

Federal Reserve Proposes Rules Affecting Default Rights in Derivatives Contracts

ISDA Publishes Resolution Stay Jurisdictional Modular Protocol and UK Module

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The Federal Reserve Board recently proposed long-awaited rules intended to further the policy goals of the special resolution regime (SRR) established under the Dodd-Frank Act for global systemically important banking organizations (GSIBs) that become financially troubled. Under the May 3 proposal, the FRB would require U.S. GSIBs, as well as their subsidiaries and the U.S. operations of foreign GSIBs, to obtain contractual agreements from the buy-side counterparties to their over-the-counter derivatives, repurchase agreements, securities lending agreements and other qualified financial contracts (QFCs), as well as the QFCs of their affiliates, to limit certain of those counterparties' default rights. The FRB proposed rule would exclude national banks and federal savings and loan associations, which are expected to be covered by parallel OCC rules.

Under the proposal, funds and managed accounts, acting directly or through the asset managers who trade uncleared derivatives on their behalf, would agree that they could not immediately exercise termination and other default rights under affected contracts upon the occurrence of insolvency-related defaults even if they would be able to do so under safe harbors that might otherwise be available under the Bankruptcy Code or applicable non-U.S. insolvency laws. Those remedies would be subject to a brief stay that could be made permanent if certain resolution-related asset transfers are effected in the interim. The exercise of certain



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cross-default rights would also be limited.

All new QFCs with affected GSIBs and their affiliates, as well as all existing QFCs with such parties if any new QFC transactions are entered into by the buy-side counterparty or any of its affiliates, would have to be amended. Importantly, the rule's proposed treatment of an "affiliate" of an

asset manager is unclear and should be clarified in the final rule.

The proposal states that compliance can be effected through adherence to the ISDA 2015 Universal Resolution Stay Protocol (the Universal Protocol), which is not intended for adherence by buy-side counterparties. However, the proposal also contemplates that compliance could be effected by adherence to a future, U.S. Module to the ISDA Resolution Stay Jurisdictional Modular Protocol (JMP) if that Module is substantially identical to the Universal Protocol. Compliance also could be effected through separate, bilateral agreements.

The JMP and its UK Module—the first of what will be several Modules there—was also published on May 3. Together, the JMP and the UK Module allow asset managers and their clients to amend the terms of their covered financial contracts with UK GSIBs to comply with the SRR requirements of the EU Bank Recovery and Resolution Directive (BRRD), as implemented in the UK. Like the rule proposed by the FRB, the BRRD prohibits regulated entities that are subject to its jurisdiction from entering into new derivatives or similar transactions with counterparties whose agreements do not expressly provide for their counter-

parties' default rights to be limited in the manner contemplated by the BRRD and the implementing laws or rules adopted in the relevant jurisdictions.

The scope and other details of the UK Module differ in various respects from what will be contained in Modules for other jurisdictions and from what would be required under the FRB's proposed rule. However, unlike the mandates under the UK and most other SRRs, the effect of the JMP and its Modules is both prospective and retrospective, affecting outstanding transactions under existing, covered agreements irrespective of whether new transactions are entered into after adherence.

Parties can comply with the BRRD and similar requirements by adhering to a JMP Module or through a comparable, bilateral agreement. By adhering to the JMP and the UK Module, either directly or through the agency of its asset manager, a managed fund or account would agree to the specified limitations with regard to all of its covered financial contracts with (depending on the adherence option selected): (1) all banks, swap dealers and similar entities that are regulated under the rule implementing the UK SRR, (2) all such regulated entities that are GSIBs or an affiliate of a GSIB, or (3) particular UK-based regulated entities that are identified by the asset manager or its clients through the adherence process.

