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Special Resolution Regimes and the ISDA Resolution Stay Jurisdictional Modular Protocol

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COMING SOON TO YOUR INBOX: A POLITE REQUEST TO LIMIT YOUR REMEDIES UNDER DERIVATIVES, REPOS, AND OTHER FINANCIAL CONTRACTS

In the coming weeks and months, investment companies, pension plans, and other buy-side participants (for simplicity, "Funds") in swaps, repos, securities loans, or other financial contracts will be asked by their dealer counterparties to adhere to one or more Modules of the recently promulgated ISDA Resolution Stay Jurisdictional Modular Protocol (the "JM Protocol") and, thereby, to amend some or all of their financial contracts with those dealers and their affiliates. In some cases, those requests will come to Fund sub-advisers or other agents who are responsible for only a portion of the relevant Fund's trading but whose responses could in many cases bind the Fund as a whole.

ISDA launched the JM Protocol and the first of what will be several country-specific Modules thereunder, the ISDA UK (PRA Rule) Jurisdictional Module (the "UK Module"), on May 3. On the same day, the Federal Reserve Board promulgated a proposed rule (the "FRB Proposed Rule") that, when finalized, will be reflected in a U.S. Module to the JM Protocol. On June 28, ISDA published its German JM Protocol Module, and French, Swiss, and Japanese Modules are expected to follow (not necessarily in that order) in the relatively near future.

Funds (or their advisers or other agents) will be told – correctly! – that adherence to one or more JM Protocol Modules, or at least entering into bilateral agreements having substantially the same effect, is a governmentally mandated condition to their continued ability to transact with those dealers. Doing so, however, will restrict the Funds' ability to terminate transactions and exercise other contractual remedies, such as enforcing rights to collateral, due to certain insolvency- or financial condition-related defaults. And it will involve making choices that are likely to implicate the fiduciary duties of the Funds' investment adviser and its directors or trustees. Hence, it is important for Funds to understand the effects of the JM Protocol and its various Modules and to have an appropriate, internal process for determining how to proceed.

This Alert will discuss the available choices and their implications. In doing so, it will outline what the JM Protocol and its various Modules are, why they have or will come to exist, what contracts are being affected and some of the effects adherence will have on a Fund's rights under those contracts.

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The JM Protocol – Where It Came From and What It Does

For many years, parties to swaps, repos, securities loans, and other qualified financial contracts ("QFCs") have benefited from safe harbors from the automatic stay of lien enforcement and closeout netting rights that normally apply to creditors under applicable insolvency laws. Such safe harbors exist under the U.S. Bankruptcy Code and allow Funds to terminate their outstanding QFCs immediately upon the insolvency of their counterparty or its guarantor and to set off their claims for the amount owed to them under those QFCs against the value of any collateral they are holding. Similarly, various European and other insolvency laws permit Funds to exercise such termination and set-off rights Funds immediately upon a counterparty's insolvency.

The US safe harbors were adopted based on the view that QFCs are essential to the health of the financial markets and that insulating parties to those transactions from the risks of market fluctuations following a counterparty's insolvency promotes national interests. In the wake of the 2008 financial crisis, however, that view began to change. Financial regulators in the U.S. and other G-20 countries were given enhanced powers under special resolution regimes ("SRRs") designed to address potentially imminent failures of global systemically important banking organizations ("G-SIBs"). Those powers can be exercised even before there is an insolvency.

Those special resolution powers include the ability to suspend or "stay" the termination rights and remedies of any party to a contract with the failing or endangered institution or, in certain cases, to a contract with subsidiary of that institution, for a brief period pending a "resolution" in which the regulator would transfer some or all of the G-SIB's assets and related liabilities to creditworthy entities or liquidate the G-SIB in an orderly manner, in each case without the infusion of taxpayer funds. Regulators can also permanently stay solvency-related termination rights and remedies following a transfer of the QFCs as part of the resolution.

In the U.S., the Dodd-Frank Act created an SRR in the form of the Orderly Liquidation Authority ("OLA"), which was patterned in part on the bank receivership provisions in the Federal Deposit Insurance Act. In Europe, SRRs have been created pursuant to the EU Bank Recovery and Resolution Directive ("BRRD"). Pursuant to recommendations by the Financial Stability Board, similar SRRs are being implemented in key non-European jurisdictions, such as Japan.

But while a given regulator's "resolution stay" powers plainly could be enforced within its home jurisdiction, it is not certain that they would be enforced by foreign courts with respect to contracts governed by foreign laws. And regulators' experience during the financial crisis with Lehman Brothers and others, whose operations were conducted globally through a plethora of affiliates, made clear that the effectiveness of any jurisdiction's resolution powers could be seriously undermined if foreign courts would not enforce those stays.

