GIBSON DUNN

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DERIVATIVES END-USER'S GUIDE TO THE QFC RESOLUTION STAY REQUIREMENTS

To Our Clients and Friends:

Last year, the Board of Governors of the Federal Reserve System[1], the Federal Deposit Insurance Corporation ("FDIC")[2], and the Office of the Comptroller of the Currency[3] issued final rules (collectively, the "U.S. Rules") requiring globally systematic banking organizations ("G-SIBs") in the United States and their subsidiaries, as well as all U.S. operations of non-U.S. G-SIBs (each, a "Covered Entity")[4] to include in their qualified financial contracts ("QFCs")[5] language that provides for contractual stays on early termination rights. By now, most buy-side counterparties to QFCs, including corporates and other non-financial end-users (collectively, "End-User Counterparties") have been contacted by their Covered Entity counterparties with a request to amend their QFCs by January 1, 2019 to include contractual language so that the Covered Entities can comply with the U.S. Rules.

This Alert provides a brief background on the U.S. Rules from an End-User Counterparty's perspective, reviews the impacts of the U.S. Rules on End-User Counterparties and highlights practical considerations for End-User Counterparties. If you have any questions regarding this Gibson Dunn Alert, please contact a member of the Derivatives Team.[6]

I. Background

The economic dislocation in 2008, and in particular the Lehman Brothers failure, highlighted the interconnectedness of the world's financial systems. As a result, the Financial Stability Board and home country regulators focused on ways to minimize the impact of a G-SIB failure on the global financial system. Regulators in the world's financial centers urged G-SIBs to adopt modifications to their existing and future derivatives (and similar) contracts that would limit End-User Counterparty termination rights (e.g., cross-default and direct default rights) in the event of a resolution or bankruptcy of the G-SIB or one of its affiliates. Regulators believe that unfettered early termination rights make it more difficult for a G-SIB to pass through a bankruptcy or resolution proceeding, as a rush to terminate in the event of failure has significant knock-on complications.

Titles I and II of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act")[7] provided U.S. regulators with new tools to effect the orderly resolution of G-SIBs. One of those tools requires each G-SIB to prepare and submit to U.S. regulators a resolution plan commonly referred to as a "living will" that outlines the steps it would take for a rapid and orderly resolution of the G-SIB under the U.S. Bankruptcy Code in the event of material financial distress or failure. Title II of the Dodd-Frank Act enacted a special resolution regime, known as the Orderly Liquidation Authority ("OLA"), which authorizes the appointment of the FDIC as a receiver to carry out the liquidation of large

and complex financial institutions should an orderly resolution under the U.S. Bankruptcy Code not be feasible (the "U.S. Special Resolution Regime").

For more than 25 years, market participants have used ISDA Master Agreements to memorialize and govern the rights and responsibilities for their over-the-counter derivatives transactions. Under these standardized agreements, non-defaulting parties have generally had a right to designate an "Early Termination Date" in respect of an "Event of Default" by the other party or by other "Specified Entities,"[8] which typically includes affiliates who may or may not be "Credit Enhancement Providers."[9] An Event of Default thus includes a bankruptcy or resolution of the direct counterparty (i.e., a direct default) and also the bankruptcy or resolution of any of the "Specified Entities" or "Affiliates" (i.e., a cross-default).[10]

Such early termination rights generally provide the non-defaulting party with the ability to close out its relationship with the defaulting counterparty as well as its relationship with any affiliates of the defaulting counterparty. Following an Event of Default, and the occurrence of an Early Termination Date, either automatically or by designation by the non-defaulting party, the obligation to make further payments or deliveries in respect to the transactions governed by the ISDA Master Agreement will end. Instead, there will be an obligation to pay a close-out amount, calculated as provided in the ISDA Master Agreement.

A filing under the U.S. Bankruptcy Code generally does not impact the ability to exercise early termination and close-out rights. The U.S. Bankruptcy Code generally exempts QFCs (which term includes ISDA Master Agreements) from application of the automatic stay; this means that non-defaulting parties can, notwithstanding the filing of a case under the U.S. Bankruptcy Code by the defaulting counterparty or one of its Specified Affiliates, enforce an Event of Default and exercise close-out rights without the requirement to obtain any approval from the bankruptcy court.

