BETTER MARKETS

August 5, 2016

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, Docket No. R-15338, RIN No. 7100 AE-52

Dear Mr. Frierson:

Better Markets[1] appreciates the opportunity to comment on the above-captioned rule proposed ("Proposed Rule") by the Board of Governors of the Federal Reserve System ("Board"). The Proposed Rule limits the default rights of parties to non-cleared qualified financial contracts ("QFCs") that would otherwise be exempted from the Bankruptcy Code's automatic stay. The Proposed Rule limits these rights in a bankruptcy proceeding to the same extent that they would be under an orderly resolution proceeding initiated under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act and prohibiting QFC counterparties from exercising these default rights against an institution or an affiliate of an institution that has entered an orderly resolution proceeding under Title II. By limiting these default rights, the Proposed Rule improves the stability of the financial system and makes it possible to resolve large, systemically important financial institutions in an orderly fashion, without precipitating dangerous, destabilizing runs or requiring taxpayer-funded bailouts.

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

INTRODUCTION

Better Markets strongly supports the Board's Proposed Rule. As the last financial crisis demonstrated, the exemption that the counterparties to QFCs enjoy from the Bankruptcy Code's automatic stay profoundly destabilizes the financial system, allowing these counterparties to seize collateral, jumping ahead of other creditors and making it impossible to facilitate an orderly resolution of a failing firm under the Bankruptcy Code. As the Lehman bankruptcy shows, allowing the counterparties to QFCs to run on an insolvent institution needlessly destroys value for the other creditors of an institution, propagates systemic risk throughout the financial system, and all but guarantees that efforts to stabilize and reorganize or resolve the insolvent institution will fail.[2]

The Bankruptcy Code's efficacy in facilitating the orderly resolution of *any* company—whether an operating company or a financial firm—rests entirely on the automatic stay, which prevents creditors from immediately demanding payments, repudiating contracts, or seizing collateral.[3] In the same way that the Bankruptcy Code's automatic stay prevents creditors that have a security interest in a factory's machinery from seizing their collateral and destroying value for the other creditors and making it impossible for the factory to reorganize as a going concern,[4] the Bankruptcy Code's automatic stay should likewise prevent the creditors of the financial institution or its affiliates from seizing the collateral that secures a QFC.

Instead, the Bankruptcy Code was amended over time to exempt QFCs from the automatic stay in response to lobbying from the financial services industry.[5] Because the exemption for QFCs occurred gradually, regulators and legislators did not fully consider the systemic risk that that the exemption posed to financial stability or the impediment that the exemption posed to the reorganization of large financial institutions facing insolvency. In 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act expanded the exemption to allow creditors to immediately seize not only Treasury and GSE securities but also mortgage loans, mortgage-backed securities, and the collateral securing other kinds of derivatives. As the Financial Crisis Inquiry Commission has pointed out, the expansion of this exemption resulted in a "short-term repo market increasingly reliant on highly-rated

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2 *See, e.g.*, "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act," *FDIC Quarterly Review* (2011), *available at* https://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf; Mark J. Roe, "The Derivatives Market's Payment Priorities as a Financial Crisis Accelerator," 63 *Stanford Law Review* 539 (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1567075; Kenneth Ayotte and David A. Skeel, Jr., "Bankruptcy or Bailouts?" 35 *Journal of Corporation Law* 469 (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362639.

3 *See generally* Thomas H. Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain," 91 *Yale Law Journal* 857 (1982) and Douglas G. Baird, "Bankruptcy's Uncontested Axioms," *108 Yale Law Journal* 573 (1998).

4 Douglas Baird, "The Automatic Stay," in *The Elements of Bankruptcy* 191 (2014).

5 Steven L. Schwarcz and Ori Sharon, "The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis," 71 *Washington and Lee Law Review* (2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2351025.

non-agency mortgage-backed securities."[6] And the exemption for QFCs undermined the effectiveness of the Bankruptcy Code. As bankruptcy law professor Stephen Lubben explains,

> the exemptions [for QFCs] destroy "going concern" value, and prefer one set of creditors over another, in violation of the general rule of equity. Financing decisions are distorted by the exemptions, and then the very purpose of [the Bankruptcy Code] is thwarted when creditors don't have to incur costs associated with the communal system that [the Bankruptcy Code] entails. [The U.S. Bankruptcy Code] is admired the world over, yet these sorts of special provisions are slowly destroying it.[7]

The bankruptcy of Lehman Brothers highlighted the corrosive effects that the exemption for QFCs had on the Bankruptcy Code's ability to reorganize failing financial firms as well as the systemic risk that the exemption poses to the broader financial system. After Lehman filed for bankruptcy, its counterparties terminated their derivatives contracts with Lehman and seized the collateral that secured these contracts. Lehman's counterparties closed out their positions with Lehman in such a way that protected their interests and minimized their risks.[8] The exemption allowed counterparties to enrich themselves to the detriment of Lehman and Lehman's other creditors. And in the Lehman bankruptcy, the exemption also generated tremendous instability by allowing these counterparties and creditors to run while others could not.

