Alternative Investment Management Association

FINANCIAL STABILITY BOARD
Bank for International Settlements
Centralbahnplatz 2
Basel
CH-4002
Switzerland

1 December 2014

Dear all,

AIMA Response to FSB Consultation Paper on Cross-border Recognition of Resolution Action

The Alternative Investment Management Association (**AIMA**),[1] is grateful for the opportunity of responding to the FSB Consultation 'Cross-border recognition of resolution action' (the **Consultation**).

AIMA appreciates and supports the FSB's work stemming from the G20 to promote financial stability and the effective cross-border resolution of Global systemically important financial institutions (GSIFIs) and banks (G-SIBs). Our members, as counterparties to G-SIFIs, have a significant interest in strengthening financial stability and the resolution of financial institutions. Many experienced first-hand the risks of destabilising financial events as many lost significant amounts of collateral as part of the failure of Lehman Brothers (Europe) in 2008.

We recognise and support, in particular, the FSB's intention of stabilising the liquidation of large institutions by incentivising its members to take relevant action to enable the recognition or support of resolution actions undertaken by a foreign authority.

AIMA, nonetheless, has specific comments in relation to the application of statutory frameworks and significant concerns as to the FSB's work to date on the application of stays on early termination rights for derivative contracts, in particular relating to the FSB's push for the development of contractual measures before relevant legislative or prudential rules have been adopted.[2]

Our position can be summarised as follows:

- **Effective cross-border recognition or support of resolution actions, in particular the stay of termination rights for financial contracts, should only be introduced through statutory amendments that cover all relevant financial contracts.** AIMA considers that only statutory frameworks can give true cross border effect to resolution tools;

- **AIMA disagrees with the use of contractual arrangements on an instrument by instrument basis in lieu of legislative action on cross-border stays.** We consider that proceeding on a sectoral/asset class basis risks creating a two-tier system of creditors – those holding financial contracts subject to stays and those that do not;

[1] Founded in 1990, the Alternative Investment Management Association (AIMA) is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry – including hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors.
Our membership is corporate and comprises over 1,400 firms (with over 8,000 individual contacts) in more than 50 countries. AIMA's manager members manage a combined $1.5 trillion in assets (as of March 2014).
[2] Many concerns were contained in the joint trade associations' letter to the FSB of 4 November 2014, submitted on behalf of AIMA, the Managed Association (MFA), American Council of Life Insurers (ACLI), Association of Institutional Investors (AII), Commodity Customer Coalition (CCC) and the Commodity Markets Council (CMC).

- **Voluntary compliance with contractual arrangements restricting rights, such as the ISDA Protocol, is not possible for many participants with fiduciary duties such as investment managers.** Participants with fiduciary duties to clients, such as alternative investment fund managers under Directive 2011/61/EU on alternative investment fund managers (AIFMD), will be unable to adhere voluntarily to contractual arrangements restricting their clients' rights without breaching their fiduciary duties to act in their clients' best interests;

- **The principle of stays on early-termination rights for derivatives and the ISDA Protocol pose issues of conflict with sectoral regulations for investor protection.** Formal legislative requirements for eligible assets for UCITS funds and insurance companies may prevent such entities from being able to adhere to limitations on their early-termination rights; and

- **Close-out netting and the ability to manage risk remains a vital facet of the functioning of derivative markets globally.** Derivative instruments serve an especially important function in modern financial markets, including by enabling the efficient hedging and other risk management of both market and credit risk. If the derivatives position is used for hedging purposes there could well be large risk increase for hedge fund managers from the stay of their termination rights.

We articulate these positions in more detail within the Annex below and would be happy to discuss any aspects further.

Yours sincerely,

Jiri Król
Deputy CEO
Head of Government and Regulatory Affairs
The Alternative Investment Management Association (AIMA)

ANNEX

1. *Do you agree that foreign resolution actions can be given effect in different ways, either through recognition procedures or by way of supportive measures taken by domestic authority under its domestic resolution regime? Do you agree with the report's analysis of these approaches?*

AIMA recognises the need for globally concerted action to promote financial stability and enable the orderly liquidation of G-SIFIs and G-SIBs. A clear and certain statutory regime for the recognition of resolution actions by a foreign authority is, therefore, important to ensure optimal outcomes are reached.