By contrast, the U.S. Special Resolution Regime does not incorporate such provisions—non-defaulting counterparties are subject to a stay period before enforcing termination rights, or exercising close-out rights, arising from the insolvency of a Covered Entity or a specified affiliate and, if certain conditions are satisfied, they may be permanently prevented from exercising such rights.

a. The U.S. Rules

The primary objectives of the U.S. Rules are to address the threat to financial stability posed by existing default rights under QFCs and to enable the resolution of G-SIBs in a controlled manner. The U.S. Rules seek to accomplish these objectives by requiring two amendments (discussed below) to the QFCs between a Covered Entity or any of a Covered Entity's affiliates that are also Covered Entities (collectively, a "Covered Entity Group") and an End-User Counterparty or any of the End-User Counterparty's consolidated affiliates (collectively, an "End-User Group"). Under the U.S. Rules, a Covered Entity will no longer be able to execute a QFC with an End-User Counterparty without violating those rules unless all QFCs between each entity in the Covered Entity Group and all relevant entities in the End-User Group are amended.

The first required amendment under the U.S. Rules addresses the uniformity of treatment between parties that opt-in to the relevant provisions of a resolution regime and parties that are subject to the law of the jurisdiction of the resolution regime because it is the governing law of the contract. To reduce the risks that courts in foreign jurisdictions would disregard the U.S. Special Resolution Regime provisions that stay an End-User Counterparty's rights under QFCs with Covered Entities due to a foreign governing law provision, the amendment effectively requires the End-User Counterparty to opt in to the U.S. Special Resolution Regime. The opt-in mechanic of this first amendment is similar to what is required under the resolution stay rules that were passed in other jurisdictions (e.g., UK, Switzerland, Japan, Germany, etc.).

The second amendment under the U.S. Rules is unique to the United States in that it restricts the ability of End-User Counterparties to exercise certain cross-default rights under QFCs. Specifically, this amendment subjects an End-User Counterparty's cross-default rights to a mandatory stay where a parent or affiliate acting as Credit Enhancement Provider to a Covered Entity counterparty's obligations under a QFC goes into insolvency proceedings (i.e., under the U.S. Bankruptcy Code), notwithstanding that the Covered Entity counterparty may still able to make payments and perform under the QFC, (i.e., the Covered Entity is not itself insolvent). Additionally, the second amendment requires an End-User Counterparty to agree that if a Covered Entity affiliate that is not a Credit Enhancement Provider goes into an insolvency, such End-User Counterparty's cross-default rights resulting from that Covered Entity affiliate's insolvency are permanently stayed with respect to the QFC with the direct Covered Entity counterparty. Effectively, this provides for a full override of the "Specified Entity" defaults in the ISDA Master Agreement. The goal of this second amendment is to facilitate "the resolution of a large financial entity under the U.S. Bankruptcy Code and other resolution frameworks by ensuring that the counterparties of solvent affiliates of the failed entity cannot unravel their contracts with the solvent affiliate based solely on the failed entity's resolution."[11]

b. Amending QFCs – Timing

The U.S. Rules mandate that if a Covered Entity enters into a QFC with an End-User Counterparty on or after January 1, 2019 (the "Trigger Date"), then all of the QFCs between the Covered Entity Group and the End-User Group must incorporate the required amendments effective as of the relevant "compliance date." The U.S. Rules provide staggered compliance dates that determine when the U.S. Rules actually become effective for different types of counterparties as follows: (a) for QFCs between Covered Entities – January 1, 2019; (b) for QFCs between Covered Entities and "financial counterparties" – July 1, 2019; and (c) for QFCs between Covered Entities and any other type of counterparty – January 1, 2020. This means that if an End-User Counterparty's QFCs are fully performed, terminated or otherwise unwound prior to the relevant compliance date for such End-User Counterparty, those QFCs would not be subject to the U.S. Rules and would not need to be amended. Further, to the extent End-User Counterparties adhere to the ISDA Protocol (discussed below) or agree to a bilateral amendment in advance of the appropriate compliance date, such amendment would likely not become effective until the appropriate compliance date. Therefore, End-User Counterparties could retain their current default rights under the ISDA Master Agreement until their respective required compliance dates regardless of when such counterparties actually amend their QFCs.

