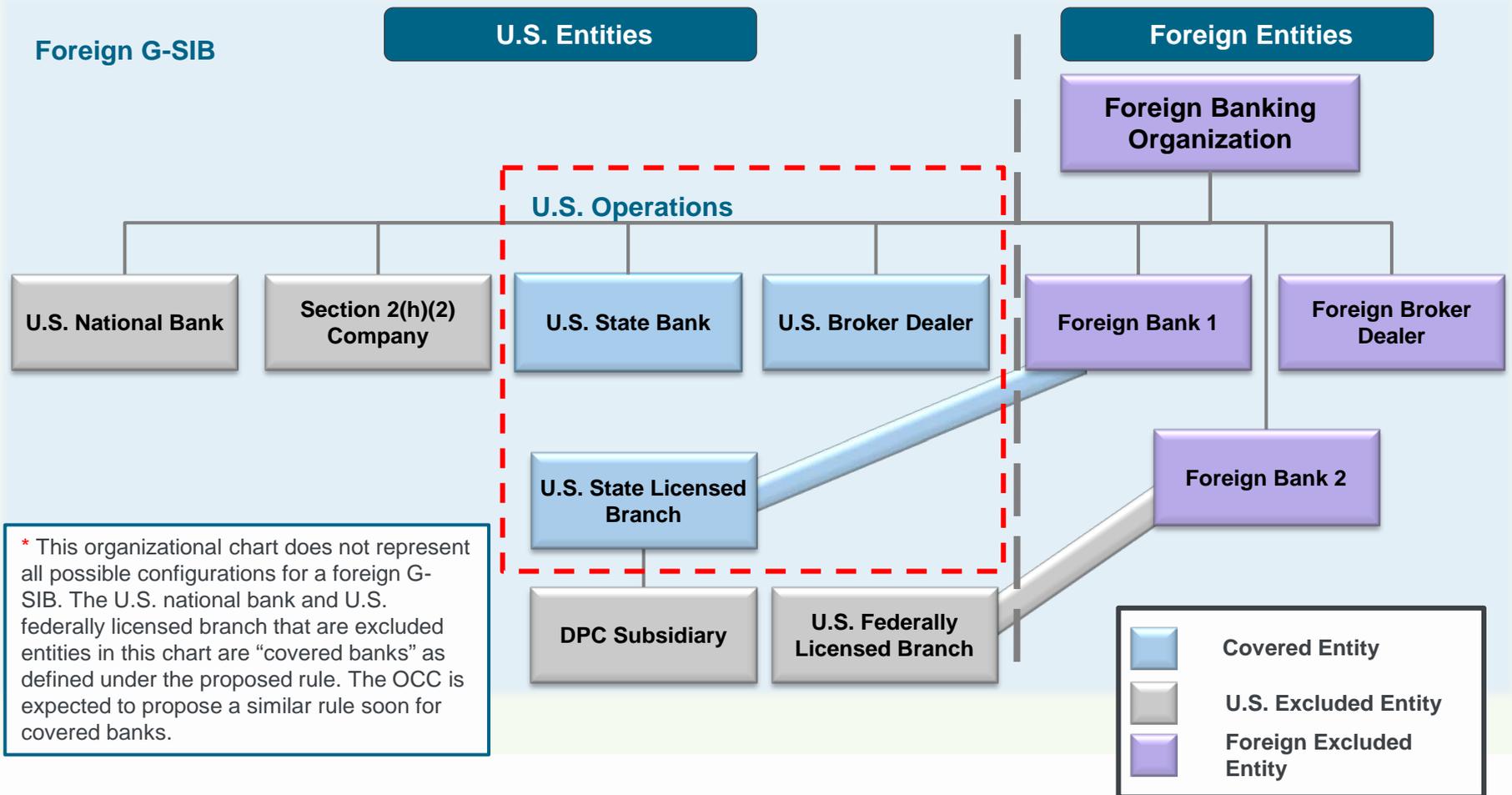


* This organizational chart does not represent all possible configurations for a U.S. G-SIB. The entities that are excluded entities in this chart are "covered banks" as defined under the proposed rule. The OCC is expected to propose a similar rule soon for covered banks.

	Excluded Entity
	Covered Entity
	Foreign Covered Entity

Covered Entities (cont.)

U.S. Operations of Foreign G-SIBs*



III. Covered QFCs

Covered QFCs

Definitions

- **Definition of QFC.** The proposed rule would define QFC by incorporating by reference Title II's definition of a **qualified financial contract (QFC)**.
 - Under Title II, a QFC includes: swaps, repo transactions, reverse repo transactions, securities lending and borrowing transactions, commodity contracts, forward agreements and guarantees of or credit enhancements related to the foregoing.
 - Because the QFC definition includes guarantees of and credit enhancements related to other QFCs, certain requirements of the proposed rule distinguish between **direct QFCs** and QFCs that are guarantees and other **credit enhancements** of direct QFCs (**credit support**).
- **Definition of Covered QFC.** The proposed rule would define covered QFC as any:
 - **New QFC** that a **covered entity** becomes a party to after the proposed rule becomes effective; and
 - **Existing QFC** that a covered entity became a party to before the proposed rule becomes effective, if the covered entity or any of its covered affiliates becomes a party to a QFC with the same counterparty or any of its affiliates after the proposed rule becomes effective.

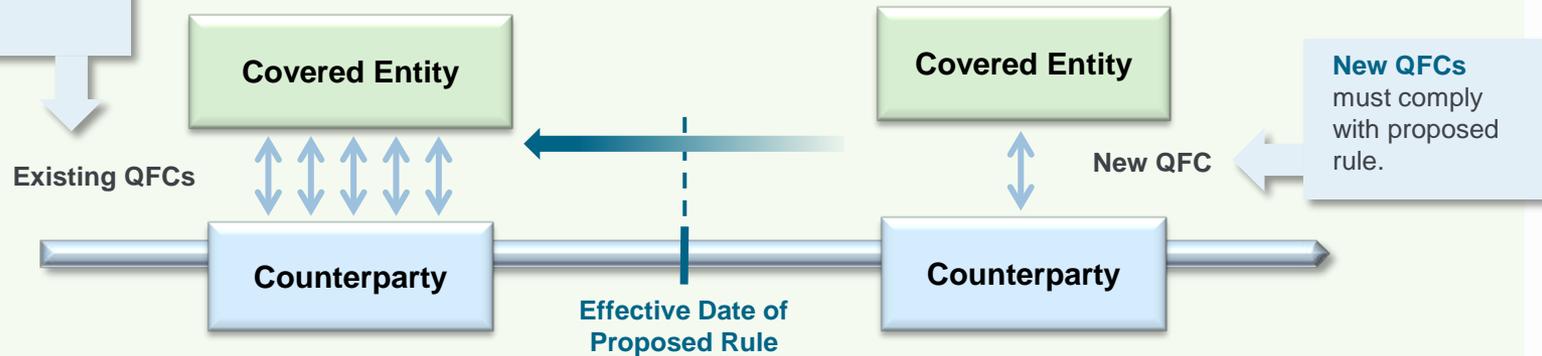
Breadth of definition. The proposed rule would apply to all QFCs, regardless of governing law. The requirements under the proposed rule would apply even if the QFC does not contain any cross-defaults, early termination provisions or anti-assignment clauses.

A **direct QFC** means a QFC that is not a credit enhancement.

Covered QFCs (cont.)

Illustration of Proposed Requirements on Covered QFCs

Existing QFCs must be amended to conform to proposed rule if, but only if, the covered entity or any of its **covered affiliates** enters into a transaction that would constitute a new covered QFC with the counterparty or any of its affiliates.

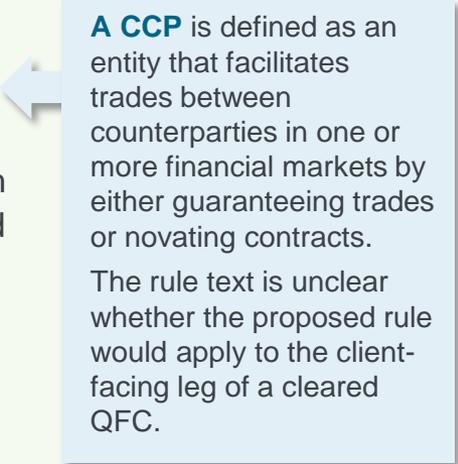


Covered QFCs *(cont.)*

Exclusions

- **Exclusions:**

- **Cleared QFCs.** Covered QFCs to which a **central counterparty (CCP)** is a counterparty would be excluded from the contractual requirements and contractual restrictions of the proposed rule.
- **Multi-branch master agreements.** Where a foreign G-SIB uses a multi-branch master agreement, a QFC for which the foreign G-SIB leg is not booked to, and payment or delivery may not be made to, a U.S. branch or agency will not be a covered QFC just because the master agreement references the foreign G-SIB's U.S. branches or agencies. Certain QFCs under multi-branch master agreements of foreign G-SIBs would not be considered to be covered QFCs. See [page 23](#).
- **Covered Banks.** Because a covered bank is excluded from the definition of covered entity, a covered bank would not be required to conform a covered QFC to the requirements of the proposed rule if the covered bank were the direct party to a direct QFC or the obligor under a guarantee or other credit support for a QFC (a **credit support provider**).



