MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via Electronic Submission: http://www.regulations.gov/

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions (Docket No. R–1538; RIN 7100 AE–52)

Dear Mr. deV. Frierson:

Managed Funds Association ("**MFA**")[1] welcomes the opportunity to comment on the Board of Governors of the Federal Reserve System's ("**Board**") notice of proposed rulemaking on "Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions" ("**Proposed Rules**").[2] MFA understands that the Proposed Rules are one in a series of Board actions intended to address the "too-big-too-fail" problem demonstrated by the failure of Lehman Brothers Holdings Inc. and its subsidiaries ("**Lehman Brothers**"),[3] by increasing "the resolvability of U.S. global systemically important banking organizations".[4] MFA has been a strong supporter of legislative and regulatory efforts to strengthen the financial system because many investors in funds managed by MFA members incurred significant losses resulting from the collapse of Lehman Brothers.[5] However, as discussed herein, we have serious concerns that the

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[1] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policymakers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] 81 Fed. Reg. 29169 (May 11, 2016), available at: https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-11209.pdf ("**Proposed Rule Release**").

[3] *See id*. at 29169.

[4] *Id*. at 291670.

[5] *See* Michael Fleming and Asani Sarkar, *The Failure Resolution of Lehman Brothers*, Federal Reserve Bank of New York Economic Policy Review, March 2014, available at: www.ny.frb.org/research/epr/2014/1403flem.pdf.

Proposed Rules will harm the stability of the financial markets while also eroding long-standing and deeply rooted rights of investors, end-users[6] and other market participants.

I. Executive Summary[7]

MFA is very troubled by the content of the Proposed Rules, and the restrictions contained therein on the ability of end-users and other market participants to exercise certain default rights under qualified financial contracts ("**QFCs**")[8] during the failure of a covered entity ("**Covered Entity**").[9] Default rights are critically important to end-users when facing a troubled counterparty and serve important public policy goals of protecting investors and the stability of the financial markets. By depriving end-users of these rights, the Proposed Rules would exacerbate the "run on the bank" problem by encouraging end-users to seek to migrate business away from a Covered Entity as soon as they have any concerns about its stability.

This concern is particularly acute with respect to the Board's application of the Proposed Rules to U.S. bankruptcy proceedings, which are typically lengthy proceedings where there is a high degree of uncertainty as to the results. Because the U.S. Bankruptcy Code does not currently stay the exercise of default rights under QFCs during bankruptcy proceedings,[10] we are troubled that the Board may be setting a precedent by using regulation to alter the effect of the U.S. Bankruptcy Code. In our view, the Board's proposed restrictions on certain end-user default rights during U.S. bankruptcy proceedings[11] is inconsistent with Congressional intent and is a substantial constraint on a key risk mitigation tool that end-users need to protect themselves and their investors and/or beneficiaries.

[6] MFA uses the term "end-user" herein to refer broadly to entities that use financial arrangements as investment and risk management tools including, without limitation, asset managers, investment managers, manufacturers, and other commercial and industrial entities.

[7] MFA notes that we also support the technical corrections to the Proposed Rules contained in the comment letter of the International Swaps and Derivatives Association, Inc. ("ISDA"), but we have substantive concerns with the Proposed Rules, as discussed herein, that go beyond the scope of ISDA's comments.

[8] *See* Proposed Rule Release at 29190, proposed §252.81, defining QFC to have the same meaning as in section 210(c)(8)(D) of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**"), Pub.L. 111–203, 124 Stat. 1376–2223, available at: https://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf. This QFC definition generally includes any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, or similar agreement.

[9] *See id.*, proposed §252.82(a), defining "covered entity" generally to include: (1) any U.S. top-tier bank holding company identified by the Board as a global systemically important banking organization ("**GSIB**"); (2) the subsidiaries of any U.S. GSIB (other than national banks and federal savings associations); and (3) the U.S. operations of any foreign GSIB (other than national banks and federal savings associations).

[10] *See* U.S. Bankruptcy Code, 11 U.S. Code §362, available at: https://www.law.cornell.edu/uscode/text/11/362.

[11] *See* Proposed Rule Release at 29190-2, proposed §252.84, generally prohibiting a Covered Entity from being party to a QFC that permits the exercise of any default right related, directly or indirectly, to an affiliate of the direct party becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding.

MFA has consistently expressed strong objections to the initiatives of the Board and other regulatory authorities to restrict end-users' rights under QFCs, including the default rights contained therein and the related parent company guarantees,[12] as further captured in the Proposed Rules and the Proposed TLAC Rules. We have also expressed concerns with the regulatory precedent that the Board and other Financial Stability Board ("**FSB**") member regulators are setting, since they seem to be have been the genesis of the ISDA protocols[13] and appear to have pre-determined to proceed with restrictions on end-users' default rights prior to issuance of their respective proposed rules.[14] Attached as Annex A is an MFA white paper[15] setting forth our views on these initiatives as well as the broader FSB initiative on cross-border recognition of resolution actions.[16] Consistent with the views in our white paper, MFA strongly believes that, before the Board proceeds, there needs to be proper study and assessment of the costs and benefits as well as the market impact of the Proposed Rules, the Proposed TLAC Rules and the broader FSB initiatives, with specific focus on the retroactive application to existing default rights and the impact on all affected market participants, including end-users. Thus, we respectfully urge the Board to defer proceeding with the Proposed Rules pending such further study and assessment.

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[12] *See e.g.,* Joint letter from MFA and five other trade associations to the FSB on "Financial Stability Board Initiative to Suspend Counterparty Early Termination Rights during Resolution and Bankruptcy Proceedings" (Nov. 4, 2014), available at: https://www.managedfunds.org/wp-content/uploads/2014/11/Joint-Trade-Association-Letter-on-FSB-Early-Termination-Rights-Suspension-Final-11-4-142.pdf. *See also* Letter from Stuart J. Kaswell, Executive Vice President, Managing Director & General Counsel, MFA, to the Board on its notice of proposed rulemaking on "Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies" ("**Proposed TLAC Rules**"), (Feb. 19, 2016), available at: https://www.managedfunds.org/wp-content/uploads/2016/02/Fed-Proposal-on-Holding-Company-Loss-Absorbing-Capacity-Final-MFA-Letter-and-Annex-2-19-161.pdf.

[13] *See infra* notes 17, 18 and 29.

[14] *See supra* note 12.

[15] *See* MFA White Paper entitled "Too Big to Default: Policy and Legal Perspectives on Current Bank Regulator Initiatives to Restrict End-Users' Default Rights Against Big Banks", dated September 2015, available at: https://www.managedfunds.org/wp-content/uploads/2015/12/MFA-Early-Termination-White-Paper.pdf.

[16] The FSB initiative and the related ISDA Resolution Stay Protocol resulted from the St. Petersburg G-20 Summit in 2013, at which the FSB made a commitment to "develop policy proposals on how legal certainty in cross-border resolution can be further enhanced" by the time of the Brisbane G-20 Summit in November 2014. *See* Press Release, FSB, FSB Releases Proposals on Cross-border Recognition of Resolution Actions and Action to Address Cross-border Close-out Risk (Sep. 29, 2014), available at: http://www.financialstabilityboard.org/wp-content/uploads/pr_140929.pdf.

See Letter from Stuart J. Kaswell, Executive Vice President, MFA, to the FSB on the FSB consultative document on "Cross-border Recognition of Resolution Action", (Dec. 1, 2014), available at: https://www.managedfunds.org/wp-content/uploads/2014/12/FSB-Consultation-on-Cross-Border-Recognition-of-Resolution-Actions.pdf; and Letter from Stuart J. Kaswell, Executive Vice President, MFA, to Andrew Hoffman and Leanne Ingledew, Prudential Regulation Authority, on its joint consultation paper with the Bank of England on "Contractual stays in financial contracts governed by third-country law" (Aug. 26, 2015), available at: https://www.managedfunds.org/wp-content/uploads/2015/08/Bank-of-England-Proposal-on-Contractual-Stays-Final-MFA-Letter-8-26-15.pdf.

Notwithstanding MFA's objections, we recognize that the Board may determine to proceed with finalizing the Proposed Rules. In that event, we express particular concern with the safe harbor in proposed §252.85(a), which would provide an alternative compliance mechanism for market participants that adhere only to the ISDA 2015 Universal Resolution Stay Protocol ("**ISDA 2015 Universal Protocol**"),[17] but not the ISDA Resolution Stay Jurisdictional Modular Protocol.[18] Because end-users have fiduciary duties to their investors, they may be unable to adhere to the ISDA 2015 Universal Protocol, which would require end-users to agree to waivers that exceed the scope of applicable law and regulation. As a result, we are concerned that, rather than facilitating compliance by market participants, the narrowness of the safe harbor will instead harm market participants' ability to comply with the Proposed Rules in an accurate and efficient manner. To ensure a reasonably short implementation period for the final rules, MFA believes that it is important for the Board to adopt a final safe harbor that works for most market participants by permitting compliance with the ISDA Resolution Stay Jurisdictional Modular Protocol and its current adherence mechanics.

In addition, MFA makes the following recommendations with respect to the substance of the Proposed Rules, as further discussed herein:

(1) We urge the Board to eliminate proposed §252.84, and the restrictions contained therein on end-users' exercise of their default rights during insolvency proceedings;

(2) If the Board does not eliminate proposed §252.84, in the alternative, we request that the Board eliminate restrictions on the exercise of default rights related "indirectly" to a Covered Entity becoming subject to an insolvency or other similar proceeding;

(3) We urge the Board to expand the safe harbor in proposed §252.85(a) to apply also to the ISDA Resolution Stay Jurisdictional Modular Protocol,[19] including the creditor protections contained therein and the mechanics that allow jurisdiction-by-jurisdiction and dealer-by-dealer adherence (collectively, the "**ISDA JM Protocol**");

(4) We strongly recommend that the Board eliminate the retroactive application of the Proposed Rules, and apply the rules solely prospectively,[20] to align the Proposed Rules

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[17] *See* ISDA, ISDA 2015 Universal Resolution Stay Protocol (Nov. 4, 2015), available at: http://assets.isda.org/media/ac6b533f-3/5a7c32f8-pdf/.

[18] *See* ISDA, ISDA Resolution Stay Jurisdictional Modular Protocol (May 3, 2016), available at: https://www2.isda.org/functional-areas/protocol-management/protocol/24.

[19] *See id*.

[20] *See* Proposed Rule Release at 29190, proposed §252.83(a)(2)(ii).

with the final rules of the U.K. Prudential Regulation Authority,[21] and the statutory requirements adopted in Germany;[22]

(5) We support the Board's determination to exclude rights to terminate at any time that are embedded in on demand contracts from the proposed definition of "default right",[23] and we request that the Board maintain this exclusion in the final rules;

(6) We request that the Board extend the proposed transition timing,[24] so that the final rule would take effect no sooner than one year from the date that the ISDA JM Protocol (as amended to comply with the final rules) is published and available for adherence, including any additional time that may be necessary to seek the Board's approval of the enhanced creditor protections contained within it.

(7) We would appreciate it if the Board could provide further clarity on its process for approving submitted QFCs with enhanced creditor protections.[25] In addition, we request that the Board modify the proposed approval process to allow, at a minimum, end-users and other Covered Entity counterparties to submit requests and to incorporate a reasonable timeline (*e.g.*, 180-days) by which market participants can expect the Board to approve or deny a submitted QFC;

(8) We request that the Board eliminate the burden of proof that would require a party seeking to exercise a default right to prove by "clear and convincing evidence" that the exercise is permitted under the QFC;[26] and

(9) In the event that, despite our objections, the Board proceeds with finalizing the rules, we believe that there should be uniform and equal treatment of all Covered Entity counterparties under the rules.

II. Further Study and Cost-Benefit Analysis is Necessary

MFA believes that further study and assessment of the costs and benefits as well as the market impact of the Proposed Rules, Proposed TLAC Rules and other FSB member initiatives is

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[21] *See* Prudential Regulation Authority "Policy Statement – PS25/15 – Contractual stays in financial contracts governed by third-country law" (November 2015), available at: http://www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps2515.pdf.

[22] *See* The German Recovery and Resolution Act, Article 60 (on contractual recognition of temporary suspension of termination rights) (May 1, 2015), available at: http://dipbt.bundestag.de/dip21/brd/2015/0193-15.pdf.

[23] *See* Proposed Rule Release at 29190, proposed §252.81, paragraph 2 of the definition of "default right".

[24] *See id*., proposed §252.82(b).

[25] *See id*. at 29192, proposed §252.85(b).

[26] *See id*., proposed §252.84(j)(1).

necessary, with specific focus on the retroactive application to existing default rights and the impact on all affected market participants, including end-users.

While the Proposed Rule Release contains cost-benefit analysis for certain aspects of the Proposed Rules,[27] there are other aspects of the Proposed Rules and the Board's efforts to facilitate the orderly resolution of GSIBs and their related entities for which we feel further study and analysis is necessary. For example, in the Proposed Rule Release, the Board discusses the ISDA 2015 Universal Resolution Stay Protocol,[28] for which ISDA published a previous iteration in 2014.[29] In 2014, 18 major dealer banks ("**G-18 banks**") adhered to the ISDA 2014 Universal Resolution Stay Protocol, whereby they agreed to stays of their default rights with respect to their swap agreements with the other G-18 banks [30] with effect from January 1, 2015.[31] As a result of their adherence, more than 90% of the outstanding swaps notional amount of these G-18 banks is already subject to the stays recommended by the FSB and contemplated in these Proposed Rules.[32] MFA would appreciate further study and analysis demonstrating why it is necessary to restrict end-users default rights by subjecting them indirectly to the Proposed Rules to capture the remaining 10% of the swaps market, if 90% of that market is already subject to the necessary restrictions due to the G-18 banks' adherence (*i.e.*, why the benefits outweigh the costs).

Similarly, MFA would request that there be further study and analysis on the impact for QFC markets other than the swaps market. For example, the definition of QFC consists of many types of agreements beyond swap agreements, such as commodity and forward contracts.[33] In the Proposed Rule Release, when explaining the purpose of the Proposed Rules, the Board discusses the need to prevent another financial crisis like the one that occurred in the wake of Lehman Brother's failure.[34] While the role of swaps (and specifically credit default swaps) in the collapse of Lehman Brothers has been widely discussed, we are not aware that commodity and forward contracts posed similar issues for Lehman Brothers or have led to the failure of any other major financial institution. As a result, when considering the costs and benefits of the Proposed Rules, MFA would appreciate further analysis on why the other categories of QFC present the same

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[27] *See id*. at 29184-5.

[28] *See supra* note 17.

[29] *See* ISDA, ISDA 2014 Resolution Stay Protocol (Nov. 4, 2014), available at: http://assets.isda.org/media/f253b540-25/958e4aed.pdf/ ("**ISDA 2014 Universal Protocol**").

[30] *See* ISDA Latest News, "Major Banks Agree to Sign ISDA Resolution Stay Protocol" (Oct. 11, 2014), available at: http://www2.isda.org/news/major-banksagree-to-sign-isda-resolution-stay-protocol. ("**ISDA News Release**")

[31] Section 1 of the ISDA 2014 Universal Protocol became effective January 1, 2015 without the implementation of any new regulations. However, Section 2 of the ISDA 2014 Universal Protocol will not become effective until the implementation of the Proposed Rules. *See* ISDA 2014 Universal Protocol at 20.

[32] *See* ISDA News Release, which proves that this figure includes: (1) transactions with all counterparties of banks that would be subject to stays upon resolution because of the governing law of their agreements; and (2) transactions with the other adhering banks.

[33] *See supra* note 11.

[34] *See supra* note 3.

concerns as swaps such that it is necessary for the Board to alter the default rights contained therein.

In addition, MFA's understanding is that, like the swaps market, the markets for the other QFCs covered by the Proposed Rules are similarly bank-centric. Since ISDA's publication of the ISDA 2014 Universal Protocol and the G-18 banks' adherence, ISDA has also published the ISDA 2015 Universal Protocol (with the corresponding Securities Financing Transaction Annex)[35] and the Other Agreements Annex[36] to amend agreements for these other types of QFCs. The G-18 banks have already adhered to the ISDA 2015 Universal Protocol and the Other Agreements Annex is currently open for adherence.[37] If these other QFC markets are similarly dominated by transactions between G-18 banks, then like the swap markets, it would seem that adherence by the G-18 banks to the ISDA 2015 Universal Protocol and the related annexes capture almost all of the outstanding notional amounts in those markets as well. If there are differences between the swaps market and the markets for these other QFCs, such that the G-18 banks adherence to the ISDA 2015 Universal Protocol, does not capture the vast majority of those markets, MFA believes that it is important for the Board to clarify those differences and conduct a related study and assessment of the costs and benefits.

The foregoing examples are intended to be a few illustrations of the many aspects of the Proposed Rules and their application that MFA believes the cost-benefit analysis in the Proposed Rule Release does not sufficiently address. Therefore, we would appreciate the Board further studying and assessing the costs and benefits and market impact of the Proposed Rules and the Proposed TLAC Rules before proceeding.

III. MFA Recommendations on the Proposed Rules

A. Restrictions on Default Rights during Insolvency Proceedings[38]

1. Eliminate Proposed §252.84

MFA has serious objections to the proposed restrictions on end-users' ability to exercise certain default rights under QFCs during insolvency proceedings,[39] especially given that these stays do

[35] *See supra* note 28. *See also* ISDA Latest News, "Major Banks Sign Relaunched ISDA Resolution Stay Protocol" (Nov. 15, 2015), available at: http://www2.isda.org/news/major-banks-sign-relaunched-isda-resolution-stay-protocol.

[36] *See* ISDA, Other Agreements Annex (Mar. 2, 2016), available at: https://www2.isda.org/functional-areas/protocol-management/protocol/23.

[37] *See supra* note 35.

[38] This sections responds to the Proposed Rule Release at 29183, Question 10: The Board invites comment on the proposed restrictions on cross-default rights in covered entities' QFCs. Is the proposal sufficiently clear, such that parties to a conforming QFC will understand what default rights are and are not exercisable in the context of a GSIB resolution? How could the proposed restrictions be made clearer?

[39] The Proposed Rules specifically referenced any receivership, insolvency, liquidation, resolution, or similar proceeding. *See id.* at 29191, proposed §252.84(b). In addition, under the Proposed Rules, insolvency proceedings

not exist under the U.S. Bankruptcy Code, are contrary to congressional policies and objectives, and include stays under state and foreign insolvency regimes. Therefore, we would urge the Board to eliminate proposed §252.84.

In general, there are two prohibitions in proposed §252.84. The first would prohibit a Covered Entity from being party to a QFC that permits the exercise of any default right that is related, directly or indirectly, to an affiliate of the direct party becoming subject to an insolvency proceeding.[40] The second would prohibit a Covered Entity from being party to a QFC that would prohibit the transfer of any credit enhancement (*e.g.*, a parent company's guarantee of the Covered Entity's obligations under the QFC) upon the entry into resolution of an affiliate of the Covered Entity.[41] In addition, in the Proposed Rule, the Board makes clear that, consistent with the automatic stay under the U.S. Bankruptcy Code, default rights related to the bankruptcy proceeding of a direct counterparty remain unaffected by the Proposed Rules.[42] The Proposed Rules also provide certain creditor protections, such as that the restrictions on default rights under QFCs or credit enhancements do not apply if the direct counterparty or the affiliated Covered Entity providing the credit enhancement fail to satisfy their payment or delivery obligations under the QFC or credit enhancement.[43]

MFA continues to have strong objections with proposed §252.84 and its restrictions on end-users being able to exercise their default rights during insolvency proceedings, including in particular, U.S. Bankruptcy proceedings. Default rights are critically important to end-users when facing a troubled counterparty (including Covered Entities). Default rights protect an end-user, its investors, and other stakeholders by allowing the end-user, for example, to terminate and settle a QFC with a failing financial institution, and thereby, minimize its exposure to such institution and better manage market risk. Thus, as a general matter, MFA believes that restricting end-users' default rights implicates fundamental public policy goals: the goals of protecting investors and ensuring the sound functioning of the financial markets.

