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October 18, 2016

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, S.W., Suite 3E-218, Mail Stop 9W-11
Washington, D.C. 20219

Re: Mandatory Contractual Stay Requirements for Qualified Financial Contracts (Docket ID OCC-2016-0009; RIN No. 1557-AE05)

To Whom It May Concern:

ICI¹ appreciates the opportunity to provide comments on the proposal (“OCC Proposal”) of the Office of the Comptroller of the Currency (“OCC”). The OCC Proposal would require OCC-regulated banks and their subsidiaries that are part of a US global systemically important banking organization (“GSIB”) or foreign GSIB that operates in the United States, to include certain restrictions in their qualified financial contracts (“QFCs”).² The OCC Proposal is substantively identical to, and would complement, the proposal (“Board Proposal”) of the Board of Governors of the Federal Reserve System (“Board”) issued in May,³ and the proposal (“FDIC Proposal”) of the Federal

¹ The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s US fund members manage total assets of \$18.5 trillion and serve more than 90 million US shareholders.

² Department of the Treasury, Office of the Comptroller of the Currency, *Mandatory Contractual Stay Requirements for Qualified Financial Contracts*, 81 Fed. Reg. 55381 (Aug. 19, 2016), available at <https://www.gpo.gov/fdsys/pkg/FR-2016-08-19/pdf/2016-19671.pdf> (“Proposing Release”).

³ See Board of Governors of the Federal Reserve System, *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*, 81 Fed. Reg. 29169 (May 11, 2016), available at <https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-11209.pdf>.

Deposit Insurance Corporation (“FDIC”) issued last month.⁴

The OCC Proposal has significant implications for investment funds. Our members – funds that are regulated under the Investment Company Act of 1940, as amended (the “1940 Act”) and similar non-US regulated funds publicly offered to investors, such as UCITS (collectively, “funds”) – regularly use contracts that may meet the OCC Proposal’s broad definition of QFC for investment and risk management purposes. Many dealers that serve as counterparties to our members’ transactions under QFCs are national banks or other bank entities regulated by the OCC.

ICI recently filed an extensive comment letter on the Board Proposal. Those comments similarly apply to the OCC Proposal, and we thereby incorporate and submit them as an attachment to this letter.⁵ After providing a brief background below, this letter includes several additional comments on the OCC Proposal.

Background

The OCC Proposal would apply to “covered banks,” which are excluded from the scope of the Board Proposal.⁶ The OCC Proposal would define a “covered bank” as:⁷ (i) a national bank or Federal savings association (“FSA”), or subsidiary of either organization, that is a subsidiary of a global systemically important bank holding company (“BHC”);⁸ (ii) a national bank or FSA, or subsidiary of either organization, that is a subsidiary of a global systemically important foreign banking organization (“FBO”);⁹ or (iii) a Federal branch or agency, and any US subsidiary of such an organization, of a global systemically important FBO.¹⁰ The OCC Proposal provides that a QFC of a subsidiary of a covered

⁴ See Federal Deposit Insurance Corporation, *Restrictions on Qualified Financial Contracts of Certain FDIC-supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions*, available at https://www.fdic.gov/news/board/2016/2016-09-20_notice_sum_b_fr.pdf (“FDIC Proposing Release”).

⁵ See Letter to Mr. Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, from David W. Blass, General Counsel, Investment Company Institute, dated Aug. 5, 2016, *attached and available at* http://www.federalreserve.gov/SECRS/2016/August/20160815/R-1538/R-1538_081216_130439_377948682013_1.pdf (“August ICI Letter”).

⁶ The Board Proposal would apply to: (1) any US GSIB bank holding company; (2) any subsidiary of such a bank holding company that is not a “covered bank;” and (3) the US operations of any foreign GSIB with the exception of any “covered bank.” The FDIC Proposal, by contrast, would apply to certain FDIC-supervised banks that are subsidiaries of the covered entities addressed in the Board Proposal, but are not otherwise covered by the Board Proposal or the OCC Proposal.

⁷ See proposed section 47.3(a).

⁸ Designated as such pursuant to section 252.82(a)(1) of Federal Reserve Board Regulation YY.

⁹ Designated as such pursuant to section 252.87 of Federal Reserve Board Regulation YY.

¹⁰ *Id.*

bank would be subject to the requirements of the OCC Proposal in the same manner and to the same extent as the covered bank.¹¹

The operative provisions of the OCC Proposal are substantively the same as the Board Proposal.¹² The proposed scope of covered QFCs and default rights is identical to the Board Proposal. Similar to the Board Proposal, the OCC Proposal would require QFCs entered into with covered banks to contain contractual provisions that recognize the automatic stay of termination and transfer provisions (“stay and transfer provisions”) applicable in resolution proceedings under the Orderly Liquidation Authority provisions of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and the Federal Deposit Insurance Act (“FDIA”).¹³

The OCC Proposal also generally would require QFCs entered into by covered banks to prohibit the non-defaulting QFC counterparty from exercising default rights when an affiliate of the covered bank counterparty becomes subject to a receivership, insolvency, liquidation, resolution, or similar proceeding.¹⁴ As we explained in the August ICI Letter,¹⁵ while we support incorporation of provisions in QFCs that recognize the applicability of enforceability protections relating to resolution proceedings and the attendant statutory stay in the cross-border context, we do not support provisions that would require contracting parties to include stay and transfer provisions and a prohibition on cross-default rights in affected QFCs.

The OCC Proposal, like the Board Proposal and the FDIC Proposal, generally would require that a QFC prohibit a counterparty’s exercise of default rights against a direct party or a guarantor. It would exclude from this prohibition, however, a direct party’s payment or delivery default, or a covered support provider’s payment or delivery default, and where the direct party enters receivership, insolvency, liquidation, resolution, or similar proceedings, other than resolution proceedings under the FDIA, Title II of the Dodd-Frank Act, or similar proceedings under foreign law.¹⁶ We strongly support these exclusions. We recommend, however, that the OCC and the Board broaden these exclusions to permit, after triggering of the stay and transfer provisions, the exercise of default rights by a counterparty against a direct party or a covered support provider with respect to *any* direct default

¹¹ See proposed section 47.3(b).

¹² The operative provisions of the FDIC Proposal also are substantively the same as the Board Proposal. We therefore anticipate making similar recommendations to the FDIC as we are making to the OCC.

¹³ See proposed section 47.4. The Bankruptcy Code, however, largely exempts QFC counterparties from the automatic stay through certain safe harbor provisions. Proposing Release, *supra* note 2, at 55384.

¹⁴ See proposed section 47.5.

¹⁵ See August ICI Letter, *supra* note 5.

¹⁶ See proposed section 47.5(e).

under the covered QFC, and not just with respect to direct defaults resulting from payment or delivery failure or the direct party becoming subject to certain resolution or insolvency proceedings.¹⁷ As discussed in more detail in our letter to the Board, failure to broaden the exclusions to permit a range of negotiated direct default rights by counterparties against covered support providers would disincentivize counterparties from utilizing affiliate guarantors or credit support providers, as such guarantees will have less value.

Proposed Safe Harbor and Process for Approval of Enhanced Creditor Protections

The OCC Proposal, like the Board Proposal and the FDIC Proposal, includes a safe harbor based on adherence to the ISDA 2015 Universal Resolution Stay Protocol (“2015 Protocol”).¹⁸ As we explained in our letter to the Board, however, the proposed safe harbor will not benefit funds. Fund advisers may not lawfully adhere to the 2015 Protocol for fiduciary reasons. Instead, asset managers and other buy-side participants may adhere to the ISDA Resolution Stay Jurisdictional Modular Protocol (“JMP”),¹⁹ which does not raise these fiduciary issues.²⁰ We urge the OCC to coordinate closely with the Board and the FDIC to broaden their proposed safe harbors in an identical manner to also include, as an alternative to the 2015 Protocol, a US JMP that would permit market participants to adhere on a jurisdiction-by-jurisdiction, client-by-client, and dealer-by-dealer basis. The August ICI Letter included specific recommendations regarding elements such a protocol should contain.²¹

Failure by the OCC, the Board, and the FDIC to broaden their proposed safe harbors in the same manner, to permit asset managers and other buy-side participants to rely through adherence to an alternative protocol, could result in buy-side market participants being subject to different rules and creditor protections depending on whether their counterparty is subject to OCC, Board, or FDIC oversight. Such a result would unfairly disadvantage buy-side market participants. It also would result in increased operational and legal complexity for buy-side market participants, to the extent that firms would be required to include in their QFCs different creditor protections depending on whether their counterparty was regulated by the OCC, the Board, or the FDIC. The regulators’ harmonization of

¹⁷ We anticipate making a similar recommendation to the FDIC.

¹⁸ See proposed section 47.6.

¹⁹ The JMP operates to amend existing agreements between two adhering parties with respect to a given jurisdictional module. As a result, adhering parties have the option to adhere on a jurisdiction-by-jurisdiction basis. The JMP also includes provisions that permit investment advisers, asset managers, and other agents to adhere on behalf of one or more clients for which they have legal authority to do so and with respect to only those dealers that they select.

²⁰ See *ISDA Resolution Stay Jurisdictional Modular Protocol*, available at <https://www2.isda.org/functional-areas/protocol-management/protocol/24>.

²¹ See August ICI Letter, *supra* note 5.

their safe harbor rules would be consistent with the stated intention of the OCC that its proposed rule “complement and work in tandem with the FRB NPRM.”²²

The OCC Proposal also includes a process for approval of enhanced creditor protection conditions that is substantially similar to that under the Board Proposal and the FDIC Proposal, except that a covered bank would apply to the OCC for review of such enhanced creditor protections. The OCC states that it expects to consult with the FDIC and the Board during its consideration of a request under this provision.²³ It is unclear, however, how the various regulators would handle requests for approval of identical enhanced creditor protections from a GSIB and its subsidiaries. For legal and operational reasons, a GSIB and its subsidiaries likely would want the ability to include in their QFCs the same enhanced creditor protections, regardless of whether the entities in the GSIB group are subject to OCC, Board, or FDIC oversight. As noted above, such consistency also is in the interest of all three regulators. We therefore strongly recommend that the OCC, the Board, and the FDIC develop a single, coordinated process for review and approval of enhanced creditor protections, when an application is made on behalf of the GSIB and its subsidiaries. Otherwise, QFCs of different entities in the GSIB group could be subject to different creditor protections, raising fairness issues, increasing legal and operational complexity, and impeding the regulators’ shared goal of orderly resolution.