A CCP is defined as an entity that facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts. The rule text is unclear whether the proposed rule would apply to the client-facing leg of a cleared QFC.

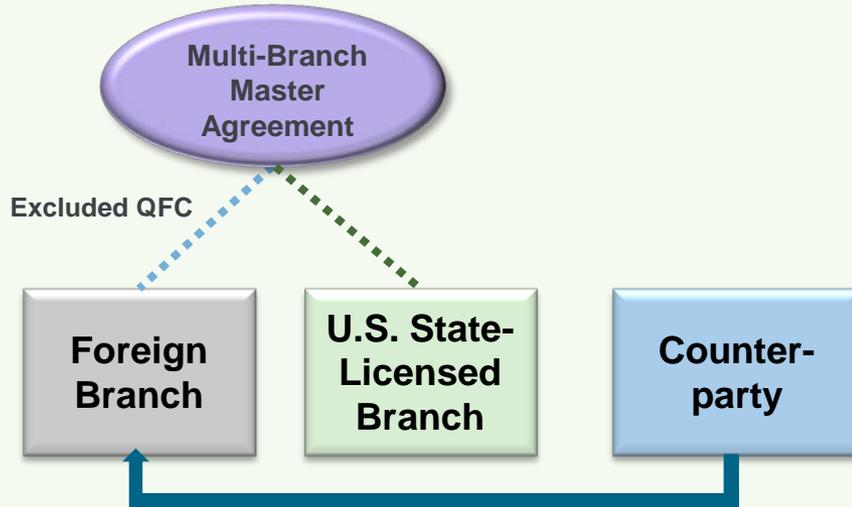
Covered QFCs (cont.)

Exclusion for Multi-Branch Master Agreements

- The purpose of this exclusion is to ensure that foreign G-SIBs will only be required to comply with the proposed rule with respect to covered QFCs that could directly affect the obligations of a covered U.S. branch or agency of a foreign bank.

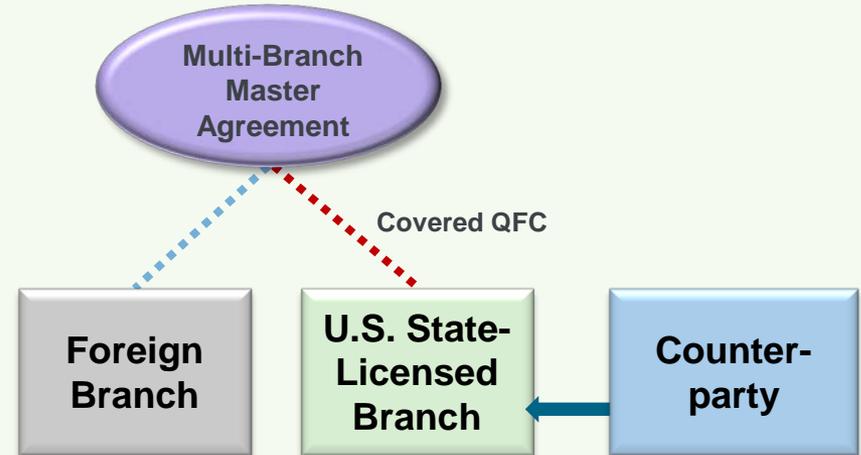
Example 1

The proposed rule would **exclude covered QFCs under a multi-branch master agreement** that are **not booked at** a covered U.S. branch and for which **no payment or delivery may be made** at the covered U.S. branch.



Example 2

The **multi-branch master agreement would be a covered QFC** with respect to covered QFC transactions that are **booked at** a covered U.S. branch or for which **payment or delivery may be made** at the covered U.S. branch.



Covered QFCs (cont.)

Acting as Agent

- The proposed rule would apply to covered QFCs regardless of whether the covered entity or the covered entity's direct counterparty is acting as a principal or as an agent.
 - **Contractual Requirements.** If the covered entity is acting as agent with respect to a covered QFC, the proposed rule's contractual requirements (see [page 26](#)) would apply where the default rights relate to the covered entity or its affiliate or the transfer relates to the covered entity.
 - **Contractual Restrictions.** If the covered entity is acting as agent on a covered QFC, the proposed rule's contractual restrictions on provisions permitting the exercise of certain cross-defaults and prohibiting certain transfers (see [page 30](#)) would apply to the extent the default rights relate to an affiliate of the covered entity and the transfer of the covered QFC relates to the covered entity.
- The Preamble also notes more generally that the contractual requirements and restrictions do not distinguish between agents and principals with respect to default rights and transfer restrictions applicable to covered QFCs.

For example, if a covered entity, acting as agent, is a direct party to a covered QFC, the proposed rule would require express contractual recognition of the limitations on default rights and transfer restrictions against the covered entity (in its capacity as agent).



The MSLA must recognize the transfer powers and restrictions under the FDI Act, with the result that the Borrower cannot terminate if the agent becomes subject to FDI Act proceedings so long as the failed Agent Bank's agent role under the MSLA is transferred to the Bridge Bank before the end of the FDI Act stay period.

IV. Contractual Requirements

Contractual Requirements

- The proposed rule would require a covered QFC to include **express recognition** of (1) the **limitations on the counterparty's exercise of default rights** and (2) the effectiveness of the **powers of the FDIC to transfer** contracts, in each case under Title II or the FDI Act. In particular, such covered QFCs would be required to **expressly provide** that:

1 Limited Exercise of Default Rights

Default rights may be exercised against the covered entity to no greater extent than would be permitted under Title II or the FDI Act if the covered QFCs were governed by U.S. law and the covered entity were in a proceeding under Title II or the FDI Act.

AND

2 Effective Transfer

The transfer of the covered QFCs from the covered entity would be effective to the same extent as it would be under Title II or the FDI Act if the covered QFC were governed by U.S. law and the covered entity were in a proceeding under Title II or the FDI Act.

Although the text of the proposed rule is somewhat ambiguous, the Preamble indicates the contractual requirements are intended to help ensure that all covered QFCs would be treated in the same way in the context of an **actual receivership** under Title II or the FDI Act.

Applies with respect to the covered QFC and any interests in and obligations under, and any property securing, the covered QFC.

The contractual requirements would apply to all covered QFCs **regardless of governing law** or the identity of the counterparty. Thus, even if a covered QFC is governed by **U.S. state or federal law**, it would need to contain the express contractual requirements. This could require amendment of a very large number of contracts.

