Briefing Note

Practical Effect of the U.S. QFC Stay Rules Express Acknowledgement Language

15 April 2019

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA), a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

Introduction

The U.S. banking regulators adopted rules (the "**QFC Stay Rules**") in 2017 to improve the resolvability and resilience of U.S. global systemically important banks ("**G-SIBs**") and their subsidiaries worldwide, as well as the U.S. subsidiaries, branches and agencies of non-U.S. G-SIBs (together, the "**Covered Entities**"). Among other things, the QFC Stay Rules require Covered Entities to amend covered qualified financial contracts ("QFCs") to include language that expressly recognizes the authority of the Federal Deposit Insurance Corporation ("**FDIC**") under the Federal Deposit Insurance Act (the "**FDIA**") and the Orderly Liquidation Authority under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("OLA" and, together with the FDIA, the "**U.S. Special Resolution Regimes**") to suspend the exercise of default rights under such contracts and to transfer such contracts away from a failing Covered Entity (the "**Express Acknowledgement Language**").

This note complements the AFME briefing note dated 15 April 2019 on the impact of the U.S. QFC Stay Rules and summarizes the requirements for and the practical implications of including such language in certain equity capital markets ("**ECM**") agreements that may be considered QFCs, and where the underwriter is a non-U.S. subsidiary of a U.S. G-SIB (a "**Non-U.S. Subsidiary**").[1] The ECM agreements that may be considered to be covered QFCs include underwriting agreements, subscription agreements, placement agreements, stock lending agreements and agreements among underwriters that contain transfer restrictions or default rights (including step-up default clauses) exercisable against underwriters. Please see the AFME briefing note dated 15 April 2019 for a more detailed discussion.

[1] For the avoidance of doubt, this note does not address an underwriter that is a U.S. insured depository institution or a non-U.S. branch of such an institution, nor does it address an underwriter that is a U.S. subsidiary, branch or agency of a non-U.S. G-SIB, as such entities are unlikely to be involved in ECM agreements used in Europe.

Specifically, the Express Acknowledgment Language sets forth recognition of the FDIC's powers in two specific scenarios. Both scenarios must be included in order for the Covered Entity to be compliant with the QFC Stay Rules:

- ***Express Recognition 1***. Recognition of the statutory powers of the FDIC to transfer the QFC to a bridge institution or third-party transferee in the event that the Covered Entity enters into a proceeding under a U.S. special resolution regime; and

- ***Express Recognition 2***. Recognition of the statutory powers of the FDIC to limit the counterparty's exercise of default rights in the event that either the Covered Entity or an affiliate of the Covered Entity enters into a proceeding under a U.S. special resolution regime.

The bullet points below summarize the practical implications of including such language in certain ECM agreements where the underwriter is a Non-U.S. Subsidiary:

- ***The Express Acknowledgement Language merely recognizes statutory powers that already exist***. Similar to language that is used to recognize the resolution authorities' under the Bank Recovery and Resolution Directive in Europe, the Express Acknowledgement Language merely recognizes powers that the FDIC already has under the FDIA and OLA, as such laws operate today.

- ***The inclusion of the Express Acknowledgement Language in ECM agreements is unlikely to have any substantive effect for Covered Entity underwriters that are organized outside of the United States***. Underwriters that are subsidiaries of U.S. GSIBs are required by the QFC Stay Rules to include the Express Acknowledgement language in their covered QFCs, regardless of where such subsidiaries are organized. However, even though such language must be included in ECM agreements that may be considered covered QFCs with underwriters that are Non-U.S. Subsidiaries, such language should have no real substantive effect for the following reasons:

    - With respect to Express Recognition 1 and Express Recognition 2 (except for the very rare situation where an ECM agreement contains a cross-default right exercisable against an underwriter, as discussed in the next bullet), a Non-U.S. Subsidiary is not eligible to be placed into U.S. special resolution proceedings. Thus, the Express Acknowledgement Language addresses a scenario that cannot arise as matter of law and therefore would have no practical impact.

    - Express Recognition 2 also refers to the scenario where an affiliate of a Non-U.S. Subsidiary becomes subject to U.S. special resolution proceedings. While it is possible that a U.S. affiliate of a Non-US Subsidiary (e.g., its top-tier U.S. parent) could be placed into OLA proceedings, under typical ECM agreements used in Europe, the inclusion of Express Recognition 2 is unlikely to have a practical impact on the rights of the other parties under the agreement.

Under OLA, the FDIC has the authority to enforce contracts of a subsidiary of a failed U.S. financial company, but only if (1) the QFC is guaranteed or otherwise supported by the failed U.S. financial company, or (2) the QFC contains a "specified financial condition clause" that specifically references the failed U.S. financial company and provides the counterparty with the right to terminate the contract or exercise certain other default rights based on the financial condition or resolution under OLA of the failed U.S. financial company. However, ECM agreements used in Europe typically do not contain such cross-default rights that would be triggered by a U.S. affiliate of a Non-U.S. Subsidiary being placed into OLA proceedings.[2] There is no similar provision regarding contracts of affiliates under the FDIA.

Unfortunately, despite the fact that inclusion of the Express Acknowledgement Language is unlikely to have any practical effect for such ECM agreements, the QFC Stay Rules still require underwriters that are Non-U.S. Subsidiaries to include such language.

AFME Contacts

Andrew Brooke
Andrew.brooke@afme.eu
+44 (0)20 3828 2758

Olu Oluwole
Olu.oluwole@afme.eu
+44 (0)20 3828 2696

[2] In the unlikely event that an ECM agreement contained a cross-default right, under OLA, the issuer would be stayed from exercising termination rights against a Non-U.S. Subsidiary based on the insolvency or financial condition of the U.S. affiliate or the entry of the U.S. affiliate into OLA proceedings. In addition, the agreement would be required to include not only the Express Acknowledgment Language but also additional language mandated by the QFC Stay Rules providing for a contractual stay of cross-default rights based on any affiliate of the Covered Entity entering into any type of insolvency proceeding. However, in each case, this stay would not affect the ability of the issuer to continue to exercise remedies based on an actual payment or performance default by the Non-U.S. Subsidiary itself.