Compliance Dates

We urge the OCC to agree with the Board and the FDIC on a uniform set of compliance dates that will be applicable to all three regulators’ final rules. As noted above, many of the dealers that serve as counterparties to fund transactions under QFCs are national or other banks regulated by the OCC. It is critical that the regulators impose consistent compliance dates under their final rules, given that covered entities subject to the Board Proposal likely will have subsidiaries subject to the OCC Proposal or the FDIC Proposal, and expecting market participants to conform to inconsistent deadlines would be confusing and inefficient. Imposing consistent compliance dates will ensure that funds and other counterparties have the time necessary to update their contracts in a consistent manner, to the extent appropriate, to reflect the final rules of all three regulators.

In connection with implementation of the final rules, we request that the OCC, Board, and FDIC provide a uniform, longer transition period for funds and asset managers. This extension is warranted in light of the substantial number of agreements that will be affected and the additional time and effort that will be necessary for asset managers to amend contracts and obtain client consent regarding the changes the final rules require. We therefore recommend that all three regulators provide asset managers with a compliance period that is at least six months longer than the compliance period

²² Proposing Release, *supra* note 2, at 55382. The FDIC Proposing Release states similarly that the FDIC Proposal is intended to “work in tandem with the [Board Proposal] and the [OCC Proposal].” FDIC Proposing Release, *supra* note 4.

²³ Proposing Release, *supra* note 2, at 55393.

provided to covered banks and covered entities under the final rules.

We appreciate the opportunity to respond to the OCC Proposal. If you have any questions, please feel free to contact the undersigned at (202) 326-5815, Sarah Bessin at (202) 326-5835, or Ken Fang at (202) 371-5430.

Sincerely,

/s/ David W. Blass

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Attachment



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August 5, 2016

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 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 No. 7100 AE-52)

Dear Mr. deV. Frierson:

ICI¹ appreciates the opportunity to provide comments on the proposal (“Proposal”) of the Board of Governors of the Federal Reserve System (“Board”) to require U.S. global systemically important banking organizations (“GSIBs”), certain subsidiaries of U.S. GSIBs, and certain U.S. operations of foreign GSIBs to be subject to restrictions on the terms of their qualified financial contracts (“QFCs”).² The Proposal has significant implications for investment funds. Our members – funds that are regulated under the Investment Company Act of 1940, as amended (the “1940 Act”) and similar non-U.S. regulated funds publicly offered to investors, such as UCITS (collectively, “funds”) – regularly use contracts that may meet the Proposal’s broad definition of QFC for investment and risk management purposes. Fund uses of QFCs include, for example, obtaining investment exposure (such as through To-Be-Announced Transactions (“TBAs”)), hedging currency positions (such as through

¹ The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (“ETFs”), closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s U.S. fund members manage total assets of \$17.9 trillion and serve more than 90 million U.S. shareholders.

² 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, 81 Fed. Reg. 29169, available at <https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-11209.pdf> (“Proposing Release”).

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currency forwards), earning a return on portfolio assets (such as through securities lending), equitizing cash that a fund cannot immediately invest in direct equity holdings (such as through a swap), managing a fund's cash positions more generally and earning a return on cash (such as through repurchase agreements), adjusting the duration of a fund's portfolio (such as through options or swaps), or providing for short sales of stock as part of an investment strategy or as a hedge (which would be effected through a prime brokerage agreement).

We appreciate the Board's focus on reducing systemic risk by seeking to ensure the orderly resolution of U.S. GSIBs that transact with non-U.S. counterparties. We have significant concerns, however, that the Proposal is broader than is necessary to achieve these goals, and may have significant unintended consequences. Furthermore, the Proposal would shift the costs of resolving large banking reorganizations to non-defaulting counterparties, such as funds and their investors.

We also object strongly to the Proposal providing an exclusive means to satisfy the safe harbor under proposed Section 252.85(a) through adherence to the 2015 ISDA Universal Resolution Stay Protocol. As discussed in more detail below, fund advisers and other asset managers may not, for fiduciary reasons, adhere to the protocol. As an alternative, we recommend that the Board broaden the safe harbor to include, in addition to the 2015 ISDA Universal Resolution Stay Protocol, a modular protocol to which the buy-side may adhere that allows asset managers to contract on a jurisdiction-by-jurisdiction basis for all, or only a sub-set of, counterparties.

We explain our views in greater detail below. **Section I** provides an executive summary of our comments. **Section II** discusses general comments regarding the Proposal. **Section III** suggests modifications to the two key operative provisions of the Proposal, proposed Sections 252.83 and 252.84. **Section IV** of the Proposal explains our concerns with the proposed safe harbor under proposed Section 252.85(a) through adherence to the 2015 ISDA Universal Resolution Stay Protocol. **Section V** expresses our views on the scope of various terms used in the Proposal, including "covered entities," "covered contracts," "default rights" and "cross default rights," and the burden of proof upon the exercise of default rights. We conclude our letter in **Section VI** with recommendations on how the Board should modify the implementation provisions of the Proposal.

I. Executive Summary

In order to avoid the adverse impact the Proposal would have on funds and on the marketplace generally, we respectfully recommend that it be revised as follows:

- *The Proposal should require that a QFC include only a choice of law provision to ensure that U.S. special resolution regime (“SRR”) stay powers are enforceable under foreign law contracts, as provided by proposed Section 252.83(b)(2), rather than also require inclusion of the stay and transfer provisions of proposed Section 252.84.*
- *If the Board does not accept our recommendation to eliminate proposed Section 252.84, the Proposal should provide appropriate protections to safeguard funds and other non-defaulting counterparties that enter into QFCs with covered entities, including the following changes:*
 - *Revise proposed Section 252.84 so that the stay and transfer provisions are triggered only when a covered entity is subject to a U.S. SRR.*
 - *If the Board is unwilling to limit the stay and transfer provisions to U.S. resolution proceedings, then it should limit proposed Section 252.84 to proceedings that are subject to regulatory oversight, such as proceedings under the Securities Investor Protection Act.*
 - *In no event should the Board extend proposed Section 252.84 beyond proceedings under the U.S. SRRs, the Securities Investor Protection Act, and the U.S. Bankruptcy Code. It is not necessary or consistent with the Board’s policy objectives to trigger the stay and transfer provisions of proposed Section 252.84 when a GSIB becomes subject to resolution or insolvency proceedings under state or foreign law.*
 - *Eliminate the transfer restrictions under proposed Section 252.84, or apply them only in the limited case of a transfer to a bridge bank or a bridge financial company subject to oversight by a regulatory authority. To ensure adequate protections for funds and other non-defaulting counterparties, the Board should, at a minimum, require that the transferee be subject to the same credit rating and financial covenant terms as the non-defaulting counterparty originally agreed with the insolvent credit provider. The Board should also require that:*
 - *The transferee be registered and regulated as a bank, broker-dealer, swap dealer, insurance company, or other similar type of regulated entity.*

- *If the obligations under the direct QFC are transferred with the guarantor's equity interest in the direct counterparty, the transferee be duly registered with, and licensed by, the primary regulator of the direct counterparty or of the transferor.*
- *If the Board retains proposed Section 252.84, we request that it broaden the language in Section 252.84(b)(2) to encompass not only circumstances in which the transfer would result in "the supported party being the beneficiary of the credit enhancement in violation any law applicable to the supported party" but also when the transfer would result in the supported party being unable to satisfy legal requirements, such as the requirements necessary to qualify for favorable tax treatment under Subchapter M of the Internal Revenue Code.*
- *Allow fund advisers and other asset managers, which are unable to rely on the 2015 ISDA Universal Resolution Stay Protocol for fiduciary reasons, to instead satisfy the safe harbor under proposed Section 252.85 through adherence to a modular protocol that would permit parties to contract to multiple QFCs on a jurisdiction-by-jurisdiction, client-by-client, and dealer-by-dealer basis.*
- *The broad proposed definition of QFC would encompass QFCs that do not provide cross-default or any default rights to the buy-side counterparty. Narrow the Proposal's QFC definition to exclude contracts that do not have bilateral default and cross-default rights, such as prime brokerage or margin loan agreements. Including such contracts in the definition would serve no regulatory purpose, and would be burdensome and impose unnecessary compliance costs on counterparties to such contracts.*
- *After triggering of the stay and transfer provisions, permit the exercise of default rights by a counterparty against a direct party or a covered support provider with respect to **any** direct default under the covered QFC. As proposed, the exclusion for exercise of default rights would be limited to direct defaults resulting from payment or delivery failures or the direct party becoming subject to a resolution or insolvency proceeding other than a resolution proceeding under the FDIA, Title II of the Dodd-Frank Act, or a similar proceeding under foreign law.*

- *Narrow the circumstances under which a counterparty to a QFC would bear the burden of proof in the event of a dispute regarding a party's right to exercise a default right. The Proposal should impose a burden of proof standard only with respect to a counterparty's exercise of cross-default rights, and shift the burden in those circumstances to make the standard a rebuttable presumption that the non-defaulting party's exercise of its default right is permitted under the covered QFC unless the defaulting covered entity demonstrates otherwise.*
- *Following the effective date of the final rule, require covered entities and their counterparties to amend QFCs only with respect to new transactions, rather than requiring them to conform pre-existing QFCs to the rule's requirements whenever a covered entity enters into a QFC with a counterparty to a preexisting covered QFC or that counterparty's affiliate.*

II. General Comments about the Proposal

Background

The Proposal is part of the Board's efforts to address the systemic implications of the failure of a major financial firm, such as the failure of Lehman Brothers in September 2008.³ The Board and the FDIC have identified the exercise of cross-default rights in QFCs as a potential obstacle to orderly resolution in the context of resolution plans filed by systemically important firms under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Board explains that the Proposal is intended to avoid systemic disruption that may be caused by the exercise of QFC default rights in the event of a GSIB's failure.⁴

The Proposal would require covered entities and their counterparties to include three categories of significant new restrictions in their QFCs. First, QFCs subject to the Proposal would be required to include provisions recognizing the automatic stay of termination and transfer provisions applicable in resolution proceedings under the Orderly Liquidation Authority ("OLA") provisions of Title II of the Dodd-Frank Act and under the Federal Deposit Insurance Act ("FDIA"). Second, QFCs would be required to contain provisions prohibiting the QFC counterparty from exercising default rights based on an affiliate of the counterparty entering into resolution or insolvency proceedings (i.e., a prohibition on the exercise of cross-default rights). Third, QFCs would be required to permit future

³ *Id.* at 29171.

