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A Primer on the ISDA Resolution Stay Protocol

NAPCO Fall 2015 Credit Conference



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Narrative

- Termination Rights for Financial Contracts
- Lehman Brothers Insolvency
- Insolvency Changes under the Dodd-Frank Act
- ISDA Resolution Stay Protocol
- Future Bank Regulatory Changes

Termination Rights for Financial Contracts and the Lehman Brothers Insolvency

The logo for Sutherland, consisting of a blue rectangular box with the word "SUTHERLAND" in white, uppercase letters. Below the box is a thin, horizontal brown line.

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ISDA Master Agreement

- Direct Counterparty Defaults and Termination Events
 - Payment or Margin Defaults
 - Bankruptcy
 - Default Under Specified Transactions
 - Cross Default
 - Other Contract Breaches
 - Merger without Assumption
 - Illegality, Tax Event, Credit Event Upon Merger
 - Additional Termination Events (ATE)
- Defaults or Termination Events Regarding a Credit Support Provider or Specified Entity

Termination Rights - Bankruptcy

- Upon default or ATE by a non-bank entity, the counterparty can immediately terminate and liquidate all transactions entered into under the ISDA
- Under “safe harbor” provisions of US Bankruptcy laws, these termination rights are protected against the automatic stay that normally applies when bankruptcy protection is sought

- Under the FDI Act, when the FDIC decides to close a bank, the FDIC acts as receiver, and termination rights are subject to a one-day stay
- NOTE: The FDI Act contains no limitations on the ability of a non-defaulting party to early terminate a swap based upon the financial condition of an affiliate (e.g., a holding company that is either a guarantor or specified entity)

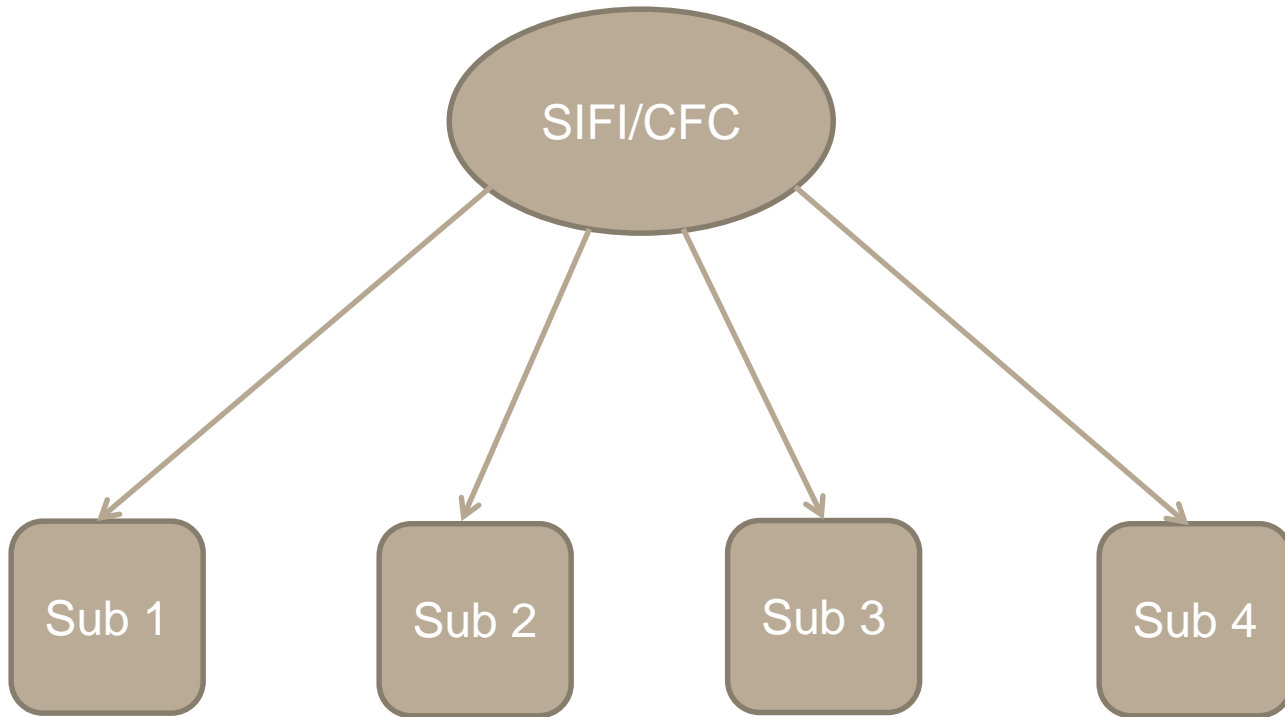
2008 - Lehman Bankruptcy Too Big to Fail (TBTF)?