In addition, MFA does not believe that the best way to preserve financial market stability is to restrict these significant end-user protections, especially during times of market stress. If implemented, the Proposed Rules would significantly alter the financial market in the U.S. and would meaningfully impair end-users' ability to use QFCs (and the default rights thereunder) as risk management and investment tools. Even strong proponents of the single-point-of-entry resolution approach,[44] acknowledge that these rights are a core feature of these instruments on

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include not only U.S. bankruptcy proceedings, but also applicable state and foreign insolvency proceedings. *See id.*, proposed §252.84(e)(1); *see also* id. at 29182, footnote 110.

[40] *See id.* at 29191, proposed §252.84(b)(1).

[41] *See id.*, proposed §252.84(b)(2).

[42] *See id.*, proposed §252.84(e)(1).

[43] *See id.*, proposed §252.84(e)(2) and (3).

[44] MFA notes that there are equally thoughtful proponents of the same rights. *See, e.g.*, Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. On the Judiciary, 113th Cong. 35 (2014), available

which market participants have come to rely, and therefore, recommend a measured approach to the introduction of any fundamental changes to these rights.[45]

MFA also emphasizes that these default rights not only protect end-users and their investors, but also preserve the integrity and stability of the financial markets by alleviating market certainty and reducing the potential for further contagion. For example, by depriving market participants of important credit protections, the Proposed Rules would encourage them to seek to migrate business away from Covered Entities as soon as they have any concerns about a Covered Entity's stability. Therefore, by restricting market participants' default rights in their QFCs with Covered Entities under the Proposed Rules, the Board could be increasing the risk of a "run" on a distressed Covered Entity. In turn, these "runs" could increase the probability that one or more entities within that Covered Entity's broader financial institution become insolvent and subject to resolution, and it could send signals of financial distress that could affect the financial markets more broadly.

In addition, the fact that the Proposed Rules differ in scope to the final regulations in other jurisdictions could further increase market uncertainty, and thus, be detrimental to the stability of the financial markets during stressed market conditions. As discussed below, while the Proposed Rules apply retroactively, the final regulations in other jurisdictions apply only prospectively.[46] Similarly, while the Proposed Rules apply to GSIBs and certain of their related entities, the rules of other jurisdictions vary as to the scope of entities to which they apply.[47] As a result, the stays on the exercise of default rights may not apply equally and universally to QFCs with a failing financial institution in these jurisdictions. Because of such fragmented application, as acknowledged by the Board, sophisticated market participants may pursue contractual countermeasures (*e.g.*, negotiating additional protections into their QFCs) and market-based actions (*e.g.*, running from the failing entity sooner) to address the absence of a level playing field.[48] Therefore, we believe that there is cause for concern that, because of this increased uncertainty and the related market contagion, the costs of the Proposed Rules to financial market stability outweigh the benefits.

From a legal perspective, MFA also has significant concerns with proposed §252.84. The end-user default rights that this provision proposes to restrict during U.S. bankruptcy proceedings have been legally enforceable under U.S. law for decades. In the Proposed Rules, the Board

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at: http://judiciary.house.gov/_cache/files/832fe54a-bf55-4567-8eeb-54cdcbec5e5e/113-90-87331.pdf (statement of Seth Grosshandler) ("[T]he Bankruptcy Code safe harbors serve a vital role in promoting systemic stability and resilience, have significantly increased the availability to customers of derivatives and repurchase agreements and the liquidity of these transactions and related assets, have reduced the cost of transactions to customers and have decreased the cost of financing to issuers of assets.").

[45] *See, e.g.*, Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 Stan. L. Rev. 539, 589 (2011), available at: http://www.stanfordlawreview.org/sites/default/files/articles/Roe-63-Stan-L-Rev-539.pdf.

[46] *See supra* notes 21 and 22. *See also* Section II.C of this letter below.

[47] *See id*.

[48] *See* Proposed Rule Release at 29184.

incorporates restrictions on default rights related to a Covered Entity entering into either a U.S. special resolution proceeding or an insolvency proceeding.[49] However, whereas Title II of the Dodd-Frank Act[50] includes specific provisions that statutorily impose stays of default rights during U.S. resolution proceedings,[51] the U.S. Bankruptcy Code does not presently stay the exercise of default rights under QFCs during bankruptcy proceedings.[52] As a result, since, in the U.S., Congress alone has the authority to enact U.S. bankruptcy legislation,[53] in our view, the Board is using proposed §252.84 to alter fundamentally the effect of the U.S. Bankruptcy Code, rather than seeking to have Congress enact necessary statutory amendments.[54]

In addition, MFA questions application of the restrictions in proposed §252.84 not only to U.S. bankruptcy proceedings, but also to insolvency proceedings under applicable state and foreign law.[55] While regulatory authorities in other jurisdictions have finalized regulations to stay the exercise of default rights during resolution proceedings under their OLA-like special resolution regimes, they have not chosen to stay these rights during proceedings under their domestic (or other jurisdiction's foreign) insolvency regimes.[56] Moreover, while in the Proposed Rule Release the Board discusses the additional protections available under OLA to protect end-users and their investors during the stay period,[57] we do not believe that these additional protections exist under state or foreign insolvency regimes. As a result, we believe that, in its totality the foregoing further exacerbates the concerns created by imposition of the proposed restrictions on default rights during insolvency proceedings.

As a result, MFA strongly believes that the Board should eliminate proposed §252.84 from the Proposed Rules.

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[49] *See id*. at 29190-2, proposed §§252.83 and 252.84.

[50] Title II of the Dodd-Frank Act is also known as the Orderly Liquidation Authority ("**OLA**").

[51] *See* Section 210(c)(8) of the Dodd-Frank Act.

[52] *See supra* note 10.

[53] *"The Congress shall have Power to...establish...uniform Laws on the subject of Bankruptcies throughout the United States....",* U.S. Const. art. I, § 8, cl. 4, available at: https://www.law.cornell.edu/constitution/articlei.

[54] However, MFA has concerns as to whether even Congressional action is inappropriate at this time given the potential consequences of these sudden and fundamental changes for the financial markets.

[55] *See supra* note 39.

[56] *See supra* notes 21 and 22.

[57] *See* Proposed Rule Release at 29173.

2. Alternatively Eliminate Restrictions on Exercise of "Indirect" Default Rights

If the Board does not eliminate proposed §252.84, as discussed above, in the alternative, MFA requests that the Board eliminate the proposed restrictions on the exercise of default rights related "indirectly" to a Covered Entity becoming subject to an insolvency proceeding.[58]

In the Proposed Rules, the Board provides that QFCs of a Covered Entity may not permit the exercise of default rights related "directly or *indirectly*" to an affiliate of the direct party becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding." We believe that it is unclear what constitutes a right related "indirectly" to an insolvency proceeding such that it will create further market uncertainty during a stressed market scenario. For example, if an end-user has a QFC with an entity that allows the end-user to terminate the QFC upon a ratings downgrade of that entity's Covered Entity parent company, and that downgrade occurs during the stay period related to Covered Entity's insolvency, is exercise by the end-user of its default right restricted? The Covered Entity's financial troubles are a clear factor in its ratings downgrade, but the event that triggered the default right is not commencement of the insolvency proceeding itself.

When this language is combined with the "clear and convincing evidence" burden of proof that the Board is proposing to place on the party seeking to exercise its rights,[59] the outcome of the Proposed Rules would effectively be a complete prohibition on the exercise of any QFC default right during the stay period related to a Covered Entity, even if a reasonable person would not consider the default right to be related to the Covered Entity's insolvency. We disagree with this outcome and the potentially limitless scope of the proposed restrictions. Thus, as an alternative to the elimination of proposed §252.84, MFA would request that the Board eliminate the restriction of the exercise of default rights "indirectly" related to the Covered Entity's insolvency proceeding.

For the avoidance of doubt, MFA notes that, if the Board determines not to eliminate proposed §252.84, we request that the Board modify the provision as necessary to address not only our recommendation that the Board eliminate the restriction on default rights "indirectly" related to the insolvency proceeding, but also our other concerns with the provision as discussed herein, such as its application to state and foreign insolvency regimes.

B. Modify Proposed Safe Harbor to Include ISDA Resolution Stay Jurisdictional Modular Protocol[60]

MFA urges the Board to expand the safe harbor in proposed §252.85(a) to apply not only to the ISDA 2015 Universal Protocol, but also to the ISDA JM Protocol (as defined herein to include the

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[58] *See id*. at 29191, proposed §252.84(b)(1).

[5959] *See supra* note 26. *See also* Section II.F of this letter.

[60] This sections responds to the Proposed Rule Release at 29183, Question 14: The Board invites comment on the proposed provisions permitting specific creditor protections in covered entities' QFCs. Does the proposal draw an appropriate balance between protecting financial stability from risks associated with QFC unwinds and maintaining important creditor protections? Should the proposed set of permitted creditor protections be expanded to allow for

creditor protections contained therein and the mechanics that allow jurisdiction-by-jurisdiction and dealer-by-dealer adherence).

Specifically, in proposed §252.85(a), the Board provides an alternative compliance mechanism, whereby a Covered Entity's QFC may permit the exercise of a default right with respect to that QFC, if the QFC has been amended by the ISDA 2015 Universal Protocol, including the Securities Financing Transaction Annex and Other Agreements Annex.[61] Unfortunately, while the Board recognizes the existence of the ISDA JM Protocol in the Proposed Rule Release,[62] the §252.85(a) safe harbor does not allow compliance with that version of the protocol to satisfy compliance with the Proposed Rules.

Rather, in footnote 106 of the Proposed Rule Release, the Board provides "[a] jurisdictional module for the United States that is substantively identical to the [ISDA 2015 Universal Protocol] in all respects aside from exempting QFCs between adherents that are not covered entities or covered banks would be consistent with the current proposal."[63] This footnote means that the Board would allow compliance with the ISDA JM Protocol to satisfy the requirements of the Proposed Rules, only if the dealer-by-dealer and jurisdiction-by-jurisdiction adherence mechanics are eliminated along with the creditor protections that exceed the protections contained in the ISDA 2015 Universal Protocol. MFA supports compliance with the ISDA JM Protocol satisfying the requirements of the Proposed Rules, but not the proposed limitations on creditor protections and the dealer-by-dealer and jurisdiction-by-jurisdiction adherence mechanics, which are critical components of that version of the protocol.

The Board's insistence on adherence to ISDA 2015 Universal Protocol, rather than the ISDA JM Protocol, in the safe harbor presents a number of issues for end-users, including first and foremost that it is a breach of end-users' fiduciary duties to their investors. In general, MFA members and other end-users have affirmative fiduciary duties to act in their investors' best interests.[64] These fiduciary duties prevent end-users from voluntarily waiving default rights (*i.e.*, waiver is permitted only to the extent required by law). As a result, end-users can amend their QFCs with Covered Entities to waive default rights as required by the Board's final rules. However, end-users cannot waive default rights with respect to any counterparties or jurisdictions where such waiver exceeds

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other creditor protections that would fall within the proposed restrictions? Is the proposed set of permitted creditor protections sufficiently clear?; and Question 15: The Board invites comment on its proposal to treat as compliant with section 252.84 of the proposal any covered QFC that has been amended by the Protocol. Does adherence to the Protocol suffice to meet the goals of this proposal and appropriately safeguard U.S. financial stability?

[61] *See id*. at 29192.

[62] *See id*. at 29181, footnote 106.

[63] *Id*.

[64] *See* Section 206 of the Investment Advisers Act of 1940, as amended ("**Advisers Act**"), which generally prohibits an adviser from engaging in any practice that is fraudulent, deceptive or manipulative. *See also* SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963), in which the U.S. Supreme Court said (in dicta) that the Advisers Act reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship", available at: https://www.sec.gov/divisions/investment/capitalgains1963.pdf.

the scope of applicable law and regulation (*i.e.*, where such waiver is not legally required, such that it is effectively a voluntary waiver).

As the Board is aware, the ISDA 2015 Universal Protocol is broader in many respects than the ISDA JM Protocol because it was created for a different purpose. The ISDA 2015 Universal Protocol was drafted by GSIBs with the intention that solely they would adhere to it.[65] Although end-users and other buy-side market participants were initially involved in discussions related to the substance of the ISDA 2014 Universal Protocol, once it became clear that only GSIBs would be adhering to it and subsequent iterations of that version of the protocol, the buy-side ceased providing input into it. Therefore, given that GSIBs are global entities that would already be subject to the full scope of restrictions under the special resolution regimes of numerous jurisdictions, the substance of the ISDA 2015 Universal Protocol is not reflective of buy-side and sell-side consensus and the scope of the waivers contained in that version of the protocol are understandably very broad.

In contrast, the ISDA JM Protocol was created to allow broad adherence by both buy-side and sell-side market participants to the specific final regulations adopted in each jurisdiction.[66] Thus, the scope of the waivers contained in the ISDA JM Protocol is narrowly tailored to the final rules and the adherence mechanics necessarily accommodate the legal restrictions applicable to the variety of different market participants that will adhere to it.[67]

From a substantive standpoint, market participants that adhere to the ISDA 2015 Universal Protocol are agreeing to amend their QFCs and restrict exercise of their default rights with respect to all other protocol adherents, including entities that are not Covered Entities.[68] Because of this structure, the ISDA 2015 Universal Protocol is dynamic in nature, such that the scope of adherents will increase over time. Thus, the universe of counterparties with which an adherent would be agreeing to restrict their default rights will change and grow over time as well. Similarly, under the ISDA 2015 Universal Protocol, adherents also agree to amend their QFCs with respect to jurisdictions that do not currently have laws and related regulations that address the failure or potential failure of a financial institution.[69] As a result, as discussed above, end-users' fiduciary

[65] *See* ISDA, ISDA Resolution Stay Jurisdictional Modular Protocol - General FAQs ("**ISDA FAQs**"), at 1, which itself provides that "the specific provisions of the ISDA 2015 Universal Protocol (and the ISDA 2014 [Universal] Protocol on which it was based) differ from the requirements of Stay Regulations enacted thus far in ways that would make it unlikely to be used by buyside market participants. On the other hand, it is expected that both sellside and buyside institutions will adhere to the ISDA Jurisdictional Modular Protocol in order to comply with Stay Regulations, including those that adhere to the ISDA 2015 Universal Protocol", available at: http://assets.isda.org/media/f253b540-93/f4a3c3c6-pdf/.

[66] *See id*.

[67] *See id*.

[68] *See* ISDA 2015 Universal Protocol, providing that each adhering party is adhering with respect to all other adhering parties. *See also* ISDA, Adhering Parties, available at: https://www2.isda.org/functional-areas/protocol-management/protocol-adherence/22. As of June 17, 2016, 217 entities had adhered to the ISDA 2015 Universal Protocol, which list includes many entities that would not be Covered Entities under the Proposed Rules.

[69] *See id*., Attachment, Section 6, the definition of "Protocol-Eligible Jurisdiction".

duties prevent them from adhering to the ISDA 2015 Universal Protocol or, as provided in footnote 106, a version of the ISDA JM Protocol that mirrors the substance of the ISDA 2015 Universal Protocol while eliminating the dealer-by-dealer adherence mechanism.

MFA supports the Board's inclusion of a safe harbor for the ISDA protocols in the final rules. However, that safe harbor needs to be modified to include the ISDA JM Protocol, so that it is reasonable and legally permissible for the broad set of market participants whose QFCs will be affected by the Proposed Rules. As currently drafted, with reference solely to the ISDA 2015 Universal Protocol, the safe harbor in proposed §252.85(a) would create an un-level playing field in the financial markets. Specifically, because of the legal requirements applicable to end-users and a large portion of other market participants, many market participants would be unable to avail themselves of the proposed safe harbor (*i.e.*, it would not be a viable and meaningful alternative). These market participants would be disadvantaged as compared to the market participants that are able to use the safe harbor and receive the benefit of the favorable creditor protections contained therein. As a result, if the Board were to broaden proposed §252.85(a) to include the ISDA JM Protocol as described herein, it would benefit the markets by allowing the vast majority of market participants to adhere to the ISDA JM Protocol thereby creating a level playing field and furthering the Board's goal of ensuring the orderly resolution of Covered Entities.

MFA also supports market participants having the options to use the ISDA JM Protocol to assist them with their compliance with the Board's final rules. However, for the ISDA JM Protocol and the Proposed Rules to work in harmony, we believe that the protocol must be completed after, and tailored to the requirements of, the final rules (*i.e.*, the protocol has to follow the final rules, not lead it).[70] For ISDA to be able to modify and finalize the ISDA JM Protocol promptly following the Board's adoption of final rules, MFA believes that the Board should draft the final rules in a clear and concise manner, whereby the baseline rules contain all the requirements that the Board thinks are necessary.

We think it is counterproductive for the Board to try to force adherence to the ISDA 2015 Universal Protocol or drive the content of the ISDA JM Protocol through overly burdensome final rules. For example, in the Proposed Rule Release, the Board discusses that the stay and transfer provisions of the ISDA 2015 Universal Protocol are narrower than the Proposed Rules, and that there are more and/or stronger creditor protections in the ISDA 2015 Universal Protocol than in the Proposed Rules.[71] While we are aware that the Board wants to incentivize use of the ISDA 2015 Universal Protocol, we think it unfairly disadvantages market participants, like end-users, that are legally unable to adhere to that version of the protocol. Given that the Board recognizes the narrower stay and transfer provisions and the broader/stronger creditor protections in the ISDA 2015 Universal Protocol as being consistent with the objective of the Proposed Rules, MFA believes that the Board should modify the Proposed Rules to incorporate these same provisions directly into the final rules. As a result, all market participants would be able to benefit from these

[70] *See supra* note 65, where ISDA explains that the ISDA JM Protocol was developed "to provide a means for the broader market to comply with the express requirements of Stay Regulations without 'over complying'".

[71] *See* Proposed Rule Release at 29182-3.

protections, not just the market participants that are legally able and willing to adhere to the ISDA 2015 Universal Protocol.

C. Eliminate Retroactive Application[72]

MFA strongly recommends that the Board eliminate the retroactive application of the Proposed Rules, and apply the rules solely on a prospective basis. While we understand the Board's desire to reduce the interconnectedness between entities in large financial institutions,[73] in the case of pre-existing QFCs, MFA believes that it is critical that the Board retain these historical default rights so as not to expose end-users to significant, unanticipated, and unmitigated counterparty risk.

As a general matter, the Proposed Rules apply to all new QFCs entered into after the effective date of the final rules.[74] However, the Proposed Rules would also apply retroactively to a legacy or pre-existing QFC[75] between, for example, an end-user and either a Covered Entity or one of the Covered Entity's affiliates, if the end-user enters into any new QFCs with the Covered Entity or one of its affiliates after the effective date of the final rules.[76] MFA has concerns with the proposed retroactive application because it would affect end-users' and other market participants historical default rights, and thus, greatly increase the risks to those end-users and the financial markets.

For end-users that are the beneficiaries of the default rights in these pre-existing QFCs, it would eliminate a critical risk mitigation tool and greatly increase the magnitude of the risks that end-users would face. Typically, the parent company in a large, global financial institution is a bank holding company regulated by the Board, and thus, is a well-capitalized and creditworthy entity. However, end-users' direct counterparty with respect to a pre-existing QFC is usually not the parent company, but instead is an affiliate or subsidiary of the parent company that may be a thinly capitalized, unrated trading entity (or, at least, less well-capitalized and creditworthy than its parent). To protect themselves from the increased risks that may result from trading with the less creditworthy entity, end-users have negotiated these historical default rights into their pre-existing QFCs.[77] Therefore, retroactive application of the Proposed Rules to pre-existing QFCs would

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[72] This section responds to the Proposed Rule Release at 29184, Question 19: The Board invites comment on the proposed transition periods and the proposed treatment of preexisting QFCs.

[73] *See id.* at 29170.

[74] *See supra* note 20.

[75] By pre-existing QFC, we mean a QFC entered into prior to the effective date of the Board's final rules.

[76] *See* Proposed Rule Release at 29190, proposed §252.83(a)(2)(ii), defining a covered QFC as, among other things, a QFC that the covered entity "[e]ntered, executed, or otherwise became a party to before the date this subpart first becomes effective, if the covered entity or any affiliate that is a covered entity or a covered bank also enters, executes, or otherwise becomes a party to a QFC with the same person or affiliate of the same person on or after the date this subpart first becomes effective."