Contractual Requirements *(cont.)*

Definition of Default Right

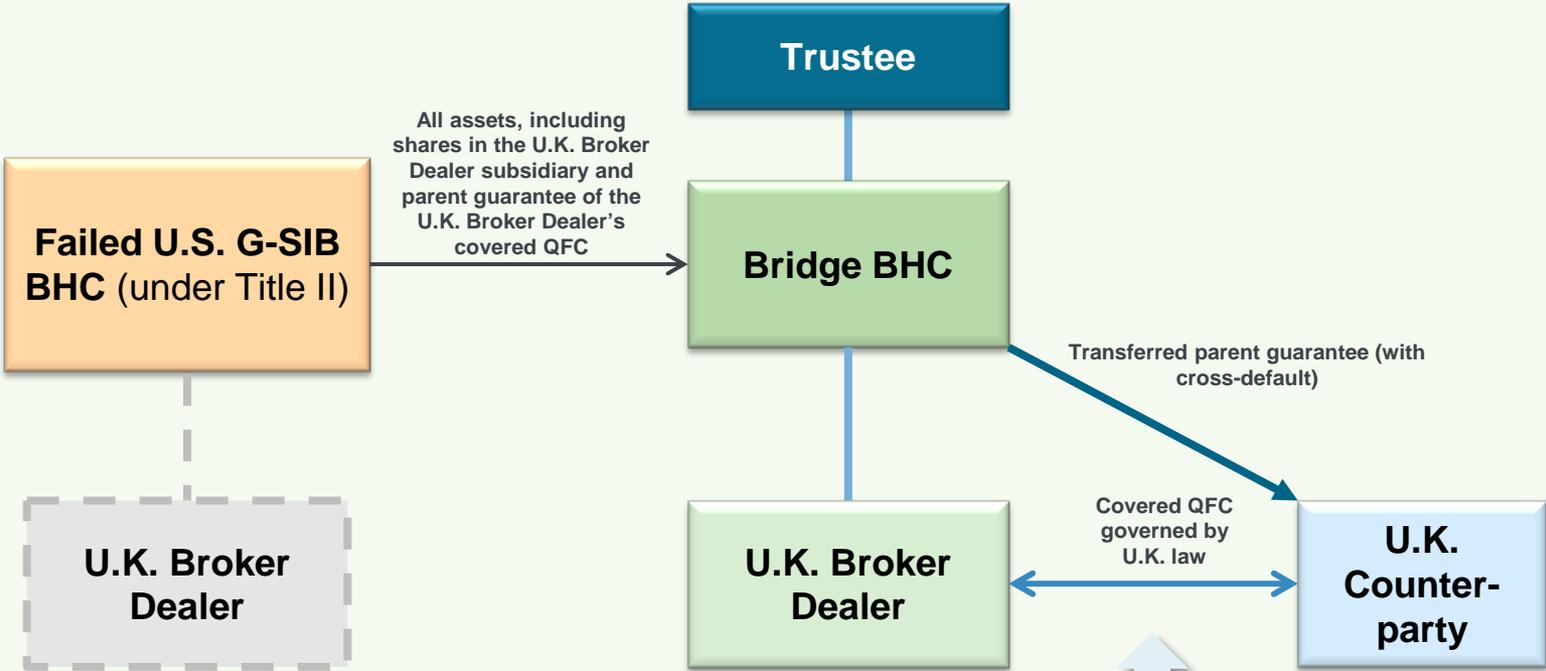
- A **default right**, with respect to a QFC, includes (for purposes of the contractual requirements) the following:
 - A right, regardless of source, including by statute, contract or common law, of a non-defaulting party to
 - **Liquidate, terminate, cancel, rescind** or **accelerate** a QFC or transactions under a QFC;
 - **Set off** or net amounts owed thereto (excluding same-day payment netting);
 - Exercise **remedies in respect of collateral** or other credit support or property related thereto (including the purchase and sale of property);
 - **Demand payment or delivery** in respect thereof (other than a right or operation of a contractual provision arising solely from a change in value of collateral or margin or a change in the amount of an economic exposure);
 - **Suspend, delay** or **defer** payment or performance thereunder;
 - **Modify** the obligations of a party thereunder; or
 - Any similar right.
 - A right or contractual provision that **alters the amount of collateral or margin** that must be provided with respect to an exposure thereunder, including by altering
 - Any initial amount;
 - Threshold amount;
 - Variation margin;
 - Minimum transfer amount;
 - Margin value of collateral; or
 - Any similar amount
- That
- Entitles a party to **demand** the **return** of any collateral or margin transferred by it to the other party;
 - That **modifies** a transferee's **right to reuse** collateral or margin (if such right previously existed); or
 - Any similar rights

In each case, **other than** a right or operation of a contractual provision arising solely from a change in the value of collateral or margin or a change in the amount of an economic exposure.

Exclusion. The definition excludes **same-day netting** and **contractual margin requirements that arise solely from a change in value** of the collateral or the amount of an economic exposure because these rights are seen as arising out of the parties' business-as-usual interactions under a QFC.

Contractual Requirements (cont.)

Example under Title II



The purpose of the contractual requirement is to help ensure that a court in a **foreign jurisdiction would enforce the effect of the stay-and-transfer provisions under Title II.**

The contractual requirements would require covered QFCs to contain provisions expressly imposing the same limits on the U.K. counterparty's rights to exercise any cross-default rights and expressly making any transfers of the parent guarantee of the covered QFCs effective, in the event the U.S. G-SIB BHC were in a Title II proceeding, to the same extent as they would be under Title II if the QFCs and related parent guarantee were governed by U.S. law.

V. Contractual Restrictions

Contractual Restrictions

General Prohibition

- **General Prohibition.** The proposed rule has **two basic prohibitions**, subject to certain **creditor protections**.

Cross-Defaults

The proposed rule would prohibit a covered QFC from permitting the counterparty to exercise any **default right** that is related, **directly or indirectly**, to an **affiliate** of the direct party **becoming subject to an insolvency proceeding**, whether domestic or foreign (**cross-default**).

Transfers

The proposed rule would prohibit a covered QFC from prohibiting the **transfer** of any **guarantee or other credit support (covered credit support)** furnished by the parent or other covered affiliate (**covered support provider**) upon the covered support provider becoming subject to an **insolvency proceeding**, **unless** the transfer would result in the counterparty benefiting from the covered credit support **in violation of any applicable laws**.

Exemption for Certain Cross-Default Rights. The general prohibition on the exercise of cross-default rights would not apply to any default right that allows a party to terminate the contract on demand or at the party's option at a specified time, or from time to time, without the need to show cause.

For example, an equity swap with optional early termination rights.

Creditor Protections

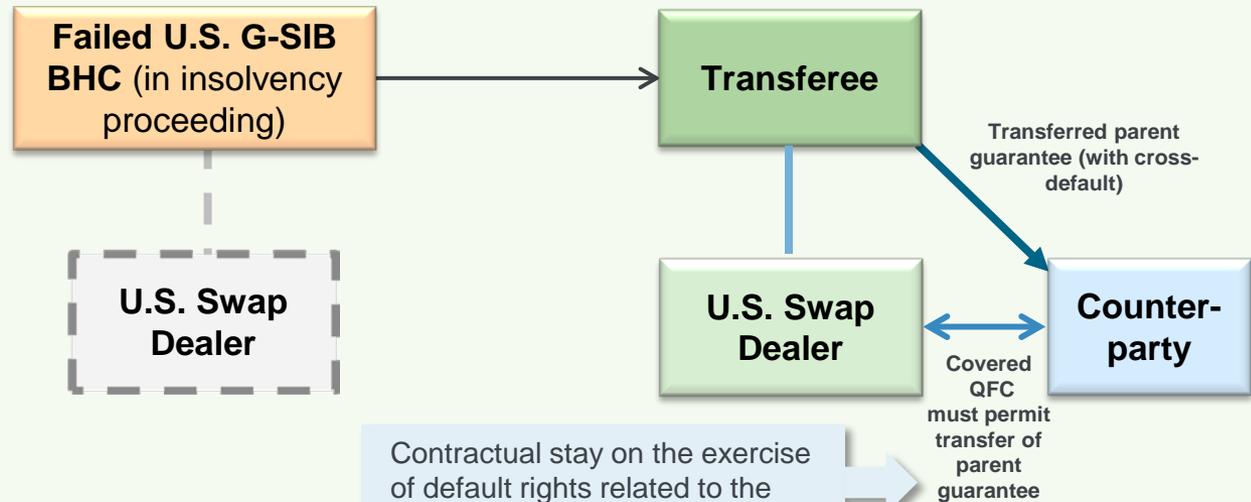
- Notwithstanding these prohibitions, the proposed rule would permit:
 - The exercise of direct default rights if there is a payment or delivery default, or the direct party enters insolvency proceedings ([page 32](#) – [page 33](#)); and
 - The exercise of cross-default rights in certain limited circumstances for supported (e.g., guaranteed) QFCs ([page 34](#) – [page 38](#)).
- In order to exercise a default right permitted by these creditor protections after an affiliate of the direct party has entered an insolvency proceeding, a counterparty bears the **burden of proof** that the exercise is permitted ([page 41](#)).
- The proposed rule provides a process for **approval of enhanced creditor protections**, if the Federal Reserve determines these protections would prevent or mitigate risks to financial stability of the United States ([page 42](#)).

Contractual Restrictions *(cont.)*

General Prohibition – Example for Transfers

Transfer Prohibition Not Permitted

The U.S. Swap Dealer's covered QFCs may not prohibit the transfer of the parent guarantee of the U.S. Swap Dealer's covered QFC upon the parent's insolvency.



Contractual Restrictions *(cont.)*

Creditor Protections – Direct Default Rights

- **Direct Default Exceptions.** Notwithstanding the proposed rule’s prohibition on a covered QFC containing a cross-default right based on an affiliate becoming subject to an insolvency proceeding, a covered QFC and related credit support may permit the immediate exercise of a default right, without the imposition of a contractual stay period, that arises as a result of:

1 Direct Party in Insolvency

The direct party itself becoming subject to an insolvency proceeding **other than** under Title II, the FDI Act, or a foreign special resolution regime that is **substantially similar**.

2 Direct Party Payment Default

The direct party’s failure to satisfy a payment or delivery obligation under the covered QFC or another contract between the same parties that gives rise to a default right under the covered QFC.

3 Credit Support Payment Default

Failure of a covered support provider (such as the parent) or a party to whom the covered credit support has been transferred (**transferee**) to satisfy a payment or delivery obligation under the covered credit support for the covered **direct QFC**.

Title II and the FDI Act generally stay direct default rights. As a result, these direct default rights would be subject to these stays if the direct party enters Title II or FDI Act resolution proceedings.

On the other hand, if the direct party becomes subject to a bankruptcy proceeding, then the QFC counterparty can exercise its direct default rights immediately.

