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March 23, 2011

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

Re: Interim Final Rule Implementing Certain Orderly Liquidation Authority Provisions

Dear Mr. Feldman:

The Investment Company Institute[1] appreciates the opportunity to comment on the FDIC's interim final rule ("IFR") implementing certain provisions of its authority to resolve covered financial companies under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] We also offer comments on the questions posed in the Notice. ICI members are investors of over $12 trillion of assets, including over $5 trillion in the U.S. bond and money markets.[3] Funds also regularly enter into qualified financial contracts ("QFCs"), including repurchase agreements[4] and over-the-counter ("OTC") derivatives transactions (*e.g.,* forward contracts and swap agreements) with counterparties that may eventually be deemed covered financial companies.[5] They

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.74 trillion and serve over 90 million shareholders.

[2] *Notice of Interim Final Rule Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 76 Fed. Reg. 4207 (Jan. 25, 2011) ("Notice").

[3] For more information on the U.S. registered investment company industry, *see* 2010 Investment Company Institute Fact Book at www.icifactbook.org.

[4] For example, ICI estimates that money market mutual funds are parties to approximately 30% of outstanding tri-party repurchase agreements. Sources: Federal Reserve of New York (for outstanding tri-party repurchase agreements) and ICI data (for money market fund repurchase agreement holdings).

[5] Under the Dodd-Frank Act, covered financial companies are nonbank financial companies that have been designated by the Secretary of the Treasury, after consultation with the President, based on certain statutory findings. These findings include that: the company is "in default or in danger of default"; its failure and resolution under otherwise applicable law

thus have a strong interest in ensuring that the liquidation of covered financial companies minimizes risk to the financial system, maximizes the value and minimizes the losses from the liquidated company, and treats creditors fairly in doing so.

As we explained in our previous letters on the proposed orderly liquidation authority provisions, we believe that clarity and certainty are critical elements of the orderly liquidation process.[6] As a general matter, Institute members have strong interest in ensuring that the financial markets are highly competitive, transparent and efficient, and that the regulatory structure that governs the financial markets encourages these traits. More specifically, a well-defined liquidation process will allow investors to better assess the risks associated with transactions involving entities that could become covered financial companies. Funds and other market participants might be wary of offering credit to such institutions without greater clarity as to how their transactions might be resolved by the FDIC in the event of an orderly liquidation. Consistent with ensuring that the liquidation process is clear and well-understood, we previously recommended that that the FDIC adopt a provision specifying that, in the absence of a rule specific to Title II, the relevant provisions of the Bankruptcy Code and related judicial interpretations will serve as binding precedent.[7] We continue to urge this approach.

In keeping with these recommendations, we applaud the FDIC for the steps it has taken to date, including offering the public multiple opportunities to comment on proposed and future orderly liquidation rulemaking, and issuing the IFR while seeking comment on how to further refine the rule. We also appreciate the attention paid to comments received prior to adopting the IFR.[8]

Along the same lines, we continue to request further clarification on the process by which QFCs, particularly those that involve collateral, would be resolved under the multiple scenarios that could arise in an orderly liquidation. As we noted in our November Letter, while we believe the Dodd-Frank Act clearly establishes the rights of parties to these contracts in the event a counterparty is liquidated, market participants could benefit from additional clarity in the implementing rules. We also address certain special considerations that may arise in the context of a covered financial company

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would have serious adverse effects on U.S. financial stability; and, there is no viable private sector alternative to prevent the company's default.

[6] *See* Letters from Karrie McMillan, General Counsel, Investment Company Institute, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation, dated November 18, 2010 ("November Letter") and January 18, 2011 ("January Letter").

[7] This is consistent with the mandate, in Section 209 of the Dodd-Frank Act, "to seek to harmonize applicable rules and regulations promulgated under this section with the insolvency laws that would otherwise apply to a covered financial company."

[8] In particular, commenters including the ICI recommended that for purposes of §380.2 of the proposed rule, government securities should be valued at their fair market value, rather than at par as initially proposed; this recommendation was incorporated into the IFR.

that is a major participant in OTC derivatives contracts and/or repurchase agreements. Finally, we recommend that, when QFCs are not transferred to a bridge financial company, the FDIC allow for additional flexibility with respect to the valuation and disposition of collateral for QFCs when market circumstances so require. These comments are discussed further below.