COMMENTS ON THE PROPOSED RULE

Better Markets strongly supports the proposed rule.

For the reasons given above, Better Markets believes that Congress should amend the Bankruptcy Code to remove the exemption from the automatic stay that the parties to QFCs currently enjoy. Until Congress acts, however, the Board's Proposed Rule—similar to the 2015 Resolution Stay Protocol adopted by the International Swaps and Derivatives Association ("ISDA")—represents the most that can be done to address the systemic risks

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6 Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* 114 (2011).

7 Stephen J. Lubben, "A Consensus Begins to Emerge on Derivatives in Bankruptcy," *N.Y. Times Dealbook* (Apr. 27, 2012), *available at* http://dealbook.nytimes.com/2012/04/27/a-consensus-begins-to-emerge-on-derivatives-in-bankruptcy/. *See also* Stephen J. Lubben, "Repeal the Safe Harbors," 18 *American Bankruptcy Institute Law Review* (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1497040 *and* Stephen J. Lubben, "Derivatives and Bankruptcy: The Flawed Case for Special Treatment," 12 *University of Pennsylvania Journal of Business Law* 61 (2009), *available at* http://scholarship.law.upenn.edu/jbl/vol12/iss1/3/.

8 Matt Levine, "Banks Agree Not to Blow Each Other Up Too Quickly," *Bloomberg View* (Oct. 14, 2014), *available at* https://www.bloomberg.com/view/articles/2014-10-14/banks-agree-not-to-blow-each-other-up-too-quickly.

posed by this exemption.[9] As Fed Chair Janet Yellen pointed out, by allowing parties to QFCs to stampede for the exits, the exemption can precipitate a financial crisis that engulfs the entire financial system:

> [I]n the 21st century, a run on a failing banking organization may begin with the mass cancellation of the derivatives and repo contracts that govern the everyday course of financial transactions. When these contracts, known collectively as Qualified Financial Contracts or QFCs, unravel all at once at a failed large banking organization, an orderly resolution of the bank may become far more difficult, sparking asset firesales that may consume many firms.[10]

Unfortunately, it was not until Lehman Brothers collapsed and the global financial system crashed that market participants fully appreciated the risk that the exemption posed. While it would have been far better for Congress to assess this risk as it considered amendments to the Bankruptcy Code in 2005, the Proposed Rule will help protect the financial system, market participants, and the global financial system from another catastrophe resulting from counterparties seizing their collateral and running from an insolvent institution. At a minimum, the Proposed Rule is necessary to effectuate the kind of reorganization of a failing financial institution that has been envisaged under both the Bankruptcy Code and Title II of the Dodd-Frank Act.

The benefits of the Proposed Rule far outweigh its costs.

As noted above, the Bankruptcy Code's exemption for QFCs encouraged their proliferation throughout the financial system. Because the parties to these contracts believed that they could protect themselves from default by seizing collateral, they charged less than they otherwise would to enter into these contracts. In effect, the exemption subsidized the cost of the credit they extended to each other.

Although the Board was not legally obligated to conduct an exhaustive cost-benefit analysis,[11] in its proposal, the Board notes that the Proposed Rule "is intended to yield

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[9] The Proposed Rule builds on the ISDA Resolution Stay Protocol and allows financial institutions to comply with the Proposed Rule by adhering to the Protocol. While the ISDA action is a good first step, a mandatory rule promulgated by the Board is superior to a voluntary protocol.

[10] Chair Janet Yellen, "Opening Statement on the Proposed Rules Implementing a Net Stable Funding Ration and Restricting Qualified Financial Contracts" (May 3, 2016), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/yellen-opening-statement-20160503.htm.