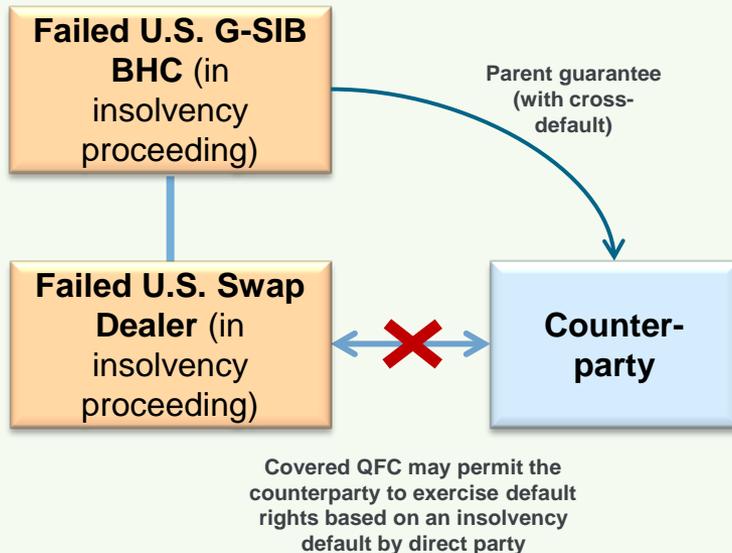
These creditor protections mean that the counterparty will continue to transact with a direct party that **remains open and operating** and that **continues to satisfy all of its payment and delivery obligations** under the QFC, including the posting of margin.

Contractual Restrictions *(cont.)*

Creditor Protections – Examples of Direct Default Rights

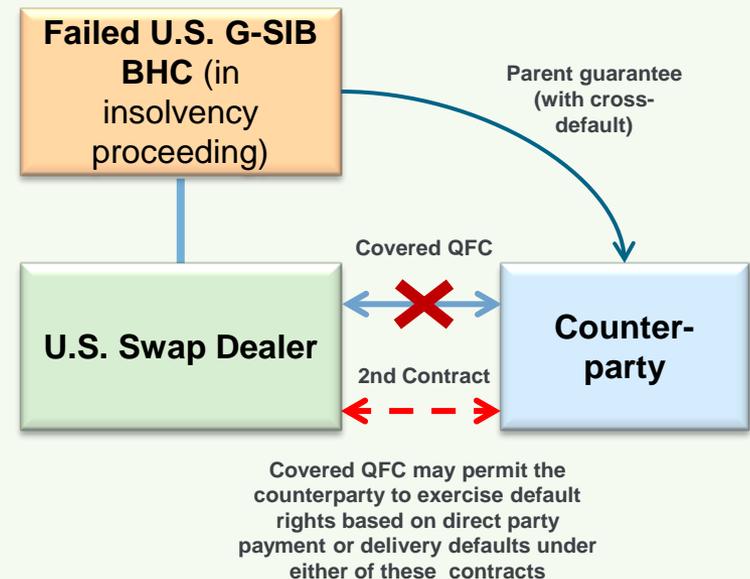
1 Direct Party in Insolvency

The U.S. Swap Dealer becomes subject to an insolvency proceeding (direct default).



2 Direct Party Payment or Delivery Default

The U.S. Swap Dealer fails to satisfy a payment or delivery obligation under the covered QFC or another contract with the covered QFC counterparty (direct party defaults).



Contractual Restrictions *(cont.)*

Creditor Protections – Supported Direct QFCs

- **Cross-Default Exceptions.** Notwithstanding the proposed rule’s prohibition on a covered QFC containing a cross-default right based on an affiliate becoming subject to an insolvency proceeding, if the covered direct QFC is supported by a guarantee or other covered credit support provided by a covered support provider, the covered QFC and related covered credit support may permit the counterparty to exercise a default right related, directly or indirectly, to the covered support provider **after a temporary stay period** in the following limited circumstances:

The **temporary stay period** is the period of time beginning when the covered support provider enters into insolvency proceedings and ending at the **later of 5:00 PM EST** on the next business day and 48 hours.

1 Covered Support Provider Insolvency

The credit support is not transferred to another entity by the end of the stay period, **and** the covered support provider (e.g., the parent) becomes subject to an insolvency proceeding **other than Chapter 11 of the Bankruptcy Code**.

2 Transferee Insolvency

The covered credit support is transferred to another entity and the transferee becomes subject to an insolvency proceeding (subject to creditor protections related to FDI Act proceedings on [page 39](#)).

3 Covered Credit Support Cherry-Picking

The covered support provider does not remain, and no transferee becomes, obligated under the covered credit support to the same, or substantially similar, extent as the covered support provider was prior to entry into insolvency proceedings, with respect to:

- The covered credit support for the supported QFC; **and**
- All other covered credit support provided by the covered support provider (e.g., the parent) for covered QFCs between the direct party and the same QFC counterparty or affiliates of the counterparty.

No cherry-picking. This provision is meant to prevent a transferee or the covered support provider from cherry-picking only those QFCs of a given counterparty that are favorable to it.

4 Partial Asset Transfer

If the covered credit support is transferred and

- All of the covered support provider’s direct and indirect ownership interests in the direct party are not transferred to the transferee, **or**
- Reasonable assurance has not been provided that substantially all of the covered support provider’s assets (excluding assets reserved for the payment of costs of administration in the proceeding) will be transferred or sold to the transferee in a timely manner.

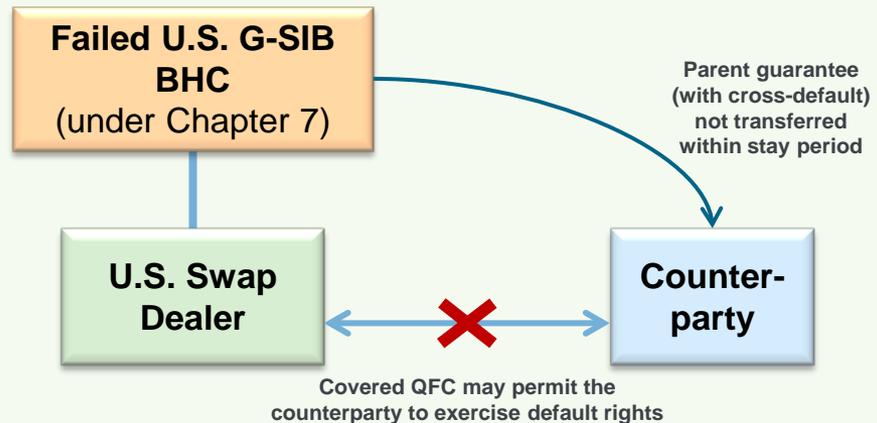
Nature of transferee. While this provision requires that substantially all of the assets of the covered support provider be transferred to the transferee, it does not impose any other requirements regarding the nature of status of the transferee.

Contractual Restrictions (cont.)

Creditor Protections – Supported Direct QFCs – Example 1

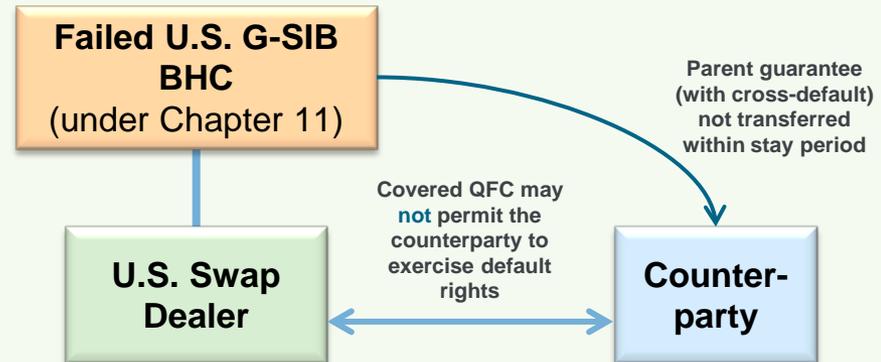
1a Covered Support Provider Insolvency

If the covered credit support is not transferred by the end of the temporary stay period, and the failed U.S. G-SIB BHC is subject to a liquidation proceeding under Chapter 7 of the Bankruptcy Code, then the covered QFC may permit the counterparty to exercise its default rights.



1b Covered Support Provider in Chapter 11

If the covered credit support is not transferred by the end of the temporary stay period, and the failed U.S. G-SIB BHC is subject to a proceeding under Chapter 11 of the Bankruptcy Code, then the covered QFC may **not** permit the counterparty to exercise its default rights.*



* So long as there is no cherry-picking of other covered QFCs between the U.S. Swap Dealer and the counterparty or the counterparty's affiliates.