From a practical perspective, however, the staggered compliance dates are unlikely to deter Covered Entities from requiring that all relevant amendments to QFCs be put in place between the End-User Group and the Covered Entity Group by no later than January 1, 2019 or the first date thereafter on which the relevant Covered Entity enters into a new QFC with any member of the End-User Group. In other words, Covered Entities are incentivized to amend all of their QFCs irrespective of the compliance dates because entering into a new QFC after January 1, 2019 without all of the required amendments in place could potentially expose the Covered Entity Group to regulatory and business risks (e.g., the risk that an End-User Counterparty that triggers the U.S. Rules' requirements will not agree to amend its QFCs by the relevant compliance date). To remove such risks, Covered Entities have been seeking to have all amendments to QFCs in place prior to January 1, 2019, regardless of a particular counterparty's compliance date.

c. Amending QFCs – Protocol Adherence or Bilateral Amendment?

There are two ways that an End-User Counterparty can amend its QFCs with Covered Entities. End-User Counterparties can either adhere to the ISDA 2018 U.S. Resolution Stay Protocol as published by the International Swaps and Derivatives Association Inc. (the "ISDA Protocol")[12] or bilaterally amend its QFCs to comply with the U.S. Rules' contractual requirements and restrictions (ISDA has also published forms of bilateral amendments).[13] The ISDA Protocol is an "all to all" method whereby all of an entity's QFCs with all Covered Entities that have adhered to the ISDA Protocol are amended. In the case of End-User Counterparties, the ISDA Protocol is essentially a global amendment to the terms of all QFCs between the End-User Counterparty and every Covered Entity that also adheres to the ISDA Protocol. The ISDA Protocol would require an adhering party to "opt in" to the special resolution regimes of France, Germany, Japan, Switzerland and the United Kingdom (which have all finalized their resolution stay rules) in addition to the U.S. Special Resolution Regime. Accordingly, the process would make the amendment process easy by allowing the End-User Counterparty to adhere to the ISDA Protocol one time in order to address all requests from all Covered Entities for the End-User Counterparty to amend its QFCs in accordance with the U.S. Rules.

In contrast, under a bilateral amendment process, the counterparties can agree (on a group-by-group basis) to amend their QFCs that are affected by the U.S. Rules. A bilateral amendment would not require an "opt in" to the special resolution regimes of France, Germany, Japan, Switzerland and the United Kingdom, although counterparties in those jurisdictions will likely request this nonetheless. Further, under a bilateral amendment, the parties can agree not to amend QFCs that do not need to be amended to be brought into compliance.

It is important to note that the ISDA Protocol and the bilateral amendments would only amend QFCs and would only be applicable to the End-User Counterparty that is the adhering party. All affiliates that have entered into QFCs with Covered Entities would each need to separately amend those QFCs. Further, the ISDA Protocol only becomes effective upon the appropriate compliance date for the adhering party (notwithstanding when the entity actually adheres to the ISDA Protocol). Bilateral amendments would need to be reviewed and negotiated to ensure the scope and timing of compliance are appropriate.

Although the ISDA Protocol generally tracks the requirements of the U.S. Rules, there are a few differences relating to creditor enhancement provisions and certain default rights in the ISDA Protocol as compared to a bilateral amendment that would track the U.S. Rules directly. The ISDA Protocol tracks the terms of the ISDA 2015 Universal Stay Protocol (which was published before the U.S. Rules) and provides a safe harbor from certain of the U.S. Rules. This variation both aligns with the preference of prudential banking regulators for ISDA Protocol adherence and incentivizes End-User Counterparties to adhere. In particular, under the ISDA Protocol provides that an End-User Counterparty only waives its rights to exercise remedies under a QFC due to an affiliate of its direct Covered Entity counterparty entering insolvency proceedings under Chapter 7 or 11 of the U.S. Bankruptcy Code or proceedings under the Securities Investor Protection Act, as amended, or Federal Deposit Insurance Act. However, a bilateral agreement has a much broader scope, because an End-User Counterparty would have to waive such rights if the affiliate of its direct Covered Entity counterparty enters into any insolvency proceeding (including non-U.S. insolvency proceedings).