Recommended Clarifications Regarding the Resolution of Collateralized Qualified Financial Contracts

Because of their frequent participation in QFCs involving collateral, Institute members are particularly interested in the application of §380.2(c), including the process by which these contracts are unwound, as well as the valuation of collateral, payment of secured claims, and assessment of unsecured claims (discussed below). As we noted in our November Letter, we believe that the scope of application of §380.2(c) – *i.e.,* in what circumstances it may be necessary to value collateral and assign an unsecured claim – is not clear. We recommend two clarifications to the rule in this regard, both of which are consistent with the Dodd-Frank Act.[9]

First, we recommend that the FDIC clarify that §380.2(c) only applies if a contract is *not* transferred to a bridge financial company.[10] As explained in the Notice, the purpose of a bridge financial company is to prevent a disorderly collapse and maximize the value in a liquidation by preventing the immediate termination of QFCs and other operations. Indeed, Section 210(c)(10) of the Dodd-Frank Act prohibits parties to QFCs transferred to a bridge financial company from terminating the QFCs simply because they are assumed by the bridge financial company. Section 210 (c)(8)(A), meanwhile, preserves, with limited exceptions, all other contractual rights of a creditor in a QFC. Based on these provisions, it is our understanding that a bridge financial company is expected to meet the obligations of the covered financial company under the terms of a QFC transferred to it, and the contract should ultimately terminate at its expiration or for other contractually permitted reasons.[11] As a result, there should be no reason, upon the appointment of a receiver for the covered financial

[9] The requested clarifications are not necessarily inconsistent with the IFR, but are somewhat ambiguous in the Notice and rule text.

[10] This clarification could be made in the text of an adopting release, rather than in rule text.

[11] We note that this understanding is consistent with a proposed rule made public by the FDIC on March 15, 2011. *See Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act,* (March 15, 2011) ("March 15 Notice"). Specifically, proposed §380.26 states that where the bridge financial entity assumes contracts or agreements, it "shall have the right and obligation to observe, perform and enforce their terms and provisions."

company, to assign a value to the collateral held under a QFC that is transferred to a bridge financial company.[12]

Second, we recommend that the FDIC clarify that nothing in §380.2(c) is intended to foreclose the right of a creditor in a collateralized QFC to take control of the collateral, following the one-business-day stay provided for in Section 210(c)(10) of the Dodd-Frank Act, in the event a termination provision is triggered (*e.g.,* if the contract is not transferred to a bridge financial company, and the contract has a termination right if the debtor is placed into receivership). Indeed, the preservation of this right is clearly contemplated by Section 210(c)(8)(A), which explicitly preserves the termination rights as well as *any* rights under security arrangements or other credit enhancements related to a QFC. The text of the IFR, however, states that a proven claim "shall be paid or satisfied in full to the extent of such collateral," suggesting that the FDIC might itself liquidate the collateral and pay its established value to the creditor under a QFC. This confusion is compounded by question 5 in the Notice, which again references the "date of payment of the claim," rather than the date a creditor takes control of the collateral. Given the importance of Section 210(c)(8)(A), we believe a clarification is warranted.[13]

Based on these proposed clarifications, we believe that §380.2(c) is only relevant for collateralized QFCs to the extent they are not transferred to a bridge financial company. Further, in such instances, the purpose of §380.2(c) with respect to QFCs is to establish the value of the collateral seized by the creditor, in order to determine the value of any remaining unsecured claim. With this understanding of §380.2(c), we offer the following considerations regarding when contracts should be transferred to a bridge financial company, and respond to questions posed in the Notice regarding the appropriate timing of collateral valuation for purposes of assessing any remaining unsecured claim, and possible adjustments in the event of market fluctuations in the value of such collateral.

Special Considerations Regarding Transfer of Repurchase Agreements and other QFCs to a Bridge

As noted above, ICI members are substantial participants in the repurchase agreement and OTC derivatives markets.[14] They are therefore particularly focused on the resolution of these types of contracts, including the circumstances under which they would be transferred to a bridge financial company or, conversely, under which a fund might have a right to terminate and take control of collateral. Repurchase agreements are typically collateralized at a minimum of 102 percent.[15]

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[12] Should the bridge financial company later default on a QFC, we expect that the creditor would maintain its contractual rights and remedies regarding default and seizure of collateral, unless and until the bridge financial company itself were placed into receivership. This is consistent with Section 210(h)(16) of the Dodd-Frank Act.

[13] *See also* November Letter, *supra* note 6,, recommending a similar clarification.

[14] *See supra* note 4.

[15] *See, e.g.,* Tri-Party Repo Margin Data as of Feb. 9, 2011 (showing the range of excess collateral required based on types of collateral accepted), available at http://newyorkfed.org/tripartyrepo/margin_data.html.

Investment companies also typically require a high level of collateralization for derivatives contracts, with frequent movements of collateral based on mark-to-market pricing. We expect that, consistent with the FDIC's goal of maximizing value in a liquidation, such fully collateralized contracts would be transferred to a bridge financial company and would terminate upon their expiration or for other contractually permitted reasons.