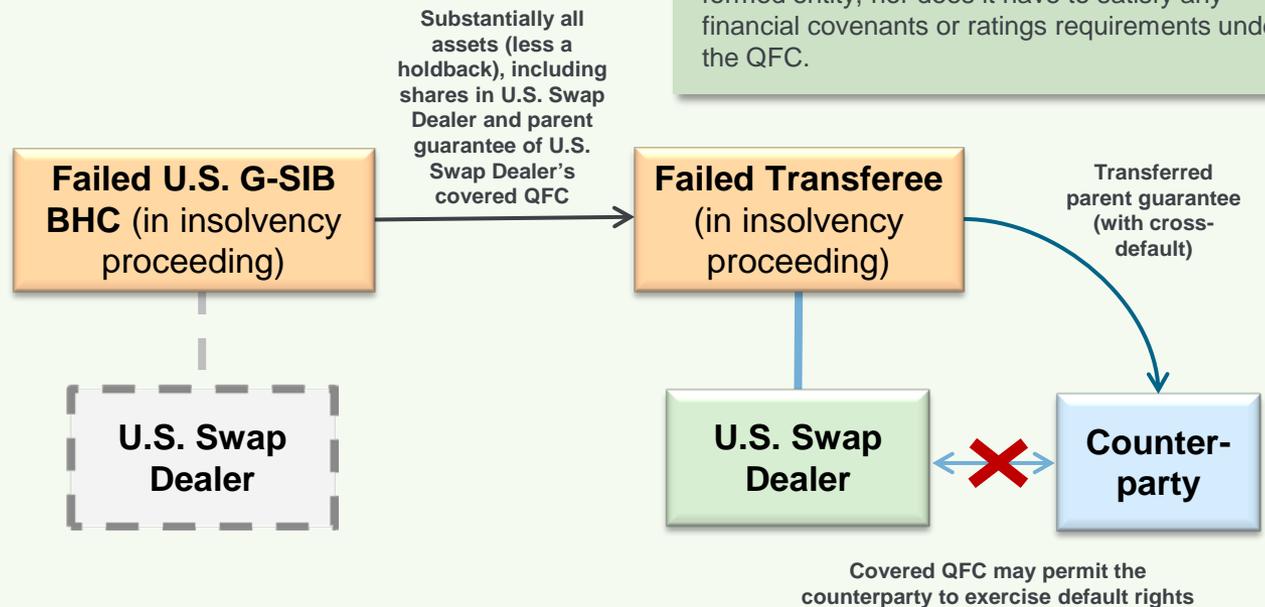
No administrative priority requirement. Unlike the ISDA Protocol, the proposed rule does not contain a requirement that the counterparty's claim under the covered credit support against the failed U.S. G-SIB BHC must be elevated to administrative priority status.

Contractual Restrictions *(cont.)*

Creditor Protections – Supported Direct QFCs – Example 2

2 Transferee Insolvency

If the parent guarantee is transferred (either to a third party or an affiliate of the covered support provider), and the transferee becomes subject to an insolvency proceeding, then the covered QFC may permit the counterparty to exercise its default rights.

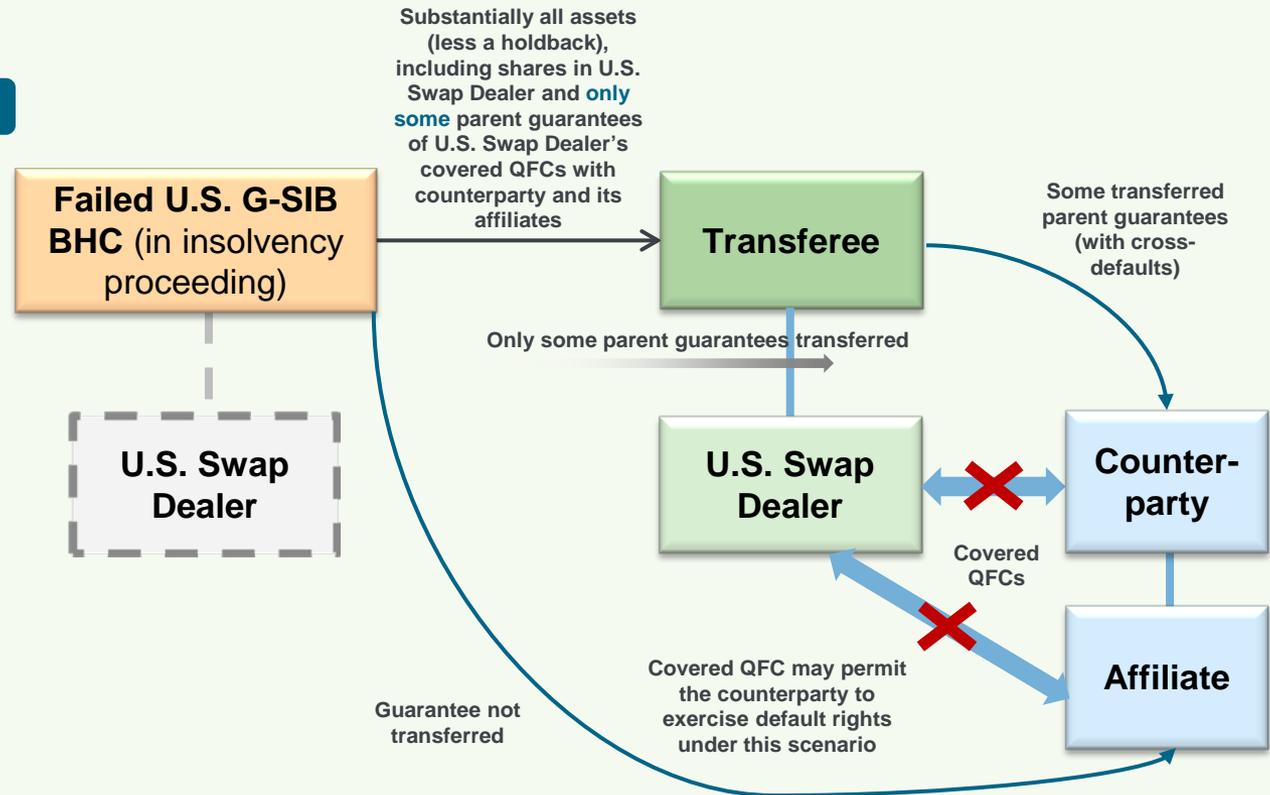


Contractual Restrictions (cont.)

Creditor Protections – Supported Direct QFCs – Example 3

3 Credit Support Cherry-Picking

If a parent guarantee of a covered QFC is transferred to a transferee, the transferee would have to become obligated to the same extent as the U.S. G-SIB BHC parent was before becoming subject to an insolvency proceeding with respect to **all of the guarantees provided by the parent** for the covered QFCs between the U.S. Swap Dealer and the counterparty **and** between the U.S. Swap Dealer and the counterparty's affiliates.



Contractual Restrictions (cont.)

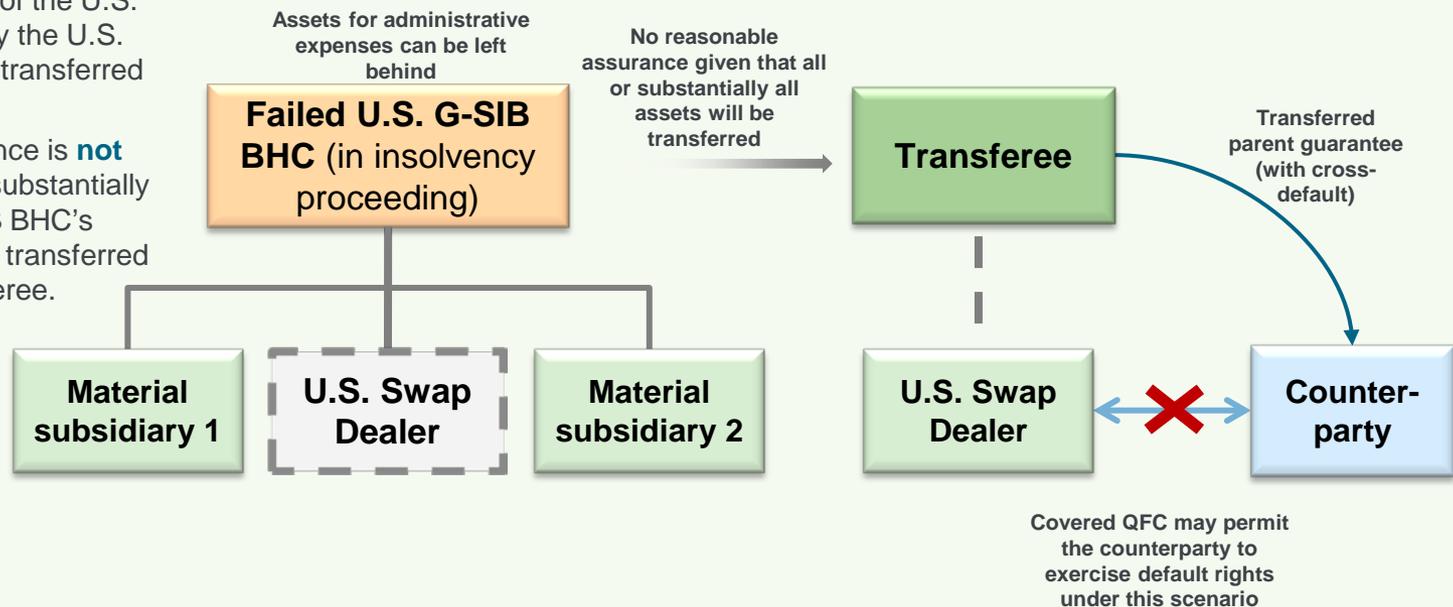
Creditor Protections – Supported Direct QFCs – Example 4

4

Partial Asset Transfer

The covered QFC may permit the counterparty to exercise its cross-default rights if:

- All of the direct and indirect ownership interests of the U.S. Swap Dealer held by the U.S. G-SIB BHC are **not** transferred to the transferee; **or**
- Reasonable assurance is **not** provided that all or substantially all of the U.S. G-SIB BHC's assets will be timely transferred or sold to the transferee.