- Lehman had operations in more than 40 countries
- Failure resulted in more than 80 insolvency proceedings
- Lehman Brothers Holdings Inc. and its subsidiaries subject to U.S. bankruptcy proceedings were party to about 930,000 derivatives contracts - two months after failure, about 733,000 were terminated or alleged to be terminated
- Seven years later, bankruptcy proceedings related to swap close-outs continue
- Lehman's futures business transferred intact to Barclays Bank without disruption

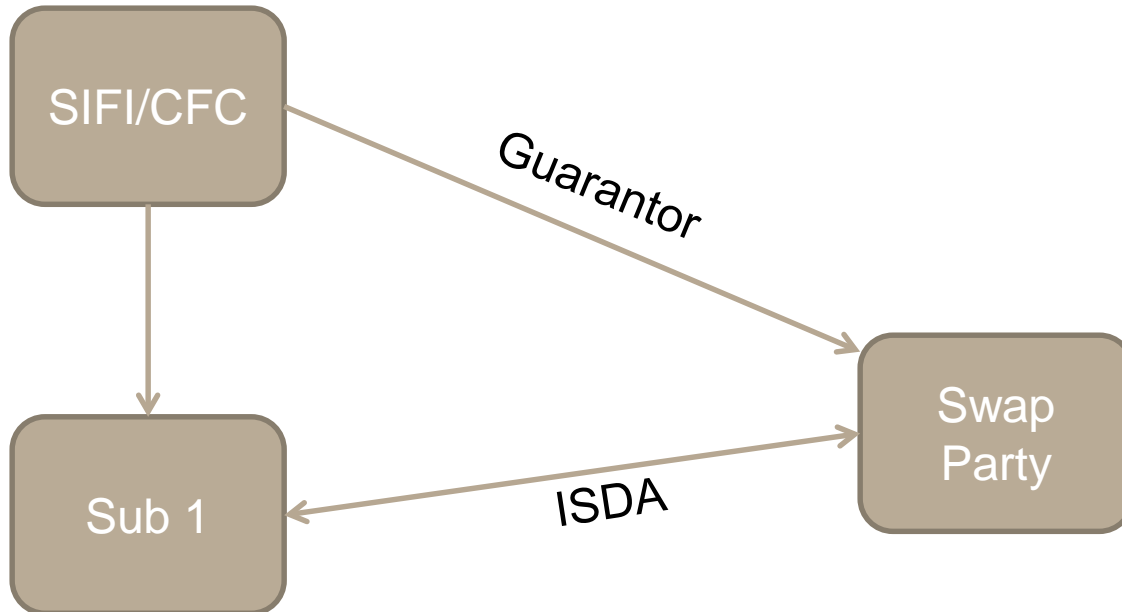
Insolvency Changes under the Dodd-Frank Act

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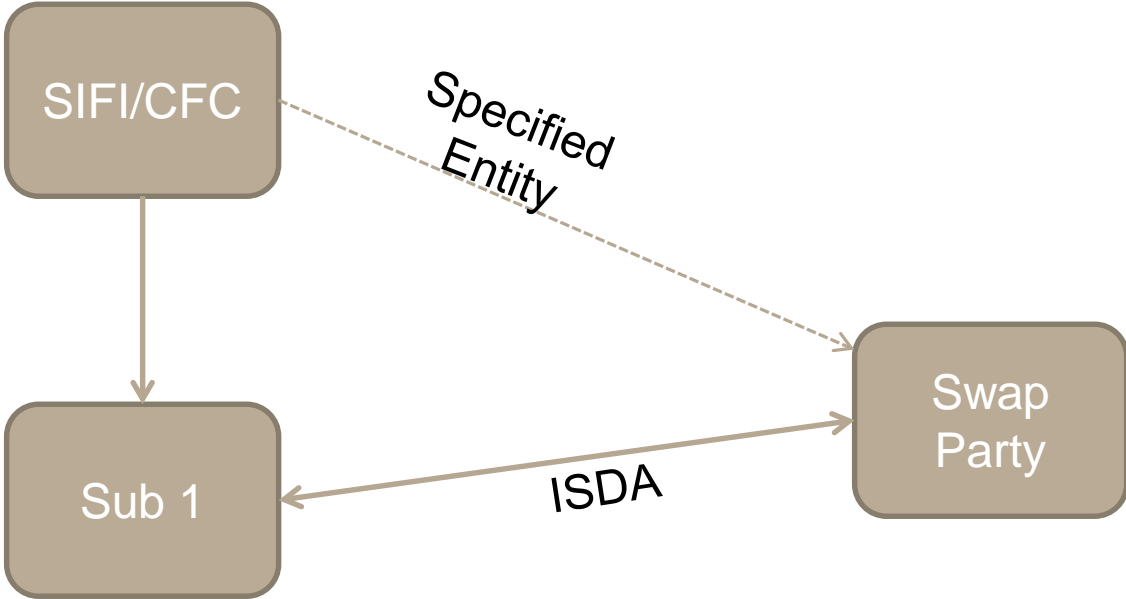
“Single Point of Entry” (SPOE) Resolution Strategy