[77] For pre-existing QFCs, the parent company in the financial group frequently will serve as a credit support provider under the QFC by guaranteeing the subsidiaries' or affiliates' obligations, as applicable, and providing related cross-default rights to the end-user. These cross-default rights and parent guarantees in the QFC provide key credit

expose end-users to risks that they might not have been willing to assume if, at the outset of their trading relationship with the subsidiary or affiliate, the end-users had known that they would not be able to rely on their default rights.

Moreover, to remedy such an unexpected increase in their counterparty risk, end-users may seek to negotiate additional credit protections into their QFCs that are unrelated to the insolvency of a Covered Entity, and thus, are not prohibited by the Proposed Rules. However, re-negotiating the terms of pre-existing QFCs would be difficult such that we do not believe it is likely that end-users will be successful in obtaining such additional credit protections. As a result, ultimately, we expect that, if the Board applies the final rules retroactively, end-users will be burdened with riskier historical positions. We believe increasing the credit risks to which market participants may become subject is contrary to the risk reduction goals of the Proposed Rules.

In addition, in keeping with the Board's goal to ensure that the Proposed Rules are "consistent with analogous legal requirements that have been imposed in other national jurisdictions",[78] MFA notes that eliminating the retroactive application of the Proposed Rules would further align the Proposed Rules with the final regulations of authorities in other FSB member jurisdictions. In particular, both the final rules of the U.K. Prudential Regulation Authority,[79] and the statutory requirements adopted in Germany[80] restrict the exercise of contractual default rights only on a prospective basis (*i.e.*, there is no retroactive application). As a result, regulators in those FSB member jurisdictions have determined to preserve end-users' historical default rights when the end-user is a counterparty to an entity that is part of a U.K. or German systemically important financial institution will be able to preserve. MFA is concerned that, if the Board's final rules apply retroactively when the rules of other FSB jurisdictions do not, when a Covered Entity begins to experience financial distress, the prospect of fragmented application of stays on default rights may enhance market anxiety and uncertainty. In turn, we believe that such uncertainty and anxiety may exacerbate financial contagion in the market and become counterproductive to the Board's goal of reducing systemic risk.

Therefore, MFA strongly recommends that the Board eliminate the retroactive application and apply the Proposed Rules solely on a prospective basis to reduce risk and to harmonize with other FSB jurisdictions.

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protections to the end-user that forms part of the end-user's credit analysis of the subsidiary or affiliate, and are a critical factor in the end-user's willingness to trade with the subsidiary or affiliate of the parent company.

[78] Proposed Rule Release at 29174. In addition, MFA notes that, under Section 165(b)(2) of the Dodd-Frank Act, when the Board applies prudential standards to foreign non-bank financial companies, the Board is required to "(A) give due regard to the principle of national treatment and equality of competitive opportunity; and (B) take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States."

[79] *See supra* note 21.

[80] *See supra* note 22.

D. Retain Exclusion for On Demand Trades[81]

MFA strongly supports the Board's decision to exclude rights to terminate at any time that are embedded in on demand contracts from the definition of "default right".

The Proposed Rules would generally prohibit a Covered Entity from being party to QFCs that would allow its counterparty to exercise default rights against the Covered Entity based on the entry into a resolution proceeding under the Dodd-Frank Act, Federal Deposit Insurance Act of 1950,[82] or any other resolution proceeding of an affiliate of the covered entity.[83] In defining what constitutes a "default right", in the Proposed Rules, the Board proposes to exclude "any right under a contract that allows a party to terminate the contract on demand or at its option at a specified time, or from time to time, without the need to show cause".[84] MFA agrees with the Board that it would not be appropriate to limit or restrict the ability to terminate on demand contracts because it would undermine the fundamental economics of such contracts.

E. Clarify and Modify Approval Process for Enhanced Creditor Protections[85]

MFA would appreciate it if the Board could provide further clarity on the process for approving submitted QFCs with enhanced creditor protections. In addition, we request that the Board modify the proposed approval process to allow, at a minimum, end-users and other Covered Entity counterparties to submit requests and to incorporate a reasonable timeline (*e.g.*, 180 days) by which market participants could expect the Board to approve or deny a submitted QFC.

The Proposed Rules include a process by which the Board may approve as compliant one or more QFCs that contain enhanced creditor protections (*i.e.*, additional creditor protections that would be otherwise impermissible under the restrictions in the Proposed Rules).[86] However, the Proposed

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[81] This section responds to the Proposed Rule Release at 29177, Question 8: The Board invites comment on all aspects of the proposed definition of "default right." In particular, are the proposed exclusions appropriate in light of the objectives of the proposal? To what extent does the exclusion of rights that allow a party to terminate the contract "on demand or at its option at a specified time, or from time to time, without the need to show cause" create an incentive for firms to include these rights in future contracts to evade the proposed restrictions? To what extent should other regulatory requirements (*e.g.*, liquidity coverage ratio or the short-term wholesale funding components of the GSIB surcharge rule) be revised to create a counterincentive? Would additional exclusions be appropriate? To what extent should it be clarified that the "need to show cause" includes the need to negotiate alternative terms with the other party prior to termination or similar requirements (*e.g.*, Master Securities Loan Agreement, Annex III—Term Loans)?

[82] Pub.L. 81–797, 64 Stat. 87, available at: https://www.fdic.gov/regulations/laws/rules/1000-100.html.

[83] *See* Proposed Rule Release at 29190, proposed §252.83(b)(2), and Proposed Rule Release at 29191, proposed §252.84(b)(1).

[84] *Id*. at 29190, proposed §252.81, paragraph 2 of the definition of "default right".

[85] This sections responds to the Proposed Rule Release at 29184, Question 18: The Board invites comment on all aspects of the proposed process for approval of enhanced creditor protections. Are the proposed considerations the appropriate factors for the Board to take into account in deciding whether to grant a request for approval? What other considerations are potentially relevant to such a decision?

[86] *See id*. at 29192, proposed §252.85(b).

Rule would allow only Covered Entities to submit QFCs for approval.[87] We request that the Board allow, at a minimum, Covered Entities' counterparties also to submit QFCs for Board approval. Although the restrictions in the Proposed Rules apply directly to Covered Entities, the rules will indirectly apply to, and have broad impact on, end-users and other Covered Entity counterparties. In other areas of the Proposed Rules, the Board has determined to place certain burdens directly on the counterparty to the QFC, rather than the Covered Entity.[88] Therefore, we believe that it is fair and equitable for the Board similarly to allow end-users and other Covered Entity counterparties to submit QFCs for approval, and such an approach is consistent with what other U.S. regulators have permitted under their rules.[89]

In addition, while the Proposed Rule discusses the nine factors that the Board would take into consideration when determining whether to approve a submitted QFC,[90] it otherwise provides little detail into the how the approval process will work in practice. For example, if the submitted QFC includes multiple, enhanced creditor protections, would the Board only approve the QFC if it views all the enhanced creditor protections as meeting the requisite standards, or could the Board approve some enhanced creditor protections in the submitted QFC but not others? In the Proposed Rule Release, the Board indicates that other Covered Entities could use enhanced creditor protections once approved by the Board.[91] How would the Board make such approvals known to Covered Entities (*e.g.*, would the Board publish them in the Federal Register)? In addition, is there a general timeframe in which the Board expects to either approve or deny a submitted QFC? MFA would appreciate it if the Board could provide further clarity and details about the approval process.

MFA also requests that the Board incorporate a reasonable timeline (*e.g.*, 180 days) into the final rules by which market participants could expect the Board to approve or deny a submitted QFC. As the Board knows, the Proposed Rules represent a significant change to the QFC markets, and could lead to market disruptions while market participants seek to bring their QFCs into compliance with the rules. In the absence of knowing how the Board will resolve the issues discussed herein, market participants will have uncertainty as to the extent to which their QFCs will fall outside of the permitted creditor protection parameters in the final rules, and thus, will require Board approval. As a result, there may be a substantial number of QFCs submitted to the

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[87] *See id*., proposed §252.85(b)(1).

[88] *See id*., proposed §252.84(j), requiring the party seeking to exercise a default right to bear the burden of proof that the exercise is permitted under the covered QFC.

[89] We note that other regulators have similarly allowed market participants not directly subject to its rules to submit matters for approval. For example, in its "Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations" ("**Cross-Border Guidance**"), the Commodity Futures Trading Commission ("**CFTC**") enumerated a broad list of persons and entities that could submit a request to the CFTC for a determination that another jurisdiction's rules were comparable to the rules of the CFTC. "Persons who may request a comparability determination include: (i) Foreign regulators, (ii) an individual non-U.S. entity, or group of non-U.S. entities; (iii) a U.S. bank that is a swap dealer or MSP with respect to its foreign branches; or (iv) a trade association, or other group, on behalf of similarly-situated entities." Cross-Border Guidance at 45344, available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf.

[90] *See* Proposed Rule Release at 29192, proposed §252.85(d).

[91] *See id*. at 29184.

Board for approval. To minimize disruptions to market trading and liquidity, we think it important that the Board establish a reasonable timeline by which it will approve or deny submission so as not to allow submissions to remain outstanding for lengthy periods. MFA believes that 180 days is a reasonable time period that we hope should provide the Board with sufficient time for its review while also minimizing the potential market impact.

F. Eliminate Burden of Proof

MFA requests that the Board eliminate the burden of proof in the Proposed Rules.

In the Proposed Rules, once an affiliate of a direct party to a QFC becomes subject to an insolvency proceeding, the party seeking to exercise its default right bears the burden of proof that the exercise of that right is permitted.[92] In addition, the Board provides that the party seeking to exercise the default right must meet *at least* a "clear and convincing evidence" standard.[93]

We are not aware of any similar regulatory burden of proof. In our experience, such legal burdens of proof are used solely at trial during litigation of civil or criminal cases. Thus, this requirement seems unnecessary and burdensome in the context of the Proposed Rules. Moreover, it seems inconsistent with the remainder of the Proposed Rules because the Board has determined to place the burden of proof on the party exercising the default right, which in the case of all QFCs (except for QFCs between two Covered Entities) will be the end-user or other non-Covered Entity counterparty. As a general matter, the restrictions in the Proposed Rules apply directly to Covered Entities because the Board prudentially regulates them. We believe that this requirement is the only one in the Proposed Rules that the Board has placed directly on an entity that is not a Covered Entity. Lastly, the "clear and convincing evidence" standard is a very high standard of proof, exceeded only by a "beyond a reasonable doubt" standard. Since the Proposed Rules relate to commercial matters, it seems reasonable to us that consistent with standards used for such matters, a party should be able to exercise its default rights if it is acting in a commercially reasonable manner based on the information available to it at the time. Therefore, MFA believes that the Board should eliminate the burden of proof in proposed §252.84(j)(1).

G. Equal Treatment of All Covered Entity Counterparties

MFA reiterates that we strongly oppose the Proposed Rules and the Board's efforts to alter end-users default rights. However, in the event that, despite our objections, the Board determines to proceed, we believe that there should be uniform and equal treatment of all Covered Entity counterparties under the rules.

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[92] *See* Proposed Rule Release at 29192, proposed §252.84(j)(1).

[93] *See id.*, proposed §252.84(j)(2).

In the Proposed Rule Release, the Board asks for comment of various issues related to the scope of the Proposed Rules, such as the scope of Covered Entities[94] and QFCs[95] covered. MFA has no comments on these issues at this time. However, one question not posed by the Board is whether the Proposed Rules should exclude, or treat differently, certain categories of counterparties. MFA emphasizes that, if the Board proceeds with finalizing the rules, we are opposed to any individual counterparty or group of counterparties being excluded from, or treated differently under, the rules. Rather, we believe that ensuring uniform treatment of all Covered Entity counterparties with respect to their QFCs is consistent with, and will further, the Board's goal of facilitating orderly resolution of a failing Covered Entity.

H. Extend Transition Timing/Compliance Date[96]

MFA respectfully requests that the Board extend the proposed transition timing, so that the final rules would take effect no sooner than one year from the date that the ISDA JM Protocol (as amended to comply with the final rules) is published and available for adherence, including any additional time that may be necessary to seek the Board's approval of the enhanced creditor protections contained within it.

Under the Proposed Rules, the final rules would take effect on the first day of the first calendar quarter that begins at least one year after the issuance of the final rules.[97] In our view, whether the proposed transition timing is reasonable and feasible depends on how the Board chooses to address MFA's comments in the final rules. In particular, it depends on whether:

(1) The Board extends the safe harbor in proposed §252.85(a) to apply to the ISDA JM Protocol (as defined herein to include the creditor protections contained therein and the mechanics that allow jurisdiction-by-jurisdiction and dealer-by-dealer adherence);

(2) Market participants will need to seek the Board's approval of the ISDA JM Protocol or other QFCs because they contain enhanced creditor protections that would be impermissible under the restrictions set forth in the Proposed Rules, and

(3) If such Board approval is necessary, the Board approves or denies the submitted ISDA JM Protocol or other QFCs in a prompt manner (*i.e.*, the recommended 180 days).

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[94] *See id*. at 29176, Question 4: The Board invites comment on whether the proposal should be expanded to cover banking organizations that are not GSIBs but that engage in especially high levels of QFC activity. If so, what specific metrics should be used to identify such banking organizations?

[95] *See id*., Question 5: The Board invites comment on the proposed definitions of "QFC" and "covered QFC." Are there financial transactions that could pose a similar risk to U.S. financial stability if a GSIB were to fail but that would not be included within the proposed definitions of QFC and covered QFC? Are there transactions that would be included within the proposed definitions but that would not present risks justifying the application of this proposal? Please explain.

[96] *See id*. at 29192, proposed §252.85(b).

[97] *See id*. at 29190, proposed §252.82(b).

If the final rules do not resolve the foregoing issues in a manner that allows compliance with the ISDA JM Protocol to satisfy compliance with the final rules, or that necessitates Board approval of the ISDA JM Protocol or other QFCs, then the proposed transition timing will not be sufficient for market participants to comply with the Proposed Rule.

As the Board knows, many market participants are expecting to adhere to the ISDA JM Protocol for purposes of complying with the requirements of the Board's final rules. In the event that the ISDA JM Protocol requires further Board approval, there will need to be sufficient time for the Board to review the ISDA JM Protocol, and if approved, for end-users to educate and obtain the consent of their investors (if necessary) prior to adhering. In addition, if the ISDA JM Protocol (as amended to comply with the final rules) is not workable for end-users and other market participants, we expect that they may need to negotiate bilaterally with their Covered Entity counterparties to amend bilaterally their QFCs to comply with the final rules. Given the enormous volume of bilateral negotiations and potentially Board approvals that this process would entail, the speed at which market participants would be able to complete such negotiations and be in compliance with the final rules would largely be a function of the resources available at each firm and the Board to move the process along promptly. In each of the foregoing circumstances, MFA does not believe that the one-year transition period in proposed §252.82(b) would be sufficient. Thus, we emphasize again that adopting MFA's recommendations contained herein is of paramount importance.

Although it is difficult to estimate exactly how much additional time end-users and others market participants would need to comply with the final rule in such circumstances, our members believe that a reasonable compliance date would be one year from the date that the ISDA JM Protocol (as amended to comply with the final rules) is published and available for adherence, including any additional time that may be necessary to seek the Board's approval of the enhanced creditor protections contained within it.

IV. MFA White Paper on FSB Initiative to Alter End-User Default Rights

Attached as Annex A is MFA's white paper on banking regulators' initiatives to restrict end-users' default rights, including the default rights that are at issue in the Proposed Rules.[98] Therefore, we believe the white paper is relevant to the Board's consideration of our concerns with the Proposed Rules as discussed herein.

MFA's white paper explains why default rights are critically important to end-users when facing a troubled bank counterparty. Default rights protect an end-user, its investors, and other stakeholders by allowing the end-user to terminate and settle financial contracts with a failing firm, and thereby, minimize its investors' exposure to such firm as well as better manage market risk and mitigate potential contagion. Because MFA members have affirmative fiduciary duties to act in their investors' best interests, they are not able to sacrifice their investors' default rights without robust legal justification. Thus, MFA believes that restricting end-users' default rights implicates fundamental public policy goals, in particular, the goals of protecting investors and ensuring the

[98] *See supra* note 15.

sound functioning of the financial markets. Therefore, in the white paper, MFA explains why it has serious concerns about the:

(1) Pace at which banking regulators' initiatives to restrict end-user default rights have advanced;

(2) Potential consequences of these sudden and fundamental changes for the financial markets;

(3) Likely response of certain market segments to the changes; and

(4) Potential impact of the changes on end-users.

In conclusion, MFA's white paper explains why, given the conflicting policy goals at issue and the potential for significant market disruption and other unintended consequences, regulators should defer any action to restrict or prohibit end-user default rights until the impact of such actions on end-users and financial markets more broadly can be properly studied and assessed.

* * * * * * *

MFA thanks the Board for considering our views on the Proposed Rules. We welcome the opportunity to discuss our views with you in greater detail. Please do not hesitate to contact Carlotta King or the undersigned at (202) 730-2600 with any questions the Board or its staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director &
General Counsel
Managed Funds Association

ANNEX A

MFA White Paper Entitled

“Too Big to Default: Policy and Legal Perspectives on Current Bank Regulator Initiatives to Restrict End-Users’ Default Rights Against Big Banks”

Dated September 2015

TOO BIG TO DEFAULT:

POLICY AND LEGAL PERSPECTIVES ON CURRENT BANK REGULATOR INITIATIVES TO RESTRICT END-USERS' DEFAULT RIGHTS AGAINST BIG BANKS

A White Paper by Managed Funds Association | September 2015

www.managedfunds.org

MANAGED FUNDS ASSOCATION

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I. Executive Summary

Managed Funds Association has prepared this white paper to present the views of its members on stays of early termination rights for consideration by public policymakers and regulators. MFA represents the global alternative investment industry and its investors by advocating for public policies that foster efficient, transparent, and fair capital markets.

As a general matter, MFA supports public and private sector efforts to facilitate the orderly liquidation of troubled financial institutions and improve the stability of the financial markets. Given that many MFA members' investors incurred significant losses resulting from the collapse of Lehman Brothers,[1] MFA has been a strong supporter of legislative and regulatory efforts to strengthen the financial system.[2]

However, MFA members have serious objections to the rapidly advancing initiatives of certain bank regulators to restrict or "stay" the Default Rights[3] of end-users[4] against a distressed financial institution (the Regulators' Stay Initiatives). As explained further in this white paper, bank regulators in the United States, Europe, and Asia are seeking to require end-users to relinquish several of theircontractual Default Rights against big banks in response to recommendations made by the Financial Stability Board (the FSB),[5] an organization that is

[1] *See* Michael Fleming and Asani Sarkar, *The Failure Resolution of Lehman Brothers*, Federal Reserve Bank of New York Economic Policy Review, March 2014, available at: www.ny.frb.org/research/epr/2014/1403flem.pdf.

2 For example, MFA has been a vocal supporter of the goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 [hereinafter the "Dodd-Frank Act"]. See, e.g., Letter from Stuart J. Kaswell, Executive Vice President, MFA, to David A. Stawick, Secretary of the Commission, CFTC (Aug. 8, 2011), available at: http://www.managedfunds.org/wpcontent/uploads/2011/09/CFTC.Cleared.Swap_.Segregation.Rules_.Final_.MFA_.Letter.pdf ("MFA strongly supports the goals of the over-the-counter derivatives regulation set forth in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act to enhance transparency and reduce risk in the swap markets including the segregation of collateral for cleared swaps."); Letter from Richard H. Baker, President & CEO, MFA, to Timothy F. Geithner, Chairman, FSOC (Feb. 25, 2011), available at: http://www.managedfunds.org/wp-content/uploads/2011/06/2.25.11-MFA.letter.on_.systemically.significant.institutions.pdf ("We strongly support the goals of the Dodd-Frank Act in establishing the Council to address potential systemic risks before they arise, and mandating enhanced regulation of systemically significant financial companies.").

[3] Capitalized terms used in this white paper and not otherwise defined have the meanings given to them in the Glossary of Key Terms contained in Appendix 1.

[4] This white paper uses the term "end-user" to refer broadly to entities that use Covered Instruments as investment and risk management tools including, without limitation, asset managers, investment managers, manufacturers, and other commercial and industrial entities.

