Bloomberg BNA

Securities Regulation & Law Report™

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DERIVATIVES

Banks Agree to ISDA Resolution Stay Protocol Despite Buy-Side Resistance but Practical Questions Remain

BY ANNE E. BEAUMONT

On Saturday, Oct. 11, 2014, the International Swaps and Derivatives Association announced the execution of an agreement among 18 "major global banks," developed in coordination with the Financial Stability Board, to sign an "ISDA Resolution Stay Protocol" (the "ISDA Protocol") to amend the ISDA Master Agreements among the signatories. While the ISDA Protocol itself has yet to be released publicly, its basic terms have been described in press coverage: if a signatory (known as an "adhering party") enters into a formal insolvency proceeding, the ISDA Protocol suspends the other signatories' right to exercise their Early Termination rights under ISDA Master Agreements with the insolvent signatory for a period of up to 48 hours. The ISDA Protocol will become effective for the 18 signatory banks as of Jan. 1, 2015.

Absent the ISDA Protocol, an insolvent bank's derivatives counterparties would be free both contractually (and in the United States, under the Bankruptcy Code's "safe harbor") to terminate their trades with the insolvent bank unilaterally and exercise any contractual remedies for such termination, including liquidating collateral posted by the bank. The ISDA Protocol would, in effect, extend to additional institutions and situations – and for a slightly longer period – the one-business-day hiatus that already would be applicable for a Systemically Important Financial Institution if the Orderly Liquidation Authority mechanism in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act is deployed.

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The ISDA Protocol thus would give an insolvent bank's regulators a short window of time in which the bank's derivatives transactions would remain active, and in theory could be assigned to another, solvent bank. In addition to this very practical effect, the ISDA Protocol also has been touted by some (including ISDA) as reducing "systemic risk" and addressing the concern that some market participants are treated as "too big to fail." In practice, the impact of the ISDA Protocol in its current form is likely to be much more limited.

Two key aspects of the ISDA Protocol are most striking – who it does *not* apply to, and the brevity of the suspension it imposes.

The ISDA Protocol by its terms does not apply to two major categories of participants in the derivatives market – those banks that did not sign onto it, and the "buy side," a category of market participants that encompasses a wide variety of firms, including financial and quasi-financial entities such as hedge funds, asset management firms, pension funds and insurance companies, and non-financial entities such as municipalities and industrial companies. Some news reports have stated that derivatives transactions that involve the banks that have agreed to the ISDA Protocol comprise approximately 90% of the market. It is unclear where that figure comes from and how that share is measured (it seems high, at least for some types of derivatives). In any event, the non-participation of even a single counterparty of a failing bank stands to give that counterparty an advantage over the bank's other counterparties, who will find their hands tied for 48 hours under

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the ISDA Protocol while the unfettered counterparty remains free to exercise its termination rights.

The non-participation of buy-side institutions in the ISDA Protocol negotiations was noted even before its adoption. At that point, the participating banks contended that they and their regulators together could simply "force" non-participants to sign onto a protocol, including by refusing to do business with them unless they did. But the contractual nature of the relationships between the signatory banks and their non-signatory counterparties meant that those counterparties would have to consent to an amendment such as that provided for in the ISDA Protocol, and a number of major buy-side market participants noted publicly that they were not in a position to relinquish valuable contractual termination rights voluntarily. Among the reasons given was the concern that such a concession could be viewed as a breach of their fiduciary duties to their own constituents.

In the end, the effort to involve the buy side in the ISDA Protocol appears simply to have been abandoned for now, a fact that was disclosed as the last bullet point of a "backgrounder" issued by ISDA in connection with the announcement of the ISDA Protocol. According to ISDA, Financial Stability Board members plan to address this gap in the ISDA Protocol's coverage by imposing new regulations. Indeed, only days after the ISDA Protocol was announced, the Federal Reserve and others were reported to be developing new rules prohibiting banks from entering into "swaps agreements" (it is unclear whether this means new ISDA Master Agreements or new derivatives transactions under existing agreements) with counterparties that do not adhere to the ISDA Protocol or include similar provisions in their documentation. This, too, does not solve the problem of how existing agreements and transactions would be treated, which could lead to unwanted market advantages and unpredictable results if a counterparty's portfolio contains a mixture of trades that are and are not covered by the ISDA Protocol. It also suggests the possibility of counterparty and regulatory arbitrage, with derivatives business migrating to institutions and jurisdictions not bound by such regulations. Even more troublesome would be the prospect that market participants would feel compelled to move their derivatives portfolios away from a failing bank if it appears that the ISDA Protocol could become relevant. Such strategic behaviors would seem to be exactly the opposite of what regulators are seeking to encourage.

