sifma
Invested in America

November 18, 2010

By electronic submission to www.regulations.gov

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**")

FR Docket No. 2010-26049

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to comment on the notice of proposed rulemaking (the "**NPR**") issued on October 19, 2010, by the FDIC to implement certain provisions of the orderly liquidation authority contained in Title II of the Dodd-Frank Act.[2]

We believe that the new orderly liquidation authority in Title II of the Dodd-Frank Act is one of the most important new tools in the U.S. regulatory toolbox. Indeed, SIFMA was one of the earliest advocates for this new authority, and consistently supported its creation throughout the legislative process.[3] If implemented and administrated properly, this new authority has the potential to address the Too Big to Fail ("**TBTF**") dilemma, which has been described by FDIC Chairman Sheila Bair as:

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] Pub. L. No. 111-203, § 201 et seq., 124 Stat. 1376 (2010).

[3] *See, e.g.*, Testimony of T. Timothy Ryan, Jr., President and CEO of SIFMA Before the U.S. House of Representatives Committee on Financial Services, Hearing on Systemic Regulation, Prudential Matters, Resolution Authority and Securitization (Oct. 29, 2009).

New York | Washington
120 Broadway, 35th Floor | New York, NY 10271-0080 | P: 212.313.1200 | F: 212.313.1301
www.sifma.org | www.investedinamerica.org

> "shorthand for the dilemma that policymakers faced in the Fall of 2008, when a number of [major banks and other financial companies] ran into serious trouble. We faced this choice: To let them fail, and risk destabilizing the entire financial system. Or to bail them out – imposing costs on the taxpayer and encouraging the type of risky behavior that caused the crisis in the first place. Needless to say, both of these options were highly problematic."[4]

The pressure to provide taxpayer-funded government support to major financial institutions is most compelling when financial regulators believe that the alternative is a risk that the financial system will collapse and that a depression as bad or worse than the Great Depression will follow.

Title II provides the FDIC with the potential to address the TBTF dilemma by giving it the ability to provide liquidity to the creditors of covered financial companies during a financial panic – thus reducing or eliminating their incentive to run or to cut off further liquidity – while ensuring that shareholders and creditors, rather than taxpayers, ultimately bear any and all losses in accordance with their relative priorities. In order for this new authority to work properly, the FDIC will need to issue rules and regulations that convince the market that Title II will be exercised in a transparent and consistent manner that strikes the right balance among preserving or restoring financial stability, maximizing the value of the enterprise, minimizing shareholder and creditor losses, preserving equal treatment among similarly situated creditors and maximizing market discipline. Creditors need to have confidence that they could be better off if Title II is invoked, but that they will never be worse off in order for Title II to have a stabilizing impact on the market during a financial panic.

The FDIC should take a careful and deliberate approach in developing these rules and regulations. It should not rush to issue rules without sufficient input from other financial regulators and experts from the private sector. While Title II requires the FDIC to issue such rules, it imposes no deadline. The FDIC should also treat its mandatory rulemaking obligations under Section 209, as well as its obligation to establish policies and procedures under Section 203(d), as part of an ongoing process, rather than as one-time events.

We have divided our comment letter into two parts. Part I explains why the TBTF dilemma arose during the financial panic of 2008 and how Title II could be used to provide a viable alternative way to address the dilemma in the future. Part I is relevant to both the questions raised in the NPR with a 30-day comment period and the broader list of questions raised with a 90-day comment period. Part II contains specific comments on the NPR, and <u>Annex A</u> provides answers to the specific questions raised in the NPR with a 30-day comment period. We plan to submit a separate letter to address the specific questions raised in the NPR with a 90-day comment

[4] Remarks by FDIC Chairman Sheila C. Bair, "Ending Too Big to Fail: The FDIC and Financial Reform," 2010 Glauber Lecture at the John F. Kennedy, Jr. Forum, Harvard University (Oct. 20, 2010).

period. We also intend to comment on the issues raised by the broker-dealer provisions, which are subject to joint rulemaking by the FDIC and the SEC, in that letter.

I. Using Title II to Address the TBTF Dilemma

The TBTF dilemma arose during the Fall of 2008 because allowing major banks and other financial institutions to fail at that time would have risked causing a "run" by creditors, and credit to dry up, throughout the system. The financial system only functions if creditors believe their counterparties can perform their obligations. The system runs on confidence. In 2008, creditors throughout the system (especially banks and other financial institutions, whether large or small, simple or complex, interconnected or not, foreign, domestic or global) risked becoming even more panicked than they already were that their financial intermediaries or counterparties were in imminent danger of failing. That would have caused them to scramble to pull their lines and other credit out of the system and to refuse to provide new credit.

Such a system-wide run and cutting off of new credit could have resulted in a collapse of the financial system because liquidity is the system's lifeblood and financial institutions would not have been able to liquidate their assets fast enough to satisfy their obligations to creditors who were able to run. Alternatively, they would have been forced to sell their assets at fire sale prices, depleting their capital, and affecting the value of assets held at other institutions. The loss of liquidity was affecting asset values that in turn were affecting the equity values of other financial firms.

