MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

December 1, 2014

Via Electronic Mail: fsb@bis.org

Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Financial Stability Board Consultative Document on Cross-Border Recognition of Resolution Action

Dear Sir or Madam:

Managed Funds Association ("**MFA**")[1] welcomes the opportunity to comment on the Financial Stability Board's ("**FSB**") "Consultative Document on Cross-Border Recognition of Resolution Action" dated 29 September 2014 ("**Consultation**").[2] MFA appreciates that the FSB is considering the proposals in the Consultation because, "uncertainties about the cross-border effectiveness of resolution measures [are] an important impediment to cross-border resolution".[3] We support legislative efforts to improve financial stability and to facilitate the orderly resolution of failing financial institutions. Therefore, MFA supports the proposals in the Consultation related to policymakers in FSB member jurisdictions adopting statutory recognition frameworks to enable resolution measures taken in foreign jurisdictions to have cross-border effect[4] as long as the statutes are crafted carefully and fairly to include all parties and provide no favorable treatment for different types of parties. MFA also wants to ensure that, at the time of any resolution, it remains clear that only one jurisdiction has ultimate authority over the resolution of the failing institution and that affected market participants that have transacted with any affiliate of the failing institution have certainty as to which jurisdiction has such authority.

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[1] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policymakers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants..

[2] Available at: http://www.financialstabilityboard.org/wp-content/uploads/c_140929.pdf.

[3] *Id*. at iii.

[4] *See id*. at 4-11, Section 1.

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However, we have strong objections to the proposals in the Consultation advocating use of the contractual approach (*i.e.*, the ISDA Protocol[5] and related FSB member prudential regulations) to impose suspensions of customer early termination rights on a cross-border basis.[6] As discussed herein, early termination rights provide significant protection to customers. Because MFA's members are customers and active participants in the financial markets, we have a strong interest in ensuring that any efforts to alter those rights results from an appropriately robust process and careful balancing of all relevant policy considerations. From both a policy and a process perspective, we have concerns with the contractual approach and strongly believe that (if employed) it would lead to market uncertainty and exacerbate the contagion in the financial systems during stressed market conditions.

Therefore, we urge the FSB to reconsider use of the proposed contractual approach. Rather, MFA believes that the only appropriate way to address suspensions of early termination rights on a cross-border basis is for policymakers in each FSB jurisdiction to undertake their usual robust, open, and transparent process to consider and enact legislation[7] and adopt the statutory recognition frameworks.

MFA hopes that this letter will foster a further dialogue among the FSB, its members and MFA on this critical matter.

1. 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?

2. 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?

MFA appreciates the FSB's thoughtful consideration of statutory recognition frameworks as the appropriate mechanisms to stabilize the financial system during liquidations of failing financial institutions. MFA has been supportive of statutory efforts to strengthen the financial system[8] and to resolve failing institutions because such failures have had severe consequences for our

[5] By the "ISDA Protocol", we mean the protocol that the FSB tasked the International Swaps and Derivatives Association, Inc. ("**ISDA**") with finalizing to amend its standard ISDA Master Agreement to impose a market-wide suspension on market participants' exercise of early termination rights with respect to derivatives contracts traded thereunder during the resolution of certain failing financial institutions ("**ISDA Protocol**").

[6] *See* Consultation at 11-13, Section 2.1.

[7] In accordance with U.S. practice, we use the term "legislation" to refer to statutory enactments in the FSB member jurisdictions.

[8] For example, MFA has been supportive of the goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**"), Pub. L. 111-203, 124 Stat. 1376 (July 21, 2010), available at: http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm; and the European Markets Infrastructure Regulation, Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (Jul. 4, 2012), available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

members. For example, many of our members' investors lost significant amounts of their collateral in the liquidation of Lehman Brothers ("**Lehman**"), and years later, they are still trying to recover those funds.

Therefore, to achieve, cross-border recognition of resolution actions, MFA strongly encourages the FSB to petition for, and support adoption by policymakers of, the statutory recognition frameworks discussed in the Consultation. From a policy and process perspective, we believe that these statutory recognition frameworks are the only appropriate solution to the FSB's orderly resolution concerns.

As a general matter, we believe that the FSB has appropriately considered the elements that should form part of such statutory recognition frameworks. In particular, we strongly agree that, "the process for giving effect to foreign resolution measures should be guided by the principle of equitable treatment of creditors".[9] Therefore, MFA opposes excluding any class of creditors from suspensions of their early terminations rights on a cross-border basis.