[5] The FSB is a not-for-profit association formed under Swiss law that was established in 2009 as the successor to the Financial Stability Forum. Per the FSB's website, "[t]he FSB's predecessor institution the FSF was founded in 1999 by the G7 Finance Ministers and

dominated by central bankers and finance ministers.[6]

Although the FSB's decisions are not legally binding on members' jurisdictions, several of the world's most important bank regulators (G-20 bank regulators), including the U.S. Federal Deposit Insurance Corporation (FDIC) and the U.S. Board of Governors of the Federal Reserve System (Federal Reserve, and together with the FDIC, the U.S. Regulators), are seeking to implement the FSB's recommendations (and the Regulators' Stay Initiatives more specifically). MFA believes that the G-20 bank regulators are attempting to implement these initiatives without adequately consulting with relevant policymakers regarding their merits and potential consequences for the world's leading financial markets. In addition, while the G-20 bank regulators will solicit public comment from industry stakeholders on proposed rules to implement the Regulators' Stay Initiatives, it appears that the G-20 bank regulators have pre-determined to proceed with the Regulators' Stay Initiatives. Therefore, MFA is concerned that issuance of such proposals will not constitute a meaningful opportunity for stakeholders to provide input on the initiatives.

Such an unexamined and global "taking" of end-user Default Rights – under the auspices of the opaque FSB – is troubling enough by itself. Moreover, it appears that U.S. Regulators are taking this FSB-led initiative a significant step further. Specifically, U.S. Regulators are proposing to require end-users to waive additional "cross-default" rights that are, and for decades have been, legally enforceable under U.S. law – something even the FSB has not recommended.[7]

In addition to our legal and process objections to such actions, MFA believes that forcing end-users to waive their Default Rights would be harmful for the markets and the global economy. Contractual Default Rights are critically important to end-users, particularly during stressed market conditions. Such rights not only allow them to protect their investors and other stakeholders from significant Lehman-like losses of their assets but also preserve the integrity and stability of the world's leading financial markets. Therefore, placing any restrictions on these Default Rights as part of yet untested resolution strategies would be highly detrimental to the financial markets during stressed market conditions. Even if there were empirical evidence that waiver of such Default Rights

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Central Bank Governors following recommendations by Hans Tietmeyer, President of the Deutsche Bundesbank. G7 Ministers and Governors had commissioned Dr Tietmeyer to recommend new structures for enhancing cooperation among the various national and international supervisory bodies and international financial institutions so as to promote stability in the international financial system. He called for the creation of a Financial Stability Forum." *See* http://www.financialstabilityboard.org/about/.

[6] As noted by Paul Schott Stevens of the Investment Company Institute in recent testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (available at: http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=bb3bb1f0-1ae6-414e-9c89-b75ef4693a8b), "By any measure, the FSB is a bank-centric organization. Among the FSB's members, central bank officials, finance ministers, and representatives of banking-related bodies (e.g., the Bank for International Settlements (BIS), International Monetary Fund (IMF) and the Basel Committee on Banking Supervision) far outnumber capital markets regulators. And central bankers hold key leadership positions[.]").

7 The FSB's paper entitled Key Attributes of Effective Resolution Regimes for Financial Institutions did not recommend stays on early termination rights arising from cross defaults (as acknowledged in footnote 30 of the ISDA/Cleary Article infra note 19). See FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (updated Oct. 15, 2014), available at: http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf.

would be beneficial to bank regulators' efforts to resolve a distressed systemically important financial institution (SIFI),[8] policymakers and regulators need to assess properly the impact of such waivers on non-defaulting market participants and financial market integrity more broadly before requiring such waivers, whether by regulation or legislation.

In this white paper, MFA: (i) highlights concerns about key aspects of these Regulators' Stay Initiatives; and (ii) proposes recommendations that would facilitate an impartial and complete analysis of the relevant issues and a fair balancing of all relevant policy concerns by taking into account the implications for affected constituents. Specifically, in this white paper, MFA identifies the following concerns with the Regulators' Stay Initiatives:

- The FSB and G-20 bank regulators are advancing the Regulators' Stay Initiatives without a mandate from public policymakers;
- The G-20 bank regulators' new resolution strategies have potential flaws and unintended consequences;
- The contractual approach to imposing the Regulators' Stay Initiatives is inherently flawed; and
- The U.S. Regulators' Cross-Default Stay Initiative is not a G-20 objective and is inconsistent with congressional intent.

In light of these concerns, MFA respectfully makes the following recommendations:

- The International Organization of Securities Commissions (IOSCO) should prepare a report for G-20 legislators on the potential impact of the Regulators' Stay Initiatives on end-users and financial markets more broadly and analyze the implications of pursuing a contract-based approach to imposing the Regulators' Stay Initiatives;
- The U.S. President's Working Group for Financial Markets should reconvene to consider the findings of IOSCO's report and, to the extent it concludes that certain of the report's recommendations merit implementation in the United States, make recommendations to Congress for their implementation; and
- The G-20 bank regulators and the U.S. Regulators should defer further action on their respective initiatives pending the outcome of the above effort.

[8] MFA uses the term "SIFI" in this white paper to refer broadly to all financial institutions that will fall within the scope of the rules that G-20 bank regulators are in the process of proposing to require end-users to waive their Default Rights with respect to Covered Instruments. *See infra* note 17. The scope of financial institutions covered by such regulations may include smaller banks that do not meet the traditional definition of SIFI, and may vary by jurisdiction.

II. Background: Why End-User Default Rights Have Generally Been Protected – Until Now

When facing a troubled SIFI counterparty, Default Rights are critically important to end-users. Default Rights protect an end-user, its investors, and other stakeholders by allowing the end-user to terminate and settle financial contracts with a failing bank entity, and thereby, minimize its exposure to such entity and better manage market risk. Because MFA members have affirmative fiduciary duties to act in their investors' best interests, they are not able to waive Default Rights voluntarily without robust legal justification. For these reasons, MFA believes that restricting end-users' Default Rights in a distressed SIFI scenario implicates fundamental public policy goals: the goals of protecting investors and ensuring the sound functioning of the financial markets.

> *MFA believes that restricting end-users' Default Rights in a distressed SIFI scenario implicates fundamental public policy goals: the goals of protecting investors and ensuring the sound functioning of the financial markets.*

Legislative efforts to protect Default Rights in the United States date back as far as the early 1980s. The U.S. President's Working Group on Financial Markets (PWG) and members of U.S. Congress (Congress) have expressed the policy basis for protecting these important end-user rights as follows:

> *"The ability to terminate most financial market contracts upon an event of default is central to the effective management of market risk by financial market participants ... Without these rights, parties are left with uncertainty as to whether the contracts will be performed, resulting in uncontrollable market risk. By providing for termination of a contract upon the default of a counterparty, a participant can remove uncertainty as to whether a contract will be performed, fix the value of the contract at that point, and attempt to re-hedge itself against its market risk."*[9]

> *"The prompt closing out or liquidation of [open contracts] freezes the status quo and minimizes the potentially massive losses and chain reactions that could occur if the market were to move sharply in the wrong direction."*[10]

> *"U.S. bankruptcy law has long accorded special treatment to transactions involving financial markets, to minimize volatility. Because financial markets can change significantly in a*

[9] President's Working Group on Fin. Mkts., Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, at 19 (1999), available at: http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.

[10] H.R. Rep. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 584 (emphasis added) (referring to the 1982 Amendment to the Bankruptcy Code (Pub. L. No. 97-222)).

matter of days, or even hours, a non-bankrupt party to ongoing securities and other financial transactions could face heavy losses unless the transactions are resolved promptly and with finality.[11] *The immediate termination for default and the netting provisions are critical aspects of swap transactions and are necessary for the protection of all parties in light of the potential for rapid changes in the financial markets."*[12]

"[T]he effect of the swap provisions will be to provide certainty for swap transactions and thereby stabilize domestic markets by allowing the terms of the swap agreement to apply notwithstanding the bankruptcy filing."[13]

"The legislative history of the Swap Amendments plainly reveals that Congress recognized the growing importance of interest rate swaps and sought to immunize the swap market from the legal risks of bankruptcy."[14]

"[I]t is intended that the normal business practice in the event of a default of a party based on bankruptcy or insolvency is to terminate, liquidate or accelerate securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements and master netting agreements with the bankrupt or insolvent party."[15]

Despite nearly three decades of efforts by Congress and other policymakers across the globe to protect market participants' Default Rights with respect to financial contracts for the reasons cited above, certain G-20 bank regulators,[16] under the auspices of the FSB, have begun proposing rules that would effectively restrict end-users' exercise of such rights against large banking groups.[17] Regulators have undertaken these efforts in connection with new resolution strategies that prioritize recapitalizing and preserving a failing bank group (or viable parts of it) as a going concern. These new resolution strategies can be broadly characterized as "single-point-of-entry" (SPOE) strategies, which have been described as follows:

The SPOE strategy envisions a "top down" approach to exercising resolution powers. In an SPOE-style resolution, only the top-level entity in a failing financial group (whether a holding company or an operating company) would enter resolution proceedings, with its operating subsidiaries continuing operations uninterrupted outside of proceedings. The top-level company of the failing financial

[11] H.R. Rep. No. 101-484, at 2 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 224 (emphasis added) (referring to the 1990 Amendment to the Bankruptcy Code (Pub. L. No. 101-311)).

[12] S. Rep. No. 101-285, at 3 (1990) (emphasis added), available at: 1990 WL 259288, at 3 (referring to the 1990 Amendment to the Bankruptcy Code (Pub. L No. 101-311)).

[13] 136 Cong. Rec. S7535, at 153 (1990) (emphasis added) (statement of Sen. DeConcini referring to the 1990 Amendment to the Bankruptcy Code (Pub. L. No. 101-311)).

[14] *Thrifty Oil Co. v. Bank of Am. Nat. Trust & Sav. Ass'n*, 322 F.3d 1039, 1050 (9th Cir. 2003) (emphasis added), available at: http://caselaw.findlaw.com/us-9th-circuit/1113702.html.

[15] H.R. Rep. No. 109-31, at 133 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 193 (emphasis added), available at: http://www.gpo.gov/fdsys/pkg/CRPT-109hrpt31/html/CRPT-109hrpt31-pt1.htm (referring to the 2005 Amendment to the Bankruptcy Code (Pub. L. No. 109-8)).

[16] Regulators in the United States, the United Kingdom, Switzerland, and Japan are in the process of proposing rules, and Germany is in the process of finalizing legislation, that will effectively require end-users to waive their Default Rights with respect to Covered Instruments with SIFIs. Regulators in other G-20 jurisdictions are expected to propose similar rules in the future.

[17] Some U.S. insolvency regimes that pre-date the 2008 financial crisis, like the U.S. Federal Deposit Insurance Act (FDIA) and the U.S. Securities Investor Protection Act (applicable to broker-dealers), impose general stays on early termination rights upon certain *direct* defaults (*i.e.*, upon the default of a direct counterparty) by a regulated financial institution but do not stay "cross-default" rights (*i.e.*, early termination rights that arise upon the default of an affiliate of the direct counterparty). As discussed further below, under U.S. law stays on cross-default rights would apply only if OLA were invoked.

group would be resolved, with losses imposed on that company's shareholders and creditors according to their priority, while viable subsidiaries would continue operations without being placed into insolvency proceedings.

Through its focus on resolving the top-level company only, SPOE allows otherwise viable operating subsidiaries to continue operations on a going-concern basis, with additional liquidity supplied by the resolution authority as needed. The strategy is designed to limit the Lehman-style cascades of separate insolvencies of subsidiaries within a financial group, the unwinding of group and subsidiary financial contracts and the potential systemic consequences of the failure of multiple companies within a large, cross-border financial group. Limiting insolvency proceedings to only the top-level company, while maintaining funding for the continued operation of subsidiaries, could limit many of the complications caused by the need to coordinate multiple insolvencies under frameworks in different jurisdictions.[18]

The FSB believes that the widespread exercise of Default Rights against a failing SIFI may undermine a bank regulator's ability to preserve the failing SIFI as a growing concern. Therefore, the FSB considers the imposition of stays on Default Rights to be a cornerstone of a bank regulator's ability to implement these new resolution strategies.[19]

In response to pressure from G-20 bank regulators seeking to impose such stays, 18 major dealer banks (G-18 banks) agreed to stays on their Default Rights with respect to their swap agreements with other G-18 banks by adhering to the ISDA 2014 Resolution Stay Protocol (Resolution Stay Protocol) in November 2014.[20] The Resolution Stay Protocol effectively amended the terms of the ISDA Master Agreements governing swaps between the G-18 banks with effect from January 1, 2015.[21] As a result of their adherence, more than 90 percent of the outstanding swaps notional amount of the G-18 banks is already subject to the stays recommended by the FSB.[22] The same G-18 banks

[18] David Geen et al., A Step Closer to Ending Too-Big-To-Fail: The ISDA 2014 Resolution Stay Protocol and Contractual Recognition of Cross-border Resolution, 35 Futures & Derivatives L. Rep., Apr. 2015, at 1, 4 [hereinafter the "ISDA/Cleary Article"], available at: http://www.cgsh.com/files/Publication/e9499fbe-a7ff-4bdd-b418-3976b6e2a00a/Presentation/PublicationAttachment/2ae1dcfc-9762-44ae-84e8-45a647bdaa47/FDLR35%233_AA_Geen.pdf (authored by in-house lawyers at ISDA and lawyers at Cleary Gottlieb Steen & Hamilton LLP, external counsel to ISDA on the Stay Protocol). These strategies also contemplate a "multiple-point-of-entry" approach, which is similar to the SPOE top-down approach, but involves multiple iterations of the SPOE strategy in different jurisdictions and therefore "could result in the involvement of multiple resolution authorities executing differing regional resolution strategies." Id.

[19] See id. at 5. See also FSB report to the G-20, Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF), at 6 (Sept. 2, 2013) [hereinafter the FSB TBTF Report], available at: http://www.financialstabilityboard.org/wp-content/uploads/r_130902.pdf ("Large-scale close-out of financial contracts based on early termination and cross-default rights when firms enter resolution can hinder the effective implementation of resolution strategies. G-20 authorities can encourage ISDA and other industry bodies to review contract provisions to prevent large-scale early termination of financial contracts.").

[20] MFA does not undertake to describe in detail the terms of the Resolution Stay Protocol published by ISDA in November 2014. For a thorough discussion of the current terms of the Resolution Stay Protocol, see the ISDA/Cleary Article, supra note 19, at 7. See also ISDA, FAQs on the ISDA 2014 Resolution Stay Protocol (Nov. 12, 2014), available at: http://www2.isda.org/functional-areas/protocol-management/faq/20/.

[21] Section 1 of the Resolution Stay Protocol became effective January 1, 2015 without the implementation of any new regulations. However, Section 2 of the Resolution Stay Protocol will not become effective until the implementation of U.S. Regulators' "regulatory restrictions" in the United States. *See* ISDA, ISDA 2014 Resolution Stay Protocol, at 20 (2014), available at: http://assets.isda.org/media/f253b540-25/958e4aed.pdf/.

[22] *See* ISDA Latest News, "Major Banks Agree to Sign ISDA Resolution Stay Protocol" (Oct. 11, 2014) [hereinafter the "ISDA News Release"], available at: http://www2.isda.org/news/major-banksagree-to-sign-isda-resolution-stay-protocol. This figure includes: (i)

are expected to expand their waivers of Default Rights under the Resolution Stay Protocol to cover securities finance transactions (in particular, securities lending and repurchase or repo transactions) in November 2015.

Nonetheless, the FSB apparently believes that imposing stays of Default Rights on this substantial portion of market activity may not be sufficient to facilitate the effective resolution of these entities. Therefore, several G-20 bank regulators, including the Bank of England and U.S. Regulators, are now in the process of proposing rules intended to force end-users to relinquish certain of their Default Rights against big banks and their affiliates under Covered Instruments.[23] The contemplated rules would, if adopted, prohibit certain large banks from entering into new Covered Instruments with an end-user unless and until the end-user agrees to "stays" on its contractual Default Rights in the event of a resolution action involving any such large bank (or its parent company or a relevant affiliate).

MFA believes that the stated objectives of the Regulators' Stay Initiatives – to support cross-border resolution of SIFIs, reduce systemic risk, and contribute to the demise of "too big to fail"[24] – are laudable. However, underlying the Regulators' Stay Initiatives is the assumption that a stay on Default Rights is so critical to these objectives that neither regulators nor markets should wait for policymakers to consider whether the contemplated stays on Default Rights are appropriate.

MFA believes that the stated objectives of the Regulators' Stay Initiatives – to support cross-border resolution of SIFIs, reduce systemic risk, and contribute to the demise of "too big to fail"[25] – are laudable. However, underlying the Regulators' Stay Initiatives is the assumption that a stay on Default Rights is so critical to these objectives that neither

transactions with all counterparties of banks that would be subject to stays upon resolution because of the governing law of their agreements; and (ii) transactions with the other adhering banks.

[23] For purposes of this white paper, the term "Covered Instruments" refers to the financial contracts that the Regulators' Stay Initiatives are likely to affect, including swap agreements, forward contracts, commodity contracts, and securities finance transactions (*e.g.*, repurchase transactions).

[24] *See, e.g.*, ISDA News Release, *supra* note 23.

[25] *See, e.g.*, ISDA News Release, *supra* note 23.

regulators nor markets should wait for policymakers to consider whether the contemplated stays on Default Rights are appropriate.[26] Rather, the FSB and G-20 bank regulators are seeking to compel end-users and other market participants to waive their Default Rights as quickly as possible to "fill the gap" where legislative frameworks supporting the cross-border recognition of statutory stays are not yet in place.[27] In addition, U.S. Regulators intend to require end-users facing U.S. SIFIs to agree to broad stays of their Cross-Default Rights, even where Congress has not enacted legislation imposing such stays.

If broadly implemented, the Regulators' Stay Initiatives would significantly alter the Default Rights of end-users under Covered Instruments. Even the most thoughtful critics of termination rights in derivatives and repurchase transactions[28] acknowledge that these rights are a core feature of these instruments on which market participants have come to rely, and therefore, recommend a measured approach to the introduction of any fundamental changes to these rights.[29] As a result, MFA has serious concerns about:

i. The pace at which the Regulators' Stay Initiatives have advanced;[30]
ii. The potential consequences of these sudden and fundamental changes for the financial markets;
iii. The likely response of certain market segments to the changes; and
iv. The potential impact of the changes on end-users.

The remainder of this white paper examines further the basis for these concerns and proposes recommendations for addressing them.

[26] *See, e.g.*, Federal Reserve Governor Lael Brainard, Dodd-Frank at Five: Assessing Progress on Too Big to Fail, Speech at the event "Dodd-Frank at Five: Looking Back and Looking Forward" hosted by the Bipartisan Policy Center and Managed Funds Association (July 9, 2015), available at: http://www.federalreserve.gov/newsevents/speech/brainard20150709a.htm.

[27] *See* FSB consultative document, Cross-border Recognition of Resolution Action, at 1 (Sept. 29, 2014) [hereinafter the "FSB Consultation Paper"], available at: http://www.financialstabilityboard.org/wp-content/uploads/c_140929.pdf?page_moved=1. *See also* FSB TBTF Report *supra* note 20, at 6 ("G-20 authorities can encourage ISDA and other industry bodies to review contract provisions to prevent large-scale early termination of financial contracts.").

[28] MFA notes that there are equally thoughtful proponents of the same rights. *See, e.g.*, Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. On the Judiciary, 113th Cong. 35 (2014), available at: http://judiciary.house.gov/_cache/files/832fe54a-bf55-4567-8eeb-54cdcbec5e5e/113-90-87331.pdf (statement of Seth Grosshandler) ("[T]he Bankruptcy Code safe harbors serve a vital role in promoting systemic stability and resilience, have significantly increased the availability to customers of derivatives and repurchase agreements and the liquidity of these transactions and related assets, have reduced the cost of transactions to customers and have decreased the cost of financing to issuers of assets.").

[29] *See, e.g.*, Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 Stan. L. Rev. 539, 589 (2011), available at: http://www.stanfordlawreview.org/sites/default/files/articles/Roe-63-Stan-L-Rev-539.pdf.