Congress enacted Title II as a central element of an overall package of reforms designed to address the TBTF dilemma. The overall package includes the creation of a new Financial Stability Oversight Council charged with the responsibility of identifying systemically important companies and activities, and subjecting them to heightened prudential standards, including stronger capital and liquidity requirements, better risk management, concentration limits, contingency recovery and resolution plans, and closer supervision. It also includes the Federal Reserve's continued ability to provide emergency secured liquidity to banks through its Discount Window facility and to non-banks through Section 13(3) of the Federal Reserve Act. These elements are designed to reduce the likelihood that systemically important financial institutions will fail because of either illiquidity or insolvency.

Indeed, many large, complex financial institutions have already taken steps to reduce their reliance on short-term funding as a result of Basel III and the heightened prudential requirements in the Dodd-Frank Act. These steps include increasing liquidity reserves to meet potential strains on short-term funding sources; extending the maturity profile of secured and short-term unsecured funding; improving the quality of collateral pledged for shorter term secured funding; and strengthening liquidity risk management governance and the depth and quality of liquidity risk reporting. These steps have been taken voluntarily, but also with encouragement from prudential regulators and in anticipation of Basel III, including the proposed liquidity coverage ratio which will require firms to hold sufficient unencumbered, high quality assets to cover 30 days of outflows under an acute liquidity stress scenario.

Title II is designed to give the FDIC the tools to provide liquidity to the creditors of covered financial companies during a financial panic – thus reducing or eliminating their incentive to run or to cut off further liquidity – while ensuring that shareholders and creditors, rather than taxpayers, ultimately bear any and all losses in accordance with their relative priorities. It is also designed to allow the FDIC to preserve the operation of any systemically important functions during a financial panic, such as payment systems, security settlement systems or other critical banking functions that a significant portion of the market relies on, especially when few or no substitutes exist from those provided by the covered financial company. In short, it is designed for those rare circumstances when the Bankruptcy Code or other applicable insolvency law does not provide a credible alternative to providing taxpayer-funded government support.

Title II creates a strong presumption in favor of applying the Bankruptcy Code or other applicable insolvency law except as to systemically important financial institutions under the most extreme financial conditions. Congress recognized that the Bankruptcy Code generally maximizes market efficiency, optimizes market discipline and minimizes moral hazard. When an insolvent company is liquidated or reorganized under the Bankruptcy Code, the shareholders are generally wiped out and the creditors absorb any remaining losses according to the rule of absolute priority of claims. In a reorganization, the company is recapitalized by converting an appropriate amount of debt into common equity, according to the absolute priority of claims, unless the claimants consent to different priorities. This allows the new owners – the most junior former creditors – to enjoy the going concern value of the company. The company, as debtor in possession, or the creditors have the option to choose a reorganization over a liquidation if they believe the going concern value of the company is greater than its liquidation value.

The reason that allowing major financial institutions to fail during the Fall of 2008 would have risked destabilizing the financial system was ***not*** because liquidations or reorganizations under the Bankruptcy Code are somehow "disorderly" or administratively too costly, or have an excessively slow claims process. Well-administered bankruptcy proceedings are very orderly, provide a high degree of due process and transparency, and provide benefits in terms of market discipline and fairness to creditors that are at least as important as speed. Indeed, as long as the market expects claims to be treated in a predictable way, creditors can borrow against or sell their claims and obtain immediate liquidity long before the final distributions are made, except during a financial panic.

Instead, the reason that allowing major financial institutions to fail during the Fall of 2008 would have risked destabilizing the financial system was that preserving or restoring financial stability is not one of the Bankruptcy Code's fundamental goals. Moreover, other than the exemption from the automatic stay for financial contracts, the Code does not contain provisions designed to promote that goal, even during a financial panic. The fundamental goals of corporate bankruptcy are to maximize the value of an insolvent enterprise for the benefit of creditors as a group, to determine who gets what, in what order according to the principle of equality of treatment of similarly situated creditors,[5] to provide a "fresh start" for debtors and to preserve employment.

We believe that Title II provides a superior alternative to bankruptcy only if the FDIC exercises its authority in a transparent and consistent manner that strikes an appropriate balance among the goals of (i) preserving or restoring financial stability, (ii) maximizing the value of the enterprise, (iii) minimizing shareholder and creditor losses, (iv) preserving equal treatment among similarly situated creditors and (v) maximizing market discipline. Indeed, as noted by the FDIC in its NPR, Congress imposed certain duties on the FDIC to ensure that Title II achieves these complementary goals, including the duty to exercise its new powers in a manner that:

- "mitigates such risk [*i.e.*, the risk that a covered financial company's failure will destabilize the U.S. financial system] and minimizes moral hazard";

- causes "creditors and shareholders . . . to bear losses," subject to a floor equal to what they would have received in a liquidation under Chapter 7 of the Bankruptcy Code;[6] and