AIMA agrees also that foreign resolution actions may be given effect in different ways through domestic statutory regimes - including through the use of mutual recognition or supportive measures. It is our position that effect can only really be given to foreign resolution actions through domestic legislative changes and not by contractual arrangements alone (see below).

However, we would note the potential issues, as recognised by Element 3 within the Consultation,[3] associated with giving a foreign regulator automatic jurisdiction[4] through relevant recognition provisions at the domestic level. National regulators understandably do not have the global financial system in mind when undertaking their activities, rather their focus is on protecting the interests of their own markets, institutions and investors. In certain situations these interests may coincide, but this would be incidental. Moreover, as the actions of foreign regulators would necessarily involve the interference with property rights which are protected under constitutional legislation and/or common law, any supportive measures or other administrative action (including the making of rules) would need to satisfy the relevant protections. This would generally require compliance with the procedural safeguards, e.g. that rules or other measures had been subject to an appropriate consultation process, and substantive safeguards, e.g. that the rules or other measures were proportionate. A failure to comply with these safeguards may result in any actions being set aside or prohibited. It is unlikely, therefore, that any domestic regulators will wish automatically to recognise the actions of a foreign regulator and, even for discretionary recognition, clear safeguards will be necessary. We note the European Bank Recovery and Resolution Directive (BRRD) mentioned at page 7 of the Consultation provides for the cross-border resolution of group entities in multiple member states across the EU. Notwithstanding the formalised framework for group resolution colleges run by a 'group-level' resolution authority, it still remains possible under Article 91(8) of the BRRD for any resolution authority to disagree or otherwise depart from a group resolution scheme as long as relevant reasons are provided.

AIMA is supportive of the three qualifying factors under Element 3 to refuse recognition of foreign resolution measures (adverse effects on financial stability, contravention of local public policy - including the inequitable treatment of domestic creditors - and material fiscal implications). We respectfully disagree, however, with the FSB's statement that recognition of foreign resolution proceedings should in principle not be contingent on reciprocity. Despite the objectives contained within the FSB Key Attributes, we do not believe that any authority would be willing to grant recognition so that a foreign authority may enforce resolution actions in relation to a G-SIFI in its territory without the corresponding ability for that authority to enforce its own resolution actions in relation to a relevant G-SIFIs in the foreign authority's territory. Without reciprocity, the authority would be placed at an immediate disadvantage to the foreign authority in line with our point above that authorities act primarily in the interests of their own jurisdiction. It is unlikely, therefore, that recognition without reciprocity could be viewed as in the interests of any individual jurisdiction.

It would be AIMA members' preference that a consistent and universal framework be applied globally, thus avoiding issues of authority self-interest and procedural complexity of applying resolution actions on a cross-

[3] Also recognised within Element 3 within the Consultation - that the legal framework should clearly identify the grounds for granting recognition or supportive measures for foreign resolution proceedings or adopting supportive measures.
[4] As is anticipated by Element 2 of the Consultation.

border basis. AIMA believes that unless a clear and consistent global framework is reached, a two-tier system for G-SIFI resolution could result whereby resolution actions are taken in some jurisdictions, but not others - advantaging one class of stakeholder at the expense of another. We suggest that frameworks only work if the entire market globally is subject to them.

2. *Do you agree that achieving cross-border enforceability of (i) temporary restrictions or stays on early termination rights in financial contracts and (ii) 'bail-in' of debt instruments that are governed by the laws of a jurisdiction other than that of the issuing entity is a critical prerequisite for the effective implementation of resolution strategies for global systemically important financial institutions (G-SIFIs)? Is the effective cross-border implementation of any other resolution actions sufficiently relevant for the resolvability of firms that the FSB should specifically consider ways of achieving their cross-border enforceability?*

AIMA believes that the ability in general to enforce a single point of entry resolution action for a G-SIFI/G-SIB group on a cross-border basis is important to ensure the effectiveness of the resolution action and the equal treatment of all stakeholders in that G-SIFI/G-SIB group.