Equal (*i.e.*, *pari passu*) treatment of creditors is a guiding principle of insolvency law because it ensures that all creditors receive the same priority during liquidation proceedings, and thus, that there is an equitable *pro rata* distribution of the debtor's assets.[10] The result of this equal treatment is that, where a domestic authority imposes a suspension of early termination rights, it must apply to all such domestic creditors' to the same degree. Therefore, we are of the view that, for statutory recognition frameworks to work as intended and be consistent with this principle when giving cross-border effect to domestic resolution actions, policymakers in foreign jurisdictions must ensure that all classes of foreign creditors are subject to the suspensions of their early termination rights to the same degree as domestic creditors. Specifically, each creditor (whether domestic or foreign) agreed to assume the same risks when transacting with the failing financial institution; therefore, we do not believe that it is appropriate to disadvantage one class of creditors as compared to another. Rather, as policymakers adopt these statutory recognition frameworks, MFA respectfully asks the FSB to urge policymakers not to exclude any class of foreign creditors from the being subject to the suspension of their early termination rights.

Although MFA supports most of the proposed elements discussed in the Consultation for inclusion in statutory cross-border recognition frameworks, we object to inclusion of element 7. We do not think it is appropriate for authorities to "require firms, or provide incentives for firms, to adopt contractual approaches, where appropriate, to reinforce the legal certainty and predictability of recognition under the statutory frameworks already in place and to fill the gap for statutory approaches until these have been fully implemented".[11] As we will discuss in response to questions 3 and 4, we have significant concerns with use of the proposed contractual approach to impose suspensions of customer early termination rights on a cross-border basis.

[9] Consultation at 9, Section 1.2.4.

[10] *See e.g.*, U.S. Bankruptcy Code, 7 U.S.C. § 752 and 766, available at: http://www.law.cornell.edu/uscode/text/11/chapter-7, discussing the ratable distribution of customer property during stockbroker and commodity broker liquidations.

[11] Consultation at 10-11, Section 1.2.7.

Because we believe that there are both policy and process issues with the contractual approach, we object to its use either as an interim measure pending adoption of the necessary statutory frameworks or as a measure to support such frameworks once adopted. Thus, MFA urges the FSB to eliminate the contractual approach as a recommended element of the statutory recognition frameworks and to cease with its own efforts to adopt the contractual approach (in particular, the prudential regulations[12]) as an interim measure.

While MFA supports adoption of the statutory recognition frameworks, we remain concerned about how resolution actions will unfold in practice. We appreciate that the FSB expressly provides in the Consultation that statutory recognition frameworks should give effect to foreign resolution measures in a manner consistent with the resolution measures taken by the foreign home resolution authority.[13] However, we also want to ensure that, at the time of resolution, it remains clear that only one jurisdiction has ultimate authority over the resolution of the failing institution and that affected market participants have certainty as to which jurisdiction that is.

By way of example, one scenario that concerns MFA is where multiple entities located in different jurisdictions but that form part of the same corporate structure begin to fail. In such case, each failing entity could become subject a resolution action that is in a different jurisdiction, subject to a different special resolution regime ("**SRR**"), and overseen by a different resolution authority. In the Consultation, it seems clear that, in this example, the FSB intends the statutory resolution frameworks of each foreign jurisdiction to recognize the multiple resolution actions and seek to take supportive measure to facilitate actions taken during those resolution proceedings.[14] However, what remains unclear is whether, for example, these statutory recognition frameworks would prevent creditors of the failing entities from being subject to multiple, separate suspensions of their early termination rights with respect to each failing entity. In practice, the terms of any suspensions imposed could differ and/or conflict depending of the requirements of the applicable SRR. MFA believes that, because the failing entities form part of a single corporate structure, there should a single jurisdiction and authority responsible for resolving the corporate structure as a whole.

If such consolidation of resolution actions does not occur, MFA is concerned that there will be substantial complexity and market uncertainty with respect to resolution of the failing corporate structure such that it would frustrate the goal of orderly and prompt resolution. Therefore, MFA believes that, as the FSB urges policymakers in each FSB member jurisdiction to adopt statutory recognition framework, it should also ask policymakers to ensure that prior to adoption they reach agreement on how they will handle such fundamental and practical issues.

MFA notes that the foregoing are solely examples of the issues that we believe policymakers must consider with respect to adoption of statutory recognition frameworks. This list is not

[12] In accordance with U.S. practice, we use the term "prudential regulation" to refer to rules that FSB members adopt in accordance with their statutory authority. We distinguish our use of this term from its usage in the European Union.

[13] *See* Consultation at 3, footnote 2.

