

MEMO# 30041

July 15, 2016

ICI Draft Comment Letter on Federal Reserve Board Proposal to Require Contractual Stays in Qualified Financial Contracts - Your Comments Requested by July 25

[30041]

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 34-16 RE: ICI DRAFT COMMENT LETTER ON FEDERAL RESERVE BOARD PROPOSAL TO REQUIRE CONTRACTUAL STAYS IN QUALIFIED FINANCIAL CONTRACTS - YOUR COMMENTS REQUESTED BY JULY 25

ICI has drafted a comment letter to the Board of Governors of the Federal Reserve System ("Board") on the Board's proposal ("Proposal") 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"). [*] ICI's draft letter is attached, and is summarized briefly below. Please provide any comments in writing by Monday, July 25, to Sarah Bessin at sarah.bessin@ici.org.

ICI's comment letter explains that the Proposal has significant implications for funds that are regulated under the Investment Company Act of 1940 and similar non-U.S. regulated funds publicly offered to investors, such as UCITS (collectively, "funds"), which regularly use contracts that may meet the Proposal's broad definition of QFC for investment and risk management purposes. The letter expresses significant concerns that the Proposal is broader than is necessary to achieve these goals, and may have significant unintended consequences. It explains that the Proposal is overly complex and will be almost impossible for market participants, as well as courts, to understand and apply. The letter asserts that the Proposal would dismantle long-held protections provided by Congress and, as drafted, shifts the costs of resolving large banking reorganizations to non-defaulting counterparties, such as funds and their investors. It explains that the Proposal could have the unintended consequences of destabilizing a GSIB and its subsidiaries well in advance of an actual credit collapse by precipitating early close-outs and "runs on the bank." By creating substantial uncertainties in the event of a counterparty insolvency, the Proposal may create an

incentive for asset managers, as fiduciaries to their clients, to close-out QFCs with counterparties in advance of an actual insolvency upon the earliest concern about solvency risk. The letter asserts that, in many cases, these early close-outs and security sales themselves may precipitate a collapse of the GSIB or GSIB subsidiary.

The comment letter makes the following additional key recommendations to the Board regarding the Proposal:

- The Proposal should be revised to 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, in the alternative, the Proposal should be revised to 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 or, if the Board is unwilling to limit the stay and transfer provisions to resolution proceedings, then also if the covered entity is subject to an insolvency proceeding under the U.S. Bankruptcy Code. These recommended revisions would ensure that the stay and transfer provisions under Section 252.84 would not be triggered by a GSIB becoming subject to resolution or insolvency proceedings under state or foreign law.
 - Enhance creditor protections included in the stay and transfer provisions, including requirements that transferees be creditworthy and subject to the terms that the parties to the QFC negotiated, including financial covenants affecting the credit support provider and the counterparty, negotiated optional termination rights, and the right to exercise default rights in the event a direct counterparty breaches material misrepresentations it made in the QFC.
 - Narrow the Proposal’s QFC definition to exclude contracts that do not have bilateral default and cross-default rights.
 - Exclude from the proposed definition of “default” under the Proposal any direct default under a covered QFC by a covered entity, relating to the direct party or a covered support provider, which the parties have negotiated and documented in the covered QFC. Under the Proposal, excluded direct default rights are limited to those based on a direct party’s payment or delivery default, a covered support provider’s payment or delivery default, or a direct party’s entrance into insolvency proceedings. The Proposal also should exclude set-offs of transactions entered into with third parties.
 - 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. We recommend that the Proposal 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.
 - 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.

- 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.

Sarah A. Bessin
Associate General Counsel

[Attachment](#)

endnotes

[*] See ICI Memorandum No. 29916 (May 16, 2016), available at <https://www.iciglobal.org/iciglobal/pubs/memos/memo29916>.

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