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BY E-MAIL

Ladies and Gentlemen

ISDA comments on the Prudential Regulation Authority's Consultation Paper CP19/15 on contractual stays in financial contracts governed by third-country law, published May 2015

The International Swaps and Derivatives Association, Inc. (ISDA)¹ is grateful for the opportunity to provide input to the Prudential Regulation Authority's (PRA's) Consultation Paper (CP19/15) on contractual stays in financial contracts governed by third-country law, published May 2015 (the Consultation).

Consistent with our mission, we are primarily concerned in this letter with the impact of the proposed implementation on the safety and efficiency of the financial markets, by considering the direct impact of the proposals on the obligations of firms with respect to derivatives and other financial transactions, and the consequential impact on market counterparties to such financial transactions in the event of a firm entering resolution. We are aware that a number of other market associations and professional bodies will be responding on some of the broader issues raised by the Consultation.

ISDA broadly supports the PRA's proposals for recognizing contractual stays in financial contracts governed by third-country law. However, in common with other stakeholders, we have some concerns with the terms of the Consultation as presently drafted. Along with these comments, we have provided a mark up of the Consultation reflecting our proposed changes.

¹ Information regarding ISDA is set out in Annex 1 to this response.

A. COORDINATION WITH OTHER FINANCIAL REGULATORS

ISDA strongly urges the PRA to coordinate with financial regulators in the United States and other jurisdictions that will implement legislation or regulations similar to the Consultation so that entities subject to the final rule (the Covered Entities) are subject to uniform standards across different jurisdictions and uniform compliance dates for applicable regulations.

Coordinating regulatory requirements will promote international harmonization and reduce competitive disparities and will allow Covered Entities to comply with the final UK rule and other similar rules in a more efficient and effective manner. The ISDA 2014 Resolution Stay Protocol (the Protocol) was perceived as successful largely because the terms and timing were coordinated globally. The Consultation as drafted could result in the UK being out of synch with other jurisdictions (both in terms of timing and in terms of substance), significantly increasing the operational costs of implementation and harming competitiveness of Covered Entities.

B. SCOPE OF CONSULTATION

ISDA generally supports a more tailored scope for the final rule.

First, ISDA supports limiting the scope of financial arrangements to those transactions that would be relevant for a temporary stay under the UK Banking Act 2009 (the Banking Act) in the event of the resolution of a BRRD undertaking. The Consultation currently excludes short-term interbank borrowings on the premise that these transactions are not subject to temporary stays under the Banking Act. In addition, the Consultation excludes UK and EEA-governed law contracts from its scope. These exclusions are consistent with the policy goals of the Consultation and reduce the compliance burden for Covered Entities. The final rule should similarly exclude overnight and cash-market transactions and demand provisions of financial arrangements, by requiring that the condition apply to financial arrangements that include termination rights based on defaults—whether direct defaults or cross defaults—that would be subject to a temporary stay under the Banking Act. For example, the final rule should only apply to a foreign subsidiary of a BRRD undertaking to the extent that the foreign subsidiary has a cross-default provision to the BRRD undertaking. Excluding financial arrangements that are not relevant for a temporary stay under the Banking Act reduces the burden of compliance for Covered Entities without undermining the policy goals of the Consultation.

For similar reasons, ISDA supports excluding from the final rule financial arrangements governed by the laws of a jurisdiction that would recognize the application of stays under the Banking Act. The final rule should take the same approach as Article 55 of BRRD, the conditions of which do not apply if the applicable resolution authority determines that the relevant contract can be subject to write-down and conversion power pursuant to the law of the third country. Excluding such financial arrangements reduces the burden of compliance for the Covered Entities while accomplishing the same goal of ensuring the financial arrangements are subject to temporary stays under the Banking Act.

Second, ISDA supports expanding the term “excluded person” to include financial arrangements with all financial market utilities, including central counterparties, depositories or settlement systems. For example, the current definition of excluded person does not apply

to non-EU central counterparties that have not applied for recognition under Article 25 EMIR or those that have applied for recognition but have not yet been recognized. Requiring Covered Entities to amend contracts with such financial market utilities would result in significant operational difficulties. ISDA strongly supports exempting all financial market utilities to promote parity of treatment among financial market utilities. Additionally, ISDA believes that were the PRA to regulate transactions with central counterparties, depositories or settlement systems in a similar manner to the current Consultation, it should do so in a separate process to minimize confusion and tailor regulations to the unique considerations of such counterparties.