[30] The Regulators' Stay Initiatives and the related Resolution Stay Protocol initiative resulted from the St. Petersburg G-20 Summit in 2013, at which the FSB made a commitment to "develop policy proposals on how legal certainty in cross-border resolution can be further enhanced" by the time of the Brisbane G-20 Summit in November 2014. *See* Press Release, FSB, FSB Releases Proposals on Cross-border Recognition of Resolution Actions and Action to Address Cross-border Close-out Risk (Sep. 29, 2014), available at: http://www.financialstabilityboard.org/wp-content/uploads/pr_140929.pdf. By October 11, 2014, ISDA was able to announce that the G-18 banks had agreed to sign the Stay Protocol, even though the comment period on the FSB Consultation Paper describing the stays imposed by the protocol was still open. *See* ISDA News Release, *supra* note 23.

III. Discussion & Analysis of the Regulators' Stay Initiatives

A. The FSB and G-20 Bank Regulators are advancing the Regulators' Stay Initiatives without a Mandate from Public Policymakers

1. The FSB is the Driving Force behind the New Resolution Strategies, the Regulators' Stay Initiatives, and the Resolution Stay Protocol

As noted above, the FSB considers the Regulators' Stay Initiatives to be a cornerstone of new SIFI resolution strategies, such as SPOE. These new resolution strategies, as well as the Regulators' Stay Initiatives, trace back directly to FSB recommendations.[31] In support of its own recommendations, the FSB has been the driving force behind the development of the Resolution Stay Protocol[32] and has publicly expressed support for efforts to promote adoption of the Resolution Stay Protocol.[33] Because the FSB's decisions are not legally binding on its members, the organization "operates by moral suasion and peer pressure, in order to set internationally agreed policies and minimum standards that its members commit to implementing at the national level."[34] However, MFA fails to see how G-20 bank regulators, and U.S. Regulators in particular, are able to commit to the FSB to implement its policies at a national level without an express mandate from the relevant public policymakers.[35]

[31] *See* FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions", October 15, 2014, available at http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf; and FSB, "Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies", July 16, 2013, available at http://www.financialstabilityboard.org/wp-content/uploads/r_130716b.pdf?page_moved=1.

[32] *See* FSB TBTF Report, *supra* note 20, ("By end 2014, the FSB will develop proposals for contractual or statutory approaches to prevent large-scale early termination of financial contracts in resolution … G-20 authorities can encourage ISDA and other industry bodies to review contract provisions to prevent large-scale early termination of financial contracts."). *See* Letter from the Home Authorities, to Stephen O'Connor, Chairman, ISDA (Nov. 2013), available at: https://www.fdic.gov/news/news/press/2013/pr13099a.pdf.

[33] *See, e.g.*, FSB Press Release, "FSB welcomes industry initiative to remove cross-border close-out risk", October 11, 2014, available at http://www.financialstabilityboard.org/2014/10/pr_141011/.

[34] *See* http://www.financialstabilityboard.org/about/.

[35] To this point, Peter J. Wallison of the American Enterprise Institute recently presented testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs stating that the FSB "has no legal authority in the United States; nor would a G-20 statement or an agreement by US regulators at the FSB by itself confer this authority", available at: http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=7aa7a014-6aac-4f94-a1e9-d842552e0a95.

2. U.S. Regulators are proceeding with the Regulators' Stay Initiatives in the United States without a Congressional Mandate

MFA is concerned that the U.S. Regulators, in the context of international policy discussions, are pre-judging the suitability of measures like the Regulators' Stay Initiatives for the U.S. financial markets, one of this country's most important assets. The fact that certain U.S. regulators[36] are members of the FSB does not equate to a mandate from Congress to implement FSB policies without the protections afforded by the U.S. legislative framework.

The Regulators' Stay Initiatives will meaningfully impair the rights of end-users that use Covered Instruments as risk management and investment tools. If implemented in the United States, these initiatives, in effect, will modify the operation of federal insolvency laws and may inject risks into the U.S. economy in contravention of stated congressional policy as it relates to Default Rights.

> *The Regulators' Stay Initiatives will meaningfully impair the rights of end-users that use Covered Instruments as risk management and investment tools.*

In a recent hearing held by the U.S. Senate Committee on Banking, Housing and Urban Affairs to consider the role of the FSB in the U.S. regulatory framework, the Chairman of the Committee, Senator Richard Shelby, expressed concern about the possibility that the FSB process was circumventing proper U.S. rulemaking processes supervised by Congress.[37] MFA shares this concern in the context of the Regulators' Stay Initiatives. In this instance, U.S. Regulators are seeking to implement FSB policy and recommendations through their rules at the direction of the FSB, rather than Congress.

Furthermore, the end-users that the Regulators' Stay Initiatives would affect have no representation on the FSB.[38] In fact, there is no process available to end-users to challenge properly the FSB's directives. Although MFA has submitted detailed comments to the FSB regarding its members' concerns with the Regulators' Stay Initiatives,[39] the FSB has failed to address or respond to these comments in any manner. Absent congressional action requiring U.S. Regulators to implement FSB recommendations only with the approval of Congress, MFA fears that the U.S. Regulators will implement the Regulators' Stay Initiatives

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36 The Federal Reserve, the U.S. Securities and Exchange Commission (SEC) and the U.S. Department of the Treasury ("Treasury") represent the United States on the FSB. However, the primary U.S. regulator for the multi-trillion dollar swaps market, the U.S. Commodity Futures Trading Commission (CFTC), is not on the FSB. Therefore, the CFTC, as the agency responsible for oversight of this important U.S. market, did not have an effective voice in the development of the Regulators' Stay Initiatives, despite the initiatives' material impact on swap markets.

37 Senator Richard Shelby Opening Statement on the Role of the FSB in the U.S. Regulatory Framework, Senate Committee on Banking, Housing and Urban Affairs, July 8, 2015, available at: http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=4bdb8a23-5056-a063-c0bc-5b0be18e4cea.

38 As noted above, supra notes 7 and 36, capital markets regulators are not well represented on the FSB, and the U.S. Commodity Futures Trading Commission (i.e., the U.S. primary swaps regulator) has no seat on the FSB. Therefore, MFA questions whether the FSB has properly considered the interests of U.S. capital markets in relation to the Regulators' Stay Initiatives.

39 See MFA letter to the FSB on the FSB Consultation Paper (Dec. 1, 2014), available at: https://www.managedfunds.org/wp-content/uploads/2014/12/FSB-Consultation-on-Cross-Border-Recognition-of-Resolution-Actions.pdf. See also MFA and five other trade associations' joint letter to the FSB on "Financial Stability Board Initiative to Suspend Counterparty Early Termination Rights during Resolution and Bankruptcy Proceedings" (Nov. 4, 2014), available at: https://www.managedfunds.org/wp-content/uploads/2014/11/Joint-Trade-Association-Letter-on-FSB-Early-Termination-Rights-Suspension-Final-11-4-142.pdf.

across major U.S. financial markets without the proper involvement of Congress or meaningful consultation with affected industry constituents.

> *MFA fears that the U.S. Regulators will implement the Regulators' Stay Initiatives across major U.S. financial markets without the proper involvement of Congress or meaningful consultation with affected industry constituents.*

B. The Regulators' New Resolution Strategies: Potential Flaws and Unintended Consequences

1. The New Strategies are Untested and Have Recognized Vulnerabilities

The G-20 bank regulators continue to argue that SPOE "achieves the important goals of imposing market accountability and maintaining financial stability in all jurisdictions in which [a banking group] operates."[40] Proponents of the SPOE approach prefer it because they believe that: (i) the shareholders and creditors of a SIFI's ultimate parent company will bear any losses, thus minimizing the impact on taxpayers (*e.g.*, limiting the need for a SIFI "bail-out" because it is "too-big-to-fail); and (ii) it will insulate the operating subsidiaries from the insolvency of the parent company, and thus, the impact on the market as a whole will be less drastic.[41]

However, in their rush to approve SPOE as the preferred resolution approach, the G-20 bank regulators continue to ignore important questions regarding the efficacy and potential consequences of this strategy. In particular:

i. Even proponents of SPOE acknowledge that it is not a silver bullet because the strategy has significant vulnerabilities and does not prevent financial institutions from being "too-big-to-fail".[42]

ii. SPOE will not solve the problems of uncertain application of SRRs because it does not impose time requirements in which regulators must act. As a result, such an approach may exacerbate the risk of a "run" on a distressed bank.[43]

iii. Because SPOE does not give bank regulators additional means to provide support to troubled subsidiaries, bank regulators may be hesitant to take prompt resolution action where it appears a subsidiary may

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40 Joint paper by the FDIC and the Bank of England on "Resolving Globally Active, Systemically Important, Financial Institutions", at 14 (Dec. 10, 2012), available at: https://www.fdic.gov/about/srac/2012/gsifi.pdf.

41 See id. See also discussion of SPOE infra Section 1.

42 David A. Skeel Jr., Single Point of Entry and the Bankruptcy Alternative, at 3 (2014), available at: http://scholarship.law.upenn.edu/faculty_scholarship/949/.

43 Id. at 11. See also Darrell Duffie, How Big Banks Fail and What to Do About It (2011) [hereinafter the "Duffie Paper"], at 60 ("[T]he discretion held by a resolution authority to initiate a resolution process could raise uncertainty among creditors regarding the potential timing of any such initiative, and generate doubt over the treatment of their claims against the failing institution. Faced with such uncertainty, a run by creditors might be accelerated. In the case of OTC derivatives and repurchase agreements, a run of this type could be accelerated if counterparties and creditors that have the ability to run on short notice would be harmed in the event of a resolution process that would stay their contracts for any significant period of time, or even if their contracts are not stayed but are terminated under a threat of significant loss. The bankruptcy approach, if well designed, is likely to offer less discretion, and thus be more predictable in its consequences for counterparties and creditors. This would lower the risk of a run.").

not have sufficient resources to continue operating as a going-concern.[44]

iv. The application of SPOE does not guarantee that it will be the only strategy used.[45] Successful recapitalization will likely depend on the value of the SIFI, which, in turn, will be largely a function of the value of the SIFI's subsidiaries.[46] If the SIFI's value is no longer sufficient to support its needs, the resolution authority may have to impose losses at the subsidiary level, which undermines the rationale for SPOE.[47]

v. Finally, and perhaps most importantly, "assuming that counterparties will continue business as usual while the parent company is undergoing an untested [resolution] proceeding seems somewhat cavalier."[48]

Despite these outstanding questions and disputed presumptions, in December 2013, the FDIC released a notice and request for comment[49] that describes the manner in which it would implement an SPOE resolution strategy in the United States. In the release, the FDIC indicated that, where: (i) there is no viable private-sector solution; and (ii) resolution of an entity under the U.S. Bankruptcy Code would pose a systemic risk to the U.S. economy, SPOE would be an alternative approach available to the FDIC, as receiver, upon a firm's entry into resolution proceedings under the U.S. Orderly Liquidation Authority provisions of Title II of the Dodd-Frank Act (OLA).[50]

By the February 18, 2014 comment period deadline, the FDIC had received 30 comments on its proposed new resolution strategy, which expressed the following views:

- There is a need for a cross-border cooperation agreement;[51]
- The FDIC should confirm that it would recapitalize U.S. and foreign

[44] *See supra* note 42, at 11. *See also* David VanHoose, Systemic Risks and Macroprudential Bank Regulation: A Critical Appraisal, at 25, available at: https://www2.indstate.edu/business/NFI/leadership/briefs/2011-PB-04_VanHoose.pdf ("Of course, the literature on rules versus discretion almost unanimously comes down in favor of rules … Nevertheless, both past and recent experiences verify that regulators commonly opt for policy discretion based on sometimes overly rosy views of favorable outcomes for banks' market valuations in relation to the social costs of discretion.").

[45] *See* Jonathan C. Lipson, Against Regulatory Displacement: An Institutional Analysis of Dodd-Frank's Orderly Liquidation Authority, Banking & Fin. Services Pol'y Rep., June 2015, at 1, 8 (citing Stephen J. Lubben, OLA After Single Point of Entry: Has Anything Changed?, at 4 (2014), available at: https://perma.cc/7WUP-3FJJ?type=pdf), available at: http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1486&context=jbl.

[46] *See id.* at 8-9.

[47] See id.

[48] *Id.* at 5.

[49] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013), available at: http://www.gpo.gov/fdsys/pkg/FR-2013-12-18/pdf/2013-30057.pdf.

[50] *Id.* at 76615.

[51] *See* Letter from Bill Woodley, Deputy CEO, Deutsche Bank N. Am., to Robert E. Feldman, Executive Secretary, FDIC, at 2 (Feb. 18, 2014), available at: https://www.fdic.gov/regulations/laws/federal/2013/2013-single-point-entry-c_12.pdf.

subsidiaries in an equitable manner;[52]

- Forced subsidiarization[53] of cross-border operations will not reduce the risk of foreign ring-fencing;[54]
- It is necessary to have greater detail on the mechanisms through which resolution authorities will recapitalize the subsidiaries;[55]
- The proposed time limit on the operation of a "bridge" financial company is short and could lead to fire sales;[56]
- Ring-fencing poses a challenge, but the FDIC should not address it though mandatory subsidiarization;[57] and
- There is a need for transparency in the resolution process.[58]

Over a year later, the FDIC does not appear to have publicly responded to any of the comments it received, and it has not issued any updated information or guidance on its SPOE strategy. Since the comment period ended, there has been no indication that the FDIC is reconsidering the SPOE approach in light of the foregoing concerns. Rather, the only response from the FDIC appears to be several disclosures on its website indicating that members of its staff are meeting with industry participants to discuss the strategy.[59]

2. The New Strategies Depend Upon Unprecedented Cooperation among Banking Regulators in Different Jurisdictions

The SPOE approach contemplates the resolution authority in the "home" country of the failing institution (most likely the jurisdiction

[52] *See* Letter from John Court, Managing Dir. & Senior Assoc. Gen. Counsel, The Clearing House, et al., to Robert E. Feldman, Executive Secretary, FDIC, at 5 (Feb. 18, 2014), available at: https://www.fdic.gov/regulations/laws/federal/2013/2013-single-point-entry-c_19.pdf.

53 "Subsidiarization" refers to the breaking up of complex financial institutions, including branches that cross borders, into distinct subsidiaries to identify clearly the operations in each jurisdiction and to facilitate orderly resolution.

54 See Letter from John Court, supra note 52, at 6. "Ring fencing" refers to a financial institution or financial group separating certain risky activities, assets, and/or liabilities into a separate entity to prevent those activities from harming the healthy or less troubled entities during resolution. "In a pre-failure context, ring-fencing may take a variety of forms, including stand-alone host country capital and liquidity requirements which significantly limit outward-bound transfers by the host country operations and compliance with which may be determined in a manner that minimizes or precludes in some measure support that may be available from operations outside the host country. In a post-failure context, host country ring-fencing typically entails providing a priority to the payment of third-party liabilities attributable to the ring-fenced operations and marshalling the assets of those operations (and perhaps also marshalling assets of operations outside the host country that are located in the host country) to pay off all such liabilities in their entirety prior to making those assets (should any remain after satisfying the ring-fenced-protected claims) available to pay off liabilities of operations of the non-domestic bank outside the host country." Letter from Richard Coffman, Gen. Counsel, Inst. of Int'l Bankers, to Robert E. Feldman, Executive Secretary, FDIC, at 2 (Feb. 18, 2014), available at: https://www.fdic.gov/regulations/laws/federal/2013/2013-single-point-entry-c_13.pdf.

55 See Letter from R. Glenn Hubbard, Co-chair, Comm. on Capital Mkts. Regulation, to Robert E. Feldman, Executive Secretary, FDIC, at 2 (Feb. 18, 2014), available at: https://www.fdic.gov/regulations/laws/federal/2013/2013-single-point-entry-c_18.pdf.

56 See Letter from Adam Cull, Senior Dir. Int'l & Fin. Policy, British Bankers' Ass'n, to Robert E. Feldman, Executive Secretary, FDIC, at 2 (Mar. 20, 2014), available at: https://www.fdic.gov/regulations/laws/federal/2013/2013-single-point-entry-c_25.pdf. "Fire sales" refers to the sale of goods or assets at a very low price, typically when the seller is in financial distress and facing bankruptcy.

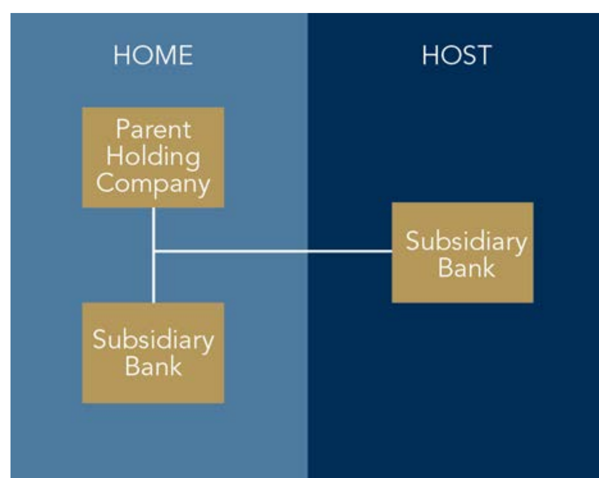
57 See Letter from Richard Coffman, supra note 54, at 2.

[58] *See* Letter from Lyn Perlmuth, Dir. Fixed Income Forum, Credit Roundtable, to Robert E. Feldman, Executive Secretary, FDIC, at 2 (Feb. 14, 2014), available at: https://www.fdic.gov/regulations/laws/federal/2013/2013-single-point-entry-c_08.pdf.

[59] *See* Memoranda to file of FDIC staff meetings with stakeholders under "Staff Disclosures", available at: https://www.fdic.gov/regulations/laws/federal/2013/2013-single-point-entry.html.

responsible for the global consolidated supervision of the relevant banking group) effectively acting as a manager of a global resolution syndicate.[60] However, because resolution authorities in various jurisdictions may have authority over different legal entities within the financial group, MFA is doubtful as to whether resolution authorities will necessarily cooperate with, and defer to, the resolution authority in the "home" country.

Under an SPOE strategy, the relevant "home" country resolution authority would have primary responsibility for overseeing the resolution of the failed institution and coordinating the resolution of the banking group with regulatory authorities in other "host" jurisdictions. The figure below[61] illustrates how this resolution strategy typically distinguishes between "home" and "host" country authorities:



When a single resolution authority commences resolution at the parent company level of a banking group pursuant to a SPOE strategy, it would also seek to preserve the assets and operations of particular subsidiaries of the parent company as a going concern where possible. The G-20 bank regulators expect that regulatory authorities for the banking group's affiliates in other jurisdictions (that is, host country regulators) will "exercise powers to support the resolution led by the home authorities."[62]

> *But such a global approach can only work if: (i) the home country is willing and able to take on the direction and leadership of a global resolution process, and (ii) the host countries are willing to accept the leadership of the home country and refrain from unilateral action to initiate and/or conduct a separate resolution process for the banking group's subsidiaries or branches in the host country.*[63]

In fact, several financial services industry trade associations have argued that a general lack of international coordination and cooperation, as well as foreign ring-fencing, would present significant challenges to the

[60] *See* Thomas F. Huertas, Safe to Fail, at 1 (May 7, 2013) [hereinafter the "Huertas Paper"], available at: http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP-221.pdf.

[61] *See id.* at 20, Figure 6.

[62] FSB consultative document, Recovery and Resolution Planning: Making the Key Attributes Requirements Operational, at 15 (Nov. 2012) [hereinafter "FSB Recovery and Resolution Consultation"], available at: http://www.financialstabilityboard.org/wp-content/uploads/r_121102.pdf?page_moved=1.

