April 7, 2015

Department of Treasury
Attn: Qualified Financial Contracts Recordkeeping Comments
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Qualified Financial Contracts Recordkeeping Related to Orderly Liquidation Authority; Proposed Rule (31 CFR Part 148) (RIN 1505-AC36)

Ladies and Gentlemen:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned notice of proposed rulemaking ("Proposed Rule") of the Secretary of the Treasury, as Chairperson of the Financial Stability Oversight Council ("FSOC").

INTRODUCTION AND SUMMARY OF COMMENTS

The qualified financial contract ("QFC") recordkeeping regulation is a key rulemaking focused on ending too-big-too-fail and mitigating the risk of multiple financial institution failures. Congress created a special category of QFCs in the Federal Deposit Insurance Act.[2] Those contracts are not subject to traditional Bankruptcy Code rules that apply to all other contracts. The exemptions for QFCs from the traditional process also apply in the context of an FDIC orderly liquidation proceeding. As a result, the FDIC faces legal and technological challenges in conducting the orderly recovery and resolution of financial institutions with significant QFC holdings, since some of the creditors are not subject to the usual bankruptcy rules.

The QFC recordkeeping rule is the only tool at the FDIC's disposal for determining and analyzing the direct counterparty impact and the systemic impact of the recovery and resolution actions that it undertakes under the OLA regime as those actions relate to QFCs. A good QFC recordkeeping rule must have a solid data and technology foundation, a broad scope and scale of application, and near real-time operability to enable the FDIC to conduct effective recovery and resolution of financial institutions without causing wide-spread and unintended financial contagion.

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[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking processes associated with domestic and international financial reform.

[2] 60 FR 66865, Dec. 27, 1995, as amended at 78 FR 55595, Sept. 10, 2013.

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

Section 210(c)(8)(H) of the Dodd-Frank Act ("Act") required the Federal financial regulatory agencies (Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Securities and Exchange Commission, Commodity Futures Trading Commission, Federal Housing Financial Agency) to issue a joint final or interim final QFC regulation not later than 24 months after the date of enactment of the Act (July 21, 2010). The Act further provided that if those primary financial regulatory agencies failed to prescribe such QFC requirements, the Chairperson of the FSOC would have back-up rulemaking authority.

Accordingly, in the absence of a timely joint final or interim final rule, on January 7, 2015, the Secretary of the Treasury, as Chairperson of the Financial Stability Oversight Council, released the Proposed Rule regarding QFC recordkeeping related to orderly liquidation authority.

As noted above, because Congress failed to eliminate the early termination rights for QFCs, the QFC recordkeeping regulation is a key component of an effective regime for orderly resolution and recovery of financial institutions. Legislative elimination of early termination rights is the only long-term solution to the problem of QFCs front-running all other creditors. Although the Act did not go so far, it at least provided a tool for a marginal solution to the QFC problem that largely depends on effective QFC recordkeeping.

As Davis Polk notes, under the Orderly Liquidation Authority of the FDIC, *ipso facto* close-out of QFCs are suspended for a 1-business day period to allow FDIC selection of contracts to transfer to bridge or third parties. "During 1-business day stay, the FDIC has the option to preserve and transfer all QFCs with a particular counterparty and its affiliates to a single third-party financial institution or bridge (importantly, no contract-by-contract cherry-picking is permitted)."[3] Practically speaking, this means that because a stay lasts only 1-day, FDIC needs to have accurate, current, and immediately available information that can be aggregated and segmented in real time to be able to make appropriate decisions about the treatment of the QFCs. Moreover, FDIC must have the complete set of relationship data of QFC counterparties to determine and analyze any cross-default and other cross-entity provisions.

Unfortunately, the Proposed Rule contains a number of critical weaknesses that make QFC recordkeeping ineffective and counterproductive. Unless strengthened, the Proposed Rule would undermine the FDIC's goal of orderly recovery and resolution. The key shortcomings of the Proposed Rule are:

1. <u>The scope of entities subject to the requirements of the Proposed Rule is too narrow and arbitrary, in conflict with the Ac</u>t. The Proposed Rule introduces the concept of "record entities" that is not present in the Act. The resulting patchy and fragmented application of QFC recordkeeping means that the information available to the FDIC will be incomplete and potentially erroneous. The Proposed

[3] David Polk, *A creditor's Guide to the FDIC's Orderly Liquidation Authority* (November 30, 2011), page 19.

Rule should adhere to the requirements outlined in the Act and prescribe the QFC recordkeeping requirements as stated in Section 210(c)(8)(H) of the Act.

2. The Proposed Rule includes exemptions that should not be permitted, at least until FDIC has full access to swap data more generally. The lack of FDIC direct and real-time access to the Swap Data Repositories ("SDRs") is a fundamental impediment to the implementation of resolution authority. The Proposed Rule must eliminate any exemptions from any QFC recordkeeping requirements by financial companies at least until the FDIC has unfettered and real-time access to SDRs under CFTC and SEC jurisdiction. Only then can possible exemptions be developed.

3. The Proposed Rule mistakenly treats position (portfolio) level data and transaction level data as substitutes, when in fact they complement each other. SDR data does not contain collateral data and as such represents only the gross derivatives positions. Those positions will be different from the data accumulated on a position (portfolio) level under a Credit Support Annex or similar document of the type that reflects netting provisions and collateral data. Those two types of reporting should not be confused as substitutes because they represent different information. SDR data alone will not enable the FDIC to evaluate the proper treatment of QFCs in the OLA process; position level data is also critical.

4. The Proposed Rule would not capture critical relationship data relating to QFC counterparties. The lack of such data would not allow FDIC to assess cross-default provisions in QFCs. Moreover, the Proposed Rule adopts an outdated and irrelevant concept of control. The Proposed Rule should develop and adopt a flexible system of relationship representations by, first, defining the type of relationships that are relevant for QFC recordkeeping and, second, establishing a recordkeeping framework to reflect those relationships.