[14] *See id*. at 4-6, Section 1.

exhaustive, and MFA would be happy to provide further views on these matters as part of the legislative process.

3. 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?

4. 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?

I. MFA Policy Concerns

MFA strongly opposes use of the proposed contractual approach (*i.e.*, the ISDA Protocol and related FSB member prudential regulations) to achieve cross-border enforceability of statutory suspensions of early termination rights.

MFA believes that seeking to implement changes with respect to counterparties' early termination rights implicates fundamental public policy goals, in particular the goals of protecting investors and the functioning of the financial markets.[15] We note that our members have fiduciary duties to their investors.[16] Therefore, our members have an affirmative duty to act in good faith and in the best interests of their investors.[17] Because early termination rights ultimately protect investors, our members' fiduciary duties prevent them from voluntarily waiving these rights. Specifically, early termination rights protect a counterparty and its investors by ensuring that, when the counterparty transacts with a financial institution (*e.g.*, a G-SIFI), in the event of the financial institution's default, the counterparty may be able to mitigate its exposure by recovering its investors' assets.

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[15] *See e.g.*, the text of Dodd-Frank, where Congress stated that the purpose of Dodd-Frank is "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes".

[16] *See* ISDA media comment, "Resolution Protocol: Staying Power?", available at: http://isda.mediacomment.org/, in which ISDA agreed with buy-side concerns around their fiduciary duties and noted that it expressed these concerns to the FSB.

[17] *See e.g.*, SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); and In re Arleen W. Hughes, Exchange Act Release No. 4048, 27 S.E.C. 629 (Feb. 18, 1948), available at: https://www.sec.gov/litigation/opinions/ia-4048.pdf, which sets forth the specific obligations that the U.S. Securities and Exchange Commission has imposed on registered investment advisers in the U.S., which includes, among other things, a duty to be loyal to their clients and to obtain best execution for those clients' transactions.

Because protection of investors and their assets is a fundamental public policy goal, and early termination rights are a key mechanism for protecting investors, we respectfully submit that it is inappropriate for the FSB to compel non-defaulting fiduciaries to waive early termination rights through use of the ISDA Protocol and prudential regulation. Rather, such core public matters are usually addressed through legislation adopted by policymakers, and thus, we believe that the FSB is setting a dangerous precedent that would harm (rather than protect) the global economy if it instead used the proposed contractual approach. MFA strongly believes that it is the responsibility of policymakers to determine whether changing this public policy under the U.S. Bankruptcy Code or on a cross-border basis with respect to SRRs is appropriate, and if so, enact legislation to adopt necessary statutory changes.

A. Overriding U.S. Bankruptcy Code Exclusion for Qualified Financial Contracts

In the Consultation, the FSB briefly references suspending counterparties' early termination rights with respect to "qualified financial contracts" during certain insolvency proceedings under the U.S. Bankruptcy Code.[18] MFA is aware that, at present, the suspensions under the U.S. Bankruptcy Code are contained solely in the ISDA Protocol.[19] However, we understand that, as part of their prudential regulations, U.S. banking regulators expect to require such suspensions during U.S. bankruptcy proceedings. Moreover, we understand that non-U.S. FSB members expect to recognize these U.S. bankruptcy suspensions on a cross-border basis as part of their prudential regulations.

MFA objects to the FSB's efforts to use the proposed contractual approach to impose waivers of key customer rights during insolvency proceedings under the U.S. Bankruptcy Code. In the case of SRRs, the FSB is seeking to ensure the cross-border effect of existing statutory suspensions of early termination rights. In contrast, the U.S. Bankruptcy Code has an express exclusion for "qualified financial contracts"[20] from suspensions of early termination rights that the FSB contractual approach would circumvent. Therefore, MFA believes that the portions of the ISDA Protocol and forthcoming FSB member prudential regulations that apply to U.S. bankruptcy proceedings, in effect, would amend the U.S. Bankruptcy Code by eliminating statutory protections afforded by Congress to "qualified financial contracts"[21].

MFA recognizes that, during insolvency proceedings of certain financial institutions, the U.S Bankruptcy Code suspends counterparties' early terminations rights that result from direct

[18] *See* Consultation at 12, footnote 13, where the FSB references that the ISDA Protocol also" provides for a stay that would apply in the context of a U.S. Bankruptcy Code proceeding".

[19] *See id*.