⁴ *Id.* at 29170.

transfers of guarantees provided by GSIBs and their subsidiaries for the benefit of the direct counterparty, where the transfer is effected in connection with the resolution or insolvency of the guarantor.

The Proposal is designed to encourage parties to opt into the Universal Resolution Stay Protocol, which was developed by the International Swaps and Derivatives Association (“ISDA”), in coordination with the Financial Stability Board (“FSB”). The ISDA Universal Resolution Stay Protocol is a voluntary protocol that enables parties to amend the terms of covered agreements to recognize contractually the cross-border application of SRRs applicable to certain financial companies and, under the 2015 version of the protocol (“2015 Protocol”), supports the resolution of systemically important firms under the U.S. Bankruptcy Code (“Bankruptcy Code”). The Proposal expressly provides that adherence to the 2015 Protocol will satisfy compliance with the stay and transfer provisions of proposed Section 252.84 (“Stay and Transfer Provisions”). The Board acknowledges, however, that there are key differences between the terms of the 2015 Protocol and the Proposal, and that the Proposal is less favorable to counterparties than the 2015 Protocol.⁵

The Board Should Harmonize the Proposal with Foreign Regulators

Many countries have developed, or are expected to develop, implementing laws or regulations relating to contractual stays for QFCs.⁶ Because GSIBs operate on a global basis, regulators are legitimately concerned with harmonizing their laws and regulations regarding resolution of these firms. GSIBs may have multiple subsidiaries that operate on a cross-border basis. Consistency and coordination among international regulators is critical to avoid costly complexity, lack of predictability, and confusion that could result from GSIB subsidiaries being subject to different approaches to resolution and insolvency. The FSB has recognized the importance of these considerations in its *Key Attributes of Effective Resolution Regimes for Financial Institutions* (“Key Attributes”), which provides

⁵ *Id.* at 29183 (observing that, as compared to the creditor protections provided in the Proposal, the 2015 Protocol’s additional creditor protections “appear to meaningfully increase a supported party’s assurance that material payment and delivery obligations under its covered QFCs will continue to be performed and should meaningfully decrease the supported party’s credit risk to its direct parties.”)

⁶ *See, e.g.*, Bank of England, Prudential Regulation Authority, Contractual stays in financial contracts governed by third-country law (November 2015), *available at* <http://www.bankofengland.co.uk/pru/Documents/publications/ps/2015/ps2515.pdf> (“UK PRA”); the German contractual stay requirement came into effect on November 6, 2015 (*see* Gesetz zur Sanierung und Abwicklung von Instituten und Finanzgruppen, Sanierungs- und Abwicklungsgesetz [SAG] [German Act on the Reorganisation and Liquidation of Credit Institutions], Dec. 10, 2014, § 60a, *available at* <https://www.gesetze-im-internet.de/bundesrecht/sag/gesamt.pdf>).

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guidance and policy recommendations for development of resolution regimes for systemically important financial institutions.⁷ The FSB followed this guidance with a Consultative Document (the “Consultative Document”) on cross-border recognition of resolution action.⁸ The Consultative Document provided guidance to FSB member jurisdictions⁹ regarding (i) elements to include in statutory provisions recognizing foreign resolution regimes for systemically important firms and (ii) interim contractual approaches to facilitate cross-border implementation of foreign resolution regimes pending adoption of legislation. While we do not support all aspects of this guidance, we do support the FSB’s goal of encouraging adoption of “effective statutory cross-border recognition processes consistent with the Key Attributes” to address the issue of resolution of global entities and cross-border recognition of resolution actions, and encourage the Board and other regulators to ensure that their regulations are consistent with these general principles.¹⁰ We also support the principle in the Key Attributes that “public authorities [should] . . . take measures to lessen the impact and reduce the moral hazard associated with public sector interventions and the distress or failure of such financial firms.”¹¹ We are concerned that aspects of the Proposal do not meet that standard. Rather, as discussed further below, we believe the Proposal would have significant negative effects on the financial markets and could contribute to, rather than reduce, the moral hazard associated with the failure of a GSIB.

⁷ The Key Attributes were originally published in October 2011 and were supplemented with sector-specific guidance in October 2014. Key Attributes of Effective Resolution Regimes (October 15, 2014), available at http://www.fsb.org/wp-content/uploads/r_141015.pdf.

⁸ See Consultative Document, Cross-border recognition of resolution action (September 29, 2014), available at http://www.fsb.org/wp-content/uploads/c_140929.pdf.

⁹ FSB member jurisdictions are comprised of Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, United Kingdom, United States of America, and European Union.

¹⁰ Consultative Document, *supra* note 8, at 1. See Letter to Mark Carney, Chair, Financial Stability Board, from Dan Waters, Managing Director, ICI Global, dated November 25, 2014, available at <http://www.fsb.org/wp-content/uploads/ICI-Global-on-Cross-border-Recognition-of-Resolution-Actions.pdf>. We noted in that letter, however, that while orderly resolution of systemically important firms is important to reduce systemic risk, the means for achieving orderly resolution should be subject to safeguards including recognition of creditor hierarchies and equitable treatment of creditors across countries.

¹¹ See International Association of Insurance Supervisors, Global Systemically Important Insurers: Policy Measures (July 18, 2013), at 1, *citing* Consultative Document. The Consultative Document is intended to support the FSB’s Key Attributes. The Consultative Document also references the FSB’s report, Progress and Next Steps Towards “Ending Too Big to Fail,” (September 2013), available at http://www.financialstabilityboard.org/publications/r_130902.pdf.

The Proposal is Overly Complex and Raises Serious Implementation Concerns

As an initial matter, we recommend that the Board simplify the Proposal. While we acknowledge that these issues are complex by their nature, the Proposal is overly complex and will be almost impossible for market participants to evaluate. In addition, it will be difficult for courts to interpret, particularly if the Board applies the Stay and Transfer Provisions, as proposed, to state and foreign insolvency proceedings. State and foreign court insolvency judges generally are not expert in securities financing and derivatives matters. We are concerned that the complexity of the Proposal will result in courts reaching different and, potentially, conflicting interpretations. This result runs counter to the Board's goal of facilitating consistent treatment of U.S. GSIBs in resolution and insolvency.

In our view, the provisions of the Proposal that contribute most to its complexity and lack of predictability for market participants are the Stay and Transfer Provisions. For example, as proposed, it is difficult to predict the risks a fund may take on by opting to transact a currency forward with a dealer subject to a guarantee from the dealer's GSIB parent. It is unclear, for instance: (i) whether the guarantor could be subject to a state or foreign insolvency proceeding, in which case there would be a substantial possibility that the fund would be stayed from collecting on the guarantee, if it ever could; (ii) whether the guarantor would be more likely to be subject to a Chapter 7 proceeding or Chapter 11 proceeding under the Bankruptcy Code, because, assuming the guarantee was not transferred during the temporary stay period, the fund would have close-out rights under the former but not the latter type of proceeding; and (iii) which entity would ultimately provide credit support for the transaction and, potentially, also hold the equity of the direct counterparty after application of the Stay and Transfer Provisions since that determination would be unknowable at inception of the transaction and the transferee would not be subject to express qualifications under the Proposal.¹²

In order to streamline the Proposal while still addressing the key concern of ensuring that the temporary stay underlying the U.S. SRRs will be respected by foreign courts, we recommend that the Proposal be revised, as described on page 11, below, to remove the Stay and Transfer Provisions of Section 252.84. Proposed Section 252.83 already seeks to ensure that the temporary stay provisions incorporated into OLA and the FDIA, the two applicable U.S. SRRs, would be respected in a cross-border context without regard to whether a QFC may be governed by foreign law or performed outside the United States. It also seeks to ensure that resolution authorities have time to resolve a failing banking organization. As would be the case under the U.S. SRRs, upon lapse of the stay, the default rights of the non-defaulting party would be exercisable if the resolution were not successful and would

¹² As we explain below, funds must satisfy various requirements, including asset diversification, under Subchapter M of the Internal Revenue Code to be eligible to receive favorable tax treatment.

be unnecessary if the resolution were successful. This result would be consistent with market expectations and with the result dictated by Congress when it adopted Title II of the Dodd-Frank Act.

III. Proposed Sections 252.83 and 252.84

Comments on Proposed Section 252.83

Proposed Section 252.83 would require that a covered QFC explicitly provide both: (1) that the transfer of the QFC (and any interest or obligation in or under it and any property securing it) from the covered entity to a transferee would be effective to the same extent as it would be under the U.S. SRRs if the covered QFC were governed by the laws of the United States or of a state and the covered entity were subject to resolution under the U.S. SRRs; and (2) that default rights with respect to the covered QFC that could be exercised against a covered entity could be exercised to no greater extent than they could be exercised under the U.S. SRRs if the covered QFC were governed by the laws of the United States or of a state and the covered entity were subject to resolution under the U.S. SRRs. The Proposal would define the U.S. SRRs to mean the FDIA and the OLA provisions of Title II of the Dodd-Frank Act, as well as the regulations issued under those statutes.