In any event, the approach to adoption of the ISDA Protocol already has proven controversial and extending it to additional institutions without their voluntary consent may prove difficult. On one hand, the approach used so far, of applying pressure through non-governmental organizations such as ISDA to enact what are, in effect, regulatory and legislative measures, has been challenged as circumventing democratic processes. On the other hand, altering existing contractual relationships through regulation or legislation can be equally problematic. This was demonstrated during the Financial Crisis, when regulators attempted to reduce or eliminate bonuses provided for in bank executives' employment agreements, and "sanctity of contract" was invoked in defense of such bonuses.

Even if the ISDA Protocol can be applied to more derivatives market participants, its effect is likely to be limited because of the extremely short duration of the hiatus it creates. While such a brief hiatus was foreshadowed by the one-business-day period used in Title II of Dodd-Frank, there was reason to think a much longer hiatus might be under consideration. Earlier in 2014, ISDA had published a model provision to amend Section 2(a)(iii) of the ISDA Master Agreements to create a suspension of termination rights similar to the one adopted in the ISDA Protocol, which was expected to be up to 90 days. In light of this history, the ISDA Protocol's use of a two-day time period instead of the ninety days that seemed to be on the table initially could be viewed as indicating significant resistance from the banks that ultimately agreed to the ISDA Protocol.

It also is unclear whether either a two-day suspension or the one-business-day suspension provided for in Title II of Dodd-Frank can make any meaningful difference, given the types of activities that are supposed to occur during that period. The complexity of "moving" a major dealer's derivatives book – or, as in Title II of Dodd-Frank, potentially its entire business – to another institution cannot be understated. Lehman Brothers, for example, is reported to have had as many as 6,000 individual ISDA Master Agreements in place. It would be surprising if, in the throes of a crisis sufficiently severe to trigger the application of the ISDA Protocol, a bank would be willing to take over that many individual contractual relationships (to say nothing of the hundreds of thousands of individual trades entered into thereunder) without some due diligence. But such due diligence could not possibly be accomplished in a matter of days – indeed, Lehman and its counterparties were at pains to locate, much less analyze meaningfully, relevant derivatives documentation months and even years after its 2008 bankruptcy filing. Undertaking the necessary due diligence prior to (rather than immediately after) a formal insolvency or resolution proceeding would not solve the problem. Such work could not feasibly be undertaken in a confidential way both because, among other things, the counterparties being examined likely would become aware of it. Meanwhile, the failing institution's counterparties could feel compelled to take protective actions such as moving their derivatives business to other institutions, thus triggering the "run on the bank" scenario that the Bankruptcy Code safe harbors were enacted to prevent.

At least two other practical problems are likely to arise in connection with the movement of a failing bank's derivatives book to another institution. First, the "rescuing" bank would face the possibility of taking over derivatives transactions with counterparties with which it did not already have ISDA Master Agreements in place. Since such agreements ordinarily take considerable time – sometimes many months – to negotiate, it would not be feasible to put new agreements in place in a time-pressed situation. Again, this was illustrated in the Lehman bankruptcy, where the estate instituted a procedure to facilitate the assignment of unterminated derivatives transactions to other counterparties, but it was not widely used for this reason, among others. This could mean that some counterparties would be left out of a large-scale assignment of trades – again, surely not a desirable outcome.

Second, almost invariably *someone* would be entitled to a payment in connection with any assignment or transfer of derivatives trades. While the direction of such payment(s) would depend on the economics at the time, a valuation of the insolvent bank's derivatives

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portfolio would be necessary to determine the amount. But that valuation could not reasonably be accomplished in a matter of one or two days – Lehman, for example, is still mired in valuation disputes with counterparties more than six years after its bankruptcy filings.

The recent adoption of the ISDA Protocol is only one chapter in a story that will be unfolding for some time, and it remains unclear whether future developments will address these obvious issues or whether the ultimate goal of fostering financial-system stability and safety can or will be accomplished through these reforms.