[11] Congress has not imposed a general obligation on the Board to conduct cost-benefit analysis in the rulemaking process. The statutes conferring rulemaking authority on the Board, such as the Federal Reserve Act and the Bank Holding Company Act of 1956, "generally do not require economic analysis as part of the agency's rulemaking activities." *See, e.g.* Maeve P. Carey, Congressional Research Service Report for Congress "Cost-Benefit and Other Analysis Requirements in the Rulemaking Process" (Dec. 9, 2014), *available at* https://www.fas.org/sgp/crs/misc/R41974.pdf. As it developed the Proposed Rule, the Board was simply required to "consider" the "administrative burdens" and the "benefits" of the Rule under the Riegle Community Development and Regulatory Improvement Act, 12 U.S.C. § 4802(a).

substantial net benefits for the financial stability of the United States" and that "these benefits are expected to substantially outweigh the costs." Better Markets strongly agrees with this assessment. In the Lehman bankruptcy alone, the ability of counterparties to close out QFCs and seize collateral destroyed millions if not billions of dollars.[12] In addition to the immediate losses to Lehman's non-QFC counterparties and creditors caused by QFC counterparties closing out their QFCs and seizing collateral, the run that the exemption permitted made it impossible for Lehman's bankruptcy to be conducted in an orderly way.

Even if the assessment of benefits is limited solely to the avoidance of value destruction in the Lehman bankruptcy, the benefits of the Proposed Rule clearly outweigh its costs. But the Lehman bankruptcy was far more costly than the losses suffered by Lehman's non-QFC counterparties and creditors, and those costs were imposed far more widely than the universe of those who did business with Lehman Brothers. The Lehman bankruptcy set off the 2008 financial crisis, which devastated the global economy and resulted in the severest recession in the United States since the Great Depression. Better Markets has estimated the costs of the 2008 financial crisis in lost or avoided GDP at more than $20 trillion.[13]

To be sure, as the Board noted, the Proposed Rule may force financial institutions "to provide their QFC counterparties with better contractual terms in order to compensate those parties for the loss of their ability to exercise default rights that would be restricted" by the Proposed Rule. In other words, QFCs may become more expensive relative to other kinds of financial instruments if counterparties can no longer jump to the front of the line when an institution teeters into insolvency.

But that increase in cost is not a cost attributable to regulation; instead, that increased cost represents the removal of an implicit subsidy borne by non-QFC counterparties and creditors in the first instance, the broader financial system in the second, and ultimately by the government and taxpayers. As bankruptcy law professors David Skeel and Thomas Jackson have pointed out, the exemption that QFC counterparties currently enjoy is a subsidy; removing that exemption and preventing QFC counterparties from closing out their contracts and seizing collateral is "essential to reduce the credit subsidy for derivatives and

[12] *See, e.g.,* Thomas J. Fitzpatrick IV and James B. Thomson, "Lehman Brothers bankruptcy, what lessons can be drawn?" in *The New Palgrave Dictionary of Economics* (2012), *available at* http://www.dictionaryofeconomics.com/article?id=pde2012_L000244; Harvey R. Miller, Testimony before the House of Representatives Committee on the Judiciary Subcommittee on Commercial and Administrative Law, Hearings on "Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform" (Oct. 22, 2009), *available at* https://judiciary.house.gov/_files/hearings/pdf/Miller091022.pdf; Michael J. Fleming and Asanai Sarkar, "Where Was Value Destroyed in the Lehman Bankruptcy?" (2014).

[13] Better Markets, *The Cost of the Crisis: $20 Trillion and Counting* (2015), *available at* https://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

to facilitate the efficient disposition of the assets of the debtor."[14] Viewed from this perspective, the higher "cost" that the Proposed Rule may entail is not a cost at all; instead, the Proposed Rule simply requires that that the parties to these contracts internalize the costs of these contracts, rather than imposing them on others.

CONCLUSION

Better Markets strongly supports the Proposed Rule. The exemption for QFCs has made the financial system more fragile and also makes it difficult—if not impossible—to reorganize an insolvent institution under either the Bankruptcy Code or Title II of the Dodd-Frank Act. The Proposed Rule helps make the financial system more resilient, and it gives regulators and market participants additional time to facilitate a more orderly resolution of a failed financial institution without needlessly destroying value for non-QFC creditors or sparking a financial crisis. In addition, the Proposed Rule removes a subsidy that QFC counterparties enjoy at the expense of non-QFC creditors and counterparties, and forces QFC counterparties to internalize the costs of these arrangements.

We hope you find these comments helpful.

Sincerely,

Dennis M. Kelleher
President & CEO

Frank Medina
Senior Counsel, Director of Research

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
www.bettermarkets.com

[14] David A Skeel, Jr. and Thomas H. Jackson, "Transaction Consistency and the New Finance in Bankruptcy," 112 *Columbia Law Review* 154, 194 (2012), *available at* http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1345&context=faculty_scholarship.