Proposed Section 252.83 is intended to provide certainty that all covered QFCs would be treated similarly if a covered entity were subject to resolution under Title II of the Dodd-Frank Act or the FDIA regardless of the domicile of the counterparties or the law governing the contract.¹³ In order to confirm the Board's intent that this provision would apply only with respect to covered entities in resolution proceedings under U.S. SRRs, we recommend that the proposed rule text be revised as follows (*added text in bold, deleted text in strike-through*):

§ 252.83 (b) *Provisions required.* A covered QFC must explicitly provide that **if a covered entity becomes subject to resolution under the U.S. special resolution regimes:**

(1) The transfer of the covered QFC (and any interest and obligation in or under, and any property securing, the covered QFC) from the covered entity will be effective to the same extent as the transfer would be effective under the U.S. special resolution regimes if the covered QFC (and any interest and obligation in or under, and any property securing, the covered QFC) were governed by the laws of the United States or a state of the United States **and the transfer were effected in accordance with the terms of the U.S. special resolution regime** ~~and the covered entity were under the U.S. special resolution regime;~~ and

¹³ Proposing Release, *supra* note 2, at 29178.

(2) Default rights with respect to the covered QFC that may be exercised against the covered entity are permitted to be exercised to no greater extent than the default rights could be exercised under the U.S. special resolution regimes if the covered QFC was governed by the laws of the United States or a state of the United States ~~and the covered entity were under the U.S. special resolution regime.~~

Furthermore, QFCs governed by U.S. law should be excluded from the scope of this provision because the terms of U.S. SRRs will apply automatically and in full by virtue of the fact that U.S. law governs the contracts. This modification would make the Proposal consistent with the approach taken by the U.K. regulators, which applies only to contracts governed by “third country law.”¹⁴ It also would simplify the Proposal and make it easier to understand.

Comments on Proposed Section 252.84

Background

The Stay and Transfer Provisions would prohibit a covered entity from being party to a covered QFC that: (1) allows the exercise of any default right that is related to the entry into insolvency proceedings of an affiliate of the covered entity (i.e., prohibition of cross-default rights); and (2) prohibits the transfer of a credit enhancement applicable to the QFC (such as a guarantee) from an affiliate to a transferee upon the affiliate’s entry into resolution.¹⁵ These provisions would appear to apply to *any* receivership, insolvency, liquidation, resolution, or similar proceeding, including not only U.S. federal resolution and insolvency proceedings, but state and foreign resolution and insolvency proceedings.

The Scope of Proposed Section 252.84 is Overly Broad

Proposed Section 252.84 Should be Limited to Resolutions under U.S. SRRs

We are concerned that the scope of proposed Section 252.84 is overly broad, and would raise significant concerns for fund counterparties to QFCs. We recommend that the Board omit the Stay and Transfer Provisions from proposed Section 252.84, and instead limit the operative provisions

¹⁴ UK PRA, *supra* note 6, at Section 2.1(3).

¹⁵The Board recognizes, however, that these restrictions may limit the ability of covered entities’ QFC counterparties to include certain protections in covered QFCs. Proposed Section 252.84 would therefore include detailed creditor exceptions intended to allow creditors to exercise both direct and cross-default rights not related to an orderly resolution of a GSIB.

of the Proposal to proposed Section 252.83.¹⁶ In our view, contractual rights should not be taken away from competent contracting parties other than in a situation where limitation of such rights is paramount for public policy reasons *and* the non-defaulting counterparty whose rights are taken away is protected through control over the process by a regulatory authority having particular expertise over resolution of entities of the type at issue. We do not believe that proposed Section 252.84 satisfies these criteria.

The Board's policy concerns center on resolutions of U.S. GSIBs. We do not think it would be likely or appropriate for a U.S. GSIB to be resolved in a state or foreign court insolvency proceeding or for the Stay and Transfer Provisions to be applied and overseen by state and foreign insolvency judges and public officials. These courts and local officials typically do not have developed rules, procedures or expertise to resolve a large U.S. financial entity.¹⁷ In addition, we do not believe there would be a defensible U.S. policy interest in restricting the assertion of privately-negotiated contract rights in a foreign or state proceeding.¹⁸ As a practical matter, it is not even clear that a U.S. regulator or receiver would be allowed to have input into a state or foreign proceeding or have the ability to ensure fair treatment of the non-defaulting counterparties.

Debtors typically seek to file for bankruptcy in jurisdictions that are the most favorable to them. In many cases, there are multiple filings and ensuing litigation to determine the appropriate forum.¹⁹ By including a large variety of insolvency proceedings in the Proposal, the Board is all but ensuring that there will be increased disruption, confusion, and delay around application of the Stay

¹⁶ We acknowledge that Section 2 of the 2015 Stay Protocol applies to U.S. Insolvency Proceedings, defined to include insolvency proceedings under Chapters 7 or 11 of the Bankruptcy Code, or under the FDIA or the Securities Investor Protection Act ("SIPA"). For the reasons we discuss above, we do not believe it is appropriate to apply the permanent or temporary stay provisions of proposed Section 252.84 to situations in which the direct party or an affiliate is in insolvency proceedings.

¹⁷ Many of these proceedings are not formal and take time to set up because there are not appointed judges, as is the case in bankruptcy proceedings under the Bankruptcy Code. Inserting the Stay and Transfer Provisions of Section 252.84 into such a proceeding is likely to result in confusion and delay.

¹⁸ A GSIB could not reasonably be expected to be resolved in a state court proceeding, inasmuch as state court insolvency proceedings are intended for use primarily by smaller companies that are seeking to avoid the cost and time associated with a federal bankruptcy court proceeding. There is also no precedent (outside of the insurance company context) for a GSIB to utilize a state bankruptcy process. The state processes do not have the regulatory schemes in place to deal with a GSIB.

¹⁹ Debtors may file for bankruptcy in multiple forums within the United States or both within and outside of the United States. For example, in July 2007, when the Bear Stearns High-Grade Structured Credit Strategies and Enhanced Leverage Funds commenced liquidation proceedings in the Cayman Islands, the United States Bankruptcy Court for the Southern District of New York determined that the place of incorporation of the funds, in which the funds had sought to file bankruptcy (i.e., the Cayman Islands) was insufficient for the New York Court to recognize the filing in the Cayman Islands as the main insolvency proceeding or provide it with comity in the United States under Chapter 15 of the Bankruptcy Code.

and Transfer Provisions. We do not believe that there is a reasonable likelihood that the Stay and Transfer Provisions will aid in an insolvency proceeding of a covered entity – particularly if foreign forums are included – and we believe that inclusion of such a broad list of forums will almost certainly guarantee that QFC counterparties will be disadvantaged.

Proposed Section 252.84 Should Not Extend to Third-Party Proceedings

While we do not believe public policy concerns adequately justify the elimination of cross-default rights as provided in Section 252.84, if the Board determines otherwise, proposed Section 252.84 should be limited to proceedings that are subject to regulatory oversight. For example, the Securities Investor Protection Corporation serves as trustee in a SIPA proceeding. It is inappropriate to extend limitations on contract rights to proceedings that are adversarial by nature and involve litigation between competing classes of creditors. As a result, we do not believe that the Stay and Transfer Provisions should apply to proceedings under the Bankruptcy Code. This stay would eliminate negotiated creditor protections or, at a minimum, substantially reduce their benefits, and override a fund's considered assessment of credit risk.

In No Event Should Proposed Section 252.84 Extend Beyond U.S. SRRs, SIPA, and Bankruptcy Proceedings

In the event that the Board determines not to limit the provisions of Section 252.84 to U.S. SRR proceedings, we urge the Board, at a minimum, to limit the application of the provisions to proceedings under the U.S. SRRs, SIPA, and the Bankruptcy Code. Based on the discussion in the Proposing Release, the language in the proposed rule appears to be significantly broader than the underlying purpose of the provision, which was to address default rights that the Board believes may pose an obstacle to the orderly resolution of U.S. GSIBs, including under the Bankruptcy Code.²⁰ According to the Proposing Release, the Board is concerned about both direct defaults, in which a GSIB, which is a direct party to a QFC, enters into a resolution proceeding, and cross-defaults, in which a GSIB affiliate or parent of a direct party to a QFC is also a credit support provider or specified entity under the QFC and the terms of the QFC allow the non-defaulting counterparty to exercise default rights against the direct counterparty if the parent or affiliate is subject to a resolution proceeding. We

²⁰ Proposing Release, *supra* note 2, at 29171, 29175 (“In particular, the proposed requirements would improve the resolvability of U.S. GSIBs under the Bankruptcy Code, Title II of the Dodd-Frank Act, or, with reference to insured depository institutions that are GSIB subsidiaries, the FDI Act, and reduce the potential that resolution of the firm will be disorderly and lead to disruptive asset sales and liquidations”) and 29179 (“A primary purpose of the proposed restrictions is to facilitate the resolution of a GSIB outside of Title II, including under the Bankruptcy Code.”)

understand that the Board is concerned, for example, about a QFC under which the insolvency of a GSIB parent guarantor allows for close out of contracts with the direct counterparty even though the direct counterparty continues to meet all of its obligations.²¹ The Board views application of the Stay and Transfer Provisions of Section 252.84 as beneficial, particularly in a single-point-of-entry (“SPOE”) resolution strategy.²²

Even in the context of bankruptcy proceedings, however, an important distinction should be made between reorganization proceedings and liquidation proceedings. In no event should the Stay and Transfer Provisions of Section 252.84 be applied to liquidation proceedings. There is much less of a policy rationale for imposing a permanent stay in a liquidation proceeding because the entity will not survive. Imposing the affiliate stay under proposed Section 252.84(b)(1) in the context of a liquidation proceeding is significantly more likely to result in losses for funds and other non-defaulting counterparties.

The Stay Against Cross-Default Rights under Proposed Section 252.84(b)(1) Should Not be Expanded

The stay against cross-default rights under proposed Section 252.84(b)(1) is permanent and would eliminate all rights to close out QFCs with a counterparty due to the resolution or insolvency of an affiliate of the direct party, such as the parent guarantor. The Board asks whether the proposed prohibition on cross-default rights should be expanded in any respect, including to explicitly cover default rights that are based on or related to the “financial condition” of an affiliate of the direct party (for example, rights based on an affiliate’s credit rating, stock price, or regulatory capital level). We strongly recommend against expanding further the proposed prohibition on cross-default rights. As discussed above, we have significant concerns about the implications of this provision for the rights of funds and other buy-side market participants. The Stay and Transfer Provisions under the Proposal would significantly impair contracting parties’ negotiated rights, and should be applied only when a regulatory authority is charged with overseeing the process.