[20] *See* U.S. Bankruptcy Code, 11 U.S.C. § 362(b)(6), (7), and (17), available at: http://www.gpo.gov/fdsys/pkg/USCODE-2011-title11/html/USCODE-2011-title11-chap3-subchapIV-sec362.htm, which excludes contractual rights related to certain "qualified financial contracts" from the automatic stay in § 362(a). The term "qualified financial contracts" includes commodity contracts, forward contracts, securities contracts, repurchase agreements, and swap agreements, which for each excluded contract or agreement also includes the right to offset or net out any termination value, payment amount, or other transfer obligation.

[21] *See id*.

defaults[22] under non-financial contracts.[23] However, the U.S. Bankruptcy Code excludes "qualified financial contracts" from such suspensions such that counterparty early terminations rights arising from direct defaults and certain cross-defaults[24] are protected during U.S. bankruptcy proceedings.[25] Therefore, MFA urges the FSB to reconsider utilizing the contractual approach to suspend rights during bankruptcy proceedings in any manner not currently provided for under the U.S. Bankruptcy Code. Instead, we request that the FSB petition Congress to enact any desired statutory amendments.

In general, under the U.S. Bankruptcy Code, if a debtor files for (or is involuntarily placed in) bankruptcy, creditors' claims against such debtor are automatically stayed (*i.e.*, suspended).[26] However, under the U.S. Bankruptcy Code, Congress expressly provided an *exclusion* from this stay for "qualified financial contracts", including swap agreements and repurchase agreements.[27] In enacting these exclusions more than 24 years ago, Congress recognized the importance of providing legal certainty as to how and when market participants will terminate, net, and settle derivatives and other financial contracts during bankruptcy proceedings.

In particular, in 1990, Congress amended the U.S. Bankruptcy Code to exclude swap agreements from the automatic stay under Section 362(a). In reintroducing the related bill S.396 into the Senate in 1989, U.S. Senator Dennis DeConcini, who sponsored the bill and was a member of the Senate Judiciary Committee at the time, explained that this exclusion for swap agreements was necessary because:

> "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 nondefaulting party is paid by the defaulting party. The immediate termination for default and the 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."[28]

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[22] By rights resulting from "direct defaults", we mean rights that a party to a contract has resulting from the bankruptcy or insolvency of its direct counterparty.

[23] *See* U.S. Bankruptcy Code, 11U.S.C. § 362(a), which imposes an automatic stay on creditor rights.

[24] By rights arising from "cross-defaults", we mean rights that a party to a contract has as a result of the bankruptcy or insolvency of an entity that is not its direct counterparty, but that is related to its direct counterparty. \

[25] MFA's understanding is that the exclusion for "qualified financial contracts" under § 362(b) of the U.S. Bankruptcy Code from the automatic stay under § 362(a) applies to rights resulting from direct defaults as well as rights arising from some (but possibly not all) cross-defaults (*e.g.*, default rights related to a guarantor's failure are excluded but default rights related to the failure that is a "specified entity" under the counterparty's ISDA Master Agreement may not be excluded).

[26] *See* U.S. Bankruptcy Code, 11 U.S.C. § 362(a), which imposes an automatic stay on certain contractual rights arising under contracts other than "qualified financial contracts".

[27] *See supra* note 15. Congress enacted amendments to the U.S. Bankruptcy Code to exclude securities contracts, repurchase agreements, and swap agreements from the automatic stay in 1982, 1984, and 1990, respectively.

[28] 135 Cong. Rec. S1414 (daily ed. Feb. 9, 1989) (statement of Senator DeConcini).

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In expressing the will of Congress in providing the exclusion, Senator DeConcini explained that, in the absence of such exclusion, "[c]ounterparties could be faced with substantial losses if forced to await a bankruptcy court decision on assumption or rejection of financial transaction agreements."[29] Therefore, Congress ultimately enacted the bill to exclude swap agreements from the automatic stay in the U.S. Bankruptcy Code because, as stated by Senator DeConcini: "[i]n this day of volatile financial markets, we cannot permit one bankruptcy to undermine the basic function of a market as large and important as the swaps market."[30]

In accordance with Senator DeConcini's remarks, MFA emphasizes that having legal certainty regarding termination, netting, and settlement rights is particularly important in the context of derivatives transactions, given the critical role they play in the U.S. financial markets and the management and hedging of credit and market risk. The legal certainty provided by excluding qualified financial contracts from the automatic stay under the U.S. Bankruptcy Code has helped to promote the growth, liquidity, and competitiveness of the U.S. financial markets. Therefore, MFA disagrees with the FSB efforts to change the effect of this exclusion, and extend the application of the automatic stay under the Bankruptcy Code through adoption of the contractual approach. Rather, if the FSB desires to impose suspensions on rights under qualified financial contracts during U.S. bankruptcy proceedings, it should petition Congress to amend the U.S. Bankruptcy Code and eliminate the express exclusion.

