Alternative Investment Management Association

Robert E. Feldman,
Executive Secretary
Federal Deposit Insurance Corporation,
550 17th Street,
NW., Washington,
DC 20429

Submitted by email to Comments@FDIC.gov

18 January 2011

Dear Sirs,

Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protect Act

The Alternative Investment Management Association ('AIMA')[1] is pleased to provide comments to the Federal Deposit Insurance Corporation ('FDIC') on its Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority ('OLA') Provisions of the Dodd-Frank Wall Street Reform and Consumer Protect Act' (the 'Dodd-Frank Act') (the 'Proposed Rules').

AIMA fully supports the FDIC in its ability to resolve, in an efficient and controlled manner, failing financial institutions which pose a threat to the stability of the US financial system. It is important that the FDIC is given the necessary power to resolve failed or failing institutions in a manner that reduces its impact on the US markets and thus prevents the risk of contamination of instability spreading to other financial institutions during times of crisis. AIMA members are active in a wide number of US markets, and therefore we support the FDIC's financial stability goals. AIMA members additionally play an important role in the markets by purchasing securities of distressed companies in situations where other investors are not permitted or are not able to retain their investments. As distressed debt investors our members provide a market for holders of distressed debt, allowing the transfer of risk inherent in distressed debt to market participants that are able to properly assess and manage those risks.

Although we believe that the FDIC in the Proposed Rules has proposed a broadly sensible resolution regime which is based on the Bankruptcy Code, we are concerned on a number of issues where we believe there is insufficient clarity, certainty and transparency on how the FDIC will use the OLA. The US Bankruptcy Code has for a number of years provided a clear, equitable and tried-and-tested set of rules for resolving financial institutions[2]. However, we appreciate the policy goals of the OLA to go beyond the Bankruptcy Code and to have a regime that (i) addresses financial stability issues (e.g. through the use of bridge banks); and (ii) does not rely on tax-payer funding or 'bailouts'. We believe however that the implementation of the OLA can be conducted in such a way to achieve these goals without unfairly impacting distressed debt investors and that provides certain of outcome for all parties concerned.

Treatment of similar situation creditors

Central to the Bankruptcy Code and the OLA is that similarly situated creditors of a failed institution will receive the same treatment, except in certain limited scenarios that are desirable from a policy perspective. If such

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[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,200 corporate bodies in 45 countries, with 11% based in the US and over 30% of AIMA members' total assets under management (AUM) managed by US investment advisers.

[2] For example, we are aware that the Bankruptcy Code worked successfully to transfer customers' futures and options contracts held by Lehman Brothers Inc to other institutions within a week of the bankruptcy filing.

The Alternative Investment Management Association Limited
167 Fleet Street, London, EC4A 2EA
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exceptions are not properly drawn and are left too broad, it is possible that creditors and investors will be disincentivised in continuing to hold their debt and equity securities and will divest them before the firm is brought under the OLA regime. Such disincentive may have consequences including increased volumes of selling of the financial institutions securities leading to depression of prices and reduction of liquidity – this in turn is likely to harm the company at the time it most requires addition capital and funding, perhaps prematurely forcing it into the resolution process.

Although the Bankruptcy Code has the ability to make additional payments in a similar manner to the Proposed Rules, these are limited to, for example, payment of critical vendors. We believe that it is right that the OLA should ensure additional, necessary payments in two key situations:

- payment to a creditor providing critical services to the failing institutions or a bridging institution – for example, a utility, payment services or other essential vendors or suppliers required to operate the financial institution during the resolution process; and
- payment to parties to financial contracts that the FDIC requires and compels those parties to perform whilst resolving the financial institution.

We are particularly concerned with the proposal that makes a bright-line distinction between creditors based on the length of the term of the finance provided to the failing institution. The Proposed Rules make a distinction between short-term and long-term debt based on a decision that those holding long-term unsecured senior debt are not going to be essential for the continued operation or the orderly liquidation of the financial institution. Whilst the outcome in practice may see short-term debt holders receiving additional payments, we see no reason why this distinction is necessary and believe that to implement this proposal could have a number of detrimental effects on the market. For example, such a rule may lead to a distortion or manipulation of the debt market in which creditors would only be willing to provide funding on terms that would qualify them for this preferential treatment (i.e. only short-term funding). If less funding is available to financial institution and much is subject to preferential treatment, the proposed rule may lead to the financial institution failing more rapidly and spreading the risk of failure to other institutions in a faster manner. Additionally, the differences in treatment of short-term and long-term debt would lead to a distortion in the pricing of debt more generally, with inefficiencies around the specific term (i.e. above and below 360 day maturity). Should the FDIC however retain the sharp distinctions between short- and long-term debt, which we would discourage, the FDIC should at least consider an amendment to the proposed rules that sees the "term" of the instrument being the remaining term left and not the initial maturity.

A further considering for the FDIC is international creditors and distressed debt buyers which are active in the US markets, and we would appreciate a clear statement that when seeking to stabilise the US financial markets, it will treat non-US creditors in the same manner as US creditors without discrimination.

Valuation

Valuation of assets is of the utmost importance for any liquidation or dissolution of any company. The proposed rules address treatment of a proportion of a secured claim which exceeds the "fair market value" of the underlying collateral as an unsecured claim and treats any "under-secured" portion of a secured claim in the same way. The term "fair market value" is not defined and thus there is much uncertainty around how claims will be valued.