Contractual Restrictions *(cont.)*

Creditor Protections – IDI Credit Support

- **FDI Act Proceedings.** Notwithstanding the proposed rule’s prohibition on a covered QFC containing a cross-default right based on an affiliate becoming subject to an insolvency proceeding, a covered direct QFC and related credit support may permit the exercise of a **cross-default right** related directly or indirectly to a **covered support provider that is an IDI becoming subject to an FDIC receivership under the FDI Act** in the following scenarios:

1 Failure to Transfer

After the temporary stay period under the FDI Act, if the covered IDI credit support has not been transferred to a bridge bank or third-party transferee by the end of the temporary stay period under the FDI Act.

2 Suspension of Performance Consistent with FDI Act

During the temporary stay period under the FDI Act, to the extent the default right permits the counterparty to suspend performance under the covered QFC to the same extent as the counterparty would be entitled to do under the FDI Act if it were party to a direct QFC with the covered IDI support provider.

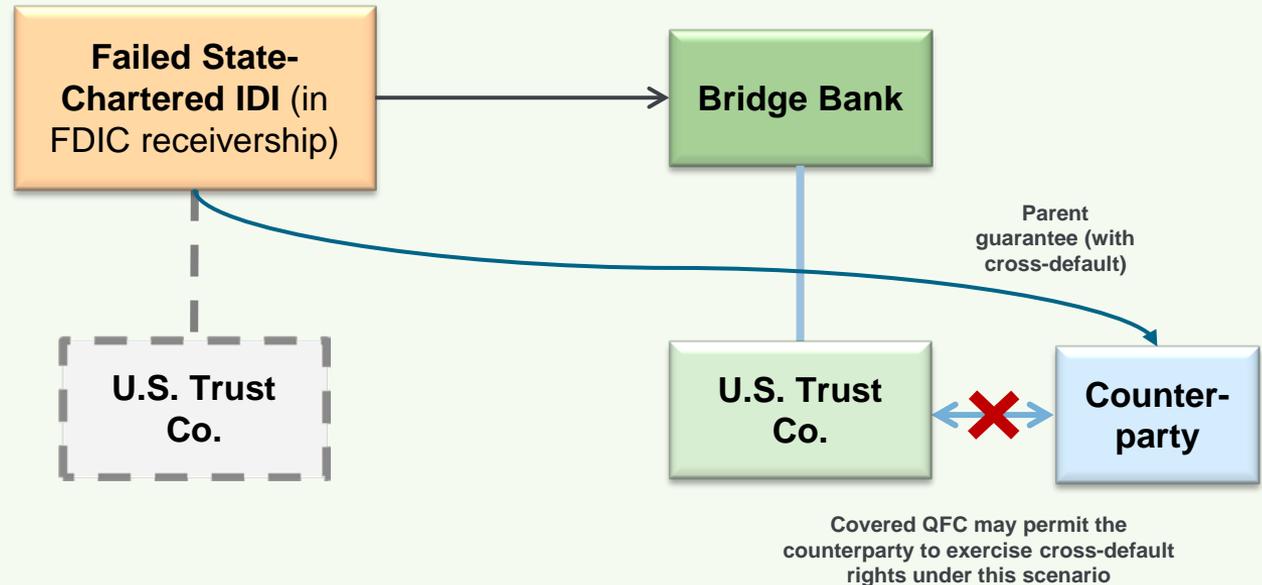
The **temporary stay period** under the FDI Act runs until **5:00 p.m. eastern on the business day** following the appointment of the FDIC as receiver.

Contractual Restrictions *(cont.)*

Creditor Protections – IDI Credit Support – Example

Failure to Transfer

If the IDI parent's guarantee of the U.S. trust company's covered QFC is not transferred to a bridge bank by the end of the temporary stay period under the FDI Act, then the covered QFC may permit the counterparty to exercise its cross-default rights based on the IDI becoming subject to an FDIC receivership under the FDI Act.



Contractual Restrictions *(cont.)*

Burden of Proof

Requirements

- A covered QFC must provide that whenever a counterparty seeks to exercise any default rights after an affiliate of the direct party becomes subject to an insolvency proceeding:

Requirement 1

The counterparty must bear the **burden of proof** that the exercise of such default rights is permitted under the covered QFC; **and**

Requirement 2

The counterparty will satisfy its burden of proof only if it establishes by “**clear and convincing**” evidence, or a similar or more demanding evidentiary standard,^{*} that the burden of proof has been met.

This requirement is meant to deter the QFC counterparty from thwarting the purpose of the proposed rule by exercising a default right based on an affiliate of the covered entity becoming subject to an insolvency proceeding **under the guise of other default rights** that are unrelated to the affiliate’s becoming subject to an insolvency proceeding.

^{*} The “similar” evidentiary standard for the burden of proof is intended to provide for the application of a similar standard in jurisdictions that do not recognize the “clear and convincing” standard.

Contractual Restrictions *(cont.)*

Enhanced Creditor Protections

- A covered entity may request that the Federal Reserve approve alternative provisions for or amendments to covered QFCs with **greater creditor protections** than allowed under the rule's creditor protection exceptions. The proposed rule enumerates **10 factors** that the Federal Reserve may consider in evaluating a proposal.
- The Federal Reserve may approve alternative credit protection provisions if the proposal, as compared to a covered QFC that complies with the contractual restrictions in the proposed rule or that is amended pursuant to the ISDA Protocol, would **prevent or mitigate risks to the financial stability** of the United States that could arise from the failure of a U.S. G-SIB or the U.S. operations of a foreign G-SIB and would **protect the safety and soundness of BHCs and state member banks** to at least the same extent.
- To support its request, the covered entity must:
 - **Provide an analysis.** The analysis of the proposed enhanced creditor protections must address each of the proposed rule's **10 listed factors**.
 - **Provide legal opinion.** The written legal opinion must verify that the proposed provisions or amendments would be valid and enforceable under applicable law of the relevant jurisdictions.
 - **Provide any other requested information.** The Federal Reserve reserves the right to request any other relevant information.

From the Preamble to the Proposed Rule:

"Creditor protections that apply broadly to a range of QFCs and covered entities would increase the chance that all of a GSIB's QFC counterparties would be treated the same way during a resolution of that GSIB and may improve the prospects for an orderly resolution of that GSIB. By contrast, proposals that would expand counterparties' rights beyond those afforded under existing QFCs would conflict with the proposal's goal of reducing the risk of mass unwinds of GSIB QFCs."

The first two factors concern the potential impact of the requested creditor protections on G-SIB resiliency and resolvability.

The next four factors concern the potential scope of the proposal:

- Whether "the set of conditions or the mechanism in which they are applied facilitates, on an industry-wide basis, contractual modifications to remove impediments to resolution and increase market certainty, transparency, and equitable treatment...";
- Coverage of existing and future transactions;
- Coverage of multiple forms of QFCs or multiple covered entities; and
- Whether it would permit adherence with respect to only one or a subset of covered entities.

The next three factors focus on the impact of requested creditor protections for QFC counterparties that benefit from covered credit support.

The last factor is whether the proposed enhancement provides the counterparty with additional default rights or other rights.

The considerations enumerated in the proposed rule suggest there will be a **high bar** for approval of any proposed alternative with enhanced creditor protections, unless it operates on an industry-wide basis.

VI. Alternative Compliance through ISDA Protocol

Alternative Compliance through ISDA Protocol

- The proposed rule allows covered entities to **comply with its provisions by adhering to the ISDA Protocol** (covering all QFCs) instead of amending each QFC bilaterally to comply with its contractual requirements and contractual restrictions.

Section 1 of the ISDA Protocol: amends agreements to contractually opt into certain qualifying special resolution regimes

Section 2 of the ISDA Protocol: introduces stays and overrides default rights directly or indirectly related to an affiliate entering into certain U.S. insolvency proceedings.