²¹ We note that performance by the direct counterparty may not be reflective of the financial health or continued performance by the direct counterparty. In many cases, the direct counterparty may not have breached a QFC because a payment or other obligation has not yet been triggered.

²² The Board explains that, under a SPOE resolution strategy, the GSIB’s top-tier bank holding company would enter a resolution proceeding. The losses that led to the GSIB’s failure would be passed up from the operating subsidiaries that incurred the losses to the holding company and would then be imposed on the equity holders and unsecured creditors of the holding company through the resolution process. The Board explains that this strategy is designed to help ensure that the GSIB subsidiaries remain adequately capitalized, and that operating subsidiaries of the GSIB are able to continue to meet their financial obligations without defaulting or entering resolution themselves. Proposing Release, *supra* note 2, at 29172.

The Board Should Eliminate the Transfer Restrictions under Proposed Section 252.84 or Apply Them Only in Case of a Transfer to a Bridge Bank and Only When the Transferee has a Similar Credit Rating and is Subject to the Same Terms

As described above, proposed Section 252.84(b)(2) would prohibit a covered entity from including in its covered QFCs provisions that would prohibit the transfer of a credit enhancement applicable to the QFC from an affiliate to a transferee when the affiliate enters into resolution. We have concerns about how this provision would operate in practice, and recommend that the Board eliminate this provision or apply it only in the limited case of a transfer to a bridge bank or bridge financial company subject to oversight by a regulatory authority.²³ By limiting transferees to bridge banks or bridge financial companies, the Board would reduce the risk that credit enhancements are transferred to entities that do not have the financial ability to satisfy the potential obligations of a credit support provider.²⁴ Such a limitation also would ensure that the transferee was overseen by a U.S. federal regulatory authority, and the Board may be able to appoint directors to the board of directors of the bridge bank, as the FDIC would do under OLA. Finally, favorable borrowing arrangements may be available to a bridge bank that would not be available to other types of transferees.

If the Board does not limit transferees to bridge banks or bridge financial companies, it is critical that the Board include requirements regarding the qualifications of the transferee, which the Proposal currently does not. This omission raises significant risks for funds and other buy-side participants. For example, there is no assurance that the transferee will be creditworthy, have sufficient expertise (e.g., pricing expertise),²⁵ or be a U.S. person. The selection of the transferee is made by the receiver for the credit support provider, which generally will not be a prudential regulator unless the credit support provider is subject to a proceeding under OLA or another U.S. SRR. As a result, the primary responsibility of the receiver will be to maximize assets for the bankrupt entity's estate rather than to protect the rights of creditors by ensuring that the transferee is creditworthy. In addition, any subsequent insolvency of the transferee may be subject to a foreign court or other non-SRR/non-

²³ For example, under the U.S. OLA, the FDIC, as the resolution authority, has the power to create a "bridge financial company" to succeed to selected assets and liabilities of the covered financial company. The bridge financial company would be managed by a board of directors appointed by the FDIC and serves as a temporary holding entity until the assets can be efficiently transferred to a private acquirer. In addition, under the terms of OLA, in connection with disposition of assets, the FDIC is required to use best efforts to maximize returns, minimize losses, and mitigate the potential for adverse effects to the financial system. These restrictions provide important protections to creditors.

²⁴ Under OLA, the liabilities assumed by a bridge company may not exceed the aggregate amount of assets that are transferred to the entity.

²⁵ The dealer counterparty typically serves as calculation agent under derivatives contracts between a dealer and a buy-side firm.

Bankruptcy Code proceeding, thereby making it more difficult and more expensive for the non-defaulting counterparty to contest a transfer or the eligibility of the transferee.

Even if the Board is not willing to limit transferees to bridge entities to ensure protections through regulatory oversight, it should add protections for funds and other non-defaulting counterparties. At a minimum, the Proposal should require that the transferee be subject to the same credit rating and financial covenant terms as the non-defaulting counterparty originally agreed with the insolvent credit provider. In addition, to ensure that the transferee is subject to some minimal level of supervision, the Board should require that the transferee be registered and regulated as a bank, broker-dealer, swap dealer, insurance company, or other similar type of registered entity. If the obligations under the direct QFC also are transferred with the guarantor's equity interest in the direct counterparty (as the Proposal contemplates that they generally will be),²⁶ we recommend that the Board require that the transferee be duly registered with, and licensed by, the primary regulator of the direct counterparty or of the transferor entity. This requirement would ensure, in a resolution situation, ongoing regulatory oversight of the direct party and of the transferee. It also would help ensure that the direct party has ongoing reporting responsibilities, conform to the non-defaulting counterparty's reasonable expectations when selecting and contracting with a counterparty, and provide clarity regarding the enforceability of the QFC.

If the Board Retains Proposed Section 252.84, it Should Broaden the Exclusion under Proposed Section 252.84(b)(2)

If the Board retains proposed Section 252.84, we request that it broaden the language in Section 252.84(b)(2) to encompass not only circumstances in which the transfer would result in "the supported party being the beneficiary of the credit enhancement in violation of any law applicable to the supported party" but also when the transfer would result in the supported party being unable to satisfy legal requirements.²⁷ Specifically, we recommend proposed Section 252.84(b)(2) be revised as follows (*added text in bold*):

(2) A covered QFC may not prohibit the transfer of a covered affiliate credit enhancement, any interest or obligation in or under the covered affiliate credit enhancement, or

²⁶ See proposed Section 252.84(g)(4).

²⁷ Section 252.84(b)(2) provides that "[a] covered QFC may not prohibit the transfer of a covered affiliate credit enhancement, any interest or obligation in or under the covered affiliate credit enhancement, or any property securing the covered affiliate credit enhancement to a transferee upon an affiliate of the direct party becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding unless the transfer would result in the supported party being the beneficiary of the credit enhancement in violation of any law applicable to the supported party."

any property securing the covered affiliate credit enhancement to a transferee upon an affiliate of the direct party becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding unless the transfer would result in the supported party being the beneficiary of the credit enhancement in violation of, **or result in the supported party being unable, without further action, to satisfy the requirements of**, any law applicable to the supported party.

The provision, as proposed, would prevent a transfer to an entity that would cause a fund to violate the provisions of the Investment Company Act of 1940 (“Investment Company Act”) relating to the types of entities with which a registered fund may transact.²⁸ However, without our recommended change, it would not, for example, prevent the transfer of a covered affiliate credit enhancement or other interest or obligation under the covered affiliate credit enhancement to an entity that would cause the fund to exceed the concentration thresholds for the fund to rely on Subchapter M of the Internal Revenue Code of 1986. In that case, the fund could legally acquire the interest, but may not be able to continue to hold it and satisfy the requirements of Subchapter M, potentially losing its favorable tax status at great cost to the fund and its shareholders. Subchapter M sets forth various requirements (including asset diversification) for a fund to be eligible to receive favorable “quasi-pass-through” tax treatment.²⁹ One element of the asset diversification test is that a fund may not have more than 25 percent of the value of its total assets invested in the securities of any one issuer at the end of each quarter of its taxable year.³⁰ Transfer of a QFC (together with ownership interests in the direct counterparty) to a transferee could potentially cause a fund to have more than 25 percent of the value of its total assets invested in one issuer at the end of the quarter, depending on what other securities the fund held. The Board should revise proposed Section 252.84(b)(2) to prohibit transfers that would cause a supported party to be unable to satisfy the requirements of applicable law, such as Subchapter M.

²⁸ For example, funds may not acquire greater than specified levels of debt and equity in entities that are brokers, dealers, underwriters, or investment advisers under Section 12(d)(3) of the Investment Company Act. The current language would protect a fund against a transfer of a credit support QFC to a transferee if the transfer could be deemed to be an “acquisition” of debt of a transferee and, thus, violate Section 12(d)(3) of the Investment Company Act if the debt or equity exposure were significant.

²⁹ See 26 U.S.C. § 851 *et seq.*

³⁰ For these purposes, funds typically calculate the percentage ownership both with respect to the derivatives counterparty and ownership in an underlying issuer. For example, if a derivative with swap dealer ABC provides exposure to the securities of issuer XYZ, funds will typically confirm that their exposure to either party not exceed 25 percent of their total assets.

IV. Safe Harbor for 2015 Universal Stay Protocol

Background

The Proposal provides that, as an alternative to complying with proposed Section 252.84, a covered entity could instead, as a safe harbor, comply with the 2015 Protocol.³¹ Significantly, the safe harbor references only the 2015 Protocol and not the ISDA jurisdictional modular protocol (“JMP”), to which the buy-side is expected to adhere.³² The Board recognizes that “ISDA is expected to supplement the [2015 Protocol] with ISDA Resolution Stay Jurisdictional Modular Protocols for the United States and other jurisdictions.” It goes on to note that “[a] jurisdictional module for the United States that is substantively identical to the [2015 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.”³³

The Board appears to advocate for adherence to the 2015 Protocol by making the scope of the Stay and Transfer Provisions less favorable to the non-defaulting counterparty than those in the 2015 Protocol. For example, the 2015 Protocol limits cross-default rights only in the context of specified U.S. insolvency proceedings³⁴ whereas the Proposal would limit cross-default rights in the context of any “receivership, insolvency, liquidation, resolution, or similar proceeding.”³⁵ Similarly, the 2015 Protocol requires the transferee to be either a bridge bank or an unaffiliated third party that satisfies ratings conditions and financial covenants under the QFC whereas the Proposal does not.³⁶ As

³¹ The Board clarifies that this includes the Securities Financing Transaction Annex and the Other Agreements Annex, as well as subsequent, immaterial amendments to the 2015 Protocol.

³² The JMP is intended to achieve the same policy goals as the 2015 Protocol with respect to the orderly resolution of GSIBs, but was developed to facilitate compliance with the stay regulations in different jurisdictions. It is expected that the buy-side would adhere to the JMP rather than the 2015 Protocol. See *ISDA Resolution Stay Jurisdictional Modular Protocol*, available at <https://www2.isda.org/functional-areas/protocol-management/protocol/24>.

³³ Proposing Release, *supra* note 2, at n.106.