The most obvious (and traditionally, necessary) way to ensure that a home authority's resolution stays would be honored would be for legislatures in the other jurisdiction to adopt laws subjecting parties within their jurisdictions to the special resolution regimes imposed in other jurisdictions. But legislative solutions can be difficult and time-consuming to obtain. Consequently, the prudential regulators opted for a mandated contractual approach.[1]

[1] In Europe, this contractual approach is expressly called for by Article 55 of the BRRD. However, there is no such statutory mandate under the Dodd Frank Act. Rather, the FRB ties its

Under implementing regulations or laws (collectively, "Stay Regulations") such as the UK PRA's final rule on "contractual stays in financial contracts governed by third-country law," the German Recovery and Resolution Act, and the FRB Proposed Rule, G-SIBs and in some cases other financial institutions that are, or that have subsidiaries that are, regulated under the home jurisdiction's law are or soon will be prohibited from entering into covered financial contracts except under agreements whereby the buy-side party subjects itself to the same limitations on the exercise of default rights and related remedies as would apply if those contracts were governed by the home jurisdiction's law. The scope of the covered contracts and covered parties differs under each jurisdiction's rules, but that is the basic requirement.

The JM Protocol and its various Modules are designed to be a one-stop shopping means of amending existing Fund agreements in order to opt-in to the related SRRs and thereby incorporate the contractual provisions mandated by each. But compliance could also be achieved through bilateral agreements.

Each JM Protocol and Module set forms a buy-side version of the ISDA 2015 Universal Resolution Stay Protocol and its 2014 swaps-only predecessor, which were intended to cover only agreements entered into between dealers. But while the Universal Protocol causes adherents to opt-in to all SRRs worldwide that satisfy certain criteria, the JM Protocol Modules involve opting-in to only a single SRR. Hence, each dealer will be asking Funds to adhere to the Module or Modules relating to the SRRs to which it or its parent holding company may be subject.

<u>How the JM Protocol and Its Modules Work</u>

The JM Protocol, together with a specific Module, constitutes a single unit to which Funds and their dealer counterparties may adhere. Funds can do that by executing an adherence letter that specifies the Module for the relevant jurisdiction, identifies the Fund as a "Module Adhering Party," and, through a notice mechanism, designates the sell-side counterparties ("Regulated Entities" that, once so designated, are "Regulated Entity Counterparties") whose existing agreements with the Fund ("Covered Agreements") are being amended. Sell-side parties adhere in substantially the same manner except that they must attest that they are "Regulated Entities" for purposes of the relevant SRR and except that their adherence automatically relates to all Module Adhering Parties who designate them as Regulated Entity Counterparties. This adherence process would need to be repeated for each Module to which the Fund adheres.

The form of adherence letter presents Funds with three choices regarding the sell-side entities that will become their Regulated Entity Counterparties under the relevant Module: "All Regulated Entities," "All G-SIBs," and "Entity-by-Entity."

> -- By choosing the "All Regulated Entities" option, a Fund would be agreeing to amend all of its Covered Agreements with all adhering parties that are subject to regulation under the relevant SRR. Typically, these are banks and broker-dealers organized or operating within the jurisdiction and at least some of their subsidiaries, but the scope can (and based upon the FRB Proposed Rule, probably will) differ significantly from jurisdiction to jurisdiction.

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authority for the proposed rule to DFA §165, which it says "instructs the Board to impose enhanced prudential standards on [large] bank holding companies," and "authorizes the Board to establish 'such other prudential standards as [it] … determines are appropriate.'"

-- By choosing the "All G-SIBs" option, a Fund would be agreeing to amend all of its Covered Agreements only with those Regulated Entities within the meaning of the Module that have been determined to be G-SIBs under the relevant Stay Regulations. Depending on the Module and the relevant Stay Regulations, this may be either a static or a dynamic list.

-- By choosing the "Entity-by-Entity" option, a Fund would be agreeing to amend all of its Covered Agreements only with those Regulated Entities that the Fund specifies either by using ISDA Amend or by separately notifying those entities.

The decision as to which of these options to choose is consequential and, as discussed below, is likely to have fiduciary implications.

How the Modules Differ

The JM Protocol Modules are intended to reflect – and, for the most part, track – the requirements set forth in the Stay Regulations for the jurisdiction to which they relate. Indeed, the style of the Modules is to express the limitations that would be imposed on a Fund's default rights by cross-referencing the terms of, and incorporating terminology that is defined in, the related Stay Regulations. This ensures that (except as to retrospectivity, as discussed below) the limitations agreed to under the Module are those required to be imposed under the relevant Stay Regulations. But it also means that the Module itself cannot be fully understood except by understanding what the Stay Regulations themselves require. Naturally, this requires understanding and interpreting various foreign laws.