[63] Huertas Paper, *supra* note 60, at 22.

successful resolution of a SIFI under the SPOE strategy.[64]

Even the FSB acknowledges that "[m]aking [an SPOE] strategy effective may require … sufficient certainty on the part of host authorities that the home authorities would allow resources generated by a recapitalization at holding company level or made available from other sources to be downstreamed to subsidiaries."[65]

On this point, academics have observed that, while SPOE may make sense in resolution scenarios involving solely countries with a history of cooperation, it may face serious challenges among countries without such a history.[66] Yet even where a history of cooperation has existed, angst over international coordination on an SPOE resolution strategy persists. For example, U.K. regulators "worry about whether US regulators [acting in the role of home resolution authority] will act as vigorously to recapitalize a troubled UK subsidiary as with a troubled US subsidiary."[67] Similarly, in the event that the U.S. Regulators are the "home" authorities in a resolution, they would face uncertainty as to whether they will have any control over the restructuring or liquidation of a non-U.S. subsidiary.[68]

3. The New Strategies Rely on Stays on Default Rights That May Entail Significant Costs and Exacerbate "Runs on the Bank"

It is unclear whether the FSB has adequately considered the potential impact of the Regulators' Stay Initiatives on, among other things, liquidity and pricing in the affected markets. The FSB also appears to have ignored the possibility that the Regulators' Stay Initiatives may lead market participants to engage in behavior that will aggravate the conditions faced by a SIFI in distress.

MFA believes that, as a first step, the FSB should consider and analyze the potential costs and benefits of these initiatives more fully. The potential costs of imposing stays on end-users' Default Rights could be significant.[69] For example, sophisticated end-users are unlikely to waive important Default

[64] *See* Letter from industry participants, to FDIC, at 32 (Feb. 18, 2014), available at: http://www.aba.com/Advocacy/commentletters/Documents/Joint%20Trades%20Single%20Point%20of%20Entry%20Comment%20Letter%20(Feb%2018,%202014).pdf.

[65] FSB Recovery and Resolution Consultation, *supra* note 62, at 15.

[66] *See* Charles Goodhart & Emilios Avgouleas, Critical Reflections on Bank Bail-ins, at 37 (2015), available at: www.bis.org/bcbs/events/bartnf/avgouleasgoodhart.pdf. These authors also note that host regulators may force foreign subsidiaries to operate as ring-fenced entities - increasing the trend towards disintegration of global banking markets - in order to avoid the possibility of home authorities interfering with transfers to, or from, foreign subsidiaries of the resolved group in the course of resolution. *See id.* at 37-38.

[67] Skeel, *supra* note 42, at 11 (2014), available at: http://scholarship.law.upenn.edu/faculty_scholarship/949/.

[68] See id.

[69] The Resolution Stay Protocol applies to existing as well as future transactions between adhering parties. However, the regulations requiring parties to agree to abide by stays contractually may or may not have retroactive effect depending on the jurisdiction concerned. The Bank of England Proposal suggests that some regulators may allow individual adherents to agree as to whether to apply stays retroactively. *See* Bank of England, Contractual Stays in Financial Contracts Governed by Third-country Law (2015) [hereinafter the "Bank of England Proposal"], available at: http://www.bankofengland.co.uk/pra/Documents/publications/cp/2015/cp1915.pdf. Even where not required by applicable local rules, some end-users may feel compelled to apply contractual stays to both new and existing transactions to avoid "splitting their book" between two master agreements. By "splitting their book", we mean having one master agreement for new transactions that stays certain Default Rights and a second master agreement for pre-existing transactions that is not amended to incorporate resolution stays. If an end-user adopts such an approach,

Rights without requiring compensation from their SIFI counterparties or taking other steps to address the additional risk they may face because of such stays.[70] These measures may take the form of the following:

- **Contractual countermeasures,** which could include demands for: (i) additional collateral; (ii) more conservative ratings downgrade, termination, and collateral provisions; and (iii) additional optional early termination or transfer rights in the trading agreement.
- **Market-based measures**, which could include efforts to: (i) purchase additional credit protection referencing large bank counterparties; (ii) reduce other exposures to such banks, for example, by reducing equity and bond inventory and limiting financing activity (such as repurchase transactions) with such banks; and (iii) short sell securities issued by such entities.

If banks accede to compensation demands, it could have immediate cost and risk implications for them by requiring them to meet increased funding demands, for example. Moreover, if the past is prologue, then demands for greater contractual protections and protective market activity by end-user counterparties will only increase as concerns about a SIFI's stability surface.[71] Unless G-20 bank regulators can undeniably demonstrate that the Regulators' Stay Initiatives will reduce the risk of loss to end-users, it seems inescapable that imposing stays on Default Rights will accelerate and heighten demand for compensating protection. That is, the Regulators' Stay Initiatives could exacerbate a "run on the bank" precisely because end-users know that their hands will be tied on the eve of bankruptcy.[72]

The Regulators' Stay Initiatives also could lead to a shift in liquidity and risk away from the largest and most highly regulated bank groups. Regulators cannot force end-users to trade with a given counterparty, and end-users may choose to limit their trading activity with counterparties most likely to become

> *The Regulators' Stay Initiatives also could lead to a shift in liquidity and risk away from the largest and most highly regulated bank groups*

it will sacrifice some of the netting and other benefits associated with having all of its trades under a single master agreement.

[70] Certain market participants have already noted this prospect and even identified it as "highly probable." *See e.g.*, William G. DeLeon et al., *Unintended Consequences of 'Staying' Early Termination* Rights, PIMCO (Dec. 2014), http://www.pimco.com/en/insights/pages/unintended-consequences-of-staying-early-termination-rights.aspx. Since the terms of derivatives and repurchase transactions are private, it is not possible to know whether the G-18 banks that have voluntarily adhered to the Resolution Stay Protocol are seeking, for example, to build compensating contractual protections into their agreements with each other. However, since the G-18 banks otherwise benefit from the terms of the Resolution Stay Protocol and their G-18 bank counterparties would likely require them to concede as much protection in negotiations as they would acquire, there are good reasons why the behavior of the G-18 banks may differ from end-users in this regard.

[71] For a discussion of the role of increasing demands for collateral, curtailment of trading, and short selling in the demise of Bear Stearns, AIG and Lehman Brothers, *see* Fin. Crisis Inquiry Comm., The Financial Crisis Inquiry Report (2011), available at: http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[72] *See, e.g.,* the Duffie Paper, *supra* note 43, at 60 ("In the case of OTC derivatives and repurchase agreements, a run … could be accelerated if counterparties and creditors that have the ability to run on short notice would be harmed in the event of a resolution process that would stay their contracts for any significant period of time[.]").

subject to certain SRRs (*e.g.*, SIFIs and their affiliates). Therefore, the Regulators' Stay Initiatives could promote a shift in liquidity away from the largest, most highly regulated banks to smaller, more aggressive and potentially less sophisticated bank counterparties. The G-20 bank regulators should fully consider these potential consequences in open fora, such as public roundtables and meetings, before they impose the Regulators' Stay Initiatives more broadly in the relevant markets.

Given the rapid pace and potential reach of the Regulators' Stay Initiatives, it seems unlikely that the G-20 bank regulators sufficiently considered the implications for all segments of the affected markets. Regulators appear to have at least preliminarily identified some adverse implications, such as the inability of fiduciaries to surrender Default Rights voluntarily.[73] However, as discussed below, it does not appear that regulators fully considered or discussed the potential knock-on effects of rules similar to those contained in the Bank of England Proposal.[74]

C. The Contractual Approach to Imposing the Regulators' Stay Initiatives Is Inherently Flawed

At present, the Regulators' Stay Initiatives rely heavily on the amendment of market participants' trading agreements by contract. There are significant, inherent flaws in such a contractual approach to the cross-border recognition of SRRs and the imposition of stays on Default Rights. As a result, the Regulators' Stay Initiatives may inject uncertainty into the markets at the worst possible time – the eve of a SIFI's bankruptcy.

1. "Any Contractual Solution Binds Only the Parties that Agree to It"[75]

The FSB accepts that broad adherence to a contractual solution is critical to its success.[76] However, end-users are unlikely to adopt contractual stays on Default Rights universally. Therefore, market participants facing a distressed SIFI will not be on a level playing field.

For example, many asset managers will have to seek their clients' consent before the managers can agree to contractual stays of Default Rights. As a result, certain asset managers may obtain authority to adopt stays of Default Rights in respect of some of their clients but not all.[77] Other end-users may agree to stays on Default Rights only to the limited extent necessary to trade a particular financial instrument. Some may elect

[73] *See* ISDA, Resolution Stay Protocol – Background, available at: http://www2.isda.org/attachment/NzA0Mw==/RESOLUTION%20STAY%20PROTOCOL%20Background%20FINAL.pdf (recognizing that buy-side firms are unable to adopt the protocol voluntarily).

[74] Bank of England Proposal, *supra* note 69.

[75] FSB Consultation Paper, *supra* note 27, at 12.

[76] *See id.* at 1 ("[U]ntil comprehensive statutory regimes have been adopted in all relevant jurisdictions, contractual arrangements, if properly crafted ***and widely adopted***, offer a workable interim solution [to the problem of cross-border recognition of SRRs] [emphasis added].").

[77] We anticipate that some asset management clients simply will not respond to requests for consent from their fiduciaries. While some investment managers and trustees may rely on a negative-affirmation approach to confirm their clients' consent, other investment managers and trustees may not be comfortable doing so for the ISDA Resolution Stay Protocol. Where an investment manager or trustee determines to obtain affirmative consent from all its clients, it could be a lengthy and drawn-out process and may not be practically achievable for large asset managers.

to cease trading financial contracts with SIFIs altogether to avoid contractual stays on the Default Rights they have with respect to their existing portfolios.

As a result, contractual stays on Default Rights are likely to apply in a fragmented manner across the end-user community. The very prospect of this fragmented application of stays on Default Rights will discourage many sophisticated end-users from voluntarily adopting them by contract (whether through adherence to the Resolution Stay Protocol or otherwise). Such end-users will be unwilling to assume the risk that, in a SIFI default scenario, they could be unable to exercise Default Rights while other end-users are exercising theirs.

2. Certain G-20 Jurisdictions Will Promote Fragmented Adoption of Contractual Stays by Excluding Certain Entities and Trades from the Scope of Their Stay Initiatives

The applicable rules and laws that each G-20 jurisdiction adopts will dictate the scope of entities and transactions that the Regulators' Stay Initiatives will cover in that jurisdiction. With respect to affected entities, both the Bank of England Proposal and the Germany Recovery and Resolution Act exclude central governments/banks and central counterparties (*i.e.*, clearinghouses) from the obligation to recognize their regimes' stays on Default Rights.[78]

In addition, the Bank of England Proposal and the Germany Recovery and Resolution Act apply only prospectively and not retroactively, which means that certain transactions executed prior to the effectiveness of these jurisdictions' requirements may be excluded from the scope of a required contractual stay on Default Rights.[79] Other jurisdictions may take a similar approach, particularly where local law prevents the government from depriving market participants' of their contractual rights and remedies on a retroactive basis. As a result, contractual stays may not apply equally and universally to transactions with a failing SIFI in these jurisdictions,[80] and sophisticated market participants may pursue contractual countermeasures and market-based actions of the type described above to address the absence of a level playing field in this regard.

The Resolution Stay Protocol could seek to promote more universal application of contractual stays by exceeding the technical requirements of the rules issued by the G-20 bank regulators. For example, the Resolution Stay Protocol may provide for retroac-

[78] *See* Bank of England Proposal, page 4 of Appendix at 4, clause 2.2 of page 4. *See also* The German Recovery and Resolution Act, (93) ("It is useful and necessary to suspend certain contractual obligations so that the resolution authority has time to put into practice the resolution tools. This should not, however, apply to obligations in relation to systems designated…central counterparties and central banks"), available at: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0059&from=DE#ntc14-L_2014173EN.01019001-E0014; and The German Recovery and Resolution Act Draft Amendment, Article 60A ("the obligation [laid out above] does not apply to financial contracts concluded with central counterparties and central banks.") available at: http://dipbt.bundestag.de/dip21/brd/2015/0193-15.pdf.

[79] An end-user facing a U.K. or German SIFI could potentially preserve its Default Rights in respect of pre-existing swap transactions by "splitting its books" as described *supra* note 69. End-users that decide to separate new transactions from old transactions in this manner would be subject to Default Right stays only with respect to the portion of their portfolio that represents new transactions; their Default Rights with respect to their historical portfolio would remain intact.

[80] Some may argue that allowing historical trades to remain on the books of a SIFI unamended is merely a transitional issue that will diminish in importance over time as such trades expire. The significance of the unamended, historical portfolio will necessarily vary by SIFI and depend on the extent to which the SIFI has entered into long-dated trades.

tive application of the stays, even where certain G-20 jurisdictions' rules require only prospective application. However, asset managers, pension plan trustees, and other market participants that are fiduciaries to their investors and clients will likely not adhere to a contractual solution if its scope exceeds the requirements of applicable law and regulation.

The prospect of fragmented application of stays on Default Rights is likely to enhance market anxiety when a SIFI begins to experience financial distress. MFA fails to see how inconsistent and inequitable application of stays on Default Rights against a failing SIFI will promote resolutions that are more orderly in the future.

3. Legal Enforceability of Contractual Stays May Be Questioned in a Distress Scenario

Legal challenges to the Regulators' Stay Initiatives may surface in the future, and potentially only once the market considers a SIFI to be in distress.

We discussed our concerns about the process underlying the Regulators' Stay Initiatives from a U.S. perspective above. Market participants in other jurisdictions could raise legal challenges based on similar concerns. For example, although the legal process requirements may differ in each G-20 jurisdiction, to the extent that G-20 bank regulators have pre-determined to proceed with the Regulators' Stay Initiatives regardless of the local lawmaking process necessary to implement the proposed rules, market participants may seek to challenge the legality of the process underlying the rules.[81]

In addition, market participants could legally challenge the terms of a particular contractual stay on their Default Rights. As a SIFI default looms, market participants will closely scrutinize the terms of any contractual stay on Default Rights. Where a market participant has any doubt as to the legal enforceability of a contractual stay on their Default Rights, the potential consequences of inaction may create a bias toward exercising Default Rights. Even where a contractual stay appears to be unambiguous, some market participants may still seek, in extreme circumstances, to close out open trades and bear the risk of liability for damages, rather than maintaining such trades with a distressed SIFI.

> *The prospect of fragmented application of stays on Default Rights is likely to enhance market anxiety when a SIFI begins to experience financial distress.*

D. U.S. Regulators' Cross-Default Stay Initiative Usurps Congress' Role and May Undermine G-20 Objectives

Similar to bank regulators in other G-20 jurisdictions, U.S. Regulators will soon be proposing rules that will promote cross-border recognition of U.S. SRRs, such as OLA. However, U.S. Regulators have signaled that they wish to go a significant step further by seeking to impose contractual stays on certain

[81] MFA acknowledges that unlike other G-20 jurisdictions, German policymakers are in the process of finalizing statutory changes to impose the stays, and thus, it may be less likely that there are legal challenges to the German process. *See* The German Recovery and Resolution Act, Draft Amendment Article 60A, *supra* note 78.

Cross-Default Rights related to ordinary insolvency proceedings under the Bankruptcy Code. To this end, U.S. Regulators have stated that they will propose rules that will require end-users to waive their Cross-Default Rights in contracts with certain SIFI affiliates, even though the Bankruptcy Code does not presently stay the exercise of such rights. If an end-user refuses to waive such rights, the new rules will prohibit a U.S. SIFI from continuing to trade with the end-user. As explained below, U.S. Regulators are seeking these waivers "in an effort to support successful resolution proceedings under these regimes."[82]

The significance of the U.S. Regulators' departure from the approach that other G-20 bank regulators are taking cannot be overstated. Whereas other G-20 bank regulators are seeking extraterritorial recognition of statutory stays that policymakers in their jurisdictions have enacted, the U.S. Regulators are seeking to impose stays on Cross-Default Rights that do not exist under U.S. law and are contrary to the congressional policies and objectives summarized in the first section of this white paper. Put another way, the U.S. Regulators are seeking to impose stays of Cross-Default Rights in connection with proceedings under the Bankruptcy Code that Congress has approved solely for proceedings under OLA.

As explained further below, in requiring waivers of Cross-Default Rights by contract where OLA does not apply, the U.S. Regulators will effectively be subjecting end-users to "OLA-like" stays by contract. Consequently, the U.S. Regulators' Cross-Default Stay Initiative circumvents the U.S. legislative process by effectively imposing key aspects of OLA in relation to U.S. ordinary bankruptcy proceedings, contrary to congressional intent.

1. U.S. Regulators' Cross-Default Stay Initiative is Not a G-20 Objective

At the behest of U.S. Regulators, ISDA included within Section 2 of the Resolution Stay Protocol provisions that would impose a contractual stay on counterparties' Cross-Default Rights when the parent company or other significant affiliate of a direct counterparty becomes subject to a Bankruptcy Code proceeding. In effect, Section 2 imposes contractual stays on Cross-Default Rights during insolvency proceedings of a failing SIFI under the Bankruptcy Code (which itself does not impose any such stays on Cross-Default Rights), thereby importing the cross-default nullification provisions of Section 210(c)(16) of OLA.[83]

However, the U.S. Regulators' Cross-Default Stay Initiative – as embodied in Section 2 of the Resolution Stay Protocol – does not ap-

[82] ISDA/Cleary Article, *supra* note 19, at 9.

[83] Dodd-Frank Act § 210(c)(16) allows the FDIC, as receiver of a covered financial company (or subsidiary of such company), to enforce contracts of subsidiaries or affiliates of such company, the obligations under which are guaranteed or otherwise supported by or linked to the financial company, notwithstanding any contractual right to cause the termination or acceleration of such contracts based solely on the insolvency of the covered financial company if such guarantee or other support and all related assets and liabilities are transferred to or assumed by a bridge financial company or third party within the transfer period applicable to such contract or the FDIC as receiver otherwise provides adequate protection with respect to such contract. The effect of this provision is to prohibit the enforceability of a cross-default provision in a Covered Instrument of a subsidiary or affiliate of a covered financial company that has guaranteed such Covered Instrument, if such cross-default is based solely on the insolvency of such covered financial company (provided the guarantee is transferred to a third party or adequate protection is otherwise provided).

pear to form part of broader G-20 objectives. When discussing the purpose of Section 2 of the Resolution Stay Protocol, the ISDA/Cleary Article notes that "[w]hile Section 1 of the Protocol addresses default rights that arise upon resolution actions taken under SRRs, Section 2 was developed as a direct response to U.S. resolution planning requirements under Title I of the Dodd-Frank Act."[84] Even the FSB Consultation Paper distinguishes Section 2 of the Resolution Stay Protocol as being separate and apart from the international effort to enhance cross-border recognition of SRRs.[85]

The U.S. Regulators also recognize that Section 2 of the Resolution Stay Protocol is a U.S.–specific initiative. For example, in their slides describing the Resolution Stay Protocol, the FDIC states that Section 2 "addresses an identified impediment to orderly resolution in the resolution plans submitted to the FDIC and the Federal Reserve by certain financial companies under Title I of the Dodd-Frank Act."[86] In other words, while Section 2 forms part of the Resolution Stay Protocol, the contractual stays it imposes are not part of the FSB's recommended solution to cross-border recognition of SRRs.

Because the U.S. Regulators' Cross-Default Stay Initiative represents a significant departure from existing U.S. bankruptcy law, the inclusion of Section 2 in the Resolution Stay Protocol may make end-users less willing to adhere to it, further fragmenting the application of Default Right stays in financial markets and undermining the G-20's goal of promoting the cross-border recognition of resolution regimes. The U.S. Regulators' Cross-Default Stay Initiative is clearly unique to the U.S. Regulators and the interests of the SIFIs they regulate and may be counterproductive to G-20 regulators' collective objectives.

2. The U.S. Regulators' Cross-Default Stay Initiative is Intended to Facilitate Approval of U.S. SIFIs' "Living Wills"

Section 165(d)(1) of the Dodd-Frank Act requires certain banking entities to submit periodically to the Federal Reserve, FSOC, and the FDIC their plans for "rapid and orderly resolution" in the event of material financial distress or failure. One purpose of such reports, commonly referred to as "living wills", is to assist regulators in their supervisory efforts to ensure that covered companies operate in a manner that is both safe and sound and that does not pose risks to financial stability generally.[87] For this purpose, Congress defined "rapid and orderly resolution" as a "reorganization or liquidation of the covered company ... under the Bankruptcy Code that can be accomplished within a reasonable period of time and in a manner that substantially mitigates the risk that the failure of the

[84] See supra note 8, where the ISDA/Cleary Article points out that "[t]he [FSB's Key Attributes] do not specifically refer to stays on early termination rights arising from cross defaults".