Contractual Requirements of the Proposed Rule

Contractual Restrictions of the Proposed Rule

Relationship with Section 1 of the ISDA Protocol. Although the proposed rule does not expressly state that amendment by way of adhering to the ISDA Protocol would also satisfy the contractual requirements of the proposed rule, the operative provisions of this section of the proposed rule are substantially similar to those contained in Section 1 of the ISDA Protocol. Therefore, it would appear that adhering to the ISDA Protocol should also satisfy the contractual requirements of the proposed rule.

- The ISDA Protocol largely tracks the requirements of the proposed rule, but there are some notable differences:
 - The **scope of the cross-defaults overridden** under the ISDA Protocol is **narrower** than under the proposed rule.
 - The ISDA Protocol contains **enhanced creditor protections**.
- The next few pages provide some highlights of the differences between the ISDA Protocol and the cross-default provisions of the proposed rule. See [Appendix: Comparison to ISDA Protocol Section 2](#) for more details.
- Under Section 2 of the ISDA Protocol, adhering parties limit their default rights only against covered entities or covered banks. Default rights against adhering parties that are not covered entities or covered banks are not affected.

ISDA is in the process of drafting the **ISDA Jurisdictional Modular Protocol**, which will eventually include a module for the United States. The Preamble to the proposed rule indicates that a “jurisdictional module for the United States that is **substantively identical** to the 2015 Protocol,” aside from exempting QFCs with parties that are not covered entities or covered banks, would be consistent with this proposed rule.

Comparison to Section 2 of the ISDA Protocol

Key Differences in Creditor Protections

ISDA Protocol

Proposed Rule

If parent guarantor is in bankruptcy and guarantee is not transferred:

- ✓ Court must issue order elevating guarantee claims to administrative priority status.
- ✓ Court order must also authorize parent to perform under the guarantee and allow default rights to be exercised if direct party or parent materially breaches the covered QFC or related guarantee.
- ✓ Court order must also allow default rights to be exercised if direct party fails to pay a close-out amount owed to any other covered QFC counterparty and parent fails to satisfy its guarantee obligations with respect to such covered QFC.

- No comparable requirement.
- No comparable requirement.
- No comparable requirement.

If parent guarantor is in bankruptcy and guarantee is transferred:

- ✓ Transferee must be newly formed entity not controlled by bankruptcy estate of the parent or must be an unaffiliated third party that satisfies any contractual requirements with respect to ratings or other financial covenants.
- ✓ Transferee must satisfy all material payment and delivery obligations to each of its creditors during the stay period.
- ✓ Court order authorizing the transfer of all or substantially all of the assets of parent (or the net proceeds thereof), less a holdback for administrative expenses, to the transferee as soon as practicably possible must be entered by the end of the stay period.

- No comparable requirement.
- No comparable requirement.
- No court order required, only reasonable assurances that all or substantially all of the assets of parent (or the net proceeds thereof), less a holdback for administrative expenses, will be transferred to the transferee in a timely manner.

Comparison to Section 2 of the ISDA Protocol *(cont.)*

Key Differences in Creditor Protections

ISDA Protocol

Proposed Rule

Conditions with respect to direct party

- ✓ Following the temporary stay period, the direct party must continue to be duly registered and licensed with the principal regulatory bodies having jurisdiction over its business related to covered QFCs

- No comparable requirement.

Scope of cross-default rights subject to override or prohibition (subject to creditor protection conditions)

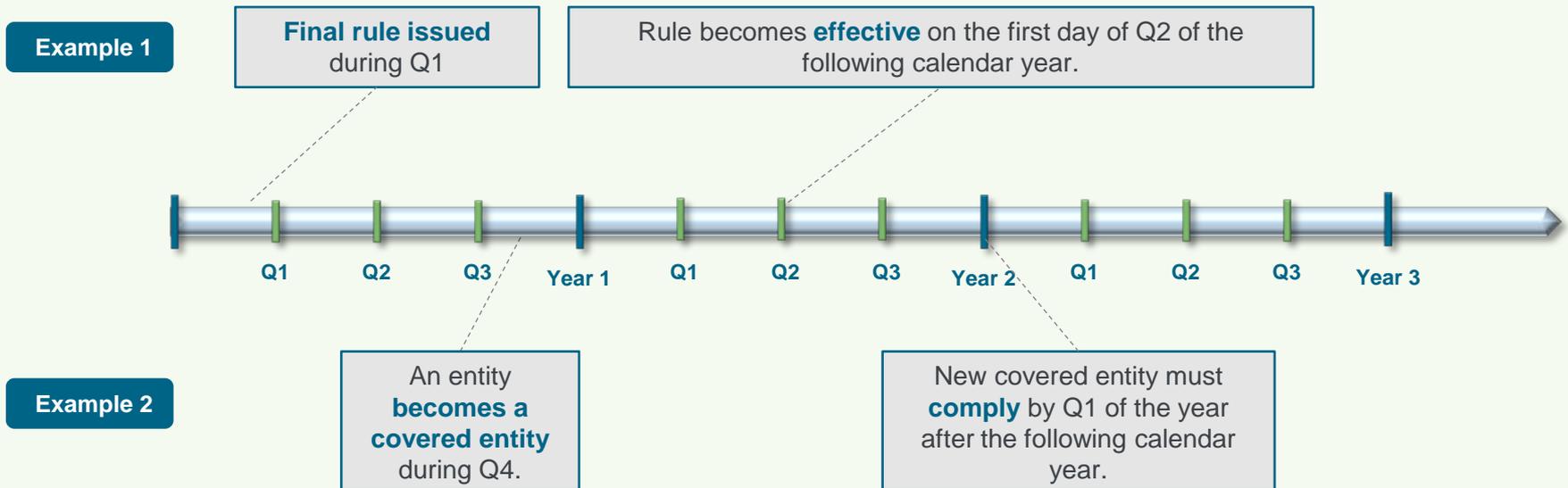
- ✓ Only default rights with respect to a covered QFC that are related directly or indirectly to an affiliate of the direct party becoming subject to insolvency proceedings under Chapter 11 or Chapter 7 of the Bankruptcy Code, SIPA or the FDI Act are overridden.
- ✓ Default rights with respect to a covered QFC that are triggered by an affiliate becoming subject to foreign insolvency proceedings would not be overridden unless this occurs after the U.S. parent has entered into Chapter 11 proceedings.

- Default rights with respect to a covered QFC that are related directly or indirectly to an affiliate of the direct party becoming subject to any insolvency proceedings, whether domestic or foreign, are prohibited.
- Default rights with respect to a covered QFC that are triggered by an affiliate at any time becoming subject to foreign insolvency proceedings are prohibited.

VII. Transition Period

Effective Dates and Transition Rules

- **Effective date.** The proposed rule would take effect on the **first day of the calendar quarter** that begins at least **one year after issuance** of the final rule.
- **New covered entities.** An entity that becomes a covered entity after the final rule is issued would be required to comply by the first day of the calendar quarter that begins at least one year after it becomes a covered entity.

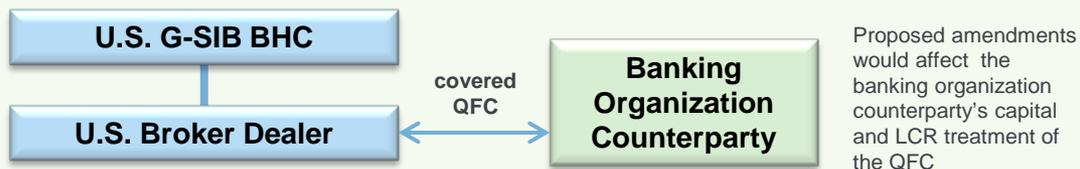


VIII. Amendments to Definitions in Board's Capital and Liquidity Rules

Amendments to Definitions in the Board's Capital and Liquidity Rules

- The proposed rule would make **technical amendments** to certain definitions in the Federal Reserve's capital and liquidity coverage ratio (**LCR**) rules related to the recognition of **netting agreements** and **collateral**.
- Under the Federal Reserve's **capital rules**, a banking organization is permitted to recognize, for the purpose of calculating its own capital requirements, the risk-mitigating benefits of **financial collateral** and **netting agreements** for certain collateralized transactions, provided that the relevant agreements provide the banking organization with certain enforceable **default rights**.
- **Absent these amendments**, for a QFC counterparty that is itself a banking organization subject to the Federal Reserve's capital and LCR rules, a covered entity's compliance with the general prohibitions under the proposed rule would deny the banking organization counterparty the benefits of netting and collateral recognition for its own capital and LCR requirements.

Benefits of Netting and Collateral Recognition: Recognizing netting and collateral arrangements for capital purposes generally reduces the amount of capital that banking organizations must maintain against the credit risk of repo and securities lending and borrowing transactions, margin loans and OTC derivatives. Banking organizations can also net derivatives cash inflows and outflows under netting agreements for LCR purposes.