Third, ISDA supports excluding financial arrangements entered into when a Covered Entity is a trading member on non-EU trading platforms or exchanges. These contracts are usually subject to the rules of the exchange or trading platform and members may have limited ability to modify these terms unilaterally. Additionally, these trades are typically given up for clearing soon after they are entered into by the trading members, and so do not pose the same risk as longer term transactions.

Fourth, ISDA supports excluding contracts with any non-material counterparty from the final rule. Such non-material counterparties would not pose a risk in the event of a Covered Entity's resolution, but would be subject to a significant compliance burden if captured by the final rule. As discussed above, ISDA urges the PRA to coordinate with other regulators to provide consistent exemptions for non-material counterparties in order to promote effective and efficient compliance by Covered Entities. We have created a defined term, "excluded counterparty," which expands the previous definition of "excluded person" to include non-material counterparties. A "non-material counterparty" is defined by reference to the definition of "non-financial counterparty" in Article 2 EMIR.

Finally, ISDA requests that the PRA clarify that transactions that are terminable on demand but also have additional termination rights are not financial arrangements subject to the requirements.

C. CONSISTENCY WITH ISDA PROTOCOL

ISDA notes that the Consultation appears inconsistent with the Protocol in several respects. ISDA requests that the PRA clarify the intent of these provisions and, to the extent of any inconsistencies, conform the final rule to the terms of the Protocol.

First, Paragraph 2.2(1) of the Consultation refers to the "laws of the UK," whereas under the Protocol parties opt in to the laws of "England and Wales." ISDA requests that the PRA clarify that the "laws of the UK" is intended to mean the laws of "England and Wales" or, alternatively, replace "UK" with "a part of the UK" in the final rule.

Second, the definition of "termination right" in the Consultation and the Banking Act does not include some remedies that are covered by the definition of "Default Right" in the Protocol, such as the exercise of remedies in respect of collateral related to a "Covered Master Agreement." The Consultation does not require the Covered Entity to agree to restrict the enforcement of a security interest in collateral covered under Section 70B of the Banking Act. To ensure parity of treatment for all counterparties of a firm subject to stays under the

Banking Act, ISDA supports expanding the definition of termination right to include the enforcement of a security interest in collateral under Section 70B.

Third, ISDA would suggest that Part 2.2(1) be amended to apply only if a crisis prevention measure, crisis management measure or recognised third-country resolution action is taken in relation to the BRRD undertaking or a member of the same group as the BRRD undertaking.

Finally, the Protocol does not require an adhering party to assume that the Covered Entity is a “CRR Firm.” ISDA would suggest deleting Part 2.2(2).

D. ADDITIONAL COMMENTS

ISDA has the following additional comments on the Consultation:

1. The clarifications in Paragraph 2.8 of the commentary to the Consultation describing what kinds of activities would be considered to “create a new obligation” or “amend an existing obligation” under a financial arrangement should be included in the text of the final rule. Including this clarification in the text of the final rule provides certainty on when a financial arrangement becomes subject to the conditions of the final rule. ISDA would suggest that “materially amend” be defined as follows:

materially amend

means actively changing the commercial parameters (such as interest or exchange rate, date of payment or reference asset) of an existing obligation in a way that would achieve the commercial intent of an ongoing trading relationship without technically creating a new obligation.

2. The final rule should clarify that “agrees in writing” in Part 2.2 can mean by electronic means. ISDA would suggest that the opening sentence of Part 2.2 be amended as follows:

The condition is that the counterparty to the financial arrangement, other than a counterparty which is an excluded party or a central government, agrees in writing (including by electronic means) that it shall be entitled to exercise termination rights under the financial arrangement to the extent that it would be entitled to do so under the Special Resolution Regime if:

3. The final rule should clarify that the enumerated list of financial contracts under the definition of “financial arrangement” is the complete set of covered contracts, as the term “financial arrangement” on its own may suggest a broader list of contracts. ISDA would suggest that the definition of financial arrangement be amended as follows:

financial arrangement

includes means the following contracts and agreements:

4. Part 2.1 of the final rule should include a carve out for excluded persons and central governments. Part 2.1 states that a new obligation cannot be entered into unless the condition in Part 2.2 is satisfied. However, Part 2.2 does not apply to counterparties

that are excluded persons or central governments, which implies that transactions with those entities are prohibited. ISDA would suggest that Part 2.1 be amended as follows:

A BRRD undertaking must not create a new obligation or materially amend an existing obligation under a financial arrangement not entered into with an excluded person that is governed by the law of a third country unless the condition in 2.2 is met.