Also, with respect to the specific resolution actions described in Question 2, we recognise that the objectives of resolution, distinct from ordinary insolvency proceedings, mean that the ability to stay rights to terminate financial contracts has been and will be provided to resolution authorities within relevant statutory special resolution regimes.

However, AIMA does not believe that the cross-border enforceability of contractual stays is a critical prerequisite for the effective implementation of a resolution strategy, with stays forming one of the suite of potential actions. However, if stays are to be applied, we do believe that their enforceability upon all financial contracts on a cross-border basis, to all arms of a G-SIFI/G-SIB, is vital to ensuring the equal treatment of all stakeholders in the G-SIFI/G-SIB group. We have significant concerns that without a statutory framework for the cross-border recognition or support of stays on all financial contracts, a two-tier system of financial contract stakeholders could be created - with those not subject to stays on their financial contracts gaining an advantage over those that are subject to stays.

We strongly recommend that any measure providing for both stays on termination rights and the recognition of foreign stays should only be introduced through formal legislative changes. We consider it vital that measures that fundamentally alter the terms on which participants enter into financial contracts should only be adopted after a full and transparent legislative process enabling the input of relevant stakeholders, including a full cost-benefit analysis and application of the checks and balances of each jurisdiction's legislative process.

3. *Do you agree that contractual approaches can both fill the gap where no statutory recognition framework is in place and reinforce the legal certainty and predictability of recognition under the statutory frameworks once adopted?*

<u>**Contractual arrangements in lieu of statutory frameworks**</u>

AIMA does not agree that contractual approaches can fill the gap where no statutory recognition or support framework is in place for the resolution of a G-SIFI/G-SIB. In our opinion, to seek to enforce resolution actions on a cross-border basis through contractual means, in the absence of a statutory framework, would be inappropriate. We would also query the necessary function of contractual approaches when statutory frameworks are in place, although we recognise that relevant contractual provisions that implement the statutory framework could make the application of cross-border resolution actions more simple and predictable for both market participants and authorities, thus reducing obstacles to the application of resolution actions upon the distress of a G-SIFI/G-SIB.

AIMA, in particular, has significant concerns about the FSB's proposals for the use of 'voluntary' contractual arrangements to limit counterparty rights and to override relevant prudential or legislative provisions. These concerns are especially pronounced in relation to the FSB's decision to mandate ISDA to develop a Protocol to its Master Agreement for the contractual recognition of stays on early termination rights for in-scope derivative contracts. It would appear that the FSB has commissioned ISDA's work on the Protocol before the Consultation, which deals with the use of contractual arrangements.[5] This to us represents a reversal of the normal consultative process.

It may also be that the use contractual measures in advance of statutory developments could potentially undermine the objectivity and independence of the subsequent legislative process. If contractual measures are agreed and broadly implemented before formal legislation is developed, we believe that it is highly likely that the substance of subsequent legislation would be heavily based on those contractual arrangements. We note that the latter may not be problematic if the contractual arrangements were developed in a manner that enabled all stakeholders to contribute to the final arrangements. However, in the case of the ISDA Protocol, we are concerned that the majority of buy-side participants only became aware of the FSB's efforts recently and had no opportunity to comment prior to its completion.[6]

AIMA would also suggest that contractual agreements on their own, in particular under the ISDA Protocol, do not necessarily assist in the cross-border application of resolution actions to the a G-SIFI/G-SIB unless a statutory regime exists in the foreign jurisdiction that recognises or supports the resolution actions of the home resolution authority. In AIMA's opinion, a contractual arrangement cannot in itself grant jurisdiction to a foreign resolution authority to apply resolution actions to an entity established in another authority's jurisdiction. For example, the contractual agreement under the ISDA protocol to stay termination rights as per the actions of a foreign resolution authority does not provide the foreign resolution authority with any power to apply third-party transfer or bail-in tools to the contracts of the entity established in the separate jurisdiction.[7] Overall, in the context of stays on termination rights, stays are intended to facilitate the use of other resolution tools; thus, without the possibility of other tools being applied, we would suggest that stays are of no benefit to the resolution of the G-SIFI/G-SIB.