³⁴ The Board notes, for example, that the Protocol only stays default rights arising from proceedings under Chapters 7 and 11 of the Bankruptcy Code, the FDIA, and SIPA. It explains that the stay under the Proposal, proposed Section 252.84, is broader; it requires a stay to apply under any receivership, insolvency, liquidation, resolution, or similar proceeding, and therefore includes applicable state and foreign insolvency proceedings. Proposing Release, *supra* note 2, at n. 110.

³⁵ See proposed Section 252.84(b)(1) and (2).

³⁶ See Section 2(b)(ii)(C)(II) of the Attachment to the ISDA 2015 Universal Resolution Stay Protocol, available at <http://assets.isda.org/media/ac6b533f-3/5a7c32f8-pdf/>. The Proposal has no comparable provision, whereby a transferee is required to be either a Bankruptcy Bridge Company (as the term is defined in the 2015 Protocol) or continue to satisfy all

a result, the Proposal provides a less beneficial model for creditors than the 2015 Protocol and incentivizes market participants to adhere to the 2015 Protocol. However, as we explain below, our members, as fiduciaries, will be unable to adhere to the 2015 Protocol because it would require them to relinquish contractual rights in the absence of a law or regulation mandating such relinquishment (since the 2015 Protocol, unlike the more tailored jurisdictional modules, applies to jurisdictions that have not yet adopted implementing laws or regulations). ISDA, as the publisher of the 2015 Protocol, noted itself that the 2015 Protocol was not designed for use by funds and other buy-side participants.³⁷ By structuring the safe harbor in this manner, the Proposal distinctly disadvantages fund advisers and other asset managers that act as agent for their clients.

Asset Managers Cannot Rely on the 2015 Protocol

While we appreciate the Board's intent to establish a safe harbor so that covered entities and their counterparties would not be required to amend each outstanding QFC on a contract-by-contract basis to incorporate the requirements of the Proposal, the proposed safe harbor will not benefit funds because fund advisers may not lawfully rely on the safe harbor for fiduciary reasons. Instead, asset managers and other buy-side participants may adhere to the JMP,³⁸ which does not raise the same fiduciary issues.³⁹ We therefore urge the Board to broaden the safe harbor to also include, as an alternative to the 2015 Protocol, a U.S. JMP that would permit market participants to adhere on a jurisdiction-by-jurisdiction, client-by-client, and dealer-by-dealer basis.

The primary reason that asset managers cannot adhere to the 2015 Protocol is that it extends to "Protocol-eligible Jurisdictions," which may include jurisdictions that have not yet adopted implementing laws or regulations.⁴⁰ As a result, adherence would be based on contractual obligations,

financial covenants and other terms applicable to the credit support provider under the covered QFC and each credit enhancement in respect thereof.

³⁷ ISDA 2015 Universal Resolution Stay Protocol, *available at* <https://www2.isda.org/functional-areas/protocol-management/protocol/22>.

³⁸ The JMP operates to amend existing agreements between two adhering parties with respect to a given jurisdictional module. As a result, adhering parties have the option to adhere on a jurisdiction-by-jurisdiction basis. The JMP also includes provisions that permit investment advisers, asset managers, and other agents to adhere on behalf of one or more clients for which they have legal authority to do so and with respect to only those dealers that they select.

³⁹ See *ISDA Resolution Stay Jurisdictional Modular Protocol*, *available at* <https://www2.isda.org/functional-areas/protocol-management/protocol/24>.

⁴⁰ The 2015 Protocol defines "Protocol-eligible Jurisdiction" as (i) each member jurisdiction, as of January 1, 2014, of the Financial Stability Board that is not a jurisdiction with an Identified Regime (such member jurisdictions being Argentina, Australia, Brazil, Canada, China, Hong Kong, India, Indonesia, Italy, Mexico, the Netherlands, Republic of Korea, Russia,

not law or regulation. Asset managers have a fiduciary duty to act in the best interests of their clients,⁴¹ including fund clients. This includes the duty to exercise creditor rights on behalf of a client when doing so is in the client's best interests, which may require exercising a default right on a contract when it is necessary to preserve client assets. An asset manager cannot voluntarily relinquish contractual rights that are for the benefit of its clients, in the absence of a law or regulation mandating it to do so.

Recommended Elements of an Alternative Safe Harbor, such as a U.S. Jurisdictional Module

We recommend that the Board include in the final rules, as an alternative safe harbor to the 2015 Protocol, a U.S. version of the JMP or a comparable module or alternative uniform adherence approach (such an amended version of the 2015 Protocol) that would allow asset managers to adhere by jurisdiction, client and dealer. The Proposal explains that, “[a] jurisdictional module for the United States that is substantively identical to the [2015] 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.”⁴² For the reasons explained above, it would not be possible for fund advisers and other asset managers to strictly satisfy this standard. They could, however, adhere to an alternative module generally consistent with this standard, with several modifications, as described below:

- Consistent with the JMP, we recommend that the Board permit a module for asset managers and other buy-side participants that would offer the option of adherence on a jurisdiction-by-jurisdiction, client-by-client, and dealer-by-dealer basis. For counterparties, this would mean buy-side participants could adhere either with respect to: (i) all regulated entities; (ii) all GSIBs; or (iii) one or more regulated entities (i.e., a dealer by dealer basis). The ability to comply on a dealer-by-dealer basis is important to ensure that asset managers do not exceed the authority granted to them by clients under investment management agreements or waive contract rights that protect clients when such waiver is not legally required (e.g., because the counterparty is not a GSIB or a subsidiary of a GSIB).
- It should apply only to QFCs governed by non-U.S. law because, as we explain above on page 10, the terms of the U.S. SRRs will apply automatically and in full to QFCs governed by U.S. law.

Saudi Arabia, Singapore, South Africa, Spain, and Turkey), (ii) with respect to only bankruptcy law, the United States of America, and (iii) any other jurisdiction that is the jurisdiction of organization of the ultimate parent entity within a banking group that has been designated by the Financial Stability Board as a “global systemically important bank.”

⁴¹ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

⁴² Proposing Release, *supra* note 2, at n.106.

- To the extent that the Board accepts our modifications to the Proposal, including the proposed elimination of the Stay and Transfer Provisions under Section 252.84, the safe harbor should not result in the re-introduction and imposition of those eliminated Stay and Transfer Provisions or similar provisions (as would be the case if the 2015 Protocol is retained as the only safe harbor).
- It should apply not only to existing QFCs but also to future QFCs. The 2015 Protocol amends only existing QFCs as of the adherence date but not new QFCs entered into after the adherence date. The Proposal should clarify how the alternative module will incorporate future QFCs.

ICI and our members would be glad to work with the Board to develop such an alternative U.S. module.

V. Scope of Terms in the Proposal and the Burden of Proof Standard

Scope of Covered Entities and Covered Contracts under the Proposal

Background

The Proposal would apply to a “covered entity,” which would be defined to include: (1) any U.S. GSIB bank holding company; (2) any subsidiary of such a bank holding company that is not a “covered bank;”⁴³ and (3) the U.S. operations of any foreign GSIB with the exception of any “covered bank.” The Proposal includes as covered entities all subsidiaries of U.S. GSIBs (other than covered banks) in recognition of the fact that U.S. GSIBs generally enter into QFCs through their subsidiaries rather than directly through the holding company. Covered entities also would include all U.S. operations of “global systemically important foreign banking organizations” (i.e., foreign GSIBs) that are not covered banks, including U.S. subsidiaries, U.S. branches, and U.S. agencies.

A QFC would be defined under the Proposal as in Section 210(c)(8)(D) of Title II of the Dodd-Frank Act, which includes any securities contract, commodities contract, forward contract, repurchase agreement, swap agreement, and any similar agreement. Each of these terms, in turn, is defined very broadly under Section 210(c)(8)(D) and would include, among other things, master agreements, credit enhancements, margin loans, extensions of credit for the clearance or settlement of

⁴³ “Covered bank” would be defined under the Proposal as a national bank, a Federal savings association, federal branch, or federal agency. These banks are supervised by the Office of the Comptroller of the Currency (“OCC”). The Board explains that the OCC is expected to issue a proposed rule that would subject covered banks that are GSIB subsidiaries to requirements substantively identical to those included in the Proposal.

securities transactions, prime brokerage agreements, options agreements, TBAs, repurchase agreements, and securities lending agreements. The provision also includes any “similar agreement,” which creates some uncertainty as to the scope of agreements covered.

While the Proposal’s broad definition of QFC would include most non-cleared securities financing agreements, it explicitly would exclude from the definition of “covered QFC” a QFC to which a central counterparty (“CCP”) is a party, as well as QFCs subject to requirements of the OCC similar to those of the Proposal.⁴⁴ The Proposal explicitly would exclude QFCs that permit transactions to be entered into both at a U.S. branch or U.S. agency of the foreign bank and at a non-US. location of the foreign bank (i.e., multi-branch master agreements) if the QFC is not booked at a covered entity, and no payment or delivery may be made at a covered entity.

The Board Should Not Expand the Scope of Covered Entities

The Board requests 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. We generally agree with the Proposal’s definition of “covered entity” and recommend that it not be expanded to include non-GSIB banks. Given the significant implications of the Stay and Transfer Provisions under the Proposal, we believe that only those banks that are defined as GSIBs as well as U.S. operations of foreign GSIBs, should be subject to the Proposal’s restrictions. Furthermore, when entering into a QFC, it is critical that funds and other buy-side counterparties have certainty, for credit, regulatory and operational reasons, regarding which entities are subject to the Proposal. The proposed definition of “covered entity” would appropriately capture those banks whose QFCs could potentially raise systemic risk concerns in a resolution situation. It also would provide the necessary certainty to contracting parties, as regulators maintain a list of current domestic and foreign GSIBs. There is no need for the Board to broaden the definition and potentially introduce uncertainty regarding which entities are subject to the Proposal.

The Board Should Narrow the Scope of Covered Contracts

The Board requests comment on the proposed definitions of QFC and covered QFC, and whether they should be broadened or narrowed. The Board also requests comment on the proposed exclusion of cleared QFCs.