- "maximizes the value of the company's assets, minimizes losses, mitigates risk, and minimizes moral hazard."[7]

Congress reinforced the strong presumption in favor of the Bankruptcy Code and other applicable insolvency law, and the FDIC's duties to carry out its new powers in a manner that strikes an appropriate balance among the statute's various goals, by imposing an elaborate process before the FDIC can be appointed as receiver of a company under Title II. This process imposes a duty on the Treasury Secretary, the Board of Governors of the Federal Reserve System (the "**Federal Reserve Board**") and one of three alternative federal financial agencies[8] to make certain determinations as a condition to the FDIC's appointment as receiver of a particular company under Title II. In addition to certain other determinations including that the company is

[5] Thomas Jackson, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, 10-17, 20 (2001).

[6] *See* Dodd-Frank Act, §§ 210(a)(7)(B); (b)(4)(B); (d)(2); (h)(5)(E)(ii).

[7] 75 Fed. Reg. 64173, 64175 (Oct. 19, 2010) (citing §§ 204(a), 210(a)(9)(E) of the Dodd-Frank Act).

[8] The Securities and Exchange Commission (the "**SEC**") is the third agency if the company or its largest U.S. subsidiary is a broker-dealer; the Federal Insurance Office (the "**FIO**") is the third agency if the company or its largest U.S. subsidiary is an insurance company; and the FDIC is the third agency in all other cases.

a financial company and it is genuinely insolvent or likely to become insolvent, the agencies are required to determine that:

- allowing the company to be liquidated, reorganized or rehabilitated under the Bankruptcy Code or other applicable insolvency law would destabilize the U.S. financial system;

- the FDIC can and will exercise its authority under Title II in a manner that will avoid or mitigate that effect (*i.e.*, it will preserve or restore the stability of the U.S. financial system) while maximizing market discipline; and

- the FDIC can and will exercise its authority under Title II in a manner that will result in the appropriate treatment of shareholders and creditors.[9]

If any of the agencies is of the view that these conditions will not be satisfied, it has the power and arguably the duty to veto the appointment of the FDIC as receiver of the company under Title II. While there is no judicial review of these determinations other than the financial company and insolvency determinations, Section 203(c) makes the determinations subject to prompt Congressional oversight and reporting.

Congress also reinforced the FDIC's duties to carry out its new powers in a way that strikes an appropriate balance among the statute's various goals by requiring the FDIC to establish policies and procedures acceptable to the Treasury Secretary governing the use of any funds to carry out Title II.[10] This statutory duty must be carried out as soon as practicable. It applies to virtually any action the FDIC may take or fail to take in carrying out any provision of Title II, because any of them could result in funds being needed or used by the FDIC.

Title II would not be needed if the only goals were to maximize market discipline and minimize moral hazard. The Bankruptcy Code is well suited to achieve those goals. Indeed, unless the FDIC is able to gain the market's confidence that Title II will be used in a way that will preserve or restore financial stability, maximize the value of the enterprise, minimize shareholder and creditor losses, and preserve equal treatment among similarly situated creditors, Title II will be no more effective than the Bankruptcy Code in stemming runs or ensuring the continual flow of liquidity during a financial panic or otherwise addressing the TBTF dilemma. Creditors will seek to avoid losses whether under the Bankruptcy Code or Title II. A system-wide fear of losing money under either of these statutes could cause creditors to run and other liquidity to dry up during a financial panic, potentially causing the system to collapse.

---

[9] Dodd-Frank Act, §§ 203(b)(2), (4) and (5); 203(a)(2)(B), (F) and (G).

[10] *Id.* § 203(d).

The statutory presumption in favor of the Bankruptcy Code or other applicable insolvency law,[11] the requirement that shareholders and creditors bear any and all losses of a covered financial company,[12] the provision imposing a maximum recovery entitlement on creditors,[13] the claw-back mechanism,[14] and the back-up assessment mechanism[15] are sufficient to maximize market discipline and minimize moral hazard. The claw-back mechanism, in particular, requires the FDIC to recover from any claimant any "additional payments" received by such claimant and any "amounts [received by such claimant] from the [FDIC] pursuant to subsection (b)(4), (d)(4), or (h)(5)(E) [of Section 210],"[16] other than payments or amounts essential to the operation of the receivership or any bridge financial company. The back-up assessment mechanism provides a fail-safe protection against any residual losses being borne by the taxpayers, by requiring large financial institutions to bear those losses. As a result of these statutory mechanisms, the FDIC does not need to create any artificial constraints on its discretion to provide liquidity to creditors during a financial panic in order to get the message across that creditors cannot reasonably expect to be bailed out of their ultimate share of a covered financial company's losses.

Instead, the FDIC needs to issue rules and regulations that convince the market that Title II will be exercised in a transparent and consistent manner that strikes the right balance among financial stability, maximizing value, minimizing losses, preserving equal treatment among similarly situated creditors and maximizing market discipline. Creditors need to have confidence that they could be better off if Title II is invoked during a financial panic, but that they will never be worse off in order for Title II to have a stabilizing impact on the market during a financial panic.