B. Using the Contractual Approach to Apply Suspensions under SRRs on a Cross-Border Basis

Although the Consultation briefly mentions using the contractual approach to suspend counterparty cross-default rights during U.S. bankruptcy proceedings, the core focus of the contractual approach is suspending counterparty rights on a cross-border basis during resolution actions under the U.S. Orderly Liquidation Authority[31] and other FSB jurisdictions' SRRs. MFA believes that giving cross-border effect to FSB member jurisdictions' SRRs represents a significant and meaningful change to counterparties' rights. Because, as the FSB acknowledges, imposing those changes through the contractual approach might not survive legal challenge,[32] we feel strongly that during a stressed market environment, use of this approach would lead to market uncertainty, and thus, would incentivize behaviors that would exacerbate the harm to the financial system.

As mentioned, when large financial institutions have previously failed (*e.g.*, Lehman), there were insufficient assets for all of the institution's creditors and counterparties to recover the full

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[29] *Id*.

[30] *Id*.

[31] *See* Title II of Dodd-Frank, which is also known as the U.S. Orderly Liquidation Authority and imposes a one business day suspension of rights.

[32] *See* Consultation Paper at 11, Section 2, where the FSB acknowledges that, "the enforceability of such contractual recognition provisions has yet to be tested in the courts and limitations on their enforceability (for example, on public policy grounds) may not always be clear. Furthermore, where the contractual drafting differs from statutory provisions, foreign counterparties may not be subject to precisely the same standards as domestic counterparties."

amount owed to them by the failed entity.[33] Fear of non-recovery during a financial institution's resolution creates incentives for market participants to move assets away from vulnerable institutions.

In response to Lehman and fears of non-recovery, investors are conducting increasingly extensive due diligence on the fiduciaries with which they invest, including with respect to the counterparty credit risk taken on by those fiduciaries. If the FSB proceeded with utilizing the contractual approach, investors' credit analysis of the financial institutions with which their fiduciaries trade would also include consideration on the effect on the investors' rights of cross-border application of those suspensions during a resolution action. However, as the FSB acknowledges, suspensions imposed by the contractual approach might not be legally enforceable and could be subject to legal challenge,[34] and thus, during a resolution action there would be uncertainty as to whether the suspensions would function as intended. To avoid the legal uncertainty created by the contractual approach, if a financial institution was perceived by the markets to be a vulnerable institution, fiduciaries trading with that financial institution would receive considerable pressure from their concerned investors to move away from such vulnerable financial institution as soon as possible (*e.g.*, to fulfill their fiduciary duties to their investors).

These "runs on the bank" prior to commencement of a resolution action are precisely what the FSB is seeking to prevent. However, in practice, imposition of these suspensions in a legally questionable manner would be procyclical (rather than countercyclical) and would have the opposite effect than what the FSB seeks to achieve.

Moreover, the legal uncertainty resulting from implementation of the contractual approach could harm not only the vulnerable financial institution but also other stable financial institutions. For example, during the volatile period after Lehman failed, market participants were fearful that their other stable financial counterparties with which they were trading might also fail, and therefore, ceased trading with these financial institutions.[35] The result was that the financial stability was jeopardized of banks that previously were not vulnerable, which contributed further to the cycle of market volatility.[36]

Because of the foregoing practical effects of using the proposed contractual approach to extend the cross-border application of suspensions of counterparties' rights under existing SRRs, MFA urges the FSB to reconsider the contractual approach.

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[33] *See* Michael Fleming and Asani Sarkar, *The Failure Resolution of Lehman Brothers*, Federal Reserve Bank of New York Economic Policy Review, March 2014, available at: www.ny.frb.org/research/epr/2014/1403flem.pdf.

[34] *See supra* note 31.

[35] *See e.g.*, Yalman Onaran, Michael J. Moore and Max Abelson, *Banks Seen at Risk Five Years After Lehman Collapse*, Bloomberg, Sept. 10, 2013, available at: http://www.bloomberg.com/news/2013-09-10/banks-seen-at-risk-five-years-after-lehman-collapse.html; and Nick Mathiason, *Three weeks that changed the world*, The Observer, Dec. 27, 2008, available at: http://www.theguardian.com/business/2008/dec/28/markets-credit-crunch-banking-2008.

[36] *See id*.

II. MFA Process Concerns

MFA has significant concerns from a process perspective with the contractual approach, and thus, strongly objects to the use of the proposed contractual approach to address gaps in the existing statutory recognition frameworks.