Even if contractual arrangements were able to confer powers on relevant foreign authorities to take the relevant resolution actions, we suggest that contractual arrangements could well still be ineffective in achieving resolution objectives due to the level of uncertainty and likely delays regarding their enforceability. Due to the private nature of the agreements and potential challenges from public and private parties, national courts will remain necessary to adjudicate their provisions. This effectively removes any benefits of speed associated with cross-border resolution recognition or support under statutory frameworks. We reference the FSB's discussion at page 11 of the Consultation which, in particular, specifies that enforceability of contractual provisions has yet to be tested in national courts and limitations may not always be clear. In AIMA's opinion, the level of uncertainty as to the potential benefits of contractual arrangement compared with the identifiable and significant costs to the affected participants' rights to due-process mean that the application of contractual arrangements in absence of statutory framework would be inappropriate.[8]

[5] The ISDA Protocol described within Paragraphs 2.1.1. and 2.1.2. of the Consultation was first published on 12 November 2014, after a letter sent by the FSB in November 2013.
[6] ISDA stated within its Frequently Asked Questions document that both buy-side and sell-side firms and associations were represented on calls 'during which all participants were invited to comment and discuss their concerns'.
[7] We note that this argument is not relevant for the contractual recognition of domestic bail-in bail-in of instruments issued under the laws of a foreign jurisdiction, as the issuing G-SIFI/G-SIB entity remains within the jurisdiction of the resolution authority seeking to apply the tool.
[8] If forced to adhere to such arrangements with no right to appeal or express their grievances relating to the decision-maker.

Stays on early termination rights for OTC derivatives and Section 1 of the ISDA Protocol

As described above, we disagree with the FSB's decision to mandate that ISDA develop and complete its Protocol for the contractual stays on early termination rights for OTC derivatives subject to an ISDA Master Agreement before the FSB consulted on the use of contractual arrangements. We do not agree with the FSB's intended approach of ensuring dealer counterparties encourage their counterparties to adhere to contractual stay provisions on their financial contracts. We believe strongly that the application of stays in resolution is an issue of great importance and economic sensitivity and so should be dealt with through a robust and open legislative process allowing all stakeholders to contribute.

In particular, the piecemeal development of contractual arrangements for particular instruments fails to account for the need for a comprehensive and consistent regime that covers all financial contracts so that all stakeholders are treated equitably. AIMA is concerned that the development of the ISDA Protocol (relating only to OTC derivatives subject to an ISDA Master Agreement) may serve only to introduce an inequitable and potentially dangerous two-tier system of creditors upon a G-SIFI/G-SIB's resolution; effectively distinguishing between those that hold OTC derivatives exposures subject to the ISDA Protocol and those that hold other financial contracts (such as repos) subject to other contractual documentation (including securities lending and prime brokerage arrangements) that do not.[9] AIMA believes that the application of the Protocol would be unfair for those with derivatives in adherence with the Protocol and, because other contracts are not covered, would not materially assist with meeting the objectives of resolution. Comprehensive legislative amendments for all relevant financial contracts are the only way that stays on termination rights may be recognised equitably and effectively for all creditors.

AIMA recognises that page 12 of the Consultation references the fact that the ISDA Protocol is formulated in a manner that is 'sufficiently generic to be adapted for use by other trade bodies (for example, SIFMA with respect to the MRA / GMRA)…' so as to enable it to be used for other financial contracts. However, until similar protocols are adopted for all other relevant financial contracts, the inequitable two-tier system of creditors will remain. We believe that the benefits of recognising such stays on OTC derivatives, in absence of such recognition for all other financial contracts, would be negligible and would pose disproportionate risks to a category of market participants when compared to simply waiting for a robust legislative process to be undertaken.