The first step in gaining the market's confidence would be to issue rules and regulations that allow creditors to determine in advance, with relative certainty, how they will be treated in a proceeding under Title II. Creditors currently believe that they understand their rights under the Bankruptcy Code. They believe that the rules are reasonably predictable. Numerous lawyers specialize in the Bankruptcy Code and have decades of experience with bankruptcy proceedings. An extensive body of case law, legal commentary and other guidelines are readily available to clarify issues in reorganizations and liquidations under the Bankruptcy Code. The process for determining the amount and treatment of claims and the value of collateral is administered by a judge, with all of the due process protections and transparency of a judicial

---

[11] *See* Dodd-Frank Act, §§ 203(a) and (b).

[12] *Id.* § 204(a)(1).

[13] *Id.* § 210(d)(2).

[14] *Id.* § 210(o)(1)(D)(i).

[15] *Id.* § 210(o)(1)(D)(ii).

[16] *Id.* § 210(o)(1)(D)(i).

proceeding. Creditors are permitted to take a leading role in the process. In the absence of these protections, it must be made clear that Title II will be administered in a way that will maximize the value of an insolvent financial company for the benefit of creditors generally, as well as other stakeholders, and in a transparent way that allocates that value fairly, consistent with the ultimate goals of maintaining and restoring financial stability.

The market has no experience with Title II. It has very little relevant experience with the bank receivership provisions on which Title II is modeled. When market participants or their lawyers read Title II or the bank receivership provisions, they perceive numerous ambiguities, contradictions and hard-to-understand provisions. It is virtually impossible to obtain unqualified opinions from lawyers on a number of important issues. The market also believes that only a very limited body of legal guidance supplements the bank receivership provisions.

As described by former general counsels to the FDIC, the Resolution Trust Corporation and the Federal Home Loan Bank Board:

> "[Bank receivership law] is a confusing area. The challenge arises less because of the complexity of the rules than because of their ambiguity and obscurity. The Bankruptcy Code generally constitutes the starting point for rules governing the financial failure of companies in the United States. It contains a detailed set of rules that fill three volumes of U.S. Code Annotated, volumes of West's Bankruptcy Reporter, and over four linear feet of Collier's [on Bankruptcy]. But the statutes governing conservatorships and receiverships of federally insured banks and thrifts fill, at most, about 111 pages of the U.S. Code Annotated."[17]

While this comment was made almost 20 years ago, the FDIC has not issued many regulations since that time,[18] or many advisory opinions, policy statements and other guidelines to supplement it.

The FDIC's rules and regulations implementing Title II need to reinforce a number of principles, including that:

- There is a strong presumption against invoking Title II, except for systemically important financial companies under the most extreme circumstances during a financial panic. Creditors should be able to rely on the Bankruptcy Code or other applicable insolvency law being the applicable law for liquidating, reorganizing or otherwise resolving the vast majority of troubled or insolvent financial companies.

---

[17] Douglas, Luke & Veal, *Introduction*, Counselling Creditors of Banks and Thrifts: Dealing with the FDIC and RTC, PLI Order No. A4-4323 (Jan. 14, 1991).

[18] The relatively sparse body of regulations that have been issued is contained in 12 C.F.R. Part 360.

- The FDIC will exercise its powers in a transparent and consistent way that will reduce or eliminate the incentive of creditors to run or to cut off liquidity during a financial panic, such as by transferring a covered financial company's liabilities to a viable third party or bridge financial company.

    - The FDIC will exercise its claw-back powers in a manner that preserves or restores liquidity during a financial panic.

    - The FDIC will preserve equal treatment among similarly situated creditors, unless absolutely necessary to preserve or restore financial stability.

- The FDIC will provide as much advance legal certainty as possible regarding the rules governing the rights of creditors, counterparties and other stakeholders in a Title II proceeding.

    - The FDIC will value collateral fairly and accept "credit bids" from secured creditors who believe that the FDIC's valuation is too low.[19]

- The FDIC will seek to maximize a covered financial company's value and minimize shareholder and creditor losses, rather than minimizing the company's value and maximizing its losses by liquidating the company's assets at the bottom of the market.

    - It will not merely seek to give creditors their minimum recovery rights – i.e., their share of the liquidation value of the company.[20]

    - To this end, the FDIC will consider, test and announce new resolution techniques designed to preserve the going concern value of covered financial companies for the benefit of shareholders and creditors.

    - For example, the FDIC might consider, test and announce the use of a bridge financial company to recapitalize the going concern by transferring all of the covered financial company's assets to the bridge, transferring all of its liabilities to the bridge less the amount needed for capital, and converting the rest of its liabilities into common stock in the bridge.

---

[19] A credit bid would permit a creditor to receive delivery of the collateral in return for a reduction in the creditor's claim equal to the value that the FDIC assigned to the collateral.