- The Federal Reserve stated that that this treatment (absent any amendments) would **not accurately reflect the risk** posed by the affected QFCs, since the implementation of consistent restrictions on default rights in G-SIB QFCs would increase the prospects for the orderly resolution of a failed G-SIB and thereby protect U.S. financial stability.

Amendments to Definitions in the Board's Capital and Liquidity Rules *(cont.)*

- **General “No-Stay” Requirement:** Under the relevant definitions, banking organizations can generally only recognize collateralized transactions and netting agreements where the banking organization’s rights to the collateral or under the netting agreements **cannot be stayed or avoided** under applicable law in the event of the counterparty’s default, including the counterparty’s bankruptcy.
- The existing capital and LCR rules also provide for **exceptions** to this general “no-stay” requirement to accommodate certain **restrictions on default rights** that are important to the prudent resolution of the counterparty, including a **limited stay under a special resolution regime** such as Title II, the FDI Act and comparable foreign resolution regimes.
- The proposed rule would amend the relevant definitions to **extend the no-stay exceptions** to accommodate the restrictions on certain default rights required under the proposed rule.
- As amended, the no-stay exceptions would permit restrictions where the banking organization’s relevant **default rights**—that is, the rights to accelerate, terminate and close-out on a net basis all transactions under the related collateral or netting agreement and to liquidate or set off collateral promptly upon an event of default of the counterparty—are **limited to the extent necessary to comply** with the proposed rule’s general prohibitions on cross-defaults and transfers.

Definitions Amended: The proposed rule would amend the following defined terms in the Federal Reserve’s capital rules:

- Collateral agreement;
- Eligible margin loan;
- Qualifying master netting agreement; and
- Repo-style transaction.

The proposed rule would also amend the definition of qualifying master netting agreement in the LCR rule.

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Appendix: Comparison to ISDA Protocol Section 2

Appendix: Comparison to ISDA Protocol Section 2

Topic	ISDA Protocol Requirements	Proposed Rule Requirements
<p>General Prohibition on Cross-Default Rights</p>	<p>Default rights related directly or indirectly to an affiliate of the direct party becoming subject to U.S. insolvency proceedings under Chapters 7 or 11 of the Bankruptcy Code, SIPA or the FDI Act are not exercisable.</p>	<p>Default rights related directly or indirectly to an affiliate of the direct party becoming subject to any insolvency proceeding, including a foreign proceeding.</p>
<p>Creditor Protection Exception – Direct Default Rights</p>	<p>A counterparty may still exercise direct default rights when:</p> <ul style="list-style-type: none"> • The direct party becomes subject to insolvency or resolution proceedings (other than special resolution regimes subject to the contractual recognition provisions of Section 1 of the ISDA Protocol); • The direct party fails to satisfy a payment or delivery obligation under the QFC; or • The covered support provider, e.g., parent or affiliate guarantor, fails to satisfy a payment or delivery obligation under the covered credit support. 	<p>As described on page 32, a counterparty may exercise substantially similar direct default rights.</p>
<p>Creditor Protection Exception – Cross-Default Rights for Supported QFCs</p>	<p>Default right overrides apply only if the insolvency proceedings to which the covered support provider has become subject are Chapter 11 proceedings (or, in the case of an covered support provider that is an IDI, a proceeding under the FDI Act).</p>	<p>As described on page 34 and page 35 the proposed rule has a substantially similar requirement.</p>

The ISDA Protocol does not prohibit the exercise of cross-defaults related to an affiliate's **foreign insolvency proceedings** unless the U.S. parent first enters U.S. insolvency proceedings. The scope of domestic proceedings covered under the proposed rule is also broader.

Comparison to ISDA Protocol Section 2 *(cont.)*

Topic	ISDA Protocol Requirements	Proposed Rule Requirements
<p>Stay Conditions if Covered Credit Support is Not Transferred</p>	<p>By the end of the stay period, the bankruptcy court must enter the following:</p> <ul style="list-style-type: none"> An order providing that the parent remains obligated with respect to the covered credit support and all covered contracts between the direct party and the counterparty, as well as all covered contracts between the direct party and the counterparty’s affiliates, to the same extent as prior to the proceeding. 	<p>Substantially similar, except the proposed rule refers to the “same or similar extent” and no court order is required.</p>
	<ul style="list-style-type: none"> An order elevating claims under the guarantee or other credit support to administrative priority status. 	<p>No comparable requirement.</p>
	<ul style="list-style-type: none"> An order authorizing the parent to perform its obligations under the covered credit support and allowing the counterparty to terminate its covered contract with the direct party without court approval if the direct party or the parent support provider fails to meet any of its material obligations to the counterparty under the covered contract or related covered credit support. 	<p>No comparable requirement.</p>
	<ul style="list-style-type: none"> An order authorizing the counterparty to exercise its default rights if there has been a close-out of a covered contract between the same direct party (i.e., the same operating subsidiary) and another stayed counterparty, and the direct party fails to pay the close-out amount thereunder when due and the parent support provider also fails to satisfy its obligations when due under any related covered credit support. 	<p>No comparable requirement.</p>

The **stay period** has the same definition under both the ISDA Protocol and the proposed rule.

Comparison to ISDA Protocol Section 2 *(cont.)*

Topic	ISDA Protocol Requirements	Proposed Rule Requirements
<p>Stay Conditions if Covered Credit Support is Transferred</p>	<p>The transferee must be either:</p> <ul style="list-style-type: none"> • A bridge company established for the purpose of being a transferee of the assets of the parent in Chapter 11 proceedings, which is not controlled by the bankrupt parent’s estate; or • An unaffiliated third party that would be required to satisfy any ratings conditions or other financial covenants applicable to the covered support provider under the contract. 	<p>No comparable requirement.</p>
	<p>The transferee must satisfy all material payment and delivery obligations to each of its creditors during the stay period.</p>	<p>No comparable requirement.</p>
	<p>By the end of the stay period, the bankruptcy court must have issued an order providing for the transfer or sale to the transferee of all or substantially all of the assets of the covered support provider (or the net proceeds thereof), minus a holdback for the costs of administering the estate, “as soon as practicably possible.”</p>	<p>No court order required, but the counterparty may exercise its default rights after the stay period if reasonable assurances were not provided that all or substantially all of the assets of the covered support provider (or the net proceeds thereof), minus a holdback for the costs of administering the estate, will be transferred or sold to the transferee in a timely manner. See page 34 and page 38.</p>
	<p>All of the direct and indirect ownership interests held by the covered support provider in the direct party must be transferred to the transferee by the end of the stay period.</p>	<p>As described on page 34 and page 38, the proposed rule has a substantially similar requirement.</p>
	<p>All of the covered credit support for the supported contracts between the counterparty and the direct party and between the counterparty’s affiliates and the direct party must be transferred to the transferee by the end of the stay period.</p>	<p>As described on page 34 and page 37, the proposed rule has a substantially similar requirement.</p>

Comparison to ISDA Protocol Section 2 *(cont.)*

Topic	ISDA Protocol Requirements	Proposed Rule Requirements
	<p>If the transferred credit support is secured, the transferee must comply with all provisions regarding attachment, enforceability, perfection and priority of the security interest.</p>	<p>No comparable requirement.</p>
	<p>The transferee must not be in insolvency or resolution proceedings.</p>	<p>As described on page 34 and page 36, the proposed rule has a substantially similar requirement.</p>
<p>Direct Party Must Remain Duly Licensed</p>	<p>Following the stay period, the direct party must be and remain duly registered and licensed with the same regulatory agencies that have principal supervisory authority over the relevant business.</p>	<p>No comparable requirement.</p>
<p>Creditor Protection Exception – Cross-Default Rights Under FDI Act Proceedings</p>	<p>If the covered support provider is an IDI, and the covered credit support is transferred to a bridge company or other transferee pursuant to the FDI Act, the counterparty is subject to the same default right limits as if it were party to a direct QFC with the IDI.</p>	<p>As described on page 39, the proposed rule has a substantially similar requirement.</p>

Comparison to ISDA Protocol Section 2 (cont.)

Topic	ISDA Protocol Requirements	Proposed Rule Requirements
<p>Burden of Proof</p>	<p>For the counterparty to exercise a default right, it must prove by clear and convincing evidence that the default right is not related, directly or indirectly, to an affiliate becoming subject to U.S. insolvency proceedings.</p>	<p>As described on page 41, the proposed rule requires that a covered QFC must provide that, after an affiliate of the direct party enters insolvency proceedings, the party seeking to exercise a default right must bear the burden of proof, by clear and convincing evidence or a similar or higher burden of proof, that the exercise of the default right is permitted under the covered QFC.</p>
<p>Transfer Restrictions</p>	<p>Contractual rights prohibiting the transfer of covered credit support are overridden.</p>	<p>As described on page 30 and page 31, the proposed rule has a substantially similar requirement.</p>

The ISDA Protocol's application is narrower than the proposed rule here. The proposed rule also applies this burden of proof to **direct default rights**, unlike the ISDA Protocol.