5. The Proposed Rule includes an unacceptable foreign subsidiary loophole. Lehman Brothers' failure and the JPMorgan London whale debacle demonstrated that international companies have a global presence and a global flow of exposures. Yet, the Proposed Rule exempts foreign affiliates of U.S. companies from the QFC recordkeeping requirements. The Proposed Rule states that "a U.K.-incorporated London affiliate of a U.S. broker-dealer would not be a records entity because it is a separate legal entity that is not incorporated or organized within the United States."[4] In light of the single-point of entry mechanism and the development of total loss absorbing capacity requirements at the holding company level, such an exclusion conflicts with the policy of cross-border coordination of recovery and resolution activities.

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[4] Proposed Rule, page 973.

BACKGROUND

Section 210(c)(8)(H) of the Dodd-Frank Act ("Act") prescribes the recordkeeping requirements for QFCs. In particular, Section 210(c)(8)(H) states:

> "(i) Joint rulemaking.—The Federal primary financial regulatory agencies shall jointly prescribe regulations requiring that financial companies maintain such records with respect to qualified financial contracts (including market valuations) that the Federal primary financial regulatory agencies determine to be necessary or appropriate in order to assist the Corporation as receiver for a covered financial company in being able to exercise its rights and fulfill its obligations under this paragraph or paragraph (9) or (10).
> (ii) Time frame.—The Federal primary financial regulatory agencies shall prescribe joint final or interim final regulations not later than 24 months after the date of enactment of this Act.
> (iii) Back-up rulemaking authority.—If the Federal primary financial regulatory agencies do not prescribe joint final or interim final regulations within the time frame in clause (ii), the Chairperson of the Council shall prescribe, in consultation with the Corporation, the regulations required by clause (i).
> (iv) Categorization and tiering.—The joint regulations prescribed under clause (i) shall, as appropriate, differentiate among financial companies by taking into consideration their size, risk, complexity, leverage, frequency and dollar amount of qualified financial contracts, interconnectedness to the financial system, and any other factors deemed appropriate."

The general concept of QFC emerged in 1982 when a so-called safe-harbor treatment was added to the Bankruptcy Code for forward contracts, commodity contacts, and securities contracts.[5] James Sprayregen and Stephen Hessler of Kirkland & Ellis explain:

> "The Bankruptcy Code currently provides that counterparties to qualified financial contracts (such as repurchase or swap agreements) are not subject to the automatic stay imposed by section 362 that otherwise bars conventional contract counterparties from relying on an *ipso facto* clause in an agreement to terminate the contract and exercise rights to enforce any security interests in the debtor's collateral. Put simply, when a debtor files for bankruptcy, most contract counterparties are stayed from terminating their agreement with the

[5] GAO, *Financial company bankruptcies. Need to further consider proposal impact on systemic risk* (July 2013) defines those financial products. "In general, a commodity contract is a contract between two parties where the commodities buyer agrees to purchase from the commodities seller a fixed quantity of a commodity at a fixed price on a fixed date in the future. A "forward contract" is a contract for the purchase, sale, or transfer of a commodity with a maturity date more than two days after the contract is entered into. A securities contract generally refers to a contract defining a financial agreement between counterparties. A securities contract includes contracts for the purchase and sale of various financial products such as a group or index of securities, mortgage loans, certificates of deposit, and extensions of credit for settlement purposes."

debtor and/or engaging in self-help remedies against estate assets, but these pro-debtor protections do not apply to qualified financial contract counterparties. As a result, a bankruptcy filing by a financial company with significant qualified financial contracts may be marked by chaos at the outset as counterparties, unimpeded by the automatic stay, proceed to determine and enforce their rights in the debtor's assets."[6]

The GAO report, "Financial company bankruptcies: Need to further consider proposals impact on systemic risk," notes that at a later stage:

"[t]he Code's definition of repurchase agreements was expanded (in 2005) to include, among other things, agreements for the transfer of mortgage related securities, mortgage loans, interests in mortgage-related securities or mortgage loans, and governmental securities issued by countries that are members of the Organization of Economic Cooperation and Development, thereby expanding the scope of contract subject to the safe-harbor treatment."[7]

The rationale for this safe harbor covering QFCs has been explained as follows, by Sprayregen and Hessler:

"The exemption from the automatic stay for qualified financial contracts was the subsequent result of the successful lobbying efforts of the financial community, not a distinction based upon sound bankruptcy policy, and the result exemplifies the law of unintended consequences. Put simply, the management of distressed financial companies with major qualified financial contract positions are not incentivized to seek bankruptcy protection early enough in the restructuring process, before so much value has been eroded that multiple reorganization options may be foreclosed. This state of affairs is caused by the understanding that proceeding to file for chapter 11 protection will not prevent a "run on the bank", as qualified financial contract counterparties retain their full termination rights after the petition date. This may not only doom the going-concern prospect of the debtor; it also may require a Federal government bailout. This was case with AIG, whose qualified financial contract positions were so sizable and interconnected to other major international financial institutions, that a possible bankruptcy filing, followed by a complete inability of AIG to stay the unwinding of

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[6] James Sprayregen and Stephen Hessler*, Too much discretion to succeed: why a modified bankruptcy code is preferable to title II of the Dodd-Frank Act, Submission in response to Federal Reserve Request for information relating to Dodd-Frank Act Section 216 study regarding the resolution of financial companies under the Bankruptcy Code*, page 16.

[7] GAO, *Financial companies bankruptcies. Need to further consider proposal impact on systemic risk* (July 2013), page 10.