“Supported Contracts”



“Linked Contract”



Title II of Dodd-Frank Act

New Resolution Authority for SIFIs

- FDIC, as receiver for SIFI/CFC (covered financial company) shall have the power to enforce contracts of subsidiaries or affiliates of the CFC
- FDIC, as receiver for CFC, may transfer qualified financial contracts (which includes swaps, commodities contracts and repos) to a bridge entity or third party not later than 5:00 p.m. on the business day following appointment
- Authorized stay of termination rights against holding companies and affiliates may impair the ability to reorganize the SIFI and pose systemic risks

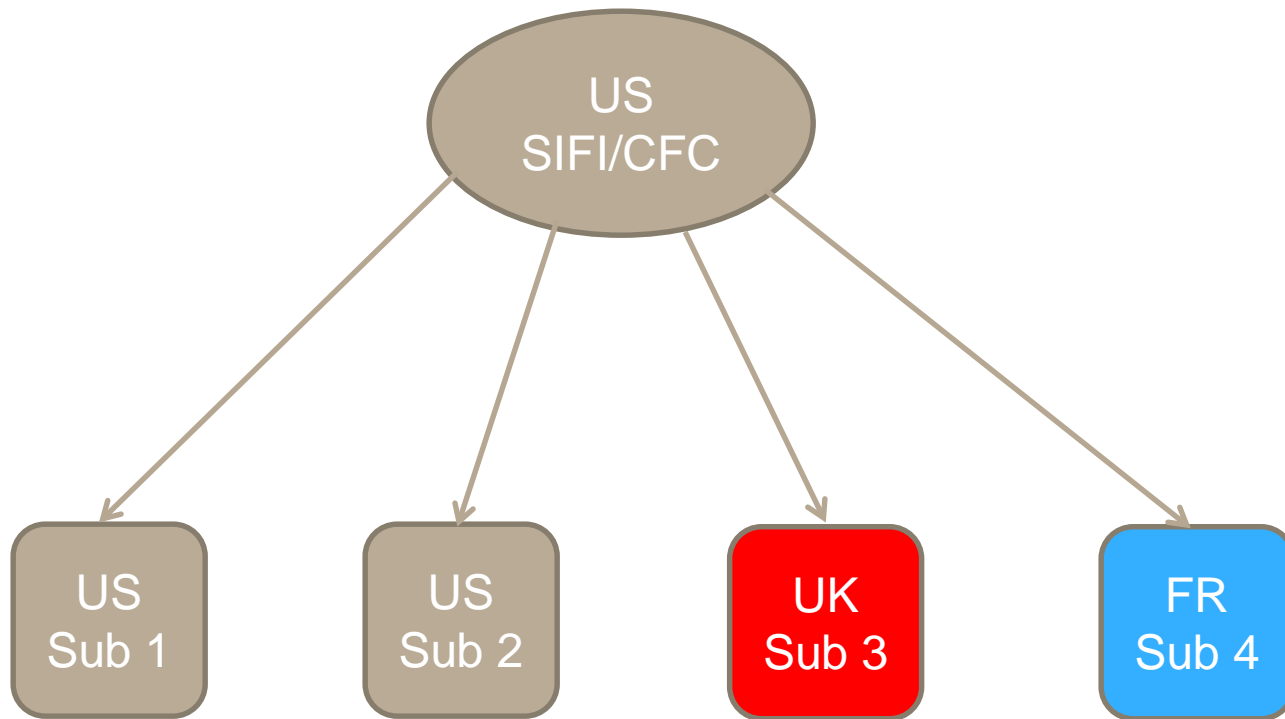
- Requires all SIFIs to prepare resolution plans (or “living wills”) to demonstrate how they would be resolved in a rapid and orderly manner under the Bankruptcy Code (or other applicable insolvency regime) in the event of material financial distress or failure
- NOTE: Bankruptcy Code does not itself contain a stay or limitations on termination rights. Title II provides a back-up authority to place a SIFI into an FDIC receivership process if no viable private sector alternative is available and resolution through bankruptcy poses serious adverse consequences for U.S. economy.