[85] *See* FSB Consultation Paper, *supra* note 27, at §2.1.1, 12 n.13. Notably, in seeking public comment on proposed rules to effect the Regulators' Stay Initiatives, the Bank of England Proposal does not reference the substance of Section 2 of the Resolution Stay Protocol at all.

[86] FDIC, ISDA Resolution Stay Protocol (Dec. 10, 2014), available at: https://www.fdic.gov/about/srac/2014/2014_12_10_presentation_isda.pdf.

[87] *See* Resolution Plans Required, 76 Fed. Reg. 67323 (Nov. 1, 2011), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-11-01/pdf/2011-27377.pdf.

covered company would have serious adverse effects on financial stability in the United States."[88]

In August 2014, the U.S. Regulators rejected the living wills of 11 of the biggest U.S. bank holding companies.[89] This rejection was due, in part, to the U.S. Regulators' belief that a "rapid and orderly resolution" under the Bankruptcy Code could not occur where the companies' financial contracts do not "provide for a stay of certain early termination rights of external counterparties triggered by insolvency proceedings."[90] These U.S. bank holding companies resubmitted their living wills for approval on July 1, 2015. If the U.S. Regulators ultimately determine that a bank's living will is not credible or would not facilitate an orderly resolution under the Bankruptcy Code, U.S. Regulators can: (i) impose more stringent capital, leverage, or liquidity requirements on the bank; (ii) restrict the growth or activities of the bank; and (iii) ultimately, acting in conjunction with FSOC, impose divestiture requirements on the bank.[91]

By maintaining that stays of certain Default Rights are essential to the approval of SIFI living wills, the U.S. Regulators appear to be interpreting Congress' definition of "rapid and orderly resolution" under the Bankruptcy Code as a basis for imposing restrictions on Default Rights that do not exist under the Bankruptcy Code. We believe that it is unlikely that Congress intended the U.S. Regulators to issue rules that would impair the valuable Default Rights of the very market participants that the Dodd-Frank Act sought to protect. We also submit that Congress expected living wills to take into account the Bankruptcy Code as enacted by Congress – that is, without the OLA-like stays that the U.S. Regulators' Cross-Default Stay Initiative seeks to impose.

> *We believe that it is unlikely that Congress intended the U.S. Regulators to issue rules that would impair the valuable Default Rights of the very market participants that the Dodd-Frank Act sought to protect.*

Even those market participants that advocate for stays on Default Rights have conceded that an approach that imposes stays on swaps, derivatives and repos is "not only missing [from the Bankruptcy Code] but is

[88] 12 C.F.R. § 243.2 (2015), available at: https://www.law.cornell.edu/cfr/text/12/243.2; 12 C.F.R. § 381.2 (2015) (emphasis added), available at: https://www.law.cornell.edu/cfr/text/12/381.2.

[89] *See* Press Release, Board of Governors of the Federal Reserve System & FDIC, Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Filers: Firms required to address shortcomings in 2015 submissions (Aug. 5, 2014), available at: http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm.

[90] *Id.*

[91] See 12 C.F.R. § 243.6, available at: https://www.law.cornell.edu/cfr/text/12/243.6; 12 C.F.R. § 381.6, available at: https://www.law.cornell.edu/cfr/text/12/381.6.

expressly contradicted by provisions that exist."[92] The legislative history[93] of the Dodd-Frank Act also evidences a clear congressional intent to permit the emergency stay provisions of OLA only in an exceptionally rare scenario.[94] Congress enacted the compromise opting for a narrow exit from the Bankruptcy Code, despite advocates' noted concerns on the Senate floor that the Bankruptcy Code precluded emergency stays of Default Rights and that staying Default Rights was not legally possible until the lengthy OLA transfer process was complete.[95]

Therefore, MFA submits that the intent of Congress to preserve the enforceability of end-users' Default Rights, including Cross-Default Rights, is clear, and the U.S. Regulators' Cross-Default Stay Initiative frustrates the resolution framework Congress sought to implement with the Dodd-Frank Act. As a result, the U.S. Regulators' interpretation is contrary to clear congressional intent and

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[92] Statement of Thomas Jackson, U.S. House of Representatives, Subcommittee on Regulatory Reform, Commercial and Antitrust law, July 15, 2014, H.R., The 'Financial Institution Bankruptcy Act of 2014 at 9, note 4, available at: http://judiciary.house.gov/_cache/files/95129263-7f56-4ae1-9f7d-3352944f610c/jackson-testimony.pdf. See also Stephen J. Lubben, Transaction Simplicity, 112 Colum. L. Rev. Sidebar 194, 203 n.33 (2012) (arguing that the safe harbors should "be entirely reconsidered" but acknowledging that "[Chapter 11] provid[es] exemption from automatic stay[s] [in] 11 U.S.C. § 362(b)(17) (2006), an exemption from certain avoiding powers [in] 11 U.S.C. § 546(g), and [and preserves all] rights of termination including under an ipso facto clause, close-out netting and swap enforcement in 11 U.S.C. § 560. The end result is that both repos and derivatives are exempt from the normal rules of bankruptcy: There is no automatic stay… and while Dodd-Frank has created a new bankruptcy system for financial institutions, it did not replace the Bankruptcy Code in all instances… Chapter 11 remains in place unless financial regulators decide to invoke the OLA. Indeed, the FDIC indicates that Chapter 11 remains the primary framework for resolving financial distress in these institutions."), available at: http://columbialawreview.org/transaction-simplicity/#29; Jodie A. Kirschner, The Bankruptcy Safe Harbor in Light of Government Bailouts: Reifying the Significance of Bankruptcy as a Backstop to Financial Risk (March 1, 2015) 18 NYU J. L. Pub. Pol (2015)(Forthcoming) ("Institutions enter the alternative OLA system in rare cases where regulators determine that bankruptcy would have serious adverse effects on financial stability in the U.S. and using OLA would avoid or mitigate such adverse effects. The key effect of introducing the OLA alongside traditional bankruptcy is to offer a work-around to the problems caused by the bankruptcy exemption. When the OLA preempts the bankruptcy law, use of the OLA triggers a one-day stay that prevents counterparties to derivatives transactions from terminating their contracts. Unlike the bankruptcy law, the OLA can therefore preserve assets within distressed institutions and support the continued viability of their operating subsidiaries."), available at: https://www.aier.org/sites/default/files/Files/Documents/Standard/WP001.pdf.

[93] The legislative history clearly shows Congress' belief that exempting qualified financial products from the bankruptcy code's automatic stay reduced systemic risk and was the chosen policy. See Shmuel Vasser, Derivatives in Bankruptcy, 60 Bus. Law. 1507, 1509–11 (2005) ("The legislative history to the various provisions [that create] the derivative and swap … safe harbors of the bankruptcy code… indicates a strong Congressional policy to protect American financial markets and institutions from the ripple effects resulting from a bankruptcy filing by a major participant in the financial markets."), available at: http://www.jstor.org/stable/40688321?seq=1#page_scan_tab_contents.

[94] 156 Cong. Rec. S3684-02, (May 13, 2010) ("So the idea was, on some rare occasions, and hopefully they are very rare, when that possibility occurs and you have to go through a number of hoops to get to that conclusion, that we would have a mechanism for a resolution, a winding down of that entity, to avoid the kind of collateral damage that could cause if bankruptcy were the only option for those complex entities.") (Statement of Sen. Chris Dodd of Connecticut); 156 Cong. Rec. S3684-02, (May 13, 2010) ("When Senator Warner and I were working on the resolution, it was with the intent that bankruptcy be the default. That would be the place where almost every financial institution would go. There may be that rare instance-that rare instance-when resolution was necessary, but it would be due to some systemic risk.") (Statement of Sen. Bob Corker of Tennessee).

[95] 156 Cong. Rec. S3684-02, (May 13, 2010) ("There are also technical problems with Title II which would cause financial instability. For example, the nature of the delay in applying the exemption from the automatic stay for qualified financial products will lead to more runs. [Instead, what] is required is an adjustment to the bankruptcy law to make it apply to nonbank financial firms in a clear way which the firms, their counterparties, and their creditors can understand and count on. With these changes, bankruptcy would be the mechanism to deal with financial institutions, and thus provisions for a government agency resolution process to override bankruptcy could be eliminated.")

does not merit deference under the *Chevron* doctrine.[96]

With this interpretation, the U.S. Regulators' have also presented the SIFIs they regulate with a difficult challenge: external counterparties are unlikely to surrender their Default Rights willingly. The U.S. Regulators' Cross-Default Stay Initiative is effectively an attempt to provide U.S. SIFIs with the contractual stays they need in order to obtain approvals of their living wills from the U.S. Regulators. In seeking to facilitate approval of the banks' living wills in this manner, however, the U.S. Regulators are depriving end-users of critical legal rights that Congress has not chosen to restrict.

3. By Importing "OLA-Like" Stays into Bankruptcy Code Insolvency Situations, the U.S. Regulators' Cross-Default Stay Initiative Usurps the Legislative Function

a. Overview of Checks and Balances in OLA

Congress intended that Treasury (in consultation with the President) would invoke OLA only in rare circumstances,[97] and that the Bankruptcy Code would remain the "dominant tool" for resolving failed financial institutions, even SIFIs.[98]

For Treasury to place a financial company into receivership under OLA, the financial company must be one whose failure creates "systemic risk."[99] On their own initiative, the

96 "In reviewing an agency's interpretation of a statute, the court must reject those constructions that are contrary to clear congressional intent or frustrate the policy that Congress sought to implement." Van Blaricom v Burlington Northern Railroad Company 17 F.3d 1224 (1994), available at: http://openjurist.org/17/f3d/1224/van-blaricom-v-burlington-northern-railroad-company. See also Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-44 (1984) (establishing two-part test for reviewing an agency's interpretation of a statute), available at: http://openjurist.org/467/us/837; State of OR. O.B.O. OR. Health Sciences v. Bowen, 854 F.2d 346, 350, available at: http://openjurist.org/854/f2d/346/state-of-oregon-oregon-health-sciences-university-v-r-bowen; New York City Health and Hospitals Corp. v. Perales, 954 F.2d 854, (2nd Cir. 1992) (New York's reductions in its state Medicare budget found contrary to goals of the Medicare Act), available at: http://openjurist.org/954/f2d/854/new-york-city-health-and-hospitals-corporation-v-a-perales-w-md; Adams v. U.S. Forest Serv., 671 F.3d 1138, 1143 (9th Cir. 2012), available at: http://www.leagle.com/decision/In%20FCO%2020120209195/ADAMS%20v.%20U.S.%20FOREST%20SERVICE; Cosgrove v. Sullivan, 783 F. Supp. 769 (S.D.N.Y 1991)(relying on legislative history to declare the agency interpretation contrary to congressional intent), available at: http://openjurist.org/999/f2d/630/cosgrove-v-w-sullivan; Schneider v Chertoff, 450 F.3d 944, 952, available at: http://openjurist.org/450/f3d/944/schneider-v-chertoff; Wilderness Soc'y v. U.S. Fish & Wildlife Serv., 353 F.3d 1051, 1059 (9th Cir. 2003) (en banc) (explaining two-step test), available at: http://www.leagle.com/decision/20031734360F3d1374_11589.xml/WILDERNESS%20SOCIETY%20v.%20U.S.%20FISH%20&%20WILDLIFE%20SERVICE; California Dep't of Soc. Servs. v. Thompson, 321 F.3d 835, 847 (9th Cir. 2003), available at: http://openjurist.org/321/f3d/835/state-of-california-department-of-social-services-v-g-thompson.

97 There should be "a strong presumption that the Bankruptcy Code will continue to apply to most failing financial institutions (other than insured depository institutions and insurance companies which have their own separate resolution processes), including large financial institutions." S. Rep. No. 111-176, at 58 (2010), available at: http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf. The process for making the systemic risk determination includes "several steps intended to make the use of the authority very rare." *Id.*

98 U.S. Department of the Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, at 76 (2009), available at: http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

99 *See* Dodd-Frank Act § 203.

U.S. Regulators can, and at the request of the Secretary of the Treasury (the Secretary) must, make a written recommendation regarding whether a financial institution presents systemic risk.[100] If the Secretary receives such a recommendation and then determines, among other things, that the default of the financial institution would have a "serious adverse effect on the financial stability of the United States",[101] the Secretary – inconsultation with the President of the-United States - may invoke OLA and seek to appoint the FDIC as receiver. That is, while the U.S. Regulators can recommend that a failing financial institution be subject to resolution under OLA, the U.S. Regulators cannot *independently* invoke OLA, and therefore, cannot unilaterally impose a stay of Cross-Default Rights on the counterparties to the institution's affiliates.

b. U.S. Regulators' Cross-Default Stay Initiative Circumvents Statutorily Mandated Checks and Balances

By issuing rules that impose OLA-like stays on Cross-Default Rights as a condition to trading with major U.S. financial institutions, the U.S. Regulators are bypassing the controls built into OLA and frustrating congressional intent. In effect, the U.S. Regulators are using rulemaking to alter the effect of the Bankruptcy Code, rather than seeking to have Congress enact necessary statutory amendments. In the United States, Congress alone has the authority to enact bankruptcy legislation.[102] Therefore, the U.S. Regulators' Cross Default Stay Initiative usurps the role of Congress, which appears to be a further basis on which the U.S. Regulators' rules could become subject to a future legal challenge (possibly on the eve of a SIFI's default).[103]

c. U.S. Regulators' Cross-Default Stay Initiative Is Being Advanced Without Adequate Consultation

As noted above, U.S. regulators have not sufficiently consulted with, or addressed the concerns of, the broad group of end-users that their Cross-Default Stay Initiative will affect. When one considers the wide-ranging consultation process that has preceded other U.S. government action in connection with bankruptcy matters, there has been a striking lack of consultation concerning the Regulators' Stay Initiatives, and the U.S. Regulators' Cross-Default Stay Initiative in particular.

For example, prior to the passage of the U.S. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),[104]

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[100] *See id.*, 12 U.S.C. § 5383(a)(1)(A) (2012).

[101] *See id.*, 12 U.S.C. § 5383(b) (2012).

[102] *"The Congress shall have Power to...establish...uniform Laws on the subject of Bankruptcies throughout the United States....",* U.S. Const. art. I, § 8, cl. 4, available at: https://www.law.cornell.edu/constitution/articlei.

[103] However, MFA has concerns as to whether even congressional action is inappropriate at this time given the potential consequences of these sudden and fundamental changes for the financial markets. *See* discussion of the inherent flaws in the rapid implementation of the Regulators' Stay Initiatives *infra* Section I.

[104] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, 109th Cong. (2005), available at: http://www.gpo.gov/fdsys/pkg/BILLS-109s256enr/pdf/BILLS-109s256enr.pdf.

there was an extensive consultation process[105] under the oversight of the PWG. During that process, Treasury, the U.S. Office of the Comptroller of the Currency, the CFTC, the SEC, and the U.S. Regulators closely collaborated with each other as well as legal and industry experts, such as ISDA and the Bond Market Association (the predecessor to SIFMA). Only following that process did the PWG make recommendations for changes to the U.S. federal insolvency regime and present them to Congress. In contrast, to date the U.S. Regulators do not appear to have formally consulted with legislators, key market regulators such as the CFTC, or the wide range of market participants in the private sector that will be affected by the Regulators' Stay Initiatives about its potential consequences.

d. U.S. Regulators' Cross-Default Stay Initiative is Inequitable and Objections in Principle Are Highly Likely

Cross-Default Rights afford significant protections to end-users. Defaults by parent companies, credit support providers, and other significant entities within a corporate group often signal the imminent collapse of other key members of the banking group.[106] A default by a G-18 bank would be a very significant market event, such that the value of a transaction with one of its affiliates would likely become highly volatile.

While financial institutions often require additional collateral (often called initial margin or, in the case of swaps, Independent Amounts) from their end-user counterparties to address the risk that the market value of a transaction moves between time of default and actual closeout of the trade,[107] financial institutions rarely post initial margin to end-users. As a result, end-users hold less collateral than their big bank counterparties and are less well protected against their default, and Default Rights (especially Cross-Default Rights) have become a primary means by which end-users manage market risk in bank default scenarios.

Because the U.S. Regulators' Cross-Default Stay Initiative does not require financial institutions to relinquish any Default Rights against distressed end-users or otherwise compensate them for the increased risk they will face, it would deprive end-users of Default Rights without adequate compensation. While proponents of the U.S. Regulators' Cross-Default Stay Initiative may argue that end-users receive compensation in the form of greater systemic stability, since the initiative may be pro-cyclical and inject

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[105] While one could argue that such a process would involve a significant delay, MFA notes that at least one key participant attributed the bulk of the delay in the BAPCPA consultation process to aspects of the legislation other than the financial transactions provisions. *See* Michael H. Krimminger, *Adjusting the Rules: What Bankruptcy Reform Will Mean for Financial Market Contracts*, FDIC (Oct. 11, 2005), available at: https://www.fdic.gov/bank/analytical/fyi/2005/101105fyi.html ("The delay in final enactment was solely the result of the many issues presented by other provisions of the larger bankruptcy legislation").

[106] *See, e.g.*, The collapse of Lehman Brothers. While Lehman Brothers Holdings Inc., the primary source of credit support within the Lehman Brothers group filed for bankruptcy protection on September 15, 2008, Lehman Brothers Special Financing, Inc., its primary swap dealer, did not file for bankruptcy protection until October 3, 2008.

[107] *See, e.g.*, The discussion of Independent Amounts in the User's Guide to the ISDA Credit Support Documents under English Law, available at: http://assets.isda.org/media/e0f39375/6a9c5827.pdf/.

significant anxiety into U.S. financial markets as discussed above, MFA believes it may actually decrease systemic stability. MFA anticipates, therefore, that a significant number of end-users will view the U.S. Regulators' Cross-Default Stay Initiative as being fundamentally inequitable and unsound.

IV. Proposed Recommendations

In summary, the Regulators' Stay Initiatives will deprive end-users of valuable Default Rights and result in fundamental changes to long-standing market paradigms. Given that these initiatives will have material implications for end-users and financial markets more broadly, it is critical that their potential impact be properly assessed prior to their implementation. Absent more thoughtful and balanced implementation, global financial stability and market integrity are at risk of being compromised, especially during stressed market conditions. Such an outcome is clearly inconsistent with the policy goals of G-20 policymakers, the SRRs in various G-20 jurisdictions, and the Bankruptcy Code. Accordingly, MFA believes that G-20 bank regulators need to reconsider their actions and work with all interested parties to adopt a more balanced approach.

In light of MFA's above concerns with both the Regulators' Stay Initiatives and the U.S. Regulators' Cross-Default Stay Initiative, we propose the recommendations below for a thoughtful, comprehensive, and equitable way forward.

A. IOSCO End-User Stay Report

IOSCO should issue a consultation paper for public comment on the implications of potential stays of the Default Rights of end-users, complete a study, and then prepare a report (the IOSCO End-User Stay Report) for G-20 legislators addressing and analyzing at least the following:

i. The likely impact of the Regulators' Stay Initiatives on end-users and financial markets more broadly and the expected costs of such stays relative to the benefits to be gained by imposing them in the manner contemplated;
ii. The extent to which end-users will participate in a contract-based approach to recognition of foreign SRRs (*e.g.*, the Resolution Stay Protocol), given the inherent flaws of such an approach and the potential impact on market stability of fragmented and inconsistent adherence;
iii. The extent to which a contract-based approach to enforcement of foreign SRRs will precipitate a reduction in liquidity in the derivatives, foreign exchange, and securities financing markets as a result of the withdrawal of end-users from those markets until appropriate statutory measures are developed;
iv. The likelihood that the uncertainties inherent in any contract-based approach to the imposition of stays on Default Rights will cause market participants (both banks and end-users)

to engage in "self-help remedies" such that the stays on Default Rights could adversely impact liquidity for SIFIs and have a counterproductive effect during stressed market conditions. In particular, the IOSCO End-User Stay Report should analyze the likelihood of end-users adopting the following measures:

1. Purchasing increased credit default swap protection referencing their bank counterparties;
2. Reducing credit exposures to such banks (whether by curtailing repo activity with, or other lending to, such entities, including by reducing their inventory of bonds issued by such entities) or demanding increased compensation from such banks for assuming such credit exposures;
3. Short selling of securities issued by such banks; and
4. Negotiating into agreements that govern Covered Instruments protections that offset the risks introduced by stays on Default Rights, such as more conservative ratings-downgrade triggers, demands for additional collateral, and rights allowing termination on demand;

v. The potential adverse impact on a distressed SIFI of investor and counterparty flight upon the first sign that such bank may be the subject of resolution action and how that might harm a troubled bank in a pre-failure context;

vi. Whether requiring end-users to waive Default Rights related to cross-defaults when a SIFI parent company or guarantor becomes subject to a U.S. bankruptcy proceeding will discourage end-users from adhering to the Resolution Stay Protocol such that the inclusion of Section 2 of the Resolution Stay Protocol frustrates the G-20's goals with respect to global recognition of SRRs;

vii. Whether the G-20 may adequately achieve its goals of global recognition of SRRs by requiring only the G-18 banks that have already adhered to the Resolution Stay Protocol to abide by its terms, at least until policymakers have adopted appropriate statutes providing for such recognition; and

viii. The potential adverse impact of imposing regulations requiring end-users and non-G-18 banks to choose between waiving Default Rights and retaining the ability to amend their existing hedge transactions.