> counterparties' contracts, severely limited the protections typically afforded by commencing a Chapter 11 case."[8]

The Federal Reserve study on "The Resolution of Financial Companies under the Bankruptcy Code" further outlined the negative impact of the QFC safe harbor on incentives and market discipline:

> "[t]he exemption from the automatic stay and trustee avoiding powers change the incentives for QFC counterparties to monitor the debtor prior to bankruptcy. Since QFC counterparties know that they can take action against the debtor on their QFC-related claims at a time when non-QFC creditor claims are stayed, QFC counterparties are likely to reduce their level of monitoring and are less likely to fully price changes in the risk of the debtor."[9]

In light of these and other shortcomings in the two traditional approaches of dealing with failing large nonbank financial companies (bankruptcy and bailout), the Act introduced a third approach – Orderly Liquidation Authority ("OLA"). Richmand Fed notes that "[this] legislation authorizes the Federal Deposit Insurance Corporation to pursue an agency-administered wind down for certain troubled financial firms."[10] "The goal of the OLA . . . is to resolve "failing financial companies that pose a significant risk to the financial stability of the U.S. in a manner that mitigates such risk and minimizes moral hazard."[11] OLA permits the FDIC to use resolution authority for non-bank financial institutions instead of the Bankruptcy Code, if the Treasury Secretary makes a certain financial distress and systemic risk determination. However, aspects of the bankruptcy regime – including preferential treatment of QFCs – remain embedded in the new OLA mechanism.

COMMENTS

The Proposed Rule should abandon the narrow and arbitrary concept of "record entity" and track the statutory requirements when defining its scope.

The Proposed Rule creates a narrow and arbitrary universe of entities subject to its requirements. The Proposed Rule introduces the concept of "record entities" that is not present in the Act. The result is a patchy and fragmented regime for QFC recordkeeping, in which the information available to the FDIC will be incomplete and potentially erroneous. The Proposed Rule should adhere to the requirements outlined in the Act and apply the QFC recordkeeping requirements to financial companies as stated in Section 210(c)(8)(H) of the Act.

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[8] James Sprayregen and Stephen Hessler, *Too much discretion to succeed: why a modified bankruptcy code is preferable to title II of the Dodd-Frank Act, Submission in response to Federal Reserve Request for information relating to Dodd-Frank Act Section 216 study regarding the resolution of financial companies under the Bankruptcy Code*, page 20.

[9] Federal Reserve Board, *Study on the Resolution of Financial Companies under the Bankruptcy Code* (July 2011), page 16.

[10] Sabrina Pellerin, John Walter *Orderly Liquidation Authority as an Alternative to Bankruptcy* (2012) page 1.

[11] Sabrina Pellerin, John Walter *Orderly Liquidation Authority as an Alternative to Bankruptcy* (2012) page 5.

Section 210(c)(8)(H) of the Act explicitly states that "[t]he Federal primary financial regulatory agencies shall jointly prescribe regulations requiring that financial companies maintain such records with respect to qualified financial contracts (including market valuations)."[12] Moreover, the Act states that "The joint regulations . . . shall, as appropriate, differentiate among financial companies by taking into consideration their size, risk, complexity, leverage, frequency and dollar amount of qualified financial contracts, interconnectedness to the financial system, and any other factors deemed appropriate."[13]

12 USC 5381 defines a financial company that should be subject to the QFC recordkeeping rule to be any company that:

> "(A) is incorporated or organized under any provision of Federal law or the laws of any State;
> (B) is—
> > (i) a bank holding company, as defined in section 1841 (a) of this title;
> > (ii) a nonbank financial company supervised by the Board of Governors;
> > (iii) any company that is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 1843 (k) of this title other than a company described in clause (i) or (ii); or
> > (iv) any subsidiary of any company described in any of clauses (i) through (iii) that is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 1843 (k) of this title (other than a subsidiary that is an insured depository institution or an insurance company); and
>
> (C) is not a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 et seq.), a governmental entity, or a regulated entity, as defined under section 4502 (20) of this title."[14]

However, the Proposed Rule offers a much narrower definition of the entities subject to the QFC recordkeeping. In particular, it defines a "record entity" to be an entity that:

> "(i) Is not an exempt entity;
> (ii) Is a party to an open QFC or guarantees, supports or is linked to an open QFC; and
> (iii) (A) Has been determined pursuant to 12 U.S.C. 5323 to be an entity that could pose a threat to the financial stability of the United States;

[12] Dodd Frank Act, Section 210(c)(8)(H).
[13] Dodd Frank Act, Section 210(c)(8)(H).
[14] 12 USC 5381.

(B) Has been designated pursuant to 12 U.S.C. 5463 as a financial market utility that is, or is likely to become, systemically important;
(C) Has total assets equal to or greater than $50 billion; or
(D) Is:
(1) A party to an open QFC or guarantees, supports or is linked to an open QFC of an affiliate; and
(2) A member of a corporate group in which at least one financial company meets the criteria under paragraphs (1)(iii)(A), (B), or (C) of this definition."[15]

In turn, the Proposed Rule also introduces a new definition of exempt entity, which is:

"(1) An insured depository institution as defined in 12 U.S.C. 1813(c)(2);
(2) A subsidiary of an insured depository institution that is not a functionally regulated subsidiary as defined in 12 U.S.C. 1844(c)(5), a security-based swap dealer as defined in 15 U.S.C. 78c(a)(71) or a major security-based swap participant as defined in 15 U.S.C. 78c(a)(67); or
(3) A financial company that is not a party to a QFC and controls only exempt entities as defined in paragraphs (1) and (2) of this definition."[16]

The fundamental problem with the suggested scope of the Proposed Rule is its circularity. Effectively, the Proposed Rule establishes a circular requirement where a party will be subject to QFC recordkeeping if FDIC determines certain contracts are QFC, but the FDIC cannot determine which contracts are QFC unless it has data under a QFC recordkeeping requirement to analyze the contagion risk of a particular contract. Because FDIC will not have information on who is holding a particular contract and whether such an instrument is a QFC, the authorities will only discover the existence of those instruments when another financial crisis strikes. The Proposed Rule's QFC definition states:

"any qualified financial contract defined in 12 U.S.C. 5390(c)(8)(D), including without limitation, any "swap" defined in section 1a(47) of the Commodities Exchange Act (7 U.S.C. 1a(47)) and in any rules or regulations issued by the Commodity Futures Trading Commission (CFTC) pursuant to such section; any "security-based swap" defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) and in any rules or regulations issued by the Securities and Exchange Commission (SEC) pursuant to such section; and any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the FDIC determines by regulation, resolution, or order to be a qualified financial contract as provided in 12 U.S.C. 5390(c)(8)(D)."