While we appreciate the Board’s intent to use a definition of QFC that is consistent with the existing definition under the Dodd-Frank Act, we believe that definition is overly broad and is

⁴⁴ *Id.*

not sufficiently precise to provide contracting parties with adequate notice of whether a contract would be deemed a QFC for purposes of the Proposal. For example, the definition could be deemed to include delayed delivery contracts. In the context of ETFs, this might include, for example, collateral posting by authorized participants and related guarantees in the event that the authorized participants are unable to secure some portion of the creation basket of securities by the settlement date. Although both the collateral posting and the guarantee could, potentially, meet the definition of a QFC, it would not be consistent with current market practice or expectations to treat either agreement as a QFC, and the ETF would likely not reasonably expect the Stay and Transfer Provisions to apply.

We recommend that QFCs that include only unilateral default rights be excluded from the final rules.⁴⁵ The overly broad scope of the proposed definition of QFC would encompass QFCs that do not provide cross-default or any default rights to the buy-side counterparty. For example, a prime brokerage or margin loan agreement generally does not provide any remedy to the customer/borrower upon the default of the broker/lender. It would serve no regulatory purpose to include such contracts as QFCs under the Proposal, as doing so would merely require funds and other counterparties to incorporate provisions into the agreements relating to cross-default rights that do not exist. Subjecting these contracts to the rules' prohibitions would be burdensome and impose unnecessary compliance costs on counterparties to such contracts. Similarly, the Proposal should make clear that it does not cover loan agreements in which counterparties are borrowers from banks, such as margin loans. These types of arrangements, like prime brokerage agreements, do not provide cross-default rights to a borrower, or even a default right against the bank-lender. Although the definition of QFC is not entirely clear regarding whether loan agreements would be covered, we do not believe that there would be any good reason to require funds and other counterparties to include in their loan agreements the types of provisions specified in the Proposal and, as a result, in order to avoid any possibility of confusion, we request that the Board clarify that bank loan agreements would not be deemed to be QFCs.⁴⁶

We agree with the Board that the Proposal should exclude cleared QFCs. In light of the existing regulatory regime governing defaults within a CCP framework, it is unnecessary to impose the Proposal's Stay and Transfer Provisions on cleared QFCs. CCPs have default protocols that are based on a waterfall hierarchy. Defaulting CCP members typically are required to absorb the first layer of losses, and the CCP itself will then be required to commit capital to satisfy losses. CCPs also have a

⁴⁵ See proposed Section 252.88.

⁴⁶ For example, in some circumstances, a fund or other end-user may negotiate a termination right and guarantee provision into a prime brokerage agreement.

guarantee fund to provide capital support. In addition, under a central clearing model, there already is a robust credit structure in place under which customers are required to post both initial and variation margin with the clearing members carrying their accounts. CCPs may raise mandatory margin levels during periods of volatility.

Furthermore, it is unclear how the Proposal would apply to cleared QFCs, as cleared QFCs do not use credit support providers. Because of the existence of the CCP, credit support providers are unnecessary. Finally, we do not believe the stay provisions of proposed Section 252.83 are necessary or appropriate in the context of cleared swaps because the regulations of the Commodity Futures Trading Commission (“CFTC”) and the rules of the CCPs already establish a robust framework for insolvency and it is not clear that CCPs would be resolved under SRRs, rather than their own rules or the rules of the CFTC.⁴⁷

Scope of Default and Cross-Default Rights under the Proposal

Background

The Proposal would define “default right” to include common default rights such as a setoff right, the right to liquidate pledged collateral, the ability to suspend or delay the non-defaulting party’s performance under the contract or accelerate the obligations of the defaulting party, the right to demand payment or delivery, or the right to terminate the QFC, as well as “any similar rights.”⁴⁸ It also would include a right or contractual provision that alters the amount of collateral or margin that must be provided with respect to an exposure including, for example, by changing the initial amount, threshold amount, variation margin, minimum transfer amount, or the margin value of collateral. The proposed definition of “default right” would exclude certain business-as-usual payments associated with a QFC, such as same-day payment netting, as well as contractual margin requirements that arise solely from the change in the value of the collateral. For purposes of proposed Section 252.84, the definition

⁴⁷ For example, the CFTC has a comprehensive regulatory scheme to address the failure of member clearing organizations. (See CFTC’s Part 190 regulations, 11 CFR Part 190). Additionally, Section 724(a) of the Dodd-Frank Act amended Section 4d of the Commodity Exchange Act to provide protection for collateral deposited by cleared swaps customers of futures commission merchants and derivatives clearing organizations. CME Group, and other designated regulatory organizations, have also developed rules to manage the default of clearing members (see Section 802 of CME Group Rulebook, available at <https://www.cmegroup.com/rulebook/CBOT/I/8/8.pdf>.)

⁴⁸ The Proposal includes all such default rights regardless of source, including rights existing under contract, statute, or common law.

of “default right” would not include contractual rights to terminate without the need to show cause, including rights to terminate on demand and rights to terminate at contractually specified intervals.⁴⁹

The Stay and Transfer Provisions also contain certain limited creditor protections. First, under the Proposal’s general creditor protections, a covered QFC and the covered affiliate credit enhancement supporting that QFC may permit the covered entity’s counterparty to exercise default rights based on the covered entity’s own entry into resolution (other than the covered entity’s resolution under a U.S. or foreign SRR) or the covered entity’s failure to make a required payment or delivery. In addition, the Proposal would allow the covered entity’s counterparty to exercise default rights based on the failure of a covered affiliate support provider⁵⁰ or a transferee to make a payment or delivery required under a credit enhancement that supports the QFC. Second, the Proposal contains additional creditor protections for a covered QFC that is supported by a credit enhancement provided by an affiliate of the covered entity if the affiliate itself is also a covered entity. Finally, the Proposal includes specific creditor protections related to covered QFCs that are supported by affiliate credit enhancements, where the support provider becomes subject to FDIA proceedings.

The Board Should Clarify that “Business as Usual” Actions Are Not Included in the Definition of Default Right

The Board requests comment on the proposed definition of “default right.” While we generally agree with the scope of the proposed definition, we have several comments. We support the proposed definition’s exclusion of “business as usual” payments associated with a QFC. We recommend that the Board clarify that certain “business as usual” actions would not be included in the definition. Specifically, because the Proposal contemplates that the direct counterparty will continue to perform its obligations under the direct QFC notwithstanding the insolvency of its credit support provider, there is no policy reason not to require the direct counterparty and its counterparty to perform all of their non-default related obligations under the QFC. While we do not believe that non-default related obligations, such as payment netting, posting and return of collateral, procedures for substitution of collateral, and modification to the terms of the QFC (e.g., to allow the counterparty to

⁴⁹ The Board explains that excluding these types of rights is consistent with the Proposal’s objective to restrict only default rights that are related, directly or indirectly, to the entry into resolution of an affiliate of the covered entity, while leaving other default rights unrestricted. As explained above, we support exclusion of these negotiated terminations rights from application of the Stay and Transfer Provisions.

⁵⁰ A “covered affiliate support provider” would be defined, with respect to a covered affiliate credit enhancement, as the affiliate of the direct party that is obligated under the covered affiliate credit enhancement and is not a transferee. A “covered affiliate credit enhancement” would be defined as an affiliate credit enhancement in which a covered entity, or covered bank referenced in the Proposal, is the obligor of the credit enhancement. See proposed Section 252.84(f).

maintain a matched hedge), should be deemed to be “default rights” at all, to avoid any ambiguity that could be caused by a broad reading of the proposed definition, the Proposal should clarify that they are excluded as “business-as-usual” actions. In addition, we recommend that the Board clarify that the definition of “default right” would not include off-setting transactions with third parties by the non-defaulting counterparty, thereby allowing the counterparty to close out or reduce its economic position under the QFC (which the counterparty may wish to do for market related reasons as well as to reduce exposure to the direct counterparty). The definition of “default right” should not include such transactions because they allow counterparties to continue to manage their portfolio exposure in the ordinary course of business and to mitigate the size of future losses and claims if the direct counterparty were to default. Doing so benefits both the covered entity and the non-defaulting counterparty.

We also support the proposed exclusion of contractual rights to terminate without the need to show cause. Optional termination rights are used by funds for a broad range of reasons, including, without limitation, ensuring that the fund can comply with its investment guidelines (e.g., a fund may exercise a termination right if the covered entity’s credit rating drops below a specified level), providing required liquidity (e.g., because the ISDA Master Agreement does not allow for transfer or termination without consent, a fund may often build in a right for the fund unilaterally to transfer or terminate the contract upon occurrence of certain non-credit related events) and linking a hedge to a particular asset (e.g., by incorporating a termination right when some or all of the hedged assets are disposed of). Because these termination rights typically are linked to non-standardized events that are customized for each counterparty, reliance on such rights is unlikely to raise the Board’s concerns that GSIB insolvencies may result in broad-based “fire sales” of assets. As a result, we agree with the Board that contractual termination rights without the need to show cause should be excluded from the definition of “default right.”

The Board Should Broaden Creditor Protections

The Board requests comment on the proposed provisions permitting specific creditor protections in covered entities’ QFCs. The Proposal generally would require that a QFC prohibit a counterparty’s exercise of default rights against a direct party or a guarantor. It would exclude from this prohibition, however, a direct party’s payment or delivery default, or a covered support provider’s payment or delivery default, and where the direct party enters receivership, insolvency, liquidation, resolution or similar proceedings, other than resolution proceedings under the FDIA, Title II of the Dodd-Frank Act, or similar proceedings under foreign law.⁵¹ We strongly support these exclusions.

⁵¹ See proposed Section 252.84(e).