As discussed in the Consultation, the FSB tasked ISDA with finalizing the ISDA Protocol[37] to amend its standard ISDA Master Agreement and suspend early termination rights arising from cross-defaults with respect to derivatives contracts traded thereunder.[38] Moreover, to compel market participants in the global financial market to waive their early termination rights and adhere to the ISDA Protocol, each FSB member expects to finalize prudential regulation by the end of 2015 that would mandate at least globally systemically important banks to cease trading with any counterparty that has not agreed to these suspensions.[39]

MFA has substantial concerns with the process that FSB employed to finalize the ISDA Protocol. In particular, we have concerns with the FSB consulting only a small group of market participants on the substance of the ISDA Protocol. We also strongly object to: (i) the FSB reversing the normal rulemaking process by finalizing the ISDA Protocol prior to issuance by its members of proposed prudential regulations, and (ii) FSB members using the ISDA Protocol to provide the substance for their prudential regulations. MFA believes that these process deficiencies effectively have resulted in FSB members finalizing the substance of their prudential regulations through the ISDA Protocol negotiations such that public opportunity to comment on the Consultation and the prudential regulations once issued is not meaningful.

MFA also objects to the FSB's proposal to have its members adopt prudential regulations to impose waivers of counterparty rights on financial institutions subject to their regulatory authority because the effect of those regulations is that FSB members would be regulating indirectly markets and market participants not subject to their regulatory authority. As the FSB knows, the suspensions of counterparties' rights that currently exist at law in FSB member jurisdictions each resulted from policymakers enacting legislation (not regulation).[40] MFA believes altering the cross-border effect of FSB member jurisdictions' SRRs only may be addressed through the robust, open, and transparent legislative process. Therefore, we believe that, if the FSB desires to change the application of such laws, it should petition policymakers in

[37] *See* Consultation at 12, Section 2.1.1.

[38] MFA notes that the ISDA Protocol would amend adhering counterparties' rights with respect to the derivatives contracts that they have traded with each other under an ISDA Master Agreement. Although counterparties typically use ISDA Master Agreements to trade over-the-counter derivatives contracts, some counterparties also include their cleared derivatives contracts under such agreements.

[39] *See* Consultation at 12-13, Section 2.1.3.

[40] *See supra* note 30. *See also e.g.*, U.S. Bankruptcy Code, 11U.S.C. § 362(a), available at: http://www.law.cornell.edu/uscode/text/11/362, which imposes an automatic stay on creditor rights, but excludes rights under "qualified financial contracts"; and the European Union Bank Recovery and Resolution Directive, *Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms*, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0059&from=EN.

each member jurisdiction to enact appropriate legislation that includes necessary rulemaking directives to the relevant regulatory agencies in each jurisdiction.

A. Use of ISDA Protocol

First, MFA is troubled that the FSB proceeded with having ISDA finalize, and begin G-SIFI adherence to, the ISDA Protocol, prior to completion of the normal prudential rulemaking process. As the FSB knows, in the ordinary course, FSB members are required to follow a legally prescribed and consultative process to adopt prudential regulations in their jurisdiction.[41] In the U.S., that process generally involves the regulators first issuing proposed prudential regulation.[42] Following issuance, the public has the opportunity to consider carefully and comment on such proposal.[43] Then, only after expiration of the public comment period and the regulators' thoughtful consideration and analysis of such comments may the regulators finalize the regulations.[44] In the past, ISDA has developed protocols in response to final derivatives regulations to ease the market's transition into compliance with those regulations. In addition, parties have become subject to those protocols only when they have agreed to adhere to them on a voluntary basis, such that where market participants are not supportive of the substance of a final ISDA protocol, they do not adhere. Such non-adherence to certain ISDA protocols has occurred previously, and as adherence was voluntary, those protocols effectively failed.

However, in this case, the FSB has reversed the process in that FSB members have worked with ISDA to complete, and begin G-SIFI adherence to, the ISDA Protocol prior to adoption of final (or even issuance of proposed) regulations.[45]

Second, MFA is dismayed that the FSB required an ISDA working group to develop the substance of its forthcoming prudential regulations. ISDA working groups are comprised only a small number of market participants compared to the overall number of participants in the financial markets. Although both sell-side and buy-side market participants were part of the ISDA working group, as discussed, their purpose is usually to develop protocols solely for voluntary market adherence. Because the FSB expects the ISDA Protocol to provide the substance for FSB members' proposed prudential regulations, the FSB essentially used ISDA working group members to draft future regulation. Given that the prudential regulations and the suspensions imposed thereunder would affect the entire market when complete, we feel strongly

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[41] *See e.g.,* U.S. Administrative Procedure Act, 5 U.S.C. § 552, available at: http://www.law.cornell.edu/uscode/text/5/part-I/chapter-5, which provides the legal procedures that U.S. regulators must follow to adopt new regulation.