[15] Proposed Rule, page 997.
[16] Proposed Rule, page 996.

The Proposed Rule also raises practical challenges. For a financial entity to be in compliance with the Proposed Rule, a financial entity will be required to constantly assess and monitor its financial contracts, the financial contracts of its parent company and its subsidiaries, and any changes in the contractual relationships with its counterparties to determine whether they are a "record entity" or not. Moreover, they will be required to monitor any FDIC determinations by regulations, resolution, or order to determine whether any of their contracts would qualify as a QFC.

In addition to the definitional challenges that the Proposed Rule raises by introducing its narrow scope of coverage for "record entities," the approach is at odds with current market practices for determining who should be subject to the QFC regime, as exemplified by the ISDA Master Agreement and Resolution Stay Protocol. ISDA notes that:

> "Title II of the Dodd-Frank Act establishes OLA, which imposes stay and override of direct-default and cross-default rights in the event of a resolution. The European Union Bank Recovery and Resolution Directive ("BRRD") does something similar.
>
> However, an issues arises with respect to cross-border trades, where a certain national resolution regime may not be recognized in a foreign jurisdiction by a foreign court. For instance, a UK bank holding company enters into resolution, and its US subsidiary has outstanding derivatives trades in place with a U.S. counterparty under New York law. The stay and overrides under BBRD may not be recognized under New York law in a New York court, potentially enabling the US counterparty to exercise cross-default clauses and terminate the outstanding trades with the subsidiary."[17]

When addressing the U.S. insolvency proceeding provisions, the ISDA is explicit that:

> "[t]he Section 2 US insolvency proceeding provisions [of the ISDA Resolution Stay Protocol] will become effective as to all adherents, whenever they adhere, only on the date the related US regulations become effective and compliance therewith is required."[18]

That means that until U.S. regulators implement the regulation on U.S. insolvency proceedings, counterparties of certain banking groups are not required to give up "certain cross-default and direct-default rights arising when an affiliate (including a parent) becomes subject to proceedings under "ordinary" U.S. insolvency regimes."

The Proposed Rule effectively would only apply the QFC recordkeeping requirement to systemically important financial institution headquarter companies. As a result, a majority of financial institutions will not record data on QFC on their books. Moreover, foreign subsidiaries and many special purpose vehicles of financial institutions will not

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[17] ISDA 2014 resolution stay protocol, list of frequently ask questions.
[18] ISDA 2014 resolution stay protocol, list of frequently ask questions.

maintain this data as well. That raises a question of how the FDIC is expected to be able to undertake orderly liquidation activities within 24 hours when it has no information about a company's cross-default and direct-default conditions and the status of foreign affiliate QFC holdings.

The Proposed Rule must eliminate any exemptions from QFC recordkeeping requirements by financial companies until the FDIC has unfettered and real-time access to SDRs under CFTC and SEC jurisdiction.

The Proposed Rule includes exemptions from the QFC recordkeeping requirements for financial companies that "maintain electronic records maintained in a swap data repository or internally in a different format."[19]These exemptions are based in part on the notion that such reporting is unnecessary in light of FDIC access to SDR data. However, that access is not unfettered, and the exemption is unwarranted.

At a December 3, 2014 speech at the Brooking Institution, Governor Brainard noted one of the challenges the Federal Reserve Board faces is the lack of regulatory data-sharing. Governor Brainard noted that data-sharing initiatives are "taking some time" and emphasized the "legal impediments" to sharing certain information between regulatory agencies. In particular, she noted the "legal impediments to sharing some information that we've encountered with some of the market regulators."[20] One of the legal impediments related to swap data is lack of data access to swap data repositories ("SDRs"). Nevertheless, the Proposed Rule relies on SDR data access as a justification for exempting certain financial entities from the QFC recordkeeping requirements.

In March 2012, Dan Berkovitz, then General Counsel of the Commodity Futures Trading Commission ("CFTC"), testified to the Congress on the nature of the SDR data access and sharing limitations:

> "The Commodity Exchange Act (CEA), as amended by the Dodd-Frank Act, contains three provisions concerning indemnification and the sharing of confidential data with regulators. The first two are found in CEA Section 21. Section 21(c)(7) requires registered swap data repositories ("SDRs"), upon request and after notifying the Commission, to make available, on a confidential basis under CEA Section 8, all data obtained by the SDR, including individual trade and position data, to each appropriate prudential regulator, the Financial Stability Oversight Council ("FSOC"), the Securities and Exchange Commission ("SEC"), the Department of Justice ("DOJ"), and any other person that the Commission determines to be appropriate, including foreign financial supervisors (including foreign futures authorities), foreign central banks, and foreign ministries. CEA Section 8 prohibits the Commission from releasing information that would disclose the business transactions or market positions

[19] Proposed Rule, page 979.

[20] Financial Stability: A Conversation with Lael Brainard, the Brookings Institution (December 3, 2014), page 30.