5. The definition of “subsidiary” does not recognize that there may be situations where the parent company is unable to secure compliance by its subsidiaries. For example, rules protecting minority shareholders or rules on director conflicts of interest may make it difficult for the UK parent to use its voting power or board representation to impose requirements on a subsidiary. ISDA would suggest Part 1.2 be amended as follows:

A BRRD undertaking that is a parent undertaking must use reasonable efforts to ensure that a subsidiary which meets the condition in 1.3 complies with the requirements of this Part as if it were a BRRD undertaking subject to those requirements.

6. It is unclear that the reference to a “central government” includes entities acting on behalf of the central government. To clarify, ISDA would suggest that the following language be added after “central government”:

A central government (including any agency or instrumentality of a central government)

7. ISDA understands that the PRA intends for the references to “a counterparty that acts on an agency basis” and “an asset management company” to apply to the principal counterparties acting through an agent or asset management company. To clarify, ISDA would suggest Part 3.2 be amended as follows:

From 1 July 2016 this Part also applies in relation to a financial arrangement under 2.1 where the counterparty is:

- (1) *a counterparty that acts through an asset management company;*
- (2) *an AIF;*
- (3) *a UCITS;*
- (4) *an insurer; or*
- (5) *a counterparty that acts ~~on an agency basis~~ through an agent.*

E. ISDA PROTOCOL COMPLIANCE

ISDA supports official guidance and policy statements by the PRA that makes clear that it will consider a Covered Entity to have satisfied the conditions of the financial regulation for any financial arrangements subject to the terms of the Protocol. The Protocol was developed



in consultation with and in response to guidance from the Bank of England and was designed to address the concerns about cross-border resolutions raised in the preamble to the Consultation. An explicit statement from the PRA supporting the Protocol will promote broad adherence to the Protocol, which would allow Covered Entities to address these issues in a standardized and transparent fashion, supporting market stability in the event of an institution's resolution.

We hope that you find our comments useful in your continuing deliberations on the implementation of contractual stays in financial contracts governed by third-country law. Please do not hesitate to contact the undersigned if we can provide further information about the derivatives market or other information that would assist the PRA in its work in relation to the Consultation.

Yours faithfully,

A handwritten signature in black ink, appearing to read "Scott O'Malia".

Scott O'Malia
Chief Executive Officer

Annex 1

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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Our registration number in the relevant EU register is 46643241096-93.

1 APPLICATION AND DEFINITIONS

1.1 This Part applies to a *BRRD undertaking* which is:

- (1) a CRR firm;
- (2) a financial holding company; or
- (3) a mixed financial holding company.

1.2 A BRRD undertaking that is a parent undertaking must use reasonable efforts to ensure that a *subsidiary* which meets the condition in 1.3 complies with the requirements of this Part as if it were a *BRRD undertaking* subject to those requirements.

1.3 The condition in 1.2 is that the *subsidiary* is:

- (1) a credit institution;
- (2) an *investment firm* or an *undertaking* which would be an *investment firm* if it had its head office in an *EEA State*; or
- (3) a financial institution; and

is not a *BRRD undertaking* which falls within 1.1.

1.4 In this Part, the following definitions shall apply:

AIF

has the meaning given in point (a) of Article 4(1) of the *AIFMD*.

AIFMD

means Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

~~crisis~~ prevention management ~~measure~~

has the meaning given in section 48Z of the Banking Act 2009.

~~excluded person~~ crisis prevention measure

has the meaning given in section ~~70D(1)~~ 48Z of the Banking Act 2009.

excluded counterparty

means the following:

(a) a person who has been declared to be, or who is an operator of, a designated system under regulation 4 of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999;

(b) a person who has been designated by an EEA state as, or who is an operator of, a system under Article 2(a) of the Directive 98/26/EC of the European Parliament and of the Council on settlement finality in payment and securities settlement systems or an operator of such a system;

- (c) a CCP as defined in Article 2(1) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories; or
- (d) a central bank;
- (e) a central government (including any agency or instrumentality of a central government);
- (f) an exchange, other trading facility, payment system, settlement system or other financial market utility or infrastructure established in a third country; or
- (g) a non-material counterparty.

financial arrangement

~~includes~~means the following contracts and agreements:

- (a) financial contracts as defined in point 100 (a) to (d) of Article 2(1) of the BRRD;
- (b) a derivative as defined in Article 2(5) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4th July 2012 on OTC derivatives, central counterparties and trade repositories; and
- (c) a master agreement in so far as it relates to:
 - (i) any of the contracts or agreements referred to in points (a) and (b); or
 - (ii) a contract for the sale, purchase or delivery of the currency of the UK or any other country, territory or monetary union.