[42] *See id*.

[43] *See id.*

[44] *See id.*

[45] *See* Consultation at 11-13, Section 2.1. *See also* ISDA Press Release, *Major Banks Agree to Sign ISDA Resolution Stay Protocol* (Oct. 11, 2014), available at: http://www2.isda.org/news/major-banks-agree-to-sign-isda-resolution-stay-protocol, announcing G-SIFI adherence to the ISDA Protocol, even though the ISDA Protocol became final and available for adherence on November 12, 2014. *See* ISDA Press Release, *ISDA Publishes 2014 Resolution Stay Protocol* (Nov. 12, 2014), available at: http://www2.isda.org/news/isda-publishes-2014-resolution-stay-protocol.

that the FSB should not have consulted solely the market participants selected to be part of an industry working group on the substance of the ISDA Protocol.

In addition, because the ISDA working group is comprised of only a small number of market participants, the vast majority of buy-side market participants only recently became aware of the FSB's efforts to suspend their cross-default rights during resolution actions in FSB member jurisdictions and U.S. bankruptcy proceedings. As a result, most buy-side market participants and did not have the opportunity to comment on the ISDA Protocol prior to completion.

MFA understands that market participants will have an opportunity to comment on any FSB member's proposed prudential regulations, and their application to FSB members' SRRs and the U.S. Bankruptcy Code through the usual notice and comment process. However, as discussed above, the FSB reversed the usual rulemaking process, and the FSB expects its members' prudential regulations largely to mirror the final ISDA Protocol. Therefore, completion of the ISDA Protocol effectively represented the expiration of market participants' opportunity for meaningful input into these crucial issues, which is, to the best of our knowledge, an unprecedented approach.

Lastly, the FSB has put pressure on G-SIFIs to adhere to the ISDA Protocol and agree to the waivers,[46] which results in undue pressure being placed on other market participants similarly to become subject to the suspensions of their rights. Specifically, in the course of reviewing G-SIFI "living wills", U.S. banking regulators recently stated that, unless the G-SIFIs renegotiated contracts with their counterparties to include these suspensions of their rights, regulators would likely reject their living wills.[47] This threat would have substantial consequences for G-SIFIs, as failure to obtain approval of their living wills may lead to increased capital charges, restrictions on their banking and trading activities, and/or possible forced divestiture of certain of their businesses. As a result, G-SIFIs were greatly incentivized to participate in developing, and adhere to, the ISDA Protocol such that they announced their agreement to waive their rights even before the substance of the ISDA Protocol was final.[48] Requiring G-SIFIs to proceed with waiving their rights with respect to SRRs and the U.S. Bankruptcy Code ahead of the remainder of market participants, has resulted in the G-SIFIs increasing the corresponding pressure on FSB member regulators to issue rules that will effectively require counterparties to adhere to the ISDA Protocol as well.[49]

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[46] *See id.*

[47] *See* Peter Eavis, Fight Brews on Changes That Affect Derivatives, NYTimes Dealbook, available at: http://dealbook.nytimes.com/2014/08/14/fight-brews-on-changes-that-affect-derivatives/ (Aug. 14, 2014), stating that "[j]ust last week, the Fed and the F.D.I.C. sharply criticized the banks' living wills. In laying out some of the improvements that regulators wanted to see, Martin J. Gruenberg, the F.D.I.C.'s chairman, said that the banks had to make 'amendments to their derivatives contracts to prevent disorderly terminations during resolution.'".

[48] *See supra* note 44.

[49] *See* Consultation at 12-3, Section 2.1.3.

B. Use of Prudential Regulation as Indirect Market Regulation and Instead of Statutory Changes

In the Consultation, the FSB discusses both prudential regulation and market regulation as possible options for compelling adherence to the ISDA Protocol and its contractual amendments.[50] However, MFA's understanding is that the FSB has already determined to have its members proceed only with prudential regulation, and is no longer contemplating engaging appropriate regulators to adopt market regulation. In addition, although there is discussion of possible statutory recognition frameworks, we know that the FSB, at present, is focused solely on the ISDA Protocol and related prudential regulations, and not on encouraging the adoption of such statutory frameworks.[51]

MFA appreciates the FSB's concerns and its need to assist the G-20 countries in their commitment to reduce systemic risk on a global basis. We also understand that the FSB believes that in determining how best to prevent the potentially disorderly insolvency of certain financial institutions it must strike a balance between protecting the financial system and protecting its market participants.[52] However, as discussed, MFA has substantial concerns that altering the cross-border effect of these waivers through the ISDA Protocol and prudential regulations will harm (rather than strengthen) the financial system.