The ISDA Stay Protocol — Terms of Protocol



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“Single Point of Entry” (SPOE) Resolution Strategy



Key Concepts for SPOE

- Uniformity of Applicable Law
- Stay on Defaults for
 - Counterparty Insolvency
 - Credit Provider Insolvency
 - Specified Entity Insolvency
 - Regulated Parent Company Insolvency
- No exports of Defaults
- No changes to collateral mechanisms
- Transfer of both contract rights and collateral
- Creditor safeguards

Where Things Stand

- At the request of international regulators, ISDA working group comprised of swap dealer and buy-side firms has developed the 2014 Resolution Stay Protocol
- In November 2014, 18 major dealer banks (and many of their affiliates) voluntarily adhered to the Protocol
- Protocol represents an effort to contractually support SIFI resolution objectives while further statutory changes are adopted

Section 1

Resolution Authority in Cross-Border Transactions

Section 1 – Principal Design Elements

- Implementation of stays under applicable SRRs
 - Stays on default rights
 - Stays on collateral recourse
- Termination and transfer related provisions interpreted and governed by law of jurisdiction of applicable SRR
- Removal of transfer restrictions in accordance with applicable SRR

Special Resolution Regimes

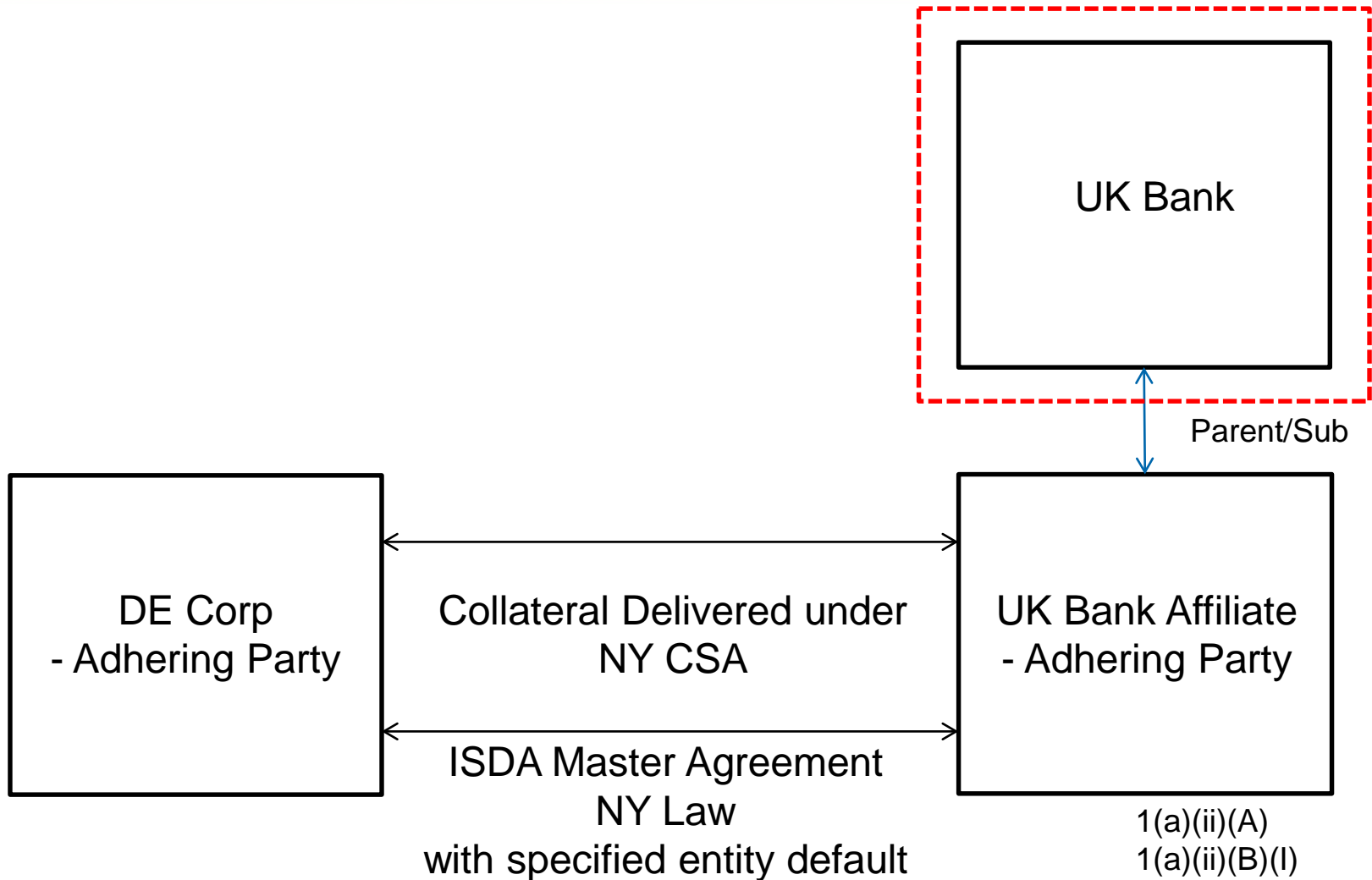
- Identified Regimes
 - France
 - Germany
 - Japan
 - Switzerland
 - UK
 - US-FDIA
 - US-OLA
- Protocol Eligible Regimes
 - Financial Stability Board jurisdictions
 - US-Bankruptcy Code
 - Each must meet criteria