Investment managers and fiduciary duties to act in the best interests of clients

For investment fund managers specifically,[10] as we understand the FSB has recognised, AIMA notes that collective investment fund managers will not be able adhere voluntarily to contractual arrangements that limit rights in relation to instruments held on behalf of clients in a given jurisdiction. Any such voluntary relinquishment of termination rights would pose significant problems in relation to managers' fiduciary duties to act in the best interests of their clients, as can be found in the EU, for example, under Article 12(1)(b) of AIFMD that requires AIFMs to 'act in the best interests of AIFs or the investors of the AIFs they manage and the integrity of the market'. It is highly unlikely that such derogation of rights could ever be considered to be in the interests of investment fund clients. Even if a stay on early termination rights were to improve the systemic consequences of a failing G-SIFI, thus benefit the market as a whole, stays on termination rights would still ultimately be a limitation on the risk management ability of an investment manager with no commensurate direct client benefit. AIMA suggests that even if all prudentially regulated firms become required to include stay provisions in their contracts, thus requiring non-prudentially regulated firms to adhere to such stay provisions in order to do business with those prudentially regulated firms,[11] investment fund managers would still not be able to adhere voluntarily

[9] Such instruments and exposures subject to the large number of other contractual documentation, including repos, securities lending, prime brokerage agreements and many more.
[10] As opposed to the managers of separate client accounts.
[11] as is envisaged by the 'indirect' mechanism to capture non-prudentially regulated firms that we consider itself may be beyond the authority of FSB member authorities that are empowered only to deal with prudentially regulated firms.

to the ISDA Protocol. Only formal legislative changes would enable a fund manager to agree to any stay on its rights without being in breach of its fiduciary duties to its clients.

The ISDA Protocol and investor protection regulation

AIMA believes that it is also important to consider how stays fit in with the recent efforts to develop regulatory initiatives for investor protection. AIMA would question whether the move to impose stays on termination rights for derivative contracts is reconcilable with the objective of investor protection. We suggest that the protection of the financial system cannot be successful without relevant protections for those participants within that system. Adherence to contractual arrangements to limit termination rights, in particular, could prohibit certain regulated entities from trading in relevant financial contracts.

For UCITS, Directive 2009/65/EC on undertakings for collective investments in transferable securities (the UCITS Directive) contains an obligation that the UCITS be able to unilaterally exit its positions in OTC derivatives at any time and at fair value. Article 50(1)(g)(iii) of the UCITS Directive specifies that a UCITS shall only be able to comprise of those OTC derivatives that are able to be sold, liquidated or closed out by an offsetting transaction at any time at their fair value at the UCITS' initiative. In our opinion, this would prevent any UCITS fund manager from being able to voluntarily adhere to any contractual measures limiting its close-out netting rights for OTC derivatives contracts, such as the ISDA Protocol. This would mean almost $8tn in assets under management would not be unable to adhere. Similarly, for insurance companies, the UK Prudential Sourcebook for Insurers (INSPRU) provides limitations on the instruments that may be owned without negative regulatory capital treatment. Only 'admissible assets' are possible, which includes only those OTC derivatives[12] that are on 'approved terms'. The notion of an 'approved term' is limited to situations whereby:

> 'the firm reasonably believes that it could, in all reasonably foreseeable circumstances and under normal market conditions, readily enter into a further transaction with the counterparty or a third party to close out the derivative or quasi-derivative at a price not less than the value attributed to it by the firm …'[13]

Guidance on this point further specifies that:

> 'In considering whether the first transaction could be readily closed out in all reasonably foreseeable circumstances under normal market conditions, the firm should satisfy itself that it cannot reasonably foresee any circumstances in which it would need to close out all or part of the contract at a few days' notice, and would not be able to do so.'[14]

We believe that the application of stays on termination rights for OTC derivatives, therefore, may not be possible for regulated entitles subject to investor protection requirements that they be able to close-out their financial contracts. We suggest that the only way for such regulated entities to adhere to stays would be through an amendment of relevant sectoral legislation and that adherence would not be possible by contractual arrangement alone.

