asset management group

Re: Recent Regulatory Developments that Affect Trading Relationships with Banks

Two recent regulatory developments affect trading relationships between banking organizations and their counterparties. The new regulatory requirements apply directly to banking organizations. They require the banking organization to include certain contractual terms in certain types of trading agreements that the banking organizations may enter into. As a consequence, various banking organizations have been, or soon will be, requiring their counterparties to amend trading agreements to include these new terms.

A high-level summary of the regulatory developments and the expected documentation changes is provided below.

Overview. Various regulatory initiatives in recent years have targeted "too-big-to-fail" banking organizations. Two of those initiatives, both of which are international in scope, concern what happens when a banking organization becomes subject to resolution proceedings. The first of the initiatives relates to limitations applicable during resolution proceedings that restrict, or "stay", the exercise of termination rights by the bank's counterparties under certain trading agreements, including swap and other derivative agreements, as well as repo and securities lending agreements. The second initiative relates to the ability of resolution authorities in the European Union to modify, or "bail in", certain liabilities, including certain trading liabilities, of banks that are in resolution.

In connection with each regulatory initiative, banking organizations subject to the new rules are required to amend trading documentation with their counterparties. The International Swaps and Derivatives Association (ISDA) has produced amendment protocols for purposes of facilitating the mandated amendments. Each regulatory initiative and its related documentation requirements are summarized below.

Limitations on Certain Termination Rights. Special resolution regimes in the United States, the European Union, Japan and other countries empower regulators that take over a failed banking organization to impose temporary stays on the exercise of certain transaction termination rights. Typically, the stays prevent counterparties from terminating trades for a period of one or two business days, while resolution authorities try to resolve and reorganize the troubled bank in a manner that permits some operations – including trading relationships – to continue. Transactions that are subject to such stays include swap and other derivative transactions governed by ISDA master agreements, and repo and securities lending transactions governed by other industry-standard master agreements. Such agreements are generally referred to below as "trading agreements."

Regulatory authorities in several jurisdictions – principally, the United States, the United Kingdom, Germany, France, Switzerland and Japan – have become concerned that the cross-border enforceability of stays under their national resolution regimes is not entirely certain. For example, UK regulatory authorities are not certain that a New York court would respect a UK stay of termination rights under a trading agreement that is governed by New York law. Accordingly, a number of regulatory authorities are requiring banking organizations to amend their trading agreements to insert provisions under which counterparties contractually acknowledge the

enforceability of such stays; this removes concern about cross-border enforcement. The largest international banking organizations have already amended trading agreements among themselves. Now, in connection with the adoption of new regulatory requirements in various jurisdictions, banking organizations must amend trading agreements with non-bank counterparties as well.

The new regulations require a banking organization to amend its trading agreements before further transactions may be executed under the agreement; in the absence of such amendment, the banking organization would likely not be permitted to trade further under the agreement. ISDA has published an amendment protocol that, for parties that adhere to it, achieves the necessary amendments of existing trading agreements. The protocol covers ISDA master agreements, and also non-ISDA master agreements (such as master repo agreements). The protocol is called the ISDA Resolution Stay Jurisdictional Modular Protocol, or "JMP" for short.

Each relevant national jurisdiction will impose requirements on its own banking organizations. Thus, industry participants may adhere to the JMP on a jurisdiction-by-jurisdiction basis, may amend agreements to incorporate terms of the JMP by reference, or may otherwise amend agreements to comply with the requirements in each separate jurisdiction. For example, adherence or other amendments for purposes of UK regulations and UK banking organizations will be separate from adherence or other amendments for purposes of German regulations and German banking organizations. For those countries, as well as others, adherence or other amendments will result in contractual changes to confirm the cross-border enforceability of the respective country's resolution regime stay provisions for certain existing agreements and for future agreements.

In the case of large *U.S. banking organizations*, amendments to trading agreements are expected to have a second consequence. Like authorities in other countries, U.S. authorities have proposed rules that would require trading agreement amendments to ensure the cross-border enforceability of U.S. resolution stay provisions (under the special resolution regimes in the United States for systemically important financial institutions and for FDIC-insured banks). In addition, however, the proposed U.S. rules would require amendments that prevent or delay the exercise of certain cross-default rights that would be triggered by a wide variety of other insolvency proceedings, such as under Chapter 11 of the U.S. Bankruptcy Code. Thus, for example, trading agreements with the dealer subsidiary of a large U.S. bank holding company would need to be amended to limit the dealer's counterparties from exercising cross-default termination rights that are triggered because the parent bank holding company enters Chapter 11 reorganization proceedings. The rights affected concern both domestic agreements (e.g., an agreement between two U.S. entities governed by New York law) and cross-border agreements. The precise restrictions on cross-default rights will not be known until the rules are finalized by U.S. authorities sometime in the future.

<u>Bail-in Powers</u>. Under the *EU bank resolution regime* (the Bank Recovery and Resolution Directive, or "BRRD"), regulatory authorities have the power to bail in a broad range of liabilities of a troubled EU banking or financial institution that becomes subject to resolution proceedings. EU bail-in powers may be used to reduce and write down the liabilities of the respective EU institution, or to convert those liabilities into equity. Liabilities subject to bail-in may include those generated under virtually any contract, including under various kinds of trading agreements; a few kinds of liabilities, including fully secured liabilities, are not subject to bail-in.

The BRRD requires EU institutions to include specific contractual provisions in various agreements that are governed by *non-EU law*. Under those provisions, counterparties must

recognize, and agree to be bound by, an EU resolution authority's powers to write down or convert liabilities under such agreements. These contractual provisions reduce the risk, perceived by EU resolution authorities, that a non-EU court would not respect the exercise of such bail-in powers by an EU resolution authority.

Industry participants may effect necessary amendments to trading agreements by means of an ISDA amendment protocol published for that purpose, by amendments that incorporates terms of the protocol, or by other amendments to comply with the requirements. This protocol is called the ISDA 2016 Article 55 BRRD Protocol, or "Article 55 Protocol" for short. Unlike the JMP, the Article 55 Protocol calls for one-time adherence (rather than jurisdiction-by-jurisdiction adherence) to cover trading agreements with banking organizations in the relevant EU jurisdictions (France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Spain and the United Kingdom). Upon adherence, non-EU trading agreements of clients will be amended to include the mandated provision recognizing, and agreeing to be bound by, an EU resolution authority's bail-in powers.