Scenario 1A – Counterparty Insolvency

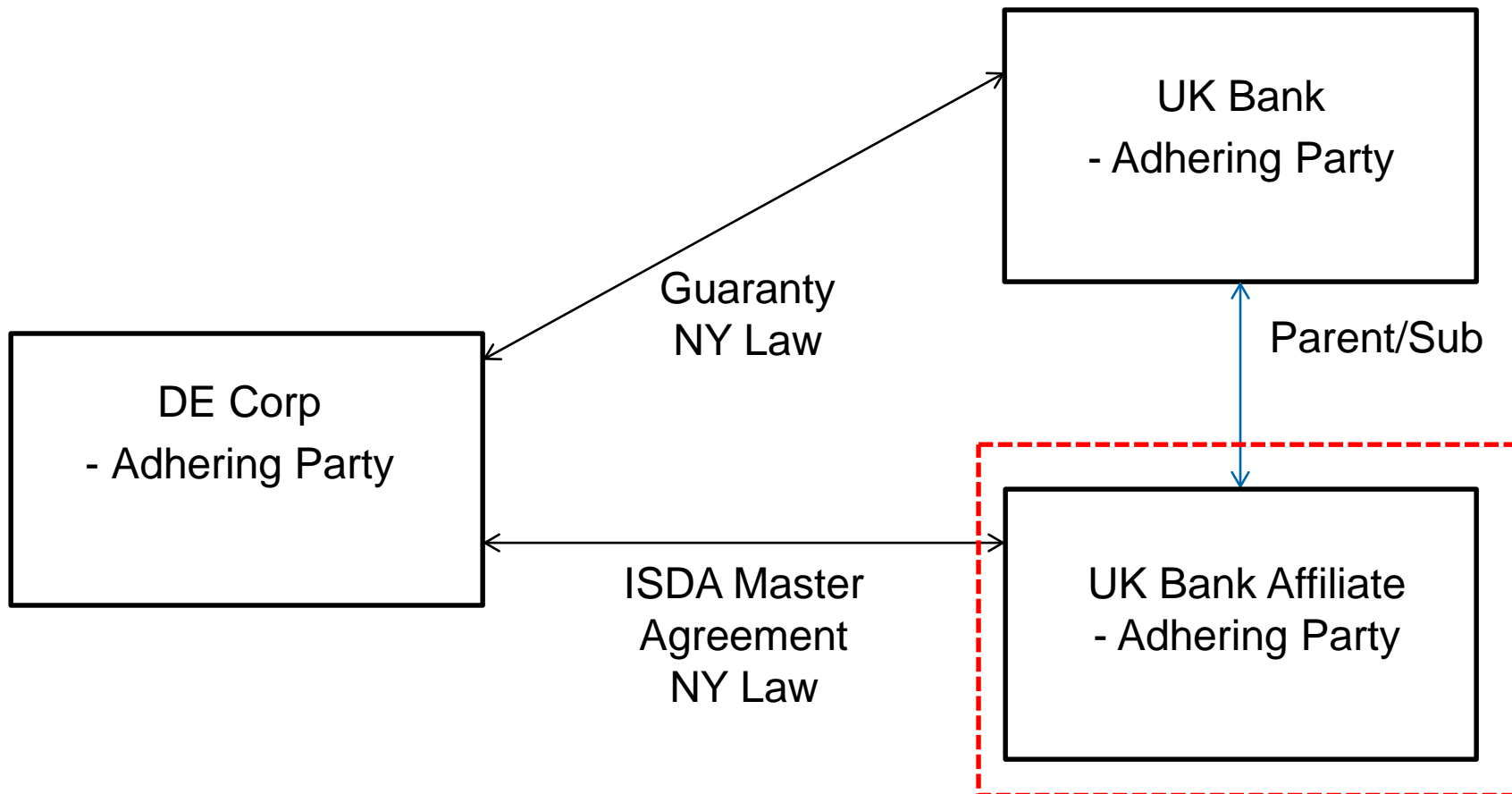


- 1(a)(i)(A)
- 1(a)(i)(B)
- 1(a)(i)(D)
- 1(a)(i)(E)

Scenario 1B – Related Entity Insolvency



Scenario 1C – Insolvency with Credit Support



1(a)(i)(B)
1(a)(i)(E)

Section 2

Provisions for US Insolvency Proceedings

Preliminary Notes

- Section 2 relates to cross-defaults that relate to affiliates and credit providers
- Not in force yet
 - Operative provisions come into effect when prudential regulators issue rules requiring financial institution to trade only with adhering party
- U.S. Insolvency Proceedings
 - Chap. 7, Chap. 11, FDIA, SIPA
 - Not other non-bankruptcy code debtors (e.g., insurance companies, government-sponsored enterprises)