MFA understands that, as national regulators, FSB members have an expansive, regulatory tool kit available to them to manage any systemic risk created by any financial institution subject to their regulatory authority (*e.g.*, imposition of capital, margin, risk management, and other requirements).[53] However, we are concerned that, by FSB members using those regulatory tools to require financial institutions that are subject to their regulation to cease trading with any market participant that has not agreed to waive its early termination rights, FSB members are indirectly and unilaterally regulating the financial markets and market participants. In particular, in the FSB Consultation, the FSB acknowledges the intended indirect application of its members' prudential regulation.

> "Many counterparties of prudentially regulated firms, such as asset managers and non-financial corporates, are not subject to prudential regulation. The options for reaching such entities by regulatory or other official action are thus reduced to indirect means through requirements on firms that are subject to prudential regulation (which might have the effect of inducing counterparties to such firms

[50] *See id*.

[51] *See id*. at 11, where the FSB explained that given that "very few jurisdictions currently have such frameworks in place" and "the time required to implement the necessary statutory changes, which are likely to be complex, the FSB agreed to develop contractual solutions" as an interim solution.

[52] As noted above, MFA does not believe that it is necessary to diminish investor protection in furtherance of reducing systemic risk.

[53] As discussed previously, in adopting regulations to manage those risks, regulatory authorities are required to engage in an open rulemaking process without which the impact of those regulations on the effective functioning of the capital markets and the impact on market participants, including corporations and end users, is not appropriately or completely considered.

> to adhere to contractual stay provisions in order to be able to trade with prudentially regulated firms)."[54]

As a result, the FSB's contemplated suspension of counterparties' early termination rights would impose restrictions on counterparties of certain financial institutions that would fundamentally alter the financial markets and have adverse effects on how the financial markets would function going forward. To the extent that legislators and other relevant governmental authorities have not given FSB members direct regulatory authority over such markets or counterparties, MFA believes that it is inappropriate for the FSB to assert such regulatory authority indirectly.[55]

In most (if not all) FSB member jurisdictions, laws enacted by policymakers in the relevant jurisdiction govern counterparties' exercise of their early termination rights.[56] To the extent that the FSB has concerns regarding the exercise of these rights during a financial institution's resolution or insolvency proceeding, MFA believes that it is more appropriate for the FSB to petition such policymakers to address such concerns by enacting legislation.

MFA appreciates that petitioning policymakers to enact legislation to achieve its goals is not a modest undertaking. However, we do not agree that it is appropriate to forego legislation due to concerns about the time required to implement such statutory changes,[57] even if the proponents believe that their objectives are noble. Although some people express frustration with the difficult and lengthy process of enacting legislation in any FSB member jurisdiction, these processes are often longstanding and intended to be difficult.[58] Because of the broad significance and applicability of issues typically addressed by legislation, the process to enact legislation in each FSB member jurisdiction is necessarily challenging to ensure that relevant policymakers have heard and carefully balanced all relevant policy considerations and that any law they enact has undergone a robust, open, and transparent legislative process. Therefore, MFA stresses that, if the FSB desires to change the application of SRRs and the U.S. Bankruptcy Code, it must do so by petitioning policymakers to make the necessary statutory changes.

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[54] Consultation at 13.

[55] It is a fundamental tenet of U.S. securities laws that, "you can't do indirectly what you can't do directly". MFA thinks that the same principal should apply in this setting, and we respectfully believe that the FSB should not seek to institute these changes indirectly (*i.e.*, through the prudential regulatory process).

[56] *See supra* note 39.

[57] *See supra* note 50.

[58] For example, in the U.S., the U.S. Constitution creates a system of government that is cumbersome by design, and thus, in our view, it is not sufficient to forego the U.S. legislative process because it is inconvenient for current circumstances. *See* The Federalist Papers, Federalist No. 62 (Feb. 26, 1788), available at: http://thomas.loc.gov/home/histdox/fed_62.html.

MFA thanks the FSB and its members for considering our views on the Consultation. We welcome the opportunity to discuss our views with you in greater detail. Please do not hesitate to contact Carlotta King or the undersigned at (202) 730-2600 with any questions the FSB, its members, or their respective staffs might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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