Overriding the US Bankruptcy Code through contractual means and Section 2 of the ISDA Protocol

AIMA fundamentally disagrees and would recommend against the FSB and ISDA's move to use the ISDA Protocol to introduce stays for cross-default events in the US, seeking to amend and override the US Bankruptcy Code on this matter. We disagree, in particular, with the FSB's assertion that the lack of national frameworks and the time required to implement the necessary statutory changes justifies the use of contractual provisions prior to the

[12] I.e., those contracts not executed on a regulated market.
[13] INSPRU 3.2.34R
[14] INSPRU 3.2.34AG

adoption of what are highly complex and commercially sensitive legislative changes.[15] We consider that if AIMA's hedge fund members were to adhere to the Protocol, this would effectively deprive their clients of their statutory rights in relation to cross-defaults for qualified financial contracts without an appropriate legislative process.[16]

We consider that the above issues can only be avoided through the use of a formal legislative process to adopt statutory rules and make the relevant amendments to the US Bankruptcy Code necessary for the resolution of G-SIFIs/G-SIBs.

AIMA believes that the extensive consideration that went into the negotiation and drafting of the relevant sections of the US Bankruptcy Code and the reasoning for the exclusion of certain financial contracts from the scope of automated stays on termination rights is still relevant to the potential application of stays to financial contracts such as derivatives today. We do not agree that such can or should be overridden by contractual means alone.

<u>The importance of close-out rights to derivative contracts</u>

AIMA accepts that the central objective of resolution regimes is to mitigate the counterparty risk posed by a G-SIFI/G-SIB. We note also that it is certainly not in our hedge fund members' interests for a G-SIB counterparty to fail in a disorderly manner. For example, many hedge funds have large collateral exposures to their prime brokers, which are often subsidiaries of G-SIBs, and it is not desirable for them to lose this collateral in a disorderly failure as was the case with Lehman Brothers in 2008. [17] Likewise, however, they also have an interest in the ongoing freedom of their market activities and ability to manage risk. Legal certainty as to the ability to terminate open contracts, net-off and sell remaining collateral upon a particular default event is especially important to the trading activities of all participants in the derivatives market. Such termination rights are therefore an important aspect of the functioning of derivatives markets more broadly. The need to ensure such close-out netting remains possible is recognised by the provision of safe-harbours from stays on early termination rights for financial contracts within ordinary insolvency proceedings.[18]

Many jurisdictions such as the US place an automatic stay on claims by creditors upon the filing for bankruptcy or entry of a debtor into insolvency provisions. Such stays are beneficial as they enable a more organised, orderly and equitable distribution of the insolvent firm's assets to creditors as part of its liquidation. These ordinary insolvency proceedings involving automatic stays are not necessarily suitable for financial entities such as banks and the liquid nature of their assets and liabilities. It is recognised in various jurisdictions, therefore, that various financial contracts should be either excluded from this automatic stay or subject to alternative treatment. Derivative instruments are a particular category of instrument to which the application of automatic stays can be viewed as inappropriate.[19] Derivative instruments serve an especially important function in modern financial markets, including by enabling the efficient hedging and other risk management of both market and credit risk. If the derivatives position is used for hedging purposes there could well be large risk increase for hedge fund managers from the stay of their termination rights. For example, if a fund manager owns a bond which pays a floating rate of interest and hedges this using an interest swap, if the bond defaults but close-out of the hedging position is not possible, a basis risk exposure will arise to the market movement between the initiation and termination of the stay. Similarly, if an investment fund is seeking to undertake a market neutral/arbitrage strategy, thus has a short physical position which it hedges with a long equity swap with its PB, if market pressures result in the stock being recalled by the lender without the corresponding ability for the fund to close-out the corresponding long equity swap, an unwanted directional exposure would result. Market movements may

