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COMMENT LETTER

January 18, 2011

ICI Comment Letter Regarding FDIC Rulemaking on Orderly Liquidation Process (pdf)

January18, 2011 Mr. Robert E. Feldman Executive Secretary Attention: Comments Federal Deposit Insurance Corporation 550 17th Street, N.W. Washington, D.C. 20429 Re: Rulemaking Implementing Certain Orderly Liquidation Authority Provisions Dear Mr. Feldman: The Investment Company Institute1 appreciates the opportunity to provide additional input regarding the Federal Deposit Insurance Corporation's implementation of its authority to resolve "covered financial companies" pursuant to Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").2 As explained in our letter dated November 18, 2010, ICI members are major investors in the U.S. bond and money markets.3 They thus have a strong interest in ensuring that any liquidation of a covered financial company minimizes risk to the financial system, maximizes the value of the liquidated company, and treats creditors fairly in doing so. ICI believes that FDIC rulemaking to implement Title II should reflect the basic proposition that a clearly defined, predictable liquidation process is essential to proper market functioning and U.S. financial stability. We recommend that the FDIC take the following two-step approach to establish 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.31 trillion and serve over 90 million shareholders. 2 Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 64170 (Oct. 19, 2010) ("Notice") (requesting comment on proposed 12 C.F.R. Part 380 and on broader questions to inform a future rulemaking addressing other orderly liquidation issues under the Dodd-Frank Act). 3 See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation, dated November 18, 2010 ("November Letter") (providing comment on proposed 12 C.F.R. Part 380). Mr. Robert E. Feldman January 18, 2011 Page 2 of 5 such a liquidation process. First, the FDIC should adopt—to the greatest extent possible—clear substantive and procedural rules that will govern the liquidation of a covered financial company. Second, the FDIC should adopt a provision specifying that, in the absence of a rule specific to Title II, the relevant provisions of the Bankruptcy Code and related judicial interpretations will serve as binding precedent. The importance of these two steps is discussed below. Following that discussion, the letter sets forth ICI's views on the application of Title II to registered investment companies ("funds") as financial companies. Need for Clear Substantive and Procedural Rules The orderly liquidation process authorized by Title II is intended as a mechanism by which the federal government can unwind a nonbank financial company whose impending failure could pose significant risk to the U.S. financial system. Title II provides the FDIC as receiver with very potent legal authority and tasks it with developing, in consultation with the Financial Stability Oversight Council ("FSOC"), the specifics of this new process through implementing rules. The FDIC is not, however, authorized to start from a "clean slate." Indeed, Congress directed that the FDIC "seek to harmonize applicable rules and regulations [to implement Title II] with the insolvency laws that would otherwise apply to a covered financial company" ("Harmonization Requirement").4 The reason for this is not surprising. The Bankruptcy Code provides companies, their investors, and the broader financial markets with an established, well-defined process for resolving a troubled company's debts and repaying its creditors. The hallmark of this process is certainty – among other things, that creditors will be repaid in an orderly way and according to an established priority; that creditors with the same priority will typically receive equal treatment; and that known rules and procedures will govern the resolution of any disputes that arise during the bankruptcy proceeding. For ICI members and other institutional investors, being able to make accurate assumptions about the potential outcomes if a company goes bankrupt is critical to an analysis of whether and how to invest in that company, and how long to hold that investment. Certainty should likewise be a hallmark of the liquidation process under Title II. Without it, funds and other market participants may be wary of offering credit to any nonbank financial company (e.g., by entering into financial contracts or acquiring debt securities) that might conceivably be subject to liquidation under Title II, because of uncertainty about how those contracts and any related claims 4 Section 209 of the Dodd-Frank Act. Typically, the applicable insolvency law would be the Bankruptcy Code. In the case of a broker-dealer, the applicable law would be the Securities Investor Protection Act, while state insolvency laws would apply in the case of an insurance company. Mr. Robert E. Feldman January 18, 2011 Page 3 of 5 would be treated by the FDIC as receiver. As under the Bankruptcy Code, a well-defined liquidation process would allow market participants to adequately assess the risk of transacting with the financial company, and to "price" that risk into their investment decisions. ICI views the FDIC's initial rulemaking under Title II as a step in the right direction. With proposed Part 380, the FDIC has attempted to clearly define—and circumscribe—the situations in which the FDIC could exercise the discretion granted to it by the Dodd-Frank Act to treat similarly situated creditors differently during the liquidation of a covered financial company. We are hopeful that the rule, as adopted, will address the concerns expressed by funds and other investors that the agency's broad authority, and uncertainty about how it might be exercised, could cause market distortions and other unintended consequences.5 We strongly believe that the U.S. financial markets and all market participants would be well served if the FDIC's rulemaking under Title II continues along these lines, and we are pleased that FDIC Chairman Bair appears to share this view. Specifically, the press release accompanying the Notice quotes Chairman Bair as saying the proposed