Additionally, under the U.S. Rules and a bilateral amendment approach, if an End-User Counterparty seeks to exercise a default right in respect of a QFC with a Covered Entity counterparty, it must demonstrate by "clear and convincing evidence" or a similar or higher burden of proof that the right to exercise such default right is permitted under the U.S. Rules. Meeting such a standard could be difficult to prove depending on the facts and circumstances. The ISDA Protocol similarly requires the stayed party to have the burden of proof to establish by clear and convincing evidence that a default right may be exercised with respect to the QFC; however, the ISDA Protocol, unlike a bilateral amendment, makes clear that default rights related to performance defaults may be exercised without meeting such burden of proof. For example, under the ISDA Protocol a stayed party could exercise its default rights in the event that its direct counterparty fails to perform (i.e., make payments) at any time; however, under a bilateral amendment, a stayed party would need to establish by clear and convincing evidence that the performance default is not related to an affiliate of the direct party becoming a party to U.S. proceedings, etc. Accordingly, under the bilateral amendment, there is a broader scope of scenarios where this heightened burden of proof may be applicable compared to the ISDA Protocol.

II. Impact on End-User Counterparties

Below are two examples to illustrate the practical implications of the U.S. Rules for End-User Counterparties.

EXAMPLE 1: Bank X (which is a Covered Entity) enters into a QFC with Company A on January 2, 2019. Entering into this QFC on or after January 1, 2019 triggers the requirements of the U.S. Rules. As a result, the following QFCs between Bank X and Company A would need to be amended:

i. the January 2, 2019 QFC between Company A and Bank X;

ii. all existing and future QFCs between Company A and Bank X;

iii. all existing and future QFCs between Company A and any Bank X affiliate that is a Covered Entity; and

iv. all existing and future QFCs entered into by any consolidated affiliate of Company A and Bank X or any Bank X affiliate that is a Covered Entity.

This means that in order to enter into this new QFC with Bank X, Company A and all of Company A's affiliates on the same consolidated financial statements must either:

i. adhere to the ISDA Protocol; or

ii. bilaterally amend all QFCs with Bank X and all of Bank X's affiliates (since all the Bank X affiliates are Covered Entities).[14]

EXAMPLE 2: Company A enters into a 10-year interest rate swap with Bank X (a U.S. bank) on December 20, 2018. On January 2, 2019, Company A's affiliate Company B enters into a 5-year interest rate swap with Bank X's affiliate, Broker Dealer Y (a U.S. broker dealer).

Company A's entry into the 10-year interest rate swap with Bank X does not trigger the U.S. Rules because it is entered into before January 1, 2019. If neither Company A nor its affiliates entered into any QFCs with Bank X or its affiliates after January 1, 2019, Company A would, under the U.S. Rules, retain its existing early termination and cross-default rights with respect to the 10-year interest rate swap.

However, Company B's entry into the interest rate swap with Broker Dealer Y after January 1, 2019 would trigger the U.S. Rules for all of Company B's consolidated affiliates, including Company A, with respect to all existing and future QFCs with any consolidated Broker Dealer Y affiliate, including Bank X. Accordingly, it would:

(i) Require Company B either to enter into the ISDA Protocol or enter into a bilateral amendment for all QFCs with Bank X, Broker Dealer Y and all of their consolidated affiliates. This would subject the Company B interest rate swap and all other QFCs with Broker Dealer Y's affiliates to the contractual stay provisions beginning on July 1, 2019 or January 1, 2020, as appropriate.

(ii) Require Company A and all other consolidated affiliates to enter into the ISDA Protocol or enter into a bilateral amendment for all QFCs with Bank X, Broker Dealer Y and all of their consolidated affiliates. This would subject the Company A 10-year interest rate swap and all other QFCs with Bank X and its affiliates to the contractual stay provisions beginning on July 1, 2019 or January 1, 2020, as appropriate.

III. Conclusions and Considerations

Although the U.S. Rules do not impose direct obligations on End-User Counterparties to QFCs with Covered Entities, those End-User Counterparties that seek to continue to trade QFCs with Covered Entities will face certain indirect requirements and effects. Specifically, End-User Counterparties must amend their QFCs with Covered Entities by either (i) adhering to the ISDA Protocol or (ii) negotiating bilateral amendments with their Covered Entity counterparties. Once effective, these amendments will limit an End-User Counterparty's existing cross-default rights under an ISDA Master Agreement (and other types of QFCs) with Covered Entities.