[15] at page 11 of the Consultation
[16] This refers to rights that a party to a contract has as a result of the bankruptcy or insolvency that is not its direct counterparty, but that is related to its direct counterparty.
[17] As described, above, fund managers lost significant amounts of collateral as a result of the collapse of Lehman Brothers in 2008.
[18] Including US Bankruptcy Code, as provided for under the UNCITRAL Legislative Guide's Recommendations 101-107.
[19] In the US, s.362 of the U.S. Bankruptcy Code allows an exclusion for certain 'qualified financial contracts' from the automatic stay that applies to other contracts. 'Qualified financial contracts' include commodity contracts, forward contracts, securities contracts, repurchase agreements and swap agreements.

at the outset of a G-SIFI's failure not be significant. However, as time progresses, market movements are likely to become increasingly extreme and unidirectional. As was the case in the Lehman's collapse, on the Monday market movements may have meant losses were not material, however, by Wednesday or Thursday market movements had intensified such that, if stays had been applied, counterparties would have been exposed to significant unidirectional market movements leading to potentially destabilising losses.

US Congress itself identified the importance of legal certainty as to how and when market participants are able to terminate, net and settle derivatives during bankruptcy proceedings. U.S. Senator Dennis DeConcini explained at the time of drafting certain elements of the US Bankruptcy Code that:

> upon termination of the agreement for default, all transactions between the parties are terminated, a single net amount is determined, and the amount due the non-defaulting party is paid by the defaulting party. The immediate termination for default and netting provisions are critical aspects of swap transactions. The immediate termination of all outstanding transactions is necessary for the protection of all parties in light of the potential for rapid changes in the financial markets…. Counterparties could be faced with substantial losses if forced to await a bankruptcy court decision on assumption or rejection of financial transaction agreements.

Even with stays lasting a maximum of two business days, AIMA would be concerned that this could undermine the basic functioning of the swaps market and encourage procyclicality during periods of financial distress, to the detriment of the global financial system. Counterparties may well be incentivised to pre-empt proceedings by either ceasing entering into any new positions with vulnerable G-SIB/G-SIFI counterparties and related entities or otherwise entering into an offsetting position to terminate their positions as soon as possible. This is particularly likely for investment managers, who are subject to strict fiduciary duties to act in the best interest of their clients and shift exposure away from the entities with which it has contracts that may be subject to stays.[20] The overall impact of this would be to exacerbate the systemic effect of a G-SIFI/G-SIB's failure as counterparties transfer their positions or exit the market in fear of the failure of more G-SIFIs/G-SIBs, thus destabilising previously non-vulnerable G-SIFI/G-SIBs. Strict margining requirements, when combined with potential stays on termination rights, could also prove counterproductive by increasing the demand for initial margin as an institution approaches insolvency or resolution, reducing the availability of collateral assets and potentially market liquidity.

We consider that this risk of disruption would be disproportionate unless a stay materially contributes to the successful resolution of the G-SIFI/G-SIB. In AIMA's opinion, the ISDA Protocol, for the reasons described above, would not make a material contribution to the successful resolution of the G-SIFI/G-SIB unless a statutory regime were in place granting recognition of or supporting the home authority's resolution actions.

In our opinion, the only viable solution to mitigate these issues is for the provisions for the cross-border recognition of stays to be introduced through formal legislation that applies to all relevant financial contracts.

4. *Are the elements of cross-border recognition frameworks identified in the report appropriate? What additional elements, if any, should jurisdictions consider including in their legal frameworks?*

AIMA believes that the elements proposed for legal frameworks are largely suitable. We, nonetheless, respectfully disagree (for the reasons expressed in our responses to Question 3) with the proposal within Element 7 on pages 10-11 of the Consultation that would require firms to adopt contractual arrangements to fill the gaps until statutory approaches have been fully implemented.

[20] It is the case that clients would place considerable pressure on their investment manager to move away from vulnerable entities should there be a risk that their rights would be suspended upon the entry of that entity into resolution or initiation of other insolvency proceedings

5. *Are the key principles for recognition clauses in debt instruments set out in the report appropriate? What other principles* ***or*** *provisions do you consider necessary to support the exercise of 'bail-in' powers in a cross-border context?*

[No comment]