> of any person, trade secrets or names of customers, or information concerning any pending investigation of any person. Section 221(d) requires receipt by the SDR of a written agreement on confidentiality and indemnification before any data may be shared.
>
> CEA Section 5b contains the third provision. Under Section 5b(k)(5), the CFTC may share information on cleared swaps that it has collected from Derivatives Clearing Organizations ("DCOs") with each appropriate prudential regulator, the SEC, the FSOC, the DOJ, and any other person that the CFTC determines to be appropriate, including foreign financial supervisors (including foreign futures authorities), foreign central banks, and foreign ministries. Such sharing is contingent upon receipt of a written agreement to comply with the confidentiality requirements of CEA Section 8 and an agreement to indemnify the CFTC for any expenses arising from litigation related to the information provided under Section 8. This restriction does not affect a DCO's ability to share information."[21]

When determining who the Appropriate Domestic Regulators are, the CFTC does not explicitly include FDIC as such an agency. Dan Berkovitz clarifies:

> "With respect to Appropriate Domestic Regulators, the final rule provides that this term includes the SEC, the Financial Stability Oversight Council, the Department of Justice, any Federal Reserve Bank, the Office of Financial Research, and any prudential regulator with respect to requests related to any such regulator's authorities."[22]

The FDIC's lack of direct and unconstrained access to SDR data for information on QFCs and their holders means that within one business day, the FDIC will not only be required to analyze the QFC data to decide whether to transfer or retain QFC positions, but also to navigate an administrative and bureaucratic process with the CFTC, FSOC, OFR, and others to be able to access the information it needs to conduct that analysis. And the law gives the FDIC just 24 hours to complete all of those activities.

This means that in addition to the questionable legislative exemption given to QFC counterparties to front-run other creditors in the event of an institution failure, the Proposed Rule also limits the ability of the FDIC to quickly gather the data it needs to at least mitigate the impact of this preferential treatment.

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[21] Dan M. Berkovitz, *Testimony before the subcommittee on capital markets and government sponsored enterprises, Committee on Financial Services, United States House of Representatives* (March 21, 2012), page 1.

[22] Dan M. Berkovitz, *Testimony before the subcommittee on capital markets and government sponsored enterprises, Committee on Financial Services, United States House of Representatives* (March 21, 2012), page 3.

The Proposed Rule must eliminate any exemptions from any QFC recordkeeping requirements by financial companies until the FDIC has unfettered and real-time access to SDRs under CFTC and SEC jurisdiction.

Although access to SDR transaction data is important, it is not a substitute for position data in connection with the FDIC's OLA activities.

The Proposed Rule includes an exemption from QFC recordkeeping requirements where sufficient SDR data is available. As argued above, such an exemption is unwarranted, since the FDIC does not actually have full, unfettered access to SDR data. The exemption is unwarranted for an additional reason: The Proposed Rule erroneously assumes that SDR is sufficient for purposes of assessing QFC exposures. In fact, the FDIC also requires position level data. Thus, the Proposed Rule confuses position (or portfolio) level data with transaction level data and mistakenly treats them as substitutes.

The CPSS-IOSCO "Report on OTC derivatives data reporting and aggregation requirements" explains the different uses for transaction and position level data:

> "For the purpose of systemic risk assessment, access to accurate position information is generally more important than transaction information, because any one transaction or a series of transactions that are quickly offset is unlikely to have systemic importance. Transactions may be defined as discrete economic relations between two counterparties that can be defined by a single contract. Positions are constructed from a set of one or more transactions attributed to the unique combination of a party and product. In order to have an accurate view of the positions of a party, authorities would need to have access to all transaction data attributable to the party that correspond to transactions open at the time the position is derived. Exposure refers to the replacement value of a transaction or, depending on context, the replacement value of a position or set of positions attributed to a party or group of parties."[23]

The CPSS-IOSCO report also explains why the transaction level data that is being collected in the U.S. by SDRs under the Act is not only inappropriate for conducting resolution activities but also could be adverse for resolution parties:

> "Resolution is required in the event of a counterparty failure. Such failures, by and large, can have an adverse impact on clearing or settlement activity and may have a destabilizing impact on the financial system. Authorities, depending on their respective legal framework, may need to obtain access to and monitor appropriate data to facilitate resolution activities.

[23] CPSS-IOSCO *Repot on OTC derivatives data reporting and aggregation requirements* (January 2012), page 24.

> Carrying out resolution involves ascertaining the obligations of the defaulting entity towards different counterparties and thereafter settling the claims of those counterparties with disposable collateral using a transparent and non-discriminatory set of rules. To that end, authorities need to identify all the trades of the defaulting entity, identify all the counterparties to the above-mentioned trades with the help of counterparty information, and have information on bilateral netting agreements, transaction economics, etc., to determine counterparty exposure. Further, information on collateralization and on collateral itself is required.
>
> Besides the quantitative data requirements, facilitation of resolution activities would require information about collateral support agreements among stakeholders to amicably settle multiple claims on collateral at the time of resolution. Even with such information, certain issues are bound to be encountered while carrying out resolution activities. As collateral would generally be on a portfolio basis and not transaction-specific, liquidation of the same for carrying out resolution activity related to a transaction increases the risk component of other positions in the portfolio and may even have an adverse impact on their market prices."[24]

Consequently, the exemption from QFC recordkeeping requirements in reliance on SDR data is inappropriate not only because of the legal obstacles to data access, but also because the SDR transactional data is not adequate for recovery and resolution purposes. The Proposed Rule must eliminate any exemptions from any QFC recordkeeping requirements by financial companies based on access to SDR data.

<u>The Proposed Rule lacks the critical element of the QFC recordkeeping – relationship data of QFC counterparties. Moreover, the Proposed Rule adopts an outdated and irrelevant concept of control for purposes of relationship data. The rule should develop and adopt a flexible system of relationship representation by, first, defining the type of relationships that are relevant for QFC recordkeeping and, secondly, establish a recordkeeping framework to reflect those relationships.</u>

Appropriate relationship data relating to QFC counterparties is an essential tool that the FDIC must have at its disposal to properly exercise its OLA authority.