[20] *See* Dodd-Frank Act, §§ 210(a)(7)(B); (b)(4)(B); (d)(2); (h)(5)(E)(ii).

- The FDIC will provide a clear administrative remedy for creditors who believe that they did not receive as much as they would have received in a liquidation under Chapter 7 of the Bankruptcy Code, in violation of their minimum recovery rights.

- The FDIC will preserve the continuous operation of any systemically important functions provided to the market by a covered financial company, such as payment systems, security settlement systems and similar critical functions relied upon by the market and for which there are few or no substitutes.

By necessity, Title II entrusts significant discretion in the hands of the FDIC and the agencies involved in deciding whether Title II should be invoked. Judicial review of the procedure is extremely limited. Many of the ordinary due process protections that claimants enjoy in a bankruptcy proceeding are set aside or suspended for the sake of expediency until the administrative claims process is over. The process is less transparent to claimants, and they have less input into it. Along with such enormous discretion and compromises of due process comes an important duty on the part of the FDIC to make it clear that it will exercise its discretion in a way that is perceived by the market to be responsible and fair. That is why it is critical for the FDIC's regulations and public statements to spell out as much as possible how this authority will be exercised and how creditors, counterparties and other stakeholders will be treated.

Although the FDIC has extensive experience applying the receivership provisions of the FDIA to insured banks and thrifts, the stakes are even higher in Title II. The institutions for which Title II is most likely to be invoked are large, complex, non-deposit-taking institutions with cross-border operations and complex webs of interconnections throughout the global financial system. They are very different from the relatively small insured institutions that the FDIC has experience supervising or liquidating, or even the handful of large, but relatively simple and domestic insured institutions that have been resolved in the past. For example, the risks of contagion for these institutions are much more severe than in the typical community bank. The creditors of these institutions do not have the benefit of federal deposit insurance. Any indication of uncertainty as to treatment has the potential to affect the liquidity of other large, systemically important interconnected financial companies. The FDIC should be particularly vigilant that its activities in handling an institution do not inadvertently create funding difficulties in other institutions.

Indeed, one of the implications of these differences is that the FDIC will need to develop new models for resolving these kinds of institutions. The purchase and assumption model, with or without loss-sharing, which has been the FDIC's tool of choice for many years, may not work with these large, complex, interconnected and often global institutions during a financial panic. It is unlikely that many third parties will exist that will be large or healthy enough to purchase and assume all of the assets and liabilities of these institutions during a financial panic, given their size, complexity, interconnectedness and global footprint. The FDIC may have to develop new models that are more appropriate to preserving the going concern value of these types of institutions. The FDIC should consider structures that mimic the outcome of a stand-alone restructuring, where the institution is recapitalized through use of a bridge financial company, and its going concern value is preserved. The tools contained in Title II can be used by the FDIC to effectively achieve such an outcome.

The FDIC should take a careful and deliberate approach to developing rules to implement Title II. It should not rush to issue rules without sufficient input from other financial regulators and experts from the private sector. While Title II requires the FDIC to issue such rules, it imposes no deadline. In particular, we believe that the FDIC and the public would benefit if the FDIC established an advisory council or at a minimum continued to seek input on how it should implement and administer Title II. This approach should include input from a cross section of interested parties, including representatives from other federal financial regulators, as well as experts from the private sector, including practicing lawyers, academics, workout experts, corporate treasurers, creditors, counterparties and other stakeholders.

The FDIC should also treat its mandatory rulemaking obligations under Section 209, as well as its obligation to establish policies and procedures under Section 203(d), as part of an ongoing process, rather than as one-time events. With feedback from the advisory council, other financial regulators, experts and the public, the FDIC can promulgate rules and regulations that evolve over time in such a way that Title II is generally perceived by the private sector and the public alike as being implemented and administered in a manner that will address the TBTF dilemma.

II. Comments on Specific Rules Proposed in NPR

The FDIC is proposing to add a new Part 380 to Title 12 of the *Code of Federal Regulations*. These new regulations would apply exclusively to Title II. They would not apply to the bank resolution provisions in the FDIA, and the rules implementing the bank resolution provisions would not apply to Title II.

These new rules would cover six distinct areas: (1) the FDIC's exercise of its power to provide any payments or credits to shareholders, long-term senior debt, subordinated debt and other creditors where such payments or credits would be inconsistent with the equal treatment of similarly situated creditors, (2) the valuation of collateral on secured claims, (3) personal services agreements, (4) contingent obligations, (5) insurance company subsidiaries and (6) liens on insurance company assets. We will comment on all but the insurance company items.

A. Restrictions on Unequal Treatment of Similarly Situated Creditors

Proposed new Rule 380.2(b) would prohibit the FDIC from making any payment or credit to the holders of long-term debt, subordinated debt or equity, if such payment or credit were inconsistent with the equal treatment of similarly situated creditors. The rule would not impose an absolute prohibition on such payments or credits to other creditors, but would require the approval of the FDIC Board before such payments or credits could be made. It would preclude the Board from delegating its authority to the FDIC staff.