We recommend, however, that the exclusions be broadened to permit, after triggering of the Stay and Transfer Provisions, the exercise of default rights by a counterparty against a direct party or a covered support provider with respect to *any* direct default under the covered QFC, and not just with respect to direct defaults resulting from payment or delivery failure or the direct party becoming subject to certain resolution or insolvency proceedings. The parties should receive the benefit of the rights they negotiated and documented in the covered QFC, when those rights do not implicate the resolution of a covered entity. For example, when a QFC requires the covered entity to maintain a particular license or capital level, failure by the direct party to comply with those negotiated provisions should not be excused. Similarly, even if the direct party has not become insolvent, the counterparty should be able to declare an event of default with respect to the direct QFC when a credit support provider is subject to an insolvency proceeding under certain circumstances.⁵² A failure to broaden the exclusions to permit a range of negotiated direct default rights by counterparties against covered support providers, as we recommend, will disincentivize counterparties from utilizing affiliate guarantors or credit support providers, as such guarantees will have less value. Our recommendation, however, with respect to both direct parties and credit support providers, would be consistent with the policy concerns underlying the Proposal as well as with sound credit management, which is important for the protection of the marketplace generally.

We recommend that the Board revise the Proposal to add three additional creditor protections to the Stay and Transfer Provisions of Section 252.84. These rights are: (1) priority rights in a bankruptcy proceeding against the transferee or original credit support provider (if the QFC providing credit support was not transferred); (2) a right to submit claims in the insolvency proceeding of the insolvent credit support provider if the transferee becomes insolvent (even if submission is after the cut-off date); and (3) the ability to declare a default and close out both the original QFC with the direct counterparty as well as all QFCs with the transferee if the transferee defaults under the transferred QFC or under any other QFC with the non-defaulting counterparty, subject to the contractual terms and consistent with applicable law. A non-defaulting counterparty should not be disadvantaged as compared to other creditors due solely to the fact that it is subject to the Stay and Transfer Provisions.

⁵² Such circumstances may include if the counterparty discovers that the direct party has provided materially false representations in the QFC or has omitted to disclose material facts. In that situation, the counterparty should be able to declare an event of default with respect to the direct QFC on the basis that the direct party has materially breached its representations.

The Board Should Modify the Standard for Exercising Default Rights

In the event of a legal dispute regarding a party's right to exercise a default right under a covered QFC, the Proposal would establish a standard under which a QFC counterparty would bear the burden to demonstrate, by clear and convincing evidence or a similar or higher burden of proof, that the exercise is permitted under the covered QFC. This burden of proof applies not only to the exercise of cross-default rights, but to the exercise of direct default rights. We believe this standard is overly strict, and should not extend to direct defaults, as it would make it too difficult for a counterparty to close out against a defaulting dealer. We recommend that the Board instead only apply the burden of proof to the exercise of cross-default rights, and shift the burden to make the standard a rebuttable presumption that the *non-defaulting* party's exercise of its default right is permitted under the covered QFC unless the defaulting covered entity demonstrates otherwise. Shifting the presumption to the defaulting covered entity would acknowledge that the transferee is selected without any input by the counterparty and, as a result, the counterparty should be allowed to act quickly in the event of a direct default, leaving to the defaulting entity the burden to challenge the exercise of such default rights if it believes they are not permitted under the QFC.

VI. Implementation Issues

Background

The Proposal would take effect on the first day of the first calendar quarter that begins at least one year after the issuance of a final rule. A covered entity would be required to ensure that covered QFCs entered into on or after the effective date comply with the rule's requirements. A covered entity would be required to conform pre-existing QFCs (those entered into prior to the effective date) to the rule's requirements no later than the first date on or after the effective date on which the covered entity or an affiliate (that is also a covered entity or covered bank) enters into a new covered QFC with the counterparty to the preexisting covered QFC or an affiliate of the counterparty. An entity that becomes a covered entity after the final rule is issued would be required to comply with the rule by the first day of the first calendar quarter that begins at least one year after the entity becomes a covered entity.

The Final Rules Should Not Apply to Pre-Existing QFCs

Our members have significant concerns about the retroactive applicability of the Proposal. We therefore recommend that the Board require covered entities and their counterparties to amend QFCs only with respect to new transactions. As currently worded, the Proposal would require

fund advisers and other asset managers to engage in a time-consuming and costly process to amend a large number of pre-existing QFCs. As a general matter, negotiating amendments to a QFC requires several revisions, and may take anywhere from several months to over a year to complete. Because funds are required to have a large number of counterparties due to regulatory diversification requirements as well as credit requirements, the process of tracking amendments of upwards of 50 agreements per fund is likely to be extraordinarily time consuming, operationally burdensome and expensive.⁵³ These costs will ultimately be borne by fund shareholders. Applying the Proposal prospectively, as we recommend, is consistent with the applicability of the UK PRA Rules,⁵⁴ and is a better means of balancing the Board's stated policy objectives⁵⁵ of QFC continuity upon a GSIB insolvency with the significant compliance costs to covered entities.

Manner of Amendment

We also believe that the Proposal should allow for amendments to be effected in a simple, cost-effective manner. For example, the required new terms should be able to be added through a confirmation document for a new agreement without requiring that a formal amendment of the QFC be agreed and signed by the parties. The Proposal should allow counterparties to implement the changes in any manner that is enforceable, such as an exchange of emails, consistent with the UK PRA Rules.⁵⁶

One Fund Entering into a New QFC Should Not Cause the Other Funds in the Fund Complex to be Required to Conform Their Pre-Existing QFCs to the Rules' Requirements

If the Board declines our recommendation and applies the final rules to pre-existing QFCs, we request at the least that, when a covered entity enters into a new QFC with one fund in a fund family, that action should not result in the other funds in the fund family being required to conform their pre-existing QFCs with that covered entity or an affiliate to the Proposal's requirements. Under the Proposal, a covered entity would be required to conform pre-existing QFCs to the rule's requirements no later than the first date on or after the effective date on which the covered

⁵³ Many funds maintain upwards of 10 or more counterparties in connection with the QFCs into which they enter.

⁵⁴ UK PRA, *supra* note 6.

⁵⁵ See Proposing Release, *supra* note 2, at 29184.

⁵⁶ UK PRA, *supra* note 6 at 2.2 (requiring a counterparty to "agree in an enforceable manner" to the required undertaking rather than, as previously proposed, to "agree in writing.").

entity or an affiliate (that is also a covered entity or covered bank) enters into a new covered QFC with the counterparty to the preexisting covered QFC *or an affiliate of the counterparty*.⁵⁷ The Board's Regulation YY defines affiliate as "any company that controls, is controlled by, or is under common control with, another company."⁵⁸ If funds in a fund complex that are potentially affiliated were required to conform pre-existing QFCs with a covered entity or its affiliate when a covered entity enters into a new QFC with one fund in the complex, this provision potentially could require amendment of thousands of QFCs by hundreds of funds in a complex based on a single triggering QFC. Such an outcome would be significantly overbroad, inappropriate, and unnecessary to accomplish the Board's policy objectives, for the reasons described below.

It is typical for funds in an investment company complex to be managed by the same investment adviser or by an affiliate of that investment adviser. Some of these funds may be subject to the oversight of a common board of directors or trustees. Management of a large number of these "series funds" through a common adviser and oversight of the funds by a common board offers various efficiencies and cost savings to fund shareholders.

Nonetheless, each of these funds is a separate legal entity and pool of securities with its own assets, liabilities, and shareholders. For example, in the United States, in creating funds, a sponsor may establish each fund as a new, separately organized entity under state law or as a new "series company," which has the ability to create multiple sub-portfolios (i.e., individual mutual funds) or series. U.S. federal securities laws and state corporate laws safeguard the assets in an individual series from market or other risks that may negatively affect another series, and consequently, protect the shareholders invested therein and the fund complex more broadly. For example, liquidation of one series is isolated to that series. Shareholders must look solely to the assets of their own series for redemption, earnings, liquidation, capital appreciation, and investment results.⁵⁹

If the Board applies the final rules to pre-existing QFCs, we request that it confirm explicitly in the final rules that a covered entity entering into a new QFC with one fund in a fund complex will not trigger applicability of the rules to other funds in the fund complex that have a common or affiliated investment adviser, or a common board of directors or trustees. To apply the

⁵⁷ See proposed Section 252.84(a)(2)(ii).

⁵⁸ See Regulation YY of the Board of Governors of the Federal Reserve System, 12 CFR 225.2(a).

⁵⁹ See Joseph R. Fleming, *Regulation of Series Investment Companies under the Investment Company Act of 1940*, Business Lawyer, August 1989. We understand that similar considerations apply in the case of "umbrella" fund structures established in certain EU jurisdictions (such as Luxembourg). The terms of a QFC with a fund is specific to that fund and does not impact the rights and obligations of other funds.

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rules otherwise could trigger broad retroactive application of the rules to potentially any other fund in the fund complex based on a transaction with a single fund. Such a result would be vastly overbroad and is unnecessary to accomplish the Board's policy objectives. Specifically, because funds in a fund complex are separate pools with their own shareholders, assets, and liabilities, there is no risk that the losses from an insolvent GSIB would be transferred from one fund counterparty to another, raising systemic risk concerns.

Compliance Date

The Proposal would not apply to a "covered bank," defined under the Proposal to include banks supervised by the OCC. The Board explains that the OCC is expected to issue a proposed rule that would subject covered banks that are GSIB subsidiaries to requirements substantively identical to those in the Proposal. Given that many of the bank dealers that serve as counterparties to fund transactions under QFCs are national banks regulated by the OCC, we urge the Board to coordinate and extend its implementation date to be consistent with the OCC, so that funds and other counterparties have the time necessary to update their contracts in a consistent manner, to the extent appropriate, to reflect the final rules of both regulators.

We also request that the Board extend its own review of this Proposal to take account of additional comments made with respect to the OCC proposal. Because the proposals are expected to be similar and to work in tandem, it will be important to consider the comments to both proposals at the same time.

In connection with implementation of the final rule, we request that the Board provide a longer transition period for funds and asset managers. This extension is warranted in light of the substantial number of agreements that will be affected and the additional time and effort that will be necessary for asset managers to amend contracts and obtain client consent regarding the changes required by the final rules. We therefore recommend that the Board provide asset managers with a compliance period that is at least six months longer than the compliance period provided to other covered entities under the final rules.

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We appreciate the opportunity to respond to the Proposal. If you have any questions, please feel free to contact the undersigned at (202) 326-5815, Sarah Bessin at (202) 326-5835, or Ken Fang at (202) 371-5430.

Sincerely,

/s/ David W. Blass

David W. Blass
General Counsel