Scope of Default Rights

**Counterparty
Insolvency
(any type of
insolvency)**

**Counterparty
fails to pay
or deliver**

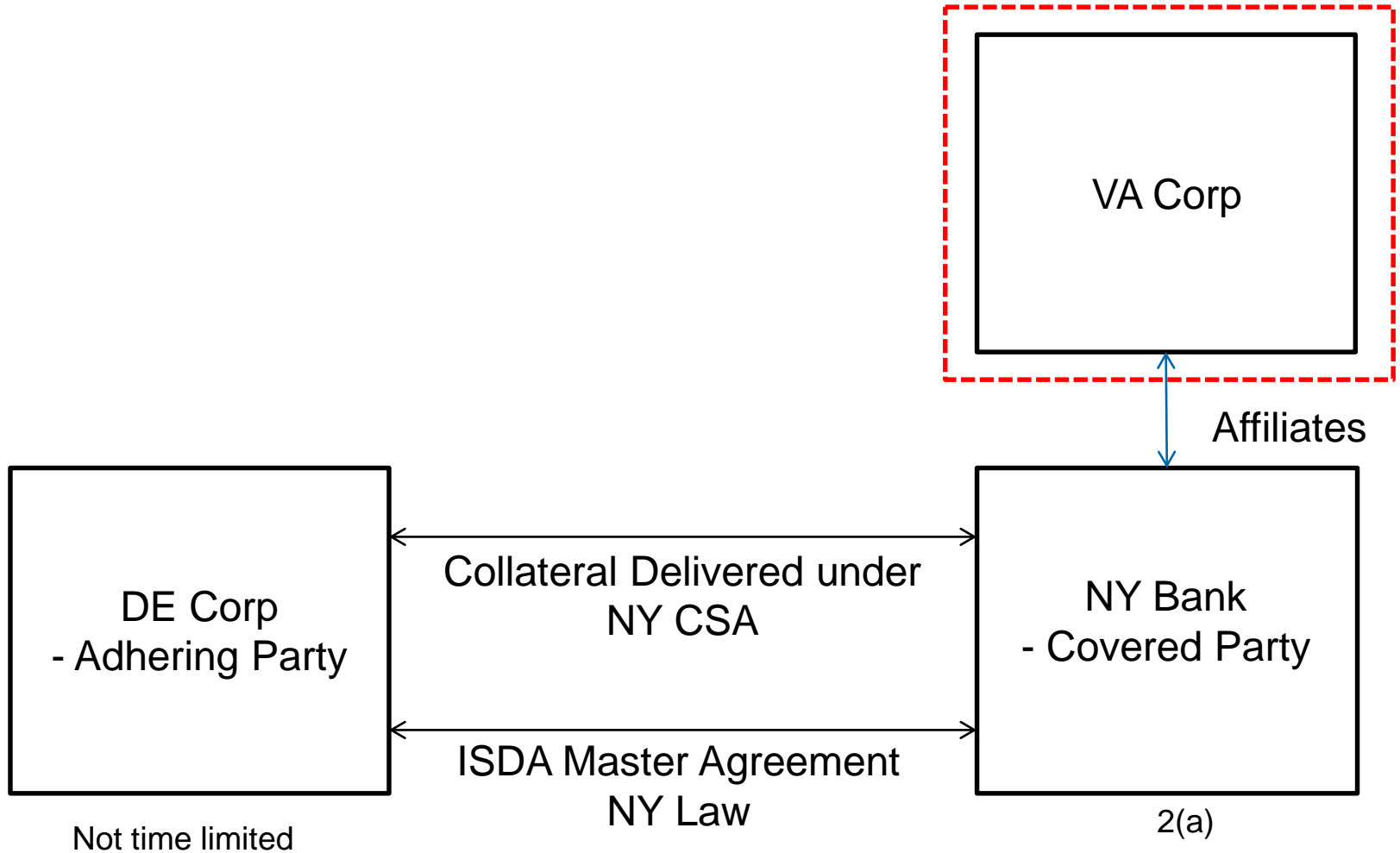
**Credit Provider
fails to pay or
deliver**

