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ISDA Resolution Stay Jurisdictional Modular Protocol

01 - Aug - 2016

Do you need to take action?

Yes, if your fund is party to a type of agreement covered by the Protocol, such as an ISDA Master Agreement or a master repurchase or securities lending agreement (for example, a Global Master Repurchase Agreement ("GMRA") or Global Master Securities Lending Agreement ("GMSLA")) with a systematically important financial institution (a "Regulated Entity") and such agreement is governed by a system of law other than the law of the Regulated Entity's home jurisdiction, the fund can expect to be asked to adhere to the ISDA Resolution Stay Jurisdictional Modular Protocol.

Brief summary

In response to the financial crisis of 2008 and to address the "too big to fail" issue, various G20 national regulators developed new statutory regimes ("Special Resolution Regimes") under which systematically important financial institutions (i.e. Regulated Entities) must ensure that supervising regulators can effectively exercise their powers to temporarily suspend (or 'stay'), or permanently override, termination rights which counterparties would otherwise be able to exercise under the relevant agreement, should a Regulated Entity become subject to a Special Resolution Regime in circumstances where the Regulated Entity is failing, and insolvency may be imminent.

The ISDA Resolution Stay Jurisdictional Modular Protocol ("Jurisdictional Modular Protocol"), published by the International Swaps and Derivatives Association, Inc. (ISDA) in May 2016, enables financial institutions in various jurisdictions, including Financial Stability Board member countries, to comply with jurisdiction-specific laws and regulations relating to stays ("Stay Regulations") by providing a mechanism to incorporate stays and restrictions on counterparties' termination rights in certain agreements.

How do you determine if you need to adhere to the Jurisdictional Modular Protocol?

Your fund will need to adhere to the Jurisdictional Modular Protocol if the answer to each of the following questions is 'yes':

i. can any of your fund's sell-side counterparties be classified as systematically important financial institutions (i.e. Regulated Entities)? For example, major banking corporations would be classified as Regulated Entities;

ii. does your fund have any agreements covering certain financial arrangements with such Regulated Entities ("Covered Agreements")? For example, ISDA Master Agreements, GMRAs and GMSLAs would be classified as Covered Agreements;

iii. are any of the Covered Agreements between your fund and a Regulated Entity subject to a system of law other than the law of the jurisdiction where the Regulated Entity is established (for example, the Regulated Entity is incorporated in the United Kingdom, but the ISDA Master Agreement is subject to the laws of the State of New York); and

iv. has ISDA published/opened for adherence a Jurisdictional Module for the Regulated Entity's home jurisdiction? Currently only two Jurisdictional Modules are open for adherence: the ISDA UK (PRA Rule) Jurisdictional Module and the ISDA German Jurisdictional Module.

If the answer to all of the above questions is yes, you can expect your fund's applicable Regulated Entity counterparties to require that your fund adheres to the Jurisdictional Modular Protocol by submitting an Adherence Letter via the Protocol Management section of the ISDA website.

Who needs to adhere?

Although adherence to the Jurisdictional Modular Protocol is voluntary, it is expected that not only Regulated Entities, but also market participants not classified/perceived as systematically important financial institutions who are parties to Covered Agreements with Regulated Entities, will adhere to the Jurisdictional Modular Protocol.

Stay Regulations will oblige Regulated Entities to require adherence by their counterparties.

When does adherence need to take place?

Stay Regulations will generally specify deadlines by which Regulated Entities must ensure that their counterparties have agreed to be bound by the Stay Regulations.

For example, for buy-side entities, 1st January 2017 is the deadline for compliance with the requirements under the Prudential Regulation Authority's ("PRA") Stay Regulations.

Which Covered Agreements are amended via the Jurisdictional Modular Protocol?

The list of Covered Agreements to be amended via the Jurisdictional Modular Protocol will be specified in each Jurisdictional Module and will reflect types of agreements covered under relevant Stay Regulations in each jurisdiction. In other words, each Jurisdictional Module is based on the underlying Stay Regulations applicable to that jurisdiction.