rule is "the first step in giving market participants greater clarity and certainty about how certain key components of the resolution authority will be implemented." From the viewpoint of an institutional investor, these key components include how the FDIC will determine which claims against a covered financial company would be part of the receivership (and likely subject to a haircut), which claims would be transferred to a bridge financial company (and likely paid off in full), and how assets passed to a bridge financial company would be valued. Beyond these key components and as discussed above, clarity and certainty are critical to all aspects of the Title II liquidation process. Relationship of Title II to the Bankruptcy Code The Notice states that "the liquidation rules of Title II are designed to create parity in the treatment of creditors with the Bankruptcy Code and other normally applicable insolvency laws."6 To effectuate this intent, and to achieve the goal of certainty of process as discussed above, the FDIC's Title II rules should specify that, in the absence of a rule specific to Title II, the relevant provisions of the Bankruptcy Code and related judicial interpretations will serve as binding precedent. The Securities Investor 5 See, e.g., November Letter, supra note 3. We further believe that, as a general matter, all payments to creditors in a Title II liquidation should be made as expeditiously as possible, in order to minimize market disruptions and potential systemic risk. 6 Notice, supra note 2 (emphasis added). Mr. Robert E. Feldman January 18, 2011 Page 4 of 5 Protection Act generally takes this approach.7 Following the Bankruptcy Code where the FDIC has not otherwise adopted a special rule for orderly liquidations would be consistent with the Harmonization Requirement and also would satisfy market participants' need for clarity and certainty as to the rules governing an orderly liquidation. Finally, an explicit statement to this effect by the FDIC would avoid the possibility that any judge or other trier of fact in subsequent litigation could treat a "gap" in the Title II rules in a fashion inconsistent with the intent of Title II.8 Application of Title II to Funds as Financial Companies ICI also has a strong interest in how the FDIC might apply the provisions of Title II to funds as financial companies. We do not believe it would ever be necessary or appropriate for federal regulators to designate a fund as a "covered financial company" and liquidate it under Title II. Designation as a covered financial company requires, among other things, a finding that the company's failure and its resolution under otherwise applicable federal or state law would have serious adverse effects on U.S. financial stability.9 In our letter responding to the FSOC's Advance Notice of Proposed Rulemaking regarding the designation of systemically important financial institutions, we discuss in detail how many characteristics of funds—including their simple capital structure, limited use of leverage, and comprehensive regulatory scheme—put them at the "less risky" end of the spectrum when considering the potential for systemic risk.10 The letter explains that a fund's potential loss of assets would affect only its investors, each of whom is an undivided pro rata owner of the fund's underlying assets through the ownership of fund shares. A fund's losses would not spill over to affect other funds in the same complex, the fund's investment adviser, or other market participants. Finally, the process by which a liquidating fund distributes its remaining assets pro rata to its shareholders and winds up its affairs, in 7 See 15 U.S.C. 78fff(b). 8 See Sec. 202(c)(2) of the Dodd-Frank Act (mandating that no provisions of the Bankruptcy Code or rules issued thereunder shall apply to matters relating to a covered financial company for which the FDIC is appointed as receiver, except as expressly provided in Title II). 9 The process and required findings for designating a "covered financial company" are set forth in Sections 203(a) and (b) of the Dodd-Frank Act. 10 See Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated November 5, 2010, available at http://www.ici.org/pdf/24696.pdf. Mr. Robert E. Feldman January 18, 2011 Page 5 of 5 accordance with state law and the Investment Company Act of 1940, is not one that should occasion disorder in the financial markets.11 In addition, we are concerned that some large funds could be assessed to pay for the costs of liquidating a covered financial company. Under the Dodd-Frank Act, the FDIC is authorized to impose assessments on certain types of financial companies, including those with total consolidated assets of at least $50 billion. Any such assessment, if imposed on a fund, would amount to a direct charge against the fund's net assets, thereby reducing pro rata the value of each shareholder's investment. We believe that this outcome should be avoided. Even the largest funds will not "fail" in a manner requiring Title II liquidation, and their shareholders should not be at risk of having to foot the bill for the liquidation of a covered financial company. Applicable provisions of the Dodd-Frank Act require the FDIC's assessment rules to distinguish among financial companies based upon the differences in risks that such companies pose to the financial stability of the United States. For the reasons discussed above and in our letter to the FSOC, we believe it would be appropriate for the FDIC, in its rulemaking prescribing the assessment system, to refrain from assessing funds and, by extension, the owners of fund shares. * * * * ICI appreciates the FDIC's attention to our comments. If you have any questions, please contact me at 202/326-5815, Rachel Graham at 202/326-5819, or Mara Shreck at 202/326-5923. Sincerely, /s/ Karrie McMillan General Counsel

11 In the case of money market funds, the Securities and Exchange Commission has adopted new rules authorizing fund boards to suspend redemptions and thereby help assure an orderly liquidation of a money market fund if it is unable to maintain its stable net asset value per share. See Rule 22e-3 under the Investment Company Act.