> "Understanding the complex and dynamic web of relationships within the financial sector poses multiple challenges to authorities responsible for various public policy goals. Interests differ according to the regulatory objectives. Prudential authorities are primarily focused on the safety and soundness of individual firms and place particular attention to the ability of risk managers to pull together a comprehensive picture of the risks faced by financial institutions and to manage these risks effectively within and across

[24] CPSS-IOSCO *Repot on OTC derivatives data reporting and aggregation requirements* (January 2012), page 11.

> the institution as a whole. Market supervisors focus on the integrity of markets and on the relationships between market participants, to avoid collusion and cartels and the manipulation of prices and conditions. Resolution authorities support the introduction and implementation of practical recovery and resolution plans for financial firms that often have complex internal organizational structures and interconnections with other institutions. And more broadly, financial stability authorities have responsibility to ensure the safety and soundness of the financial system as a whole, and thus focus on the identification and containment of system-wide risks and on the robustness and resilience of the financial network in the event of major adverse shocks such as a severe market disturbance, sharp macroeconomic downturn or the failure of a major firm. To accomplish those various objectives, financial authorities have consequently introduced a number of approaches to relationship data."[25]

Thus, financial regulators use relationship data for different purposes. As noted above, in case of the OLA, the FDIC may need to know majority and minority ownership relationships, guarantees, branch linkages, default liabilities, and collateral rights and liabilities, among many other counterparty relationships. The common starting point for relationship data, however, is the concept of control and ownership.

Concepts such as ownership and control will vary, depending upon the particular way a regulator is applying relationship data. For example, while some regulators view relationship data primarily as a tool for data aggregation, others consider it as a financial network tracing mechanism. That explains why some regulators define control as having as much as 50% of the voting stock of an entity, whereas other regulators set the benchmark at 25% or even lower. Other regulators focus on indirect control and indirect exposures rather than on ownership.

However, in this case, instead of adopting a control definition that serves the unique purposes of orderly liquation, the Proposed Rule adopts an outdated and inappropriate definition of control for recovery and resolution purposes. Borrowed from the Bank Holding Company Act, it defines control to mean a 25% voting right or control of the election of a majority of directors and trustees. These may be important initial considerations, but they do not capture the complexity of prevailing corporate models and business organizations. Consequently, the definition of control is inadequate for rapid and effective FDIC recovery efforts.

> "Intra-group linkages and structures are particularly important in developing effective recovery and resolution plans. For example, can firms and resolution authorities clearly identify any 'core functions' or services provided by a particular firm within the financial system that should ideally be preserved under resolution? Can particular parts of the firm be readily sold or

[25] Irina Leonova and Nigel Jenkinson *Relationship data: the missing link of the current financial infrastructure* (August 29, 2014), page 5.

> alternatively closed down? Do legal and contractual relationships within firms (such as intra-group guarantees and cross-default clauses) support or inhibit the separation of particular functions or legal entities (also bearing in mind informal links such as reputational risks)? Do information systems provide sufficient, high quality, timely, information in a flexible manner to support crisis planning and resolution? As set out in the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, can firms undertake a mapping of essential functions and systemically important functions and corporate structures? And do information systems enable the firm to construct a complete and accurate view of its aggregate risk profile under rapidly changing conditions including the provision of essential information on intra-group inter-linkages?"[26]

The concept of control used in the final rule should leverage the approach developed in the Joint Forum principles for the supervision of financial conglomerates.[27] The Joint Forum principles place particular importance on taking account not only of companies but also of unregulated parent companies, subsidiaries, and special purpose entities. In the assessment of risks from unregulated entities, moreover, the principles also set out the importance of taking a wide view of the following characteristics, and their influence on the regulated sector: (direct or indirect) participation, influence and/or other contractual obligations; interconnectedness; risk exposure; risk concentration; risk transfer; risk management; intra-group transactions and exposures; strategic risk; and reputational risk. Many of these elements highlight different facets of risk relationships within large complex financial firms.

The Proposed Rule should also incorporate the advances made in the field of reporting for accounting purposes, to capture the control relationship. "US [Generally Accepted Accounting Principles] ("GAAP") provides two approaches to evaluate control: the variable interest mode and the voting model. The variable interest model evaluates control based on a determination of which party has power and benefits. The voting model evaluates control based on existing voting rights."[28] While US GAAP control would normally be based on the majority ownership of voting shares, "over years, Financial Accounting Standards Board ("FASB") has been trying to move toward an accounting consolidation requirement utilizing 'effective' control, defined as an ability to direct the policies of another entity even through majority ownership could be lacking."

To achieve that goal, FASB introduced a so-called VIE rule, where 'variable interest entity' (VIE) and 'special purpose entities' (SPV) are reviewed to capture investment relationships in which a controlling financial interest is not indicated by voting rights, but is indicated by a residual interest in risks and benefits. Inclusion of this accounting control test in addition to the three control elements outlined in the Bank Holding Company act will help

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[26] Irina Leonova and Nigel Jenkinson *Relationship data: the missing link of the current financial infrastructure* (August 29, 2014), page 7.
[27] Joint Forum *Principles for the supervision of financial conglomerates* (September 24, 2012).
[28] Ernst & Young *US GAAP versus IFRS* (November 2013).

ensure that the Proposed Rule reflects the evolution of corporate structures and also fulfills the spirit of international agreements on conglomerates treatment.

Consequently, the Proposed Rule should develop and adopt a flexible system of relationship representation by, first, defining the type of relationships that are relevant for QFC recordkeeping purposes, and, second, establishing a recordkeeping framework to reflect those relationships. The concept of control, as one type of relevant financial relationship, should be revised to reflect the developments in accounting and risk management discipline. The work on identification of relationships that are relevant for the FDIC orderly liquidation authority should be undertaken by resolution and recovery experts and the frameworks for collection of that relationship data should be the part of the QFC recordkeeping rule.