Given that the Jurisdictional Modular Protocol follows in the footsteps of the previous ISDA 2014 Resolution Stay Protocol and the ISDA 2015 Universal Resolution Stay Protocol, and the aims of those two protocols were similar (and, to some extent, set a precedent), it is likely that financial agreements such as ISDA Master Agreements, GMRAs and GMSLAs will fall within the scope of each Jurisdictional Module.

The Jurisdictional Modular Protocol will have "retrospective" and "prospective" effect on transactions under a Covered Agreement. In practice, that means that the Jurisdictional Modular Protocol will apply to existing transactions and liabilities as well as any new transactions and liabilities. However, the Jurisdictional Modular Protocol will not apply to any agreements (as opposed to transactions) entered into by the parties after the date on which the parties adhered to/implemented the Jurisdictional Modular Protocol. Instead, any such new agreements would need to incorporate by reference the terms of the relevant Jurisdictional Module (irrespective of whether they have already adhered to such Jurisdictional Module).

How does the Jurisdictional Modular Protocol work?

The Jurisdictional Modular Protocol consists of two main parts: (i) the Boilerplate Part and (ii) Jurisdictional Modules to reflect national Stay Regulations for each relevant jurisdiction.

The Boilerplate Part contains provisions describing the process of adherence to individual Jurisdictional Modules as well as standard contractual terms such as representations and undertakings, definitions and governing law. The Boilerplate Part provisions apply universally to all adherents to the Jurisdictional Modular Protocol, irrespective of the Jurisdictional Modules.

Each Jurisdictional Module is developed and published by ISDA in respect of a particular jurisdiction to reflect national Stay Regulations. Each adherent chooses which Jurisdictional Modules apply.

Once a Jurisdictional Module is published and open to adherence, it forms a part of the Jurisdictional Modular Protocol and adhering parties can choose to adopt it, or not.

It follows that a Jurisdictional Module applies only to parties who have mutually agreed to adopt it.

The purpose of each Jurisdictional Module is to amend a Covered Agreement between a market participant and a Regulated Entity to incorporate specific stays on or overrides of termination rights (as against the Regulated Entity), as required by the relevant national regulator under national Stay Regulations in the home jurisdiction of the Regulated Entity.

Incorporating the required stays/overrides of termination rights in a Covered Agreement has a twofold effect: (i) it allows the applicable Regulated Entity to comply with local Stay Regulations; and (ii) it facilitates cross-border enforceability of stays on contractual termination rights, irrespective of the governing law of the Covered Agreement.

The modular nature of the Jurisdictional Modular Protocol provides market participants with the flexibility to select which specific Jurisdictional Modules to adopt, by reference to the Special Resolution Regimes applicable to their, or their counterparty's, circumstances.

Given that operative provisions in a Jurisdictional Module are based on Stay Regulations enacted in a specific jurisdiction, each Jurisdictional Module will amend a Covered Agreement in a different way, depending on the requirements under the applicable Stay Regulations. Although there will be similarities, the types of entities subject to the Stay Regulations and the types of agreements covered by the Stay Regulations, as well as other matters specific to the relevant Special Resolution Regime, will likely differ from jurisdiction to jurisdiction.

What does this mean in practice?

To take an example:

i. a UK dealer classified as a Regulated Entity and a Cayman fund are parties to an ISDA Master Agreement governed by New York law, which contains close-out and termination rights exercisable in the event of a party's insolvency;

ii. the UK dealer becomes subject to UK resolution proceedings under the UK Special Resolution Regime which imposes certain limitations such as a short-term stay on the termination rights of a non-defaulting party (i.e. the Cayman fund) against the defaulting UK dealer. Given the fact that the ISDA Master Agreement is governed by New York law, it is not clear whether the UK Stay Regulations will be recognised under New York law and therefore whether they can be effectively imposed on the non-UK counterparty (i.e. the Cayman fund); and

iii. if both parties to the ISDA Master Agreement have adhered to the ISDA UK (PRA Rule) Jurisdictional Module via the Jurisdictional Modular Protocol, they contractually agreed to incorporate the UK Special Resolution Regime requirements in their ISDA Master Agreement, to ensure effective application of the UK Stay Regulations on the non-UK counterparty (i.e. the Cayman fund) under their New York law-governed ISDA Master Agreement. In practice, this will mean that the Cayman fund's termination rights under the ISDA Master Agreement may be temporarily suspended or even overridden pursuant to the requirements of the UK Stay Regulations.