**Other default but not
U.S. Insolvency
Proceedings
if affiliate**

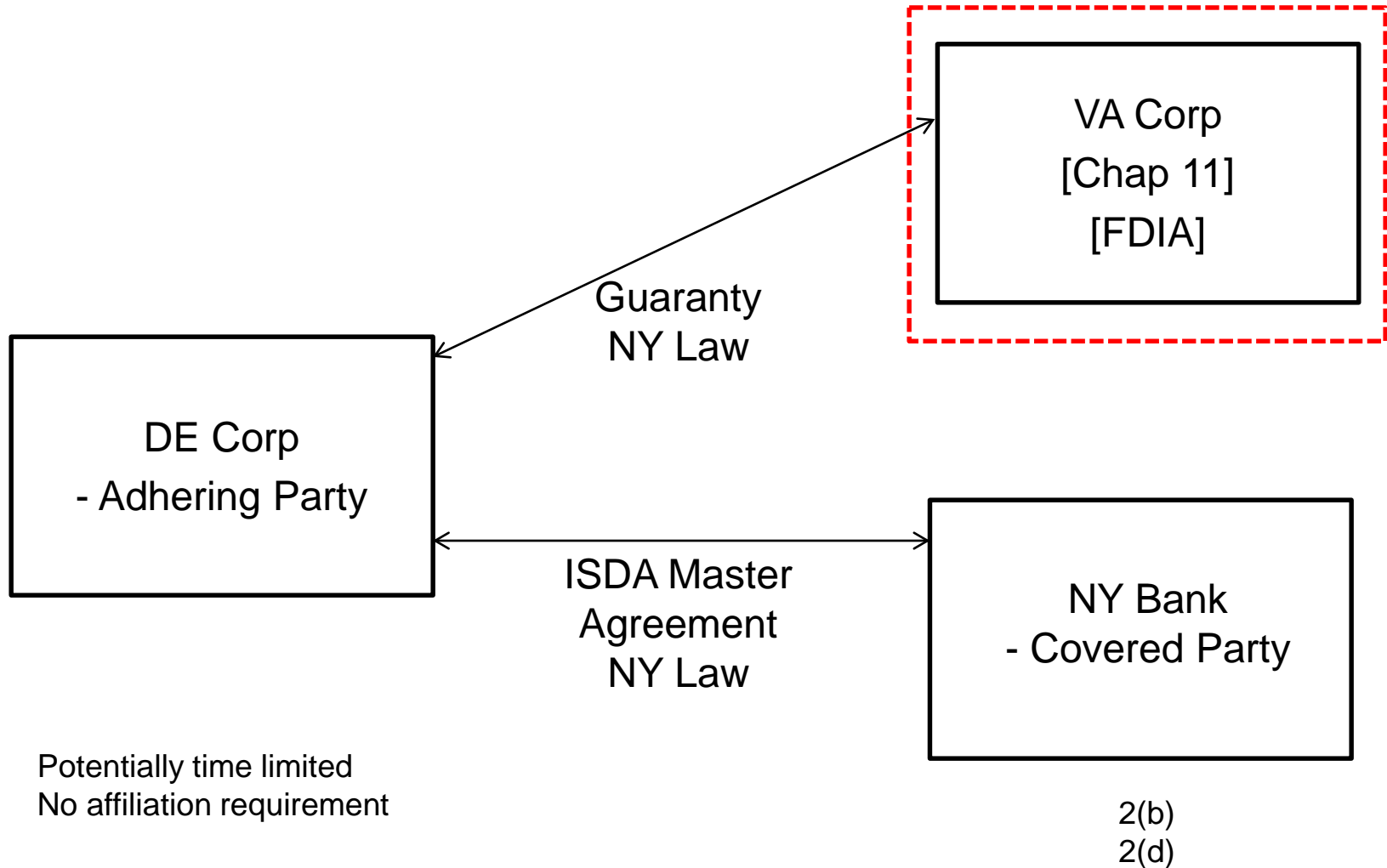
**Affiliate
in non-US
Insolvency
Proceedings
(Parent not in US
Insolvency
Proceedings)**

**[Affiliate or Credit
Provider in
U.S. Insolvency
Proceedings]**

Scenario 3A – Insolvent Affiliate



Scenario 3B – Credit Provider Insolvency



U.S. Overrides – Chapter 11

- **Default Rights Override – Chapter 11**
 - Cannot terminate for insolvency until later of (i) stay period (~ 2 BD) and (ii) failure of Transfer Conditions or DIP Conditions
- **Transfer Conditions**
 - Transferee solvent during stay period
 - Order entered to authorize transfer
 - “Transfer Stay Conditions” satisfied
 - Transferee licensed
 - Transferee meets financial covenants for credit enhancement provider
 - Security interests not diminished
- **DIP Conditions**
 - ISDA counterparty remains licensed
 - “DIP Stay Conditions” satisfied

- “Favored Nation DIP Override Exception”
 - Allows a party to terminate, despite Default Rights Override, if:
 - ISDA Counterparty does not pay close-out amount on any other protocol-stayed party; and
 - Party in Chapter 11 fails to perform under credit enhancement

2(c)