We believe that the FDIC should withdraw proposed Rule 380.2(b). We believe the FDIC should not impose an absolute prohibition on making payments or credits to the holders of any particular class of claims or impose special FDIC Board approval requirements on exercising any of the statutory authorities given to the FDIC to make payments or credits to anyone if necessary to preserve or restore U.S. financial stability during a financial panic. While we believe that the FDIC should preserve the equal treatment of similarly situated creditors unless absolutely necessary to preserve or restore financial stability, we believe that the rule, as proposed, could unduly interfere with the FDIC's ability to exercise its powers in a manner that strikes the right balance among financial stability, value maximization, loss minimization, creditor fairness and market discipline. If such payments or credits could stem a run by creditors or keep liquidity flowing during a financial panic, the FDIC should preserve the option to make them. The statutory claw-back mechanism,[21] which requires the FDIC to recover from any claimant any additional payments or other amounts received by such claimant over a five-year time period, would allow the FDIC to strike an appropriate balance between preserving or restoring financial stability and maximizing market discipline. The back-up assessment mechanism,[22] which requires the FDIC to recover any residual losses from large financial institutions, provides a fail-safe protection that taxpayers would never be required to bear any residual losses.

We also believe that making a sharp distinction between long-term and short-term creditors could have unintended and even unforeseen adverse consequences on the market. These might include creating incentives for investors to restructure their investments to fit within the short-term category or distortions in the cost of long-term credit upward and the cost of short-term credit downward.

At a minimum, the FDIC should limit the absolute prohibition to regulatory capital instruments. Such instruments are, by definition, expected to absorb losses, and the holders of such instruments have almost no ability to run because of the perpetual or very long-dated nature of their instruments. Such a more limited prohibition also seems more consistent

[21] *Id.* § 210(o)(1)(D)(i).

[22] *Id.* § 210(o)(1)(D)(ii).

with the text of Title II, which provides that the only liabilities that may not be assumed by a bridge financial company are liabilities that count as regulatory capital.[23]

The FDIC should also clarify that the rule would not prohibit the FDIC from taking either of the following actions:

- making any payments or credits to any creditors, as long as such payments or credits are consistent with the equal treatment of similarly situated creditors; or

- taking any other action under the statutory provisions that give the FDIC discretion to depart from the general rule of equal treatment for similarly situated creditors, including transferring any claims to a viable third party or bridge financial company, as long as the FDIC makes no payment or credit.

The FDIC needs to preserve its discretion to take these other actions to the extent necessary to strike the appropriate balance among financial stability, value maximization, loss minimization, equal treatment of similarly situated creditors and market discipline.

B. Valuation of Collateral

Proposed Rule 380.2(c) provides that claims secured by a perfected or enforceable security interest will be paid in full to the extent of such collateral, but that any portion that exceeds the fair market value of the collateral will be treated as an unsecured claim. We believe that the rule should either be withdrawn or provide more specific, detailed information about the valuation process, including specifying the date of valuation for purposes of determining whether there is a deficiency claim. Second, if any secured creditor disagrees with the valuation determined by the FDIC, the secured creditor should have the right to make a credit bid for the collateral at the FDIC's valuation. If the FDIC determines that the collateral cannot be sold, there should be a specified procedure for disputing the valuation and obtaining a judicial determination of any dispute, during the administrative claims process. If the right to credit bid is exercised, the creditor must agree to have its claim reduced by the amount of the credit bid, whereupon the collateral would be turned over to the creditor. The option to credit bid or require a judicial valuation is an important due process protection, which is provided to creditors under Sections 363(k) and 506 of the Bankruptcy Code.[24] It is therefore consistent with the FDIC's duty under Section 209 to harmonize the rules and regulations implementing Title II with the Bankruptcy Code.

---

[23] *Id.* § 210(h)(1)(B)(i).

[24] 11 U.S.C. §§ 363(k); 506.

Proposed Rule 380.2(c) also provides that claims secured by U.S. government securities would be valued at par value. It is not clear whether the antecedent of "valued at par value" is the claims or the collateral. Presumably it is the collateral, but the wording at a minimum should be revised to make this unambiguous. While we believe the FDIC intended this rule to provide favored treatment to U.S. government securities collateral, as written, it could actually harm secured creditors with such collateral. Suppose that a secured claim were secured by a long-term government bond that had a market value equal to 80% of its par value. If the FDIC deems the collateral to be worth par value for purposes of dividing the creditor's claim into a secured and unsecured portion, if the secured claim thus established can then be satisfied by delivering the collateral to the creditor, Rule 380.2(c) could be read to have wiped out the unsecured portion of the claim above 80%. Alternatively, Rule 380.2(c) might be read to mean that the FDIC would be prepared to give the creditor the option to receive par value in cash in lieu of the right to liquidate or take possession of collateral worth less than par. Although this probably would be acceptable to the secured creditor, it would effectively be a sub rosa exercise of the FDIC's power to treat similarly situated creditors differently. The portion of the amount paid in excess of fair market value would be a windfall to the favored secured creditor that would reduce the amount of assets available to satisfy the claims of unsecured creditors. Thus, this proposed rule, if so interpreted, could give rise to unexpected deficiency claims in favor of undersecured creditors under the minimum recovery right in Section 210(a)(7)(B) of the Dodd-Frank Act.