The foreign subsidiary loophole in the Proposed Rule should be completely eliminated. All foreign subsidiaries of U.S. financial companies must be subject to QFC recordkeeping requirements.

The Proposed Rule states that "[because] the Proposed Rules would incorporate the Title II definition of "financial company," the Proposed Rule would apply only to entities incorporated or organized in the United States that are considered record entities under the Proposed Rule. For example, a U.K.-incorporated London affiliate of a U.S. broker-dealer would not be a record entity that is not incorporated or organized within the United States."[29] This exemption from the QFC recordkeeping rule presents at least three problems as evidenced by past experience and current regulatory initiatives:

1. The exemption ignores the implications of cross-border resolution and recovery activities, as evidenced by the Lehman Brothers failure;

2. The exemption ignores the potential impact of foreign affiliate activity on U.S. operations, as evidenced by the JPMorgan London whale event;

3. The exemption ignores the implementation of the FDIC single-point of entry agenda for conducting orderly recovery and resolution activities.

Eric Rosengren, President and CEO of the Federal Reserve Bank of Boston, noted in his speech "Challenges in Resolving Systemically Important Financial Institutions":

> "Lehman Brothers operated in over 40 countries and had over 650 distinct legal operating entities outside of the United States. While there were many separate legal entities outside of the Unites States, the firm was managed globally – meaning many of its risk management and operating platforms stretched across its many distinct entities."[30]

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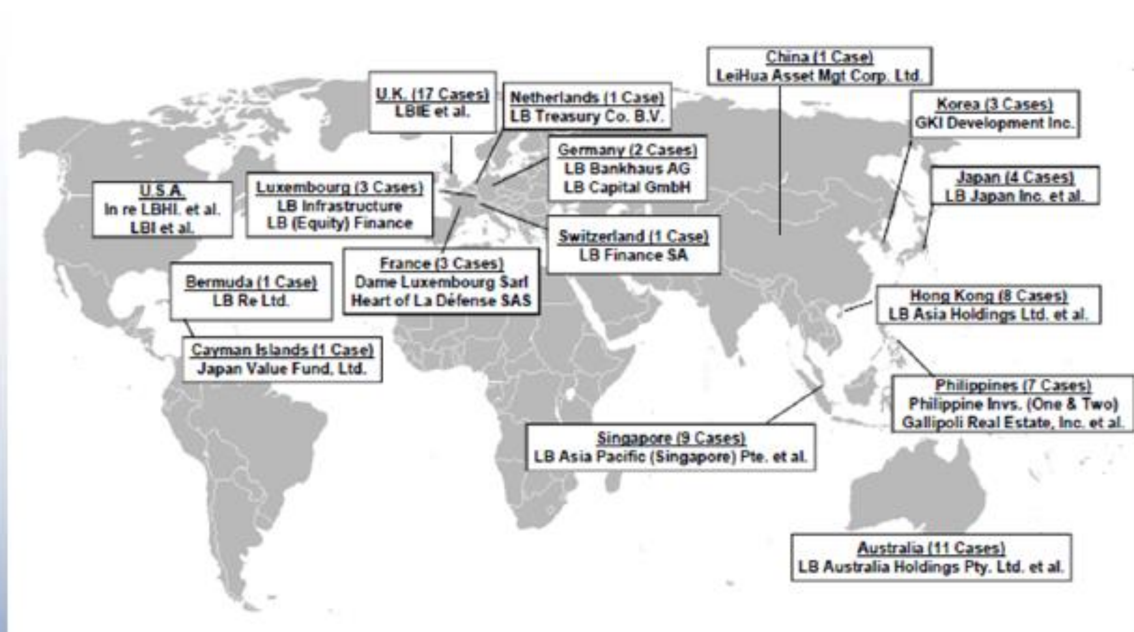
[29] Proposed Rule, page 973.
[30] Eric Rosengren, *Challenges in Resolving Systemically Important Financial Institutions* (May 5, 2009), page 4.

This map of legal proceedings resulting from the Lehman Brothers Holdings Inc. bankruptcy filing illustrates the cross-border structure of Lehman Brothers.



Source: Alvarez & Marsal Holdings, LLC., *Lehman Brothers Holdings Inc. International Protocol Proposal*, www.lehmanbrothersestate.com.

The size and complexity of U.S. financial institutions with foreign affiliates have not dramatically changed from the time of the Lehman Brothers collapse, and in fact have increased. Moreover, the share of U.S. banking assets in foreign offices has been sizeable for a prolonged period of time. In light of this recent experience involving foreign affiliates that become part of U.S. resolution and recovery proceedings, it is mystifying why the key data collection initiative for recovery and resolution activities excludes those entities from recordkeeping requirements.

The recent JPMorgan London whale incident confirmed that large losses from non-U.S. based trading activities can endanger if not lead to failure of the U.S. parent. The Financial Times described the event in these terms:

> "The London whale was a UK-based trader called Bruno Iksil who worked for JPMorgan. He was known as the London whale among hedge funds and other traders, due to his big, and as it turned out, ill-advised position in a credit derivatives index. JPMorgan's chief executive at the time, Jamie Dimon, initially dismissed the claims – made by anonymous fund managers quoted in articles in the Wall Street Journal and Bloomberg – as a "tempest in a teapot". But as one of the anonymous hedge fund managers commented, "It wasn't just a giant whale, it was the size of the Atlantic Ocean". "[31]

[31] Financial Times, *Definition of London whale*,

In studying the data and risk management shortcomings that led to the problem, Senator Carl Levin noted that:

> "The derivatives trading that produced the whale damaged a single bank. But the whale trades expose problems that reach far beyond one London trading desk or one Wall Street office towers. The American people have already suffered one devastating economic assault rooted largely in Wall Street excess, and they cannot afford another."[32]

In light of this history of large losses in derivatives positions arising from a foreign desk but profoundly affecting the U.S. parent, the Proposed Rule must not exempt from QFC recordkeeping the trades of foreign affiliates of U.S. financial companies.