Additionally, the Proposed Rules include adopting fixed valuations for US government securities and potentially other forms of collateral. We believe this is unlikely to be desirable as it will lead to significant skews in the real value of assets and distort market values giving either an unjustified additional payment or an unjustified haircut to the value of a creditor's assets to the value they could achieve in the market. A preferred option would be to set a process by which a fair market valuation can be achieved at the time the assets are required to be valued (not valued pre-insolvency). Such processes may involve complexities on how to value different assets, with particular issues around illiquid and hard-to-value assets but we believe a fair valuation process can

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be achieved. Public consultation on this process should be conducted, if possible, to ensure there is sufficient transparency on this issue and to ensure that the FDIC and the market have given full consideration on how to conduct the valuations. If there are disputes as to the fair market value determined under the process, the FDIC may consider letting creditors bid for assets. By allowing this, it will ensure that the fair market value given is in line with what the market believes the assets are worth, taking into account any additional detractors from the asset's value such as FDIC claw-back rights (see below).

Claw-backs of additional payments

In addition to our concern about when additional payments may be made to certain creditors (discussed above), is a concern with the ability for the FDIC to claw-back some additional payments if the eventual recoveries are insufficient to avoid taxpayer liabilities for the resolution of the financial institution. We understand the policy objectives of such a provision – to avoid taxpayers being liable for bailing out or propping up the financial markets – however the manner in which this is proposed causes substantial uncertainties for creditors. Whilst some parties may use payments received for other business uses, others will be justifiably and importantly entitled to sell their claims to distressed debt investors. In both scenarios, this power to claw-back payments will create uncertainty that the amount paid is not the final settlement and may be subject to change at some future date when resolution of the financial institution is complete. This uncertainty will discourage investors from investing in distressed debt and reduce market liquidity, possibly preventing certain creditors from getting out of their investments. This could be another reason why firms may rapidly sell their debt and equity in the financial institution pre-insolvency and thus speed up the failure of the institution. An example of the difficulties for AIMA members would be the unwillingness of the members' investors to accept the uncertainty, especially where investors come in and out of investment funds on a regular basis and some will be subject to risks to the profitability of their investment by factors initiated in the past that cannot be properly assessed.

There are possible solutions to this issue which will reduce the uncertainty. The first is to consider limiting the situations in which additional payments can be made – as discussed above. The reduced number of additional payments means a reduced number of instances of claw-back. Further, where a claw-back of additional payments is made it should be clearly marked that the payment is potentially subject to a claw-back, and thus those that are not can be safely invested in, whilst those that are subject to claw-back can be invested in only by those investors who are willing to accept the risk and will credit-bid as to the valuation (likely at substantial haircuts to the value otherwise achievable).

The Proposed Rules also make provision for certain qualified financial contracts (QFCs) which may receive different treatment to other contracts and assets held by the failed institution. QFCs under the existing regime for FDIC regulated entities - the Federal Deposit Insurance Act (FDIA) - are subject to either transfer by the FDIC to a solvent entity or to termination of the contract with compensatory damages being provided at the date of repudiation. Under the new OLA, QFCs may only be transferred and may not be cancelled by the FDIC or the QFCs counterparty until the contract rests with a bridge bank (where used). The reason the FDIC under the FDIA may chose to liquidate a contract may be that it is not beneficial to the failed institution for the contract to be transferred but to simply be closed out and compensate the QFC counterparty. The new OLA may lead to the QFC counterparty receiving greater amounts than it would have otherwise received under the FDIA, and we are concerned that such greater amounts may be classed as "additional payments" and be subject to claw-back, as discussed above. The FDIC is given authority to determine whether a contract is a QFC and we believe it would be unfair to the QFC counterparty if after this determination is made they may be subject to the future risk of payment to the FDIC via an after-the-fact reassessment of the contract. Further, we would seek clarity from the FDIC that they will not seek to make a claim against the QFC counterparty for under collateralized amounts related to a QFC at the point at which the FDIC assumes the QFC, except as provided for in the terms of the contract. Without such clarity, the market will be subject to considerable uncertainty with resulting undesirable consequences, as discussed above.

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Further, any equity or rights to equity provided to a creditor in the new bridge company should not be considered an additional payment, subject to claw-back, which is consistent with the goal of maximising the value of the new bridge company and for the creditors of the failed institution.

Conclusion

AIMA supports the FDIC in its work in providing a workable resolution authority for failing and failed financial institutions that contributes to the goal of financial stability. We believe there are areas still to be addressed in the Proposed Rules that would reduce the uncertain of the operation of the regime, and will allow predictable outcomes on insolvency and thus aid the resolution rather than incentivise investors to 'sell-up' and speeding up the failing of an institution.

The Bankruptcy Code and the rules under the FDIA are clear, equitable and well-known by the financial community and should therefore be the template for any new regime. The FDIC should also seek to consult with the industry on all changes and non-emergency decisions wherever possible, and should provide mechanisms whereby creditors are entitled to provide views on issues, such as valuations, including by judicial review by a federal district court. Such opportunities to comment and input, and the provision of transparency on the process, will reduce the fear and uncertainty about how the regime will be applied. The FDIC's initiation of the OLA could also be clarified by providing guidance as to what factors the FDIC will consider when deciding whether to intervene in a failing institution.

We are, of course, very happy to discuss with you in greater detail any of our comments.

Yours faithfully,

Mary Richardson
Director of Regulatory & Tax Department

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