As a result of these problems, we believe that the FDIC should simply use the fair market value test in valuing U.S. government securities collateral, just as it would for all other collateral. The lower volatility of U.S. government securities will make them desirable collateral in any event, and they do not need any further "subsidy" by the FDIC to make them valuable.

C. Personal Services Agreements

Proposed Rule 380.3(e) would provide that personal services contracts with senior executives and directors of a covered financial company would not be covered by Rule 380.3(b), which provides that if the FDIC accepts the services of any person under a personal services contract prior to the repudiation of that contract, the FDIC would be bound by the terms and conditions of the contract for any services rendered prior to repudiation and be required to treat any payments due for services accepted as administrative expenses under Title II. It would further provide that nothing in Rule 380.3(b) would limit or impair the ability of the FDIC to recover compensation from any senior executive or director under Section 210.

We do not believe it would be good policy for the FDIC to announce by rule that it will not be bound by the terms of any employment contract with a senior executive of a covered financial company, even where the FDIC accepts the executive's services. Such a rule could result in the resignation of key executives on the date of receivership, which may not be consistent with the FDIC's duty to maximize the value of the covered financial company. We believe such a rule improperly ties the FDIC's hands and could potentially inhibit achieving an optimal result for all concerned parties. This is separate from the provision in Section 210 that authorizes the FDIC to recover compensation from a senior executive that is responsible for the company's insolvency.

SIFMA respectfully requests the FDIC to withdraw proposed Rule 380.3(e), except to the extent it merely preserves the FDIC's right to recover compensation from a senior executive responsible for a company's insolvency pursuant to Section 210.

D. Contingent Claims

Proposed Rule 380.4(b) confirms that a claim based on a contingent obligation of a covered financial company "may" be provable against the receiver. Section 201(a)(4) provides that the term "claim" includes a "contingent" claim. There is no discretion under the statute about whether a contingent claim is provable against the receiver. If it is proved, the FDIC must accept it as a proven claim. As a result, the word "may" should be changed to "shall" to assure that contingent claims, once proved, will be accepted.

Proposed Rule 380.4(c) provides that the "actual direct compensatory damages for repudiation" of a contingent obligation shall be no less than "the estimated value" of the claim as of the date the FDIC is appointed as receiver, and shall be "measured based upon the likelihood that such contingent claim would become fixed and the probable magnitude thereof." This simply confirms the statute and is consistent with the standard used in the Bankruptcy Code and the FDIC's statutory duty under Section 209 to harmonize the rules and regulations implementing Title II with the Bankruptcy Code. The rule should be revised to clarify that if the contingent claim becomes fixed before final distributions are made to creditors generally, the fixed amount should be the relevant amount rather than any estimate. Again, this is consistent with the standard in bankruptcy and with the FDIC's duty under Section 209 to harmonize the rules and regulations implementing Title II with the Bankruptcy Code.

Finally, the release accompanying the proposed rules includes the following comment, but no corresponding rule implementing this concept:

> "In addition, the FDIC holds the view that an obligation in the form of a guarantee or letter of credit is no longer contingent if the principal obligator (*i.e.*, the party whose obligation is backed by the guarantee or letter of credit) becomes insolvent or is the subject of insolvency proceedings."[25]

Although we understand the FDIC intended for this passage to mean that the claim against the guarantor or letter of credit issuer becomes absolute, the FDIC should clarify this

[25] 75 Fed. Reg. at 64179.

language. The FDIC should also amend this statement so that the guarantee or letter of credit would become absolute upon the occurrence of any event that would permit a draw down as a contractual matter, including a default by the primary obligor or a cross-default, and not simply the primary obligor's insolvency or being the subject of insolvency proceedings. Finally, the guidance should be transformed into a binding rule – a new subsection (d) to proposed Rule 380.4 – rather than remain as a non-binding statement in the release accompanying the proposed rule. This issue is so important that it needs to be confirmed in the form of a binding rule.

Please see Annex A for our answers to your specific questions subject to the 30-day comment period.

* * * * * * *

SIFMA thanks the FDIC for the opportunity to comment on the FDIC's NPR. If you have any questions, please do not hesitate to call me at 202-962-7400, or SIFMA's counsel, Randall D. Guynn, Davis Polk & Wardwell LLP, at 212-450-4239.