B. PWG Recommendations to Congress

The PWG (consisting of the Secretary of the Treasury and the Chairpersons of the Federal Reserve, the CFTC, and the SEC) should reconvene and consider the findings of the IOSCO End-User Stay Report. To the extent that the PWG concludes that the costs associated with imposing a stay on end-users' Default Rights under Covered Instruments are warranted to promote systemic stability, the PWG should submit to Congress recommendations for implementing such stays by statute.

C. Deferral of Further Action by G-20 Bank Regulators

Given the need for further consultation on, and analysis of, the Regulators' Stay Initiatives, including the U.S. Regulators' Cross-Default Stay Initiative, the G-20 bank regulators and the U.S. Regulators should defer further action on their respective initiatives pending the outcome of the foregoing efforts.

Appendix 1:Glossary of Key Terms

Glossary of Key Terms

Term	Definition
Bank of England	Bank of England, which is the central bank and prudential regulatory authority of the United Kingdom.
Bank of England Proposal	Bank of England's Consultation Paper 19/15 - Contractual Stays in Financial Contracts Governed by Third-Country Law. [108]
Bankruptcy Code	The U.S. Bankruptcy Code.
Covered Instruments	Financial contracts that the Regulators' Stay Initiatives are likely to affect, including swap agreements, forward contracts, commodity contracts, and securities transactions (e.g., repurchase transactions).
Cross-Default Rights	Default Rights that arise upon the default of an affiliate of a party's direct counterparty.
Default Rights	Rights that a counterparty has, whether contractual or statutory, automatic or otherwise, to: (i) liquidate, terminate, or accelerate a Covered Instrument; (ii) set off or net certain amounts owing in respect of a Covered Instrument; (iii) exercise remedies in respect of collateral or other credit support related to a Covered Instrument: (iv) demand certain payments or deliveries under a Covered Instrument; (v) suspend, delay, or defer payment or performance under a Covered Instrument; (vi) modify the obligations of a party under a Covered Instrument; and/or (vii) alter the amount of collateral or margin that must be provided with respect to an exposure under a Covered Instrument. "Default Rights" do not include any right under a contract that allows a party to terminate the contract on demand or at its option at a specified time, or from time to time, without the need to show cause.
Dodd-Frank Act	The U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act.
End-User	A term used in this white paper to refer broadly to entities that use Covered Instruments as investment and risk management tools and which includes, without limitation, asset managers, investment managers, manufacturers, and other commercial and industrial entities.
FDIC	The U.S. Federal Deposit Insurance Corporation.
Federal Reserve	The U.S. Board of Governors of the Federal Reserve System.

[108] Available at: http://www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp1915.aspx#_blank.

Glossary of Key Terms

Term	Definition
FSB	The Financial Stability Board, a not-for-profit association under Swiss law that was established as the successor to the Financial Stability Forum and monitors and makes recommendations about the global financial system. The FSB's members include various G-20 bank and market regulators as well as international financial institutions and standard-setting bodies.
FSB Consultation Paper	The FSB's Consultative Document on "Cross-border recognition of resolution action" (September 29, 2014).
FSOC	The U.S. Financial Stability Oversight Council, a joint U.S. body created by the Dodd-Frank Act to oversee issues related to U.S. systemic risk whose members including the following U.S. authorities:
G-18 banks	The Group of Eighteen, a group of 18 major derivatives dealers designated by bank regulators. • Bank of America Merrill Lynch • Bank of Tokyo-Mitsubishi UFJ • Barclays • BNP Paribas • Citigroup • Crédit Agricole • Credit Suisse • Deutsche Bank • Goldman Sachs • HSBC • JP Morgan Chase • Mizuho Financial Group • Morgan Stanley • Nomura • Royal Bank of Scotland • Société Générale • Sumitomo Mitsui Financial Group • UBS
G-20	The Group of Twenty, a forum for the governments and central bank governors from 20 major economies. Generally, this forum meets annually in an effort to improve global financial regulation and implement key economic reforms. The G-20 is currently comprised of representatives from the following governments: • Argentina • Japan • Australia • Republic of Korea • Brazil • Mexico • Canada • Russia • China • Saudi Arabia • France • South Africa • Germany • Turkey • India • The United Kingdom • Indonesia • The United States • Italy • The European Union

Glossary of Key Terms

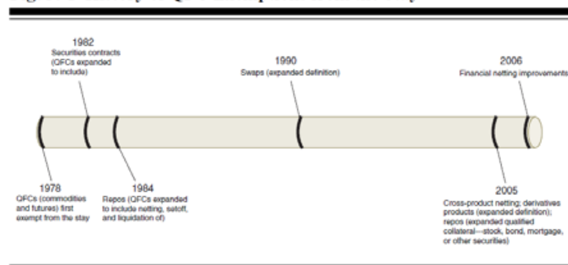
IOSCO	The International Organization of Securities Commissions, which is an international body that is comprised of securities regulators throughout the world that develops, implements, and promotes adherence to internationally recognized standards for securities regulation.
ISDA	The International Swaps and Derivatives Association, Inc., the primary trade association for participants in the derivatives markets and publisher of the Resolution Stay Protocol.
OLA	The Orderly Liquidation Authority provisions of Title II of the Dodd-Frank Act.
Regulators' Stay Initiatives	Current initiatives by G-20 bank regulators to implement rules requiring end-users to restrict or "stay" certain of their Default Rights against a distressed SIFI (including the U.S. Regulators' Cross-Default Stay Initiative).
Resolution Stay Protocol	The ISDA 2014 Resolution Stay Protocol, which ISDA published on November 4, 2014. It enables parties to amend the terms of ISDA Master Agreements on a multilateral basis to recognize contractually the cross-border application of SRRs applicable to certain financial companies and "support the resolution of certain financial companies under the Bankruptcy Code."
SIFI	A systemically important financial institution.
SRR	A statutory "special resolution regime" that temporarily stays the exercise of certain Default Rights against a failing SIFI to give resolution authorities time to take actions in an attempt to stabilize the failing SIFI. In contrast to an SRR, many ordinary insolvency regimes, like the Bankruptcy Code, protect (or provide a "safe harbor" that protects) the exercise of early termination rights by financial contract counterparties.
U.S. Regulators	Together, the FDIC and the Federal Reserve.
U.S. Regulators' Cross-Default Stay Initiative	U.S. Regulators' efforts to impose rules that require parties to agree contractually to waive their Cross-Default Rights in contracts with certain SIFI affiliates despite the fact that the Bankruptcy Code insolvency regime applicable to the relevant banking groups does not stay the exercise of such rights.

[109] Available at: http://www2.isda.org/functional-areas/protocol-management/open-protocols/. The text of the Resolution Stay Protocol is available at: http://assets.isda.org/media/f253b540-25/958e4aed.pdf/.

Appendix 2: Timeline of Key Events Leading to Regulators' Stay Initiatives

The diagram below[110] provides an overview of the history of exemptions for Covered Instruments from the Bankruptcy Code's automatic stay:

Figure 1 History of QFC Exemptions from the Stay



I. Events Related to Protection of Contractual Default Rights Under Title 11 of the Bankruptcy Code

A. 1982: Bankruptcy Code Amendments

- Purpose: "[T]he amendments are intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries."[111]
- Summary: "[T]he stay provisions of the code are not construed to prevent brokers from closing out the open accounts of insolvent end-users or brokers. The prompt closing out or liquidation of such open accounts freezes the status quo and minimizes the potentially massive losses and chain reactions that could occur if the market were to move sharply in the wrong direction."[112]

B. 1990: Bankruptcy Code Amendments

- Purpose: "[T]o clarify bankruptcy law with respect to the treatment of swap agreements and forward contracts."[113]
- Summary: With respect to forward contracts, "[t]he principal purpose of the Code's forward contract provisions is to prevent the insolvency of one party to a forward contract from threatening the solvency of the other party to the contract and, in doing so, the solvency of some or all of the other participants in the market in

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[110] Sabrina R. Pellerin & John R. Walter, *Orderly Liquidation Authority as an Alternative to Bankruptcy*, 98 Econ. Q. 1, 21 (2012), available at: https://www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_quarterly/2012/q1/pdf/walter.pdf
(Figure 1).

[111] H.R. Rep. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583.

[112] *Id.* at 2.

[113] S. Rep. No. 101-285, 101st Cong. (1990), available at: 1990 WL 259288.

which the second party does business."[114]

- With respect to swap agreements, the amendments created an exception. "This exception permits the prompt termination of the agreement and allows the netting rights to be exercised. This will reduce the potential market impact of the bankruptcy filing by allowing immediate termination and netting, eliminating the uncertainty otherwise caused by a bankruptcy filing."[115]

C. 2005: U.S. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

- Purpose: "[T]o clarify the definitions of the financial contracts eligible for netting and . . . allow eligible counterparties to net across different types of contracts" [in order to] "reduce the likelihood that the procedure for resolving a single insolvency will trigger other insolvencies due to the creditors' inability to control their market risk."[116]

- Summary: "S. 256 contains a series of provisions pertaining to the treatment of certain financial transactions under the Bankruptcy Code and relevant banking laws. These provisions are intended to reduce 'systemic risk' in the banking system and financial marketplace. To minimize the risk of disruption when parties to these transactions become bankrupt or insolvent, the bill amends provisions of the banking and investment laws, as well as the Bankruptcy Code, to allow the expeditious termination or netting of certain types of financial transactions. Many of these provisions are derived from recommendations issued by the [PWG] and revisions espoused by the financial industry."[117]

- The FDIC recognized the importance of the legal certainty provided by this legislation. "As financial markets have become more complex and interrelated, legal certainty about how derivatives and other financial contracts will be netted and settled in an insolvency has become a prerequisite for dealing effectively with financial distress. Greater legal certainty on these issues has far-reaching effects in the economy by allowing banks and other financial market participants to better assess and more effectively manage their risks, which provides a more stable and resilient market environment. The new Bankruptcy Act of 2005 is a landmark in this respect, marking the culmination of a more than 20-year legislative trend to reduce the risk of systemic crises in financial markets by defining rules for the prompt settlement and netting of claims."[118]

- Similarly, the PWG expressed the benefits of early termination rights for counterparties and the reduction

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[114] S. Rep. No. 101-285, 101st Cong. (1990), available at: 1990 WL 259288.

[115] *Id.*

[116] The President's Working Group on Financial Markets, Hedge Funds, Leverage and the lessons of Long term Capital Management (1999) available at http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf; H.R. Rep. No. 109-31, at 20, 2005 U.S.C.C.A.N. at 106 (citing to the PWG as a source of the enacted provisions) available at: http://www.gpo.gov/fdsys/pkg/CRPT-109hrpt31/pdf/CRPT-109hrpt31-pt1.pdf.

[117] *Id.*

[118] Krimminger, *supra* note 105.

of systemic risk. "The ability to terminate financial contracts upon a counterparty's insolvency enhances market stability. Such close-out netting limits losses to solvent counterparties and reduces systemic risk. It permits the solvent parties to replace terminated contracts without incurring additional market risk and thereby preserves liquidity. The ability to exercise close-out netting also will generally serve to prevent the failure of one entity from causing an even more serious market disruption."[119]

D. 2006: U.S. Financial Netting Improvements Act of 2006

- Goal and Objective: "H.R. 5585 makes technical changes to the netting and financial contract provisions incorporated by Title IX of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, to update the language to reflect current market and regulatory practices, and help reduce systemic risk in the financial markets by clarifying the treatment of certain financial products in cases of bankruptcy or insolvency."[120]

II. Orderly Liquidation Authority Events

A. 2010

- On July 21, Congress adopts the Dodd-Frank Act, which creates OLA "to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."[121]

B. 2011

- On July 15, the FDIC issues a final rule that will "establish a more comprehensive framework for the implementation of the FDIC's OLA and will provide greater transparency to the process for the orderly liquidation of a systemically important financial institution."[122]
- On November 1, the U.S. Regulators issue a final rule requiring nonbank financial companies designated by FSOC for supervision and bank holding companies with assets of $50 billion or more to report plans for rapid and orderly resolution in the event of financial distress or failure.[123]

C. 2012

- On October 16, the FDIC issues final rule implementing authority granted by Dodd-Frank to enforce contracts of subsidiaries or affiliates of a covered financial company despite con-

[119] President's Working Group on Financial Markets, *supra* note 10, at 40.

[120] H.R. Rep. No. 109-648, 109th Cong., at 2 (2006), available at: http://www.gpo.gov/fdsys/pkg/CRPT-109hrpt648/pdf/CRPT-109hrpt648-pt1.pdf.

[121] 12 U.S.C. § 5384(a) (2012), available at: https://www.law.cornell.edu/uscode/text/12/5384.

[122] *See* Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41626 (July 15, 2011) (codified at 12 C.F.R. pt. 380), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-07-15/pdf/2011-17397.pdf.

[123] *See* Resolution Plans Required, 76 Fed. Reg. 67323 (Nov. 1, 2011) (codified at 12 C.F.R. pt. 381), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-11-01/pdf/2011-27377.pdf.

tract clauses that purport to terminate, accelerate or provide for other remedies in case of insolvency.[124]

- On June 22, the FDIC issues a final rule governing calculation of the maximum obligation limitation, which limits the aggregate amount of outstanding obligations that the FDIC may issue or incur in connection with the orderly liquidation of a covered financial company.[125]
- On April 30, the FDIC issues a final rule clarifying that it will conduct the liquidation and rehabilitation of a covered financial company that is a mutual insurance holding company in the same manner as an insurance company.[126]

D. 2013

- On June 10, the FDIC issues a final rule establishing criteria for determining whether a company is predominantly engaged in ''activities that are financial in nature or incidental thereto.''[127]

E. 2014

- On April 14, the FDIC issues a final rule establishing a self-certification process that is a prerequisite to the purchase of assets of a covered financial company from the FDIC.[128]
- On October 24, the FDIC issues a notice of proposed rulemaking to establish schedules for the retention by the FDIC of the records of a covered financial company for which the Treasury has appointed FDIC as receiver.[129]

F. 2015

- On January 7, the Treasury issues a notice of proposed rulemaking indicating FSOC's intention to implement regulations requiring financial companies to maintain records with respect to Covered Instruments if the primary financial regulatory agencies fail to prescribe such regulations themselves.[130]

III. Events Leading to Regulators' Stay Initiatives

A. 2010 – 2012

- Certain FSB member jurisdictions develop and adopt new "special resolution regimes."
- In the United States, on July 10, 2010, Congress adopts OLA, which provisions would apply to an SPOE resolution approach and provide a

[124] *See* Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company, 77 Fed. Reg. 63205 (Oct. 16, 2012) (codified at 12 C.F.R. pt. 380), available at http://www.gpo.gov/fdsys/pkg/FR-2012-10-16/pdf/2012-25315.pdf.

[125] *See* Calculation of Maximum Obligation Limitation, 77 Fed. Reg. 37554 (June 22, 2012) (codified at 31 C.F.R. pt. 149).

[126] *See* Mutual Insurance Holding Company Treated as Insurance Company, 77 Fed. Reg. 25349 (Apr. 30, 2012) (codified at 12 C.F.R. pt. 380), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-04-30/pdf/2012-10146.pdf.

[127] Definition of "Predominantly Engaged in Activities That Are Financial in Nature of Incidental Thereto," 78 Fed. Reg. 34712 (June 10, 2013) (codified at 12 C.F.R. pt. 380), available at: http://www.gpo.gov/fdsys/pkg/FR-2013-06-10/pdf/2013-13595.pdf.

[128] *See* Restrictions on Sales of Assets of a Covered Financial Company by the FDIC, 79 Fed. Reg. 20762 (Apr. 14, 2014) (codified at 12 C.F.R. pt. 380), available at: http://www.gpo.gov/fdsys/pkg/FR-2014-04-14/pdf/2014-08258.pdf.

[129] *See* Record Retention Requirements, 79 Fed. Reg. 63585 (Oct. 24, 2014), available at: http://www.gpo.gov/fdsys/pkg/FR-2014-10-24/pdf/2014-25338.pdf.

[130] *See* Qualified Financial Contracts Recordkeeping Related to Orderly Liquidation Authority, 80 Fed. Reg. 966 (Jan. 7, 2015), available at: http://www.gpo.gov/fdsys/pkg/FR-2015-01-07/pdf/2014-30734.pdf.

one business day stay on exercise of termination and default rights.

- In Europe, in 2012, policymakers propose the U.K. Bank Recovery and Resolution Directive, which similar to OLA imposes a temporary stay on the exercise of early termination and default rights.

B. 2013

- In September, the FSB publishes a progress report on efforts to end too-big-to-fail and commits to the following objective: "By end 2014, the FSB will develop proposals for contractual or statutory approaches to prevent large-scale early termination of financial contracts in resolution."[131]
- In November, banking authorities from Germany, Switzerland, the United Kingdom, and the United States (the "Home Authorities") send a letter to ISDA requesting that ISDA agreements be revised to provide for a suspension of closeout rights triggered by a bank resolution or insolvency event.[132]

C. 2014

- In response to the Home Authorities' request, ISDA starts developing the Resolution Stay Protocol. The ISDA Working Group consists of dealer and buy-side firms and it has been working closely with the Home Authorities and other FSB members.
- On August 5, the Federal Reserve and FDIC inform 11 banks that their living wills are "not credible" and demand improvements in living wills that those banks must submit in 2015. Martin J. Gruenberg, the FDIC's Chairman, states that the banks have to make "amendments to their derivatives contracts to prevent disorderly terminations during resolution."[133]
- On October 11, which commences the annual meetings of the International Monetary Fund and the World Bank, ISDA announces that the G-18 banks have agreed to sign the Resolution Stay Protocol.[134]
- In late October, the G-18 banks and certain of their affiliates formally sign up to the Resolution Stay Protocol in advance of the G-20 meeting in Brisbane in November 2014. The G-20 members do not expect end-users to adhere as part of this first adherence phase.

D. 2015

- Throughout 2015, FSB members are encouraging broader adoption of the Resolution Stay Protocol by imposing new regulations in their jurisdictions. FSB members expect these regulations to require waivers of termination/default rights as a condition to trading with a financial institution and should become effective in late 2015/2016.

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[131] FSB, Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF), at 6 (2013), available at: http://www.financialstabilityboard.org/wp-content/uploads/r_130902.pdf.

[132] *See* Letter from the Home Authorities, to Stephen O'Connor, Chairman, ISDA (Nov. 2013), available at: https://www.fdic.gov/news/news/press/2013/pr13099a.pdf.

[133] Press Release, FDIC, Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Fliers (Aug. 5, 2014), available at: https://www.fdic.gov/news/news/press/2014/pr14067.html.

[134] *See* ISDA News Release, *supra* note 19.

MANAGED FUNDS ASSOCIATION
600 14th Street, N.W., Suite 500 | Washington, DC 20005 | 202.730.2600
546 Fifth Avenue, 12th Floor | New York, NY 10036 | 212.542.8460
managedfunds.org | @MFAUpdates