Moreover, the substantive terms of the contract amendments to which the parties agree by adhering – including the types of agreements that constitute Covered Agreements, the type of default rights being stayed or overridden, and the specifics of those stays and overrides – will vary from Module to Module. The author or others in the K&L Gates investment management practice can advise you on the specifics of those terms.

But all the Modules will have one thing in common. Unlike most if not all SRRs and Stay Regulations, the Modules have both retrospective and prospective effect. In other words, while the Stay Regulations may only require that agreements be amended only with respect to new transactions or only if new transactions are entered into under them, the effect of the Modules will be to limit the adhering Fund's rights with respect to both its future and existing transactions under the covered agreements.

Implications for Fiduciaries

As noted above, adhering to a JM Protocol Module would mean giving up rights and remedies that might otherwise be available under applicable law. Moreover, the Modules would limit rights with respect to outstanding transactions under agreements that the applicable SRR and Stay Regulations may not require to be modified. Accordingly, the decision as to whether and how to adhere implicates Funds' fiduciary duties to their investors, as well as that of their investment advisers, boards, or other decision makers.

In many cases, that may be a relatively easy decision as, for example, if the trade-off is the ability to enter into new transactions that are part of the Fund's investment strategy, with dealers with whom the Fund wants to continue to do business. However, a different, and perhaps more difficult, balancing applies with respect to agreements under which there are outstanding transactions but no expectation of entering into new ones. In either case, the decision is one that ought to be made in a reasoned and well-documented manner.

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Accordingly, Funds will need to have a process for making the decision as to whether to adhere to a Module and, remembering the three adherence options, with whom. That process should include making a record of the factors considered in making the decision.

Agency Considerations (Direct Your Agents!)

Funds often become parties to QFCs by reason of being one of many parties to an umbrella agreement that has been entered into by an adviser, sub-adviser, or other agent on their behalf. Or, in the case of multi-manager Funds, they may be parties to multiple agreements of the same type with a single dealer or its affiliates. Such situations are commonplace with ISDAs and similar agreements.

An extreme but common example of an agent acting under an umbrella agreement is a securities lending arrangement, under which a lending agent lends its customers' securities pursuant to a Master Securities Lending Agreement that is between the borrower and itself as agent. In such cases, it likely will be the agent-not the Fund-that will be asked to adhere to a JM Protocol Module. The agent's authority to do so extends only to the agreements as to which it acts as agent, but the decision as to whether and on what basis to adhere will be determinative of the Fund's rights.

Accordingly, it is important that Funds communicate with their advisers and other agents and agree as to whether to enter into new transactions with a particular Regulated Entity counterparty and as to whether the agent should adhere to a particular Module with respect to that counterparty or with others.

A Buy-Side To-Do List

Funds and their counsel should carefully consider the terms of the JM Protocol and each relevant Module (as they become available), as well as the scope and impact of Protocol adherence with respect to their derivative transactions, SFTs, and other Covered Agreements. Among other things:

-- Determine which existing agreements would be affected.

-- Determine which SRRs would be implicated by transactions with which active counterparties.

- Are there specific SRR jurisdictions as to which you would not want to adhere?
- Is adherence consistent with your fiduciary duties to each client? Is that true for all counterparties or just for some in order to preserve rights with respect to *some* existing transactions?
- Could it be in your or your client's interest – and is it practicable – not to adhere at all, but instead enter into bilateral agreements in order to avoid retroactivity with respect to *all* existing transactions?

-- If an agent has entered into a QFC on your behalf, be sure that that agent knows whether and on what basis it should adhere to a JM Protocol Module on your behalf. Conversely, if you are an adviser and have entered into master QFC agreements as agent for one or more clients, determine whether you have the requisite authority to enter into the Protocol on their behalf.

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-- Determine whether adherence to the Protocol is consistent with your investment parameters for each client and with other rules and regulations applicable to those transactions.

-- Revisit your swap and QFC program requirements.

- Consider whether there are jurisdictions in which you do not wish to conduct derivatives business due to the specifics of their SRRs and implementing regulations or, perhaps, due to uncertainties in those SRRs and regulations.
- Consider strengthening your creditworthiness criteria for eligible counterparties or securities borrowers.
- Consider whether the collateral levels – and particularly collateral maintenance levels – that you require for counterparties should be increased, either generally or for G-SIBs and their affiliates.

The author and other members of the K&L Gates investment management practice are available to advise you regarding this process and, as noted above, regarding the specifics of the various Modules and Stay Regulations.

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