What do you need to do to adhere to the Jurisdictional Module Protocol?

Each market participant wishing to adhere to the Jurisdictional Modular Protocol should access the Protocol Management section of the ISDA website and complete the online questionnaire. Once completed, the questionnaire will generate a form of Adherence Letter. To be prepared for the online questionnaire, you will need to determine the following:

i. in what capacity will your entity adhere to a Jurisdictional Module, i.e. (a) as a Regulated Entity and/or (b) as a Module Adhering Party?

The selection should be based on an objective evaluation as to whether your entity falls within the definition of Regulated Entity as provided in the Stay Regulations on which the relevant Jurisdictional Module is based. If your entity is a fund, it will most likely be acting as a Module Adhering Party;

ii. will your entity adhere on behalf of itself as a principal, or as agent on behalf of its clients?

If you choose to adhere as an agent on behalf of clients, you will need to determine whether to adhere on behalf of all clients or some (and not all) clients. You also will need to identify which Regulated Entities will be selected for which clients; and

iii. which Regulated Entities should be identified as your entity's Regulated Entity counterparties?

The Boilerplate Part of the Jurisdictional Modular Protocol allows a Module Adhering Entity to adhere for (a) all Regulated Entities within a jurisdiction, (b) all Financial Stability Board designated entities; or (c) only specifically identified Regulated Entities within a jurisdiction.

The Adherence Letter will need to be "signed" by an authorised signatory. This can be done by typing the name of the authorised signatory on the Adherence Letter (instead of 'ink' signing).

Adherence is not free: each adhering party must pay a one-time fee of US$500 in respect of each Jurisdictional Module.

What are the consequences if you choose not to adhere to the Jurisdictional Modular Protocol?

In order to ensure the enforceability of statutory stays/overrides in resolution proceedings, national resolution authorities will require that Regulated Entities subject to Stay Regulations must ensure that their counterparties opt in/consent to the application of the regulatory stays/overrides under the Stay Regulations applicable to such Regulated Entity, including by adhering to the Jurisdictional Modular Protocol.

This will be a condition to the Regulated Entity continuing to trade with a relevant buy side entity.

The applicable Stay Regulations and Jurisdictional Module can be expected to designate a deadline by which market participants and Regulated Entities must adhere to the Jurisdictional Modular Protocol and specific Jurisdictional Module.

What about the ISDA 2014 Resolution Stay Protocol and the ISDA 2015 Universal Resolution Stay Protocol?

The original ISDA 2014 Resolution Stay Protocol (“2014 Protocol”) was developed as a response to proposals from authorities in Germany, Japan, Switzerland, the United Kingdom and the United States that ISDA Master Agreement documentation should be amended to ensure that, if a systematically important financial institution were to enter into resolution proceedings, its counterparties would all be subject to regulatory stays and overrides.

In 2015, the same authorities proposed changes to the 2014 Protocol to expand the scope of its application. To accommodate the additional requirements, ISDA developed the ISDA 2015 Universal Resolution Stay Protocol (“2015 Protocol”), which replaced the 2014 Protocol. Any entity may adhere to the 2015 Protocol, although buy-side market participants (i.e. which are not directly subject to Stay Regulations) are expected to adhere to the Jurisdictional Modular Protocol instead of the 2015 Protocol.

The Jurisdictional Modular Protocol allows parties to comply with applicable Stay Regulations without “over complying”.

Which Jurisdictional Modules are open for adherence as of August 2016?

The following Jurisdictional Modules are open for the adherence on the ISDA website:

- the ISDA UK (PRA Rule) Jurisdictional Module; and
- the ISDA German Jurisdictional Module.

Additional Jurisdictional Modules are expected to be published by ISDA in due course, to cover national Stay Regulations enacted for other jurisdictions.