The exemption actually casts doubt on the ability of the FDIC to undertake effective cross-border recovery and resolution activities via single a point of entry strategy for failing international financial institutions. The FDIC explains the single point of entry strategy:

> "U.S. SIFIs generally are organized under a holding company structure with a top-tier parent and operating subsidiaries that comprise hundreds, or even thousands, of interconnected entities that span legal and regulatory jurisdictions across international borders and share funding and support services. Functions and core business lines often are not aligned with individual legal entity structures. Critical operations can cross legal entities and jurisdictions and funding is often dispersed among affiliates as need arises. These integrated structures make it very difficult to conduct an orderly resolution of one part of the company without triggering a costly collapse of the entire company and potentially transmitting adverse effects throughout the financial system. Additionally, it is the top-tier company that raises the equity capital of the institution and subsequently down-streams equity and some debt funding to its subsidiaries.
>
> In resolving a failed or failing SIFI the FDIC seeks to promote market discipline by imposing losses on the shareholders and creditors of the top-tier holding company and removing culpable senior management without imposing cost on taxpayers. This would create a more stable financial system over the longer term. Additionally, the FDIC seeks to preserve financial stability by maintaining the critical services operations and funding mechanisms conducted throughout the company's operating subsidiaries. The Dodd-Frank Act provides certain statutory authorities to the FDIC to effect an orderly resolution."[33]

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[32] Opening statement of Senator Carl Levine (D-Mich.) U.S. Senate Permanent Subcommittee on Investigations Hearing on JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuse (March 15, 2013), page 7.

[33] FR Vol 78, No. 243 (December 18, 2013), page 76615.

If the FDIC lacks complete information about the QFC exposures of all of an entity's subsidiaries, it is not clear how it will be able to implement a single-point of entry recovery and resolution activity, or more specifically, how it will be able to determine when the bail-in conversion of debt to equity should be triggered. The exclusion of foreign QFC recordkeeping will sabotage the FDIC efforts to complete orderly recovery through the single point of entry approach. Therefore, all financial entities, as defined in the Act, should be subject to the QFC recordkeeping requirements without exemptions for foreign affiliates of U.S. companies.

CONCLUSION

The comment letter explains why the QFC recordkeeping regulation is one of the key rulemakings focused on ending too-big-too-fail and mitigating the risk of multiple institution failures. The QFC recordkeeping rule is essential tool for enabling the FDIC to analyze the systemic and direct counterparty impact of its actions under the OLA regime. Unfortunately, the proposed rule contains a number of critical weaknesses that make QFC recordkeeping ineffective and counterproductive, thus undermining the FDIC's ability to conduct orderly recovery and resolution. The key shortcomings of the Proposed Rule are:

1. The scope of entities subject to the requirements of the Proposed Rule is too narrow and arbitrary, in conflict with the Act. The Proposed Rule introduces the concept of "record entities" that is not present in the Act. The resulting patchy and fragmented application of QFC recordkeeping means that the information available to the FDIC will be incomplete and potentially erroneous. The Proposed Rule should adhere to the requirements outlined in the Act and prescribe the QFC recordkeeping requirements as stated in Section 210(c)(8)(H) of the Act.

2. The Proposed Rule includes exemptions that should not be permitted, at least until FDIC has full access to swap data more generally. The lack of FDIC direct and real-time access to the Swap Data Repositories ("SDRs") is a fundamental impediment to the implementation of resolution authority. The Proposed Rule must eliminate any exemptions from any QFC recordkeeping requirements by financial companies at least until the FDIC has unfettered and real-time access to SDRs under CFTC and SEC jurisdiction. Only then can possible exemptions be developed.

3. The Proposed Rule mistakenly treats position (portfolio) level data and transaction level data as substitutes, when in fact they complement each other. SDR data does not contain collateral data and as such represents only the gross derivatives positions. Those positions will be different from the data accumulated on a position (portfolio) level under a Credit Support Annex or similar document of the type that reflects netting provisions and collateral data. Those two types of reporting should not be confused as substitutes because they represent different information. SDR data alone will not enable the FDIC to evaluate the proper treatment of QFCs in the OLA process; position level data is also critical.

4. <u>The Proposed Rule would not capture critical relationship data relating to QFC counterparties</u>. The lack of such data would not allow FDIC to assess cross-default provisions in QFCs. Moreover, the Proposed Rule adopts an outdated and irrelevant concept of control. The Proposed Rule should develop and adopt a flexible system of relationship representations by, first, defining the type of relationships that are relevant for QFC recordkeeping and, second, establishing a recordkeeping framework to reflect those relationships.

5. <u>The Proposed Rule includes an unacceptable foreign subsidiary loophole</u>. Lehman Brothers' failure and the JPMorgan London whale debacle demonstrated that international companies have a global presence and a global flow of exposures. Yet, the Proposed Rule exempts foreign affiliates of U.S. companies from the QFC recordkeeping requirements. The Proposed Rule states that "a U.K.-incorporated London affiliate of a U.S. broker-dealer would not be a records entity because it is a separate legal entity that is not incorporated or organized within the United States."[34] In light of the single-point of entry mechanism and the development of total loss absorbing capacity requirements at the holding company level, such an exclusion conflicts with the policy of cross-border coordination of recovery and resolution activities.

We hope these comments are helpful as the Secretary of the Department of Treasury, as Chairperson of the Financial Stability Oversight Council, finalizes the Proposed Rule.

Sincerely,

Dennis M. Kelleher
President & CEO

Irina S. Leonova
Banking Specialist

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

dkelleher@bettermarkets.com
ileonova@bettermarkets.com

www.bettermarkets.com

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[34] Proposed Rule, page 973.