At this time, the consequences of the U.S. Rules on the marketplace are unclear as there is little precedent to assist in interpretation and negotiation. There appear to be divergent views in the marketplace. While it is true that an End-User Counterparty's cross-default rights are limited under the U.S. Rules, some argue that such limitations on early termination rights will likely protect End-User Counterparties by decreasing the chances of a systemic failure and, given the creditor safeguards, decrease the likelihood that an End-User Counterparty would suffer an unanticipated loss due to the failure of a Covered Entity. On the other hand, others have argued that the U.S. Rules could cause market participants to shy away from a vulnerable entity thereby further increasing the likelihood of failure of that entity and End-User Counterparties could face potential exposure during the stay period in the event the resolution proceedings do not work out as planned. In any event, credit, pricing and risk determinations will continue to evolve as the market adapts to the U.S. Rules and a "new normal" will result.

In the meantime, End-User Counterparties should be sure to coordinate an approach for amending their QFCs (particularly if the affiliates are controlled by different treasury centers or boards). Additionally, because adherence to the ISDA Protocol is a universal amendment, End-User Counterparties will want to identify each outstanding QFC to which it is a party with a Covered Entity in order to evaluate the extent to which their default rights may be restricted under those QFCs.

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[1] 12 C.F.R. §§ 252.2, 252.81-88; *see also*, Restrictions on Qualified 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. 42,882 (Sept. 12, 2017).

[2] 12 C.F.R. §§ 382.1-7.

[3] 12 C.F.R. § 47.1-8.

[4] The following U.S. banking institutions have been identified as G-SIBs: Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley, State Street, and Wells Fargo. The following foreign banking institutions have been identified as G-SIBs: 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 Canada, Santander, Société Générale, Standard Chartered, Sumitomo Mitsui FG, UBS, and Unicredit Group.

[5] The definition of QFC is expansive and includes a broad range of transactions including, but not limited to, derivatives, repurchase, reverse repurchase and securities lending transactions. *See* 12 U.S.. § 5390(c)(8)(D).

[6] https://www.gibsondunn.com/practice/derivatives/

[7] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[8] The standard terms of Section 6(a) of the 1992 and 2002 ISDA Master Agreement (some of which are capitalized in this alert) provide parties to a derivatives transaction the right to terminate following an "Event of Default" (as such term is defined in the ISDA Master Agreement). Specifically, this provision notes that if "Automatic Early Termination" has been selected in the ISDA Schedule, then upon the occurrence of certain defaults, including bankruptcy-related events, an "Early Termination Date" is deemed to have automatically occurred immediately before such event. In other circumstances, an Event of Default gives the non-defaulting party the right to terminate the agreement and trigger the close-out, netting and setoff provisions therein by designating an Early Termination Date.

[9] A Credit Enhancement Provider is a party that provides credit enhancement or support in respect of an ISDA Master Agreement entered into by another party. Credit enhancement or support can take the form, among others, of a guarantee, pledge of collateral, letter of credit, transfer of margin or any similar arrangement, in each case only to the extent such credit enhancement relates to the ISDA Master Agreement. The definition of "Credit Enhancement Provider" is found in the ISDA Protocol (as defined below).

[10] *See* Section 5(a)(vii) of the 1992 or 2002 ISDA Master Agreement.

[11] 82 Fed. Reg. at 42,883.

[12] The text of the ISDA Protocol is *available at* https://www.isda.org/a/CIjEE/3431552_40ISDA-2018-U.S.-Protocol-Final.pdf.

[13] Each affiliate that is a separate legal entity that has QFCs with a covered entity will need to separately adhere to the ISDA Protocol or enter into a bilateral amendment. ISDA has published four different form of bilateral amendments as well as model language that an entity can use to amend its QFCs with respect to a particular covered entity and its affiliates. The form of bilateral amendments are *available at* https://www.isda.org/a/vrCEE/US-Stay-Regulations-Bilateral-Amendments.pdf.

[14] There is no requirement that all of Company X's affiliates amend their QFCs in the same way; however, if some affiliates choose a bilateral amendment while others choose the ISDA Protocol, they could have different rights and be in a different position with respect to their rights against a QFC with the same party.

The following Gibson Dunn lawyers assisted in preparing this client update: Arthur Long, Jeffrey Steiner, Carl Kennedy and Erica Cushing.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Derivatives or Business Restructuring and Reorganization practice groups, or the following:

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