The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 30119

August 5, 2016

ICI Files Comment Letter on Federal Reserve Board Proposal to Require Contractual Stays in Qualified Financial Contracts

[30119]

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 40-16
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 18-16
SEC RULES MEMBERS No. 40-16 RE: ICI FILES COMMENT LETTER ON FEDERAL RESERVE BOARD PROPOSAL TO REQUIRE CONTRACTUAL STAYS IN QUALIFIED FINANCIAL CONTRACTS

ICI has filed a comment letter with 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 comment letter is attached, and is summarized briefly below.

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 the Board's objectives to reduce systemic risk by seeking to ensure the orderly resolution of U.S. GSIBs, 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 shift the costs of resolving large banking reorganizations to non-defaulting counterparties, such as funds and their investors.

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

- 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 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, 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.

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Attachment

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