UK regulated entities are required to obtain agreements from their investment management counterparties by January 1, 2017. ISDA is expected to promulgate a German Module to the JMP by the end of June. French, Swiss and Japanese Modules are expected later this year. The U.S. JMP Module will

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CFTC Chairman Massad Looks Back, Looks Ahead

CFTC Chairman **Timothy Massad** spoke on June 9 about CFTC regulatory accomplishments and future agency initiatives. Massad noted that one of these successes was the recent enactment of an equivalence accord with the European Commission (EC) that allows European market participants to continue clearing derivatives on U.S. clearinghouses. The CFTC has also furthered international harmonization through the registration of Eurex and the issuance of exemptive orders to several foreign central clearing counterparties (CCPs).

Margin for Uncleared Swaps. Chairman Massad noted that the Dodd-Frank Act's margin requirements for uncleared swaps is one of the most significant provisions affecting the swaps market, and that last year the CFTC successfully adopted an exemption for commercial end users which tailors the rule to transactions between large financial institutions. Under the rule, non-U.S. swap dealers operating in the U.S. will be eligible for substituted compliance as will U.S. swap dealers conducting international business. On a related and surprising note, it was reported on June

10 that the EC delayed implementation of its margin for uncleared swaps rules until mid-2017. As a result, market participants have recently urged U.S. regulators to likewise delay U.S. margin rules.

SEFs. In an effort to increase transparency in the swaps market, the CFTC granted registration to 21 swaps execution facilities (SEFs) last year. Moving forward, market participants will face new rules regarding trade errors, trade confirmation, and products deemed "made available to trade" (MAT) via SEFs.

Position Limits. Position limits has also been a hot topic for the CFTC. The Dodd-Frank Act's mandated rulemaking on position limits will be finalized in the coming year. Recently, the CFTC unanimously proposed changes which would allow exchanges to grant exemptions from the position limits for certain hedging activity. Chairman Massad seemed encouraged by the progress in this area and stated that "this is a critical piece of our effort to finish this rule by year's end."

Regulation Automated Trading (AT). Chairman Massad also discussed the CFTC's proposed rules governing automated trading activities in the derivatives market. Regulation AT would require registration of "AT Persons," implementation of certain pre-trade controls, self-trading measures, and source code preservation. Chairman Massad stated that he "would like to finalize a rule to implement the risk controls...this year." The comment period for Regulation AT was reopened for two weeks in light of a June 10 CFTC roundtable on the proposal.

The text of the speech is available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-47>.

The equivalence accord is available at http://www.cftc.gov/PressRoom/Press-Releases/cftc_euapproach021016. There is a related memorandum of understanding between the CFTC and ESMA relating to derivatives clearing organizations, available at <http://www.cftc.gov/idc/groups/public/@internationalaffairs/documents/file/cftc-esma-clearingmou060216.pdf>. 

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be prepared and promulgated after the FRB's proposed rule has been finalized.

The decision as to whether and on what basis to adhere to any JPM Module implicates the fiduciary responsibilities of asset managers, fund boards and other decision makers. Asset managers will need to determine, and should document the basis of their decision as to, whether to adhere to a particular JPM Module and with whom, weighing the effects of adherence against the ability to continue to trade with particular sell-side counterparties on behalf of the affected clients.

The May 3 Federal Reserve QFC proposal is available at <https://www.federal>

[reserve.gov/newsevents/press/bcreg/bcreg20160503b1.pdf](http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160503b1.pdf). The ISDA Resolution Stay JPM is available at <http://assets.isda.org/media/f253b540-95/83d17e3d-pdf/>. ISDA's Frequently Asked Questions on the Resolution Stay JPM published on May 3 is available at <http://www2.isda.org/functional-areas/protocol-management/faq/24>, and ISDA guidance is available at <http://www2.isda.org/functional-areas/protocol-management/protocol/24>.

The UK (PRA Rule) Jurisdictional Module is available at <https://www2.isda.org/functional-areas/protocol-management/protocol/25>, and FAQs are available at <https://www2>.

[isda.org/functional-areas/protocol-management/faq/25/](http://www.isda.org/functional-areas/protocol-management/faq/25/).

Comments on the proposed Fed rules are due August 5. Members with comments on the Fed proposal should contact IAA Associate General Counsel Monique Botkin at monique.botkin@investmentadviser.org.

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