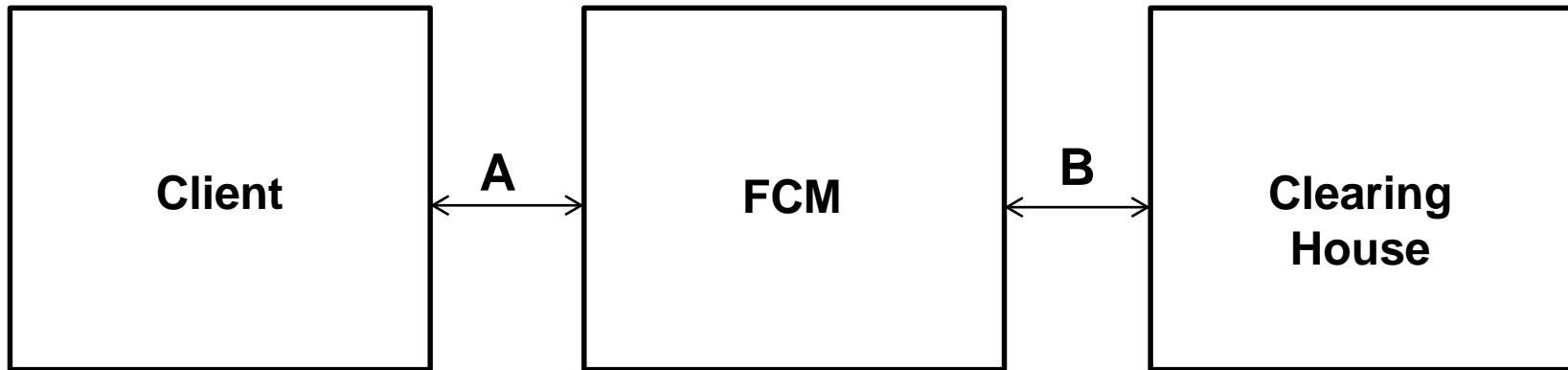
- **Default Rights Override (FDIA)**
 - Cannot terminate for insolvency (i) during stay period (defined under FDIA and implementing regulations) and (ii) never if credit enhancement properly transferred
- **Performance Suspension**
 - Performance suspension rights under master are the same as if the non-defaulting party faced the credit provider (thus, suspension rights dictated by FDIA)

2(d)(i) and (ii)

- Applies only when affiliate of direct party enters U.S. Insolvency Proceedings
- Default before U.S. Insolvency Proceedings Start is not exercisable unless exercised before start of such proceedings
 - Early Termination must have occurred or have been declared
- Performance default rights before insolvency of counterparty affiliates maintained

2(e)

Cleared Transactions



Protocol applies to cleared swap transactions under covered master agreements, however:

- A – Party can terminate with clearing member if clearing house can terminate; 2(k)
- B – Protocol does not apply to the extent inconsistent with clearing house rules; 5(c)

Key Issues for End-Users

- Extremely technical protocol and requires lots of study to understand effect
- Loss of contractual remedies previously seen as advantageous to operation of efficient markets
 - Fiduciary duty concern (e.g., should asset managers sign, do they have authority?)
- Expansion to other products (e.g., repo, securities lending)
- Applies to both existing and future derivatives trades (“retroactivity”)

Key Issues for End-Users

- How will end-users be bound when new SRRs are identified or come into effect?
- Protocol Implementation
 - Universal – strictest standards applied in all jurisdictions
 - Modular – each jurisdiction handled differently
- Limited or no ability of an end-user to customize terms in the protocol
- Possibility of non-protocol, bilateral agreements
- Circumvention of the traditional regulatory process
 - Compulsion over end-user firms that are not subject to regulatory oversight

Key Issues for End-Users

- Application of foreign resolution paradigm that (i) is not directly applicable to counterparty or (ii) does not match the law governing the contract
- Consequences for counterparty credit assessments and derivatives pricing
 - Arguably, covered entities should not have the benefits of unsecured thresholds
 - Return of ratings thresholds or NAV triggers
- Adjustments in market composition based on perceptions of insolvency regimes

Key Issues for End-Users

- Unique issues for physical trade
 - effect of termination stay at delivery
 - what about the application of penalties (e.g., demurrage)?
 - what if multiple delivery days are possible?
 - capability of bridge company – don't know whom this might be
 - concentration risk

Key Take Aways

- Effectively mandatory
- Contracts may be subject to insolvency regimes of foreign affiliates
- In U.S., lose certain cross-defaults to affiliate insolvencies
- U.S. Prudential Regulators have forthcoming regulations



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David T. McIndoe is a partner at Sutherland Asbill & Brennan LLP. Based in Washington, DC, he is co-head of the Energy and Commodity Trading Team. David has a transactional and regulatory practice focused on the trading of commodities and financial instruments. He regularly advises clients about the negotiation and execution of physical trades, derivatives and structured transactions. He also plays a significant role in derivatives reform under the Dodd-Frank Wall Street Reform and Consumer Protection Act and similar measures in Europe, Canada and Asia. David received a BA from Dartmouth College in Philosophy and a J.D. from Washington & Lee University School of Law.

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