Sincerely,

Kenneth E. Bentsen, Jr.
Executive Vice President, Public Policy and Advocacy
Securities Industry and Financial Markets Association

<u>Annex A</u>

Solicitation for Comments on the Orderly Liquidation Authority

<u>Questions on the FDIC NPR with 30-day Comment Period (by November 18, 2010)</u>

1. Should "long-term senior debt" be defined in reference to a specific term, such as 270 or 360 days or some different term, or should it be defined through a functional definition?

Please see Section II.A of our comment letter in which we recommend that the FDIC withdraw proposed Rule 380.2(b). We believe the FDIC should not impose an absolute prohibition on making payments or credits to the holders of long-term debt, subordinated debt or equity or impose any special FDIC Board approval requirements on making payments or credits to anyone if necessary to promote financial stability during a financial panic. At a minimum, any absolute prohibition should be limited to regulatory capital instruments.

To the extent the FDIC retains an absolute prohibition on making payments or credits to long-term senior debt in the final rule, SIFMA believes that "long-term senior debt" should be defined by reference to remaining maturity as of the determination date, rather than maturity as of the date of issuance (unless that is the determination date). Any period chosen should be based on a judgment as to whether the period is long enough to eliminate any practical incentive to run.

2. Is the description of "partially funded, revolving or other open lines of credit" adequately descriptive? Is there a more effective definition that could be used? If so, what and how is it more effective?

Please see Section II.A of our comment letter in which we recommend that the FDIC withdraw proposed Rule 380.2(b). We believe the FDIC should not impose an absolute prohibition on making payments or credits to the holders of long-term debt, subordinated debt or equity or impose any special FDIC Board approval requirements on making payments or credits to anyone if necessary to promote financial stability during a financial panic. At a minimum, any absolute prohibition should be limited to regulatory capital instruments.

3. Should there be further limits to additional payments or credit amounts that can be provided to shorter term general creditors? Are there further limits that should be applied to ensure that any such payments maximize value, minimize losses, or are to initiate and continue operations essential to the implementation of the receivership or any bridge financial company? If so, what limits should be applied consistent with other applicable provisions of law?

On the contrary, please see Sections I and II.A of our comment letter in which we explain why the FDIC would need to exercise its powers under Title II, including through the issuance of implementing rules, in a manner that reduces or eliminates the incentive for the creditors of a covered financial company to run or cut off liquidity during a financial panic in order for Title II to provide a viable alternative approach to address the TBTF dilemma.

4. Under the Proposed Rule, the FDIC's Board of Directors must determine to make additional payments or credit amounts available to shorter term general creditors only if such payments or credits meet the standards specified in 12 U.S.C. 5390(b)(4), (d)(4), and (h)(5)(E). Should additional requirements be imposed on this decision-making process for the Board? Should a super-majority be required?

On the contrary, please see Sections I and II.A of our comment letter in which we explain why the FDIC would need to exercise its powers under Title II, including through the issuance of implementing rules, in a transparent and consistent manner that reduces or eliminates the incentive for the shorter term general creditors of a covered financial company to run or cut off liquidity during a financial panic in order for Title II to provide a viable alternative approach to address the TBTF dilemma.

While we believe that the FDIC should preserve the equal treatment of similarly situated creditors unless absolutely necessary to preserve or restore financial stability, we believe that the rule, as proposed, could unduly interfere with the FDIC's ability to exercise its powers in a manner that strikes the right balance among financial stability, value maximization, loss minimization, creditor fairness and market discipline.

5. Under the Dodd-Frank Act, secured creditors will be paid in full up to the extent of the pledged collateral and the proposed rule specifies that direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States shall be valued for such purposes at par value. How should other collateral be valued in determining whether a creditor is fully secured or partially secured?

Please see Section II.B of our comment letter in which we recommend that the FDIC rely on fair market valuations for all collateral, including U.S. government and agency securities collateral, and permit creditors to make credit bids for collateral if they believe the FDIC's valuation is too low.

6. During periods of market disruption, the liquidation value of collateral may decline precipitously. Since creditors are normally held to a duty of commercially reasonable disposition of collateral [Uniform Commercial Code], should the FDIC adopt a rule governing valuation of collateral other than United States or agency collateral? Would a valuation based on a rolling average prices, weighted by the volume of sales during the month preceding the appointment of the receiver, provide more certainty to valuation of other collateral? Would that help reduce the incentives to quickly liquidate collateral in a crisis?

Please see Section II.B of our comment letter in which we recommend that the FDIC rely on fair market valuations for all collateral, including U.S. government and agency securities collateral, and permit creditors to make credit bids for collateral if they believe the FDIC's valuation is too low. While we believe that secured creditors should be bound by standards of commercial reasonableness in disposing of collateral, we do not believe that any further rules, other than the ability of creditors to make credit bids for collateral they believe the FDIC is undervaluing, are necessary or appropriate at this time.

7. Are changes necessary to the provisions of proposed Section 380.3 through 380.6? What other specific issues addressed in these sections should be addressed in the proposed rule or in future proposed rules?

Please see Sections II.C and II.D of our comment letter for our comments on proposed Rules 380.3 and 380.4.