In each case,

- (a) in the case of a BRRD undertaking, that include termination rights based on defaults that would be subject to a suspension of termination rights under Banking Act 2009, and, in the case of a third-country affiliate of a BRRD undertaking, that include termination rights based on cross-defaults in relation to such BRRD undertaking that would be subject to a suspension of termination rights under Banking Act 2009; and
- (b) that are not terminable on demand.

materially amend

means actively changing the commercial parameters (such as interest or exchange rate, date of payment or reference asset) of an existing obligation in a way that would achieve the commercial intent of an ongoing trading relationship without technically creating a new obligation.

non-material counterparty

means a non-financial counterparty as defined in Article 2 of Regulation 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("EMIR"), and any entity established in a third country that would be a non-financial counterparty if it were established in the European Union, but excludes any such person that is subject to the clearing obligation under Article 4 of EMIR.

recognized third-country resolution action

has the meaning given in section 48Z of the Banking Act 2009.

Special Resolution Regime

means the provisions of Part I of the Banking Act 2009 and any measure taken under that Part.

termination right

has the meaning given in section 70C(10) of the Banking Act 2009 and includes enforcement of a security interest in collateral under Section 70B of the Banking Act 2009.

UCITS

has the meaning given in point (ao) of Article 4(1) of the AIFMD.

- 1.5 Unless otherwise defined, any italicised expression used in this Part and in the *CRR* has the same meaning as in the *CRR*.

2 STAY IN RESOLUTION

- 2.1 A *BRRD undertaking* must not create a new obligation or *materially amend* an existing obligation under a *financial arrangement* that is governed by the law of a *third country* (other than as set out in 2.3 below) unless the condition in 2.2 is met.
- 2.2 ~~The condition is that the counterparty to the *financial arrangement*, other than a counterparty which is an excluded person or a central government, agrees in writing that~~ agrees in writing (including by electronic means) that, if a crisis prevention measure, crisis management measure or recognised third-country resolution action is taken in relation to the *BRRD undertaking* or a member of the same group as the *BRRD undertaking*, it shall be entitled to exercise termination rights under the *financial arrangement* to the extent that it would be entitled to do so under the *Special Resolution Regime* if:

~~(1) the *financial arrangement* were governed by the laws of a part of the UK; and~~

~~(2) where the *BRRD undertaking* is not a *CRR firm*, the *BRRD undertaking* were a *CRR firm*.~~

2.3 The requirement in 2.1 shall not apply where:

- (1) the counterparty to the *financial arrangement* is an excluded counterparty;
- (2) the *financial arrangement* is entered into on or subject to the rules of an exchange or other trading facility established in a third country and the rules of that exchange or trading facility do not permit the counterparties to the *financial arrangement* to vary the termination rights under the *financial arrangement*; or
- (3) the Bank of England issues a notice that it has determined that the suspension of termination rights under the Banking Act 2009 would be recognized pursuant to the law of the *third country* or to a binding agreement concluded with that *third country*.

- 2.4 ~~2.3~~ For the purpose of 2.2, section 48Z of the Banking Act 2009 is to be disregarded to the extent that it relates to a *crisis prevention measure* other than the making of a mandatory reduction instrument by the Bank of England under section 6B of the Banking Act 2009.

3 TRANSITIONAL PROVISIONS

- 3.1 From 1 January 2016 this Part applies in relation to a *financial arrangement* under 2.1 where the counterparty is:
- (1) a *credit institution*,
- (2) an *investment firm*; or

(3) an *undertaking* which would be an *investment firm* if it had its head office in the *EEA*.

3.2 From 1 July 2016 this Part also applies in relation to a *financial arrangement* under 2.1 where the counterparty is:

(1) a counterparty that acts through an *asset management company*;

(2) an *AIF*;

(3) a *UCITS*;

(4) an *insurer*; or

(5) a counterparty that acts ~~on~~through an ~~agency~~basis.

3.3 From 1 January 2017 this Part applies in relation to all *financial arrangements* under 2.1 where ~~the counterparty is not an excluded person or a central government~~2.3 does not apply.