In connection with the demise of a covered financial company (which, by definition, could have serious adverse effects on U.S. financial stability), however, it is possible that the value of the collateral accepted under these contracts could experience a sudden, significant, and likely temporary drop. This drop could be further compounded if the contracts secured by these assets, which may be undersecured as a result of the drop in value, were left in the receivership, forcing counterparties to take control of and sell the collateral. Indeed, if the covered financial company was a substantial participant in OTC derivatives and/or repurchase agreements, this could result in a glut of collateral being liquidated at once, resulting in a "fire sale" environment.[16]

As the Notice explains, the purposes of a bridge financial company are both to maximize the value in a liquidation and to "prevent the immediate and disorderly liquidation of collateral during a period of market distress." We believe the latter directive dictates that, in a circumstance where a sudden drop in the market value of collateral renders a portfolio of QFCs undersecured, particularly where the rapid liquidation of that collateral could further destabilize the market, such contracts should be transferred to the bridge financial company for orderly resolution. This is a critical element of the FDIC's orderly liquidation mandate.

The Appropriate Timing for Valuation of Collateral

We agree with the FDIC's assessment, set forth in the Notice, that applying a fair market value to all types of collateral for purposes of establishing residual claims will provide crucial certainty.[17] We also concur that, to the extent possible, clarity regarding the establishment of dates for determining the value of collateral for a secured claim will provide potential claimants with greater certainty when

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[16] The largest borrowers in the tri-party repurchase agreement market routinely finance as much as $100 billion at any one time, backed by collateral that can range from Treasury securities to non-investment-grade private-label collateralized mortgage obligations. *See* Tri-Party Repo Infrastructure Reform, A White Paper Prepared by the Federal Reserve Bank of New York, May 17, 2010, available at http://www.newyorkfed.org/banking/nyfrb_triparty_whitepaper.pdf. Treasury securities and agency mortgage-backed securities *each* comprise approximately 30 percent of outstanding collateral in this market. *See* Tri-Party Repo Margin Data as of Feb. 9, 2011, *supra* note 15. Even though such securities are generally extremely liquid, the potential flood of collateral to the market resulting from the default of a large borrower could substantially impact the price of such securities.

[17] *See supra* note 8. We note that many QFCs set forth specific terms for determining the fair market value of collateral. Where these terms exist, the FDIC should honor them. Honoring the terms of the parties' agreement would provide more certainty than any valuation method the FDIC could impose, and is also consistent with Section 210(c)(8)(A) of the Dodd-Frank Act which, subject to limited exceptions, preserves the contractual rights of creditors under QFCs.

determining the extent of their secured and unsecured claims. We do not agree, however, that the date of appointment of the receiver is the appropriate valuation date for collateral securing a QFC. The *earliest* that such collateral should be valued is the time at which a creditor is entitled to take control of the collateral. Further, in certain circumstances we urge the FDIC to permit additional flexibility in establishing the valuation date for collateral securing a QFC.

As a preliminary matter, in no event should collateral securing a QFC be valued prior to the time at which a creditor is entitled to take control of – and therefore dispose of – the collateral. In most circumstances, this would be concurrent with the termination of the one-business-day stay, at which point a creditor would likely terminate the QFC.[18] We note that the Dodd-Frank Act treats repudiation of QFCs by the receiver in a manner consistent with this approach. Specifically, Section 210(c)(3) of the Dodd-Frank Act states that a QFC that is repudiated by the receiver is valued as of the date of repudiation – *i.e.,* the date the creditor is entitled to take control of the collateral.

Such an approach would eliminate the possibility of a fluctuation in value between the date of valuation and the date of "payment of the claim" (*i.e.,* the seizure of collateral), as discussed in question 5 of the Notice, and would offer immediate clarity on the value of a creditor's remaining unsecured claim, if any. In addition to being consistent with Section 210(c)(3), this approach is similar to Section 562 of the Bankruptcy Code, under which damages for QFCs are typically determined at the earlier of the date the contract is terminated, or the date it is rejected – again, as of the date the creditor is able to take control of the collateral.

In some instances, however, a creditor under a QFC may not reasonably be able to dispose of collateral immediately upon taking control of it. For Institute members, this is a particular concern in the circumstances described above, in which the covered financial company is a substantial participant in the OTC derivatives and/or repurchase agreement market, such that the termination of even a portion of its QFCs (*i.e.,* those not transferred to a bridge financial company) could result in a large amount of collateral being disposed of by counterparties simultaneously. As we noted earlier, we believe the FDIC's orderly liquidation mandate dictates that any group of QFCs that could create such circumstances should be transferred to the bridge financial company to avoid such disorderly liquidation, as well as any knock-on market effects that may follow.

In the event such QFCs are not transferred to a bridge financial company, we recommend that the FDIC acknowledge that there may be circumstances in which a date certain for establishing the valuation of collateral may not be feasible. In such cases, a fact-based inquiry as to the appropriate time or method for valuation may be necessary. The Bankruptcy Code takes one such approach in circumstances where a date certain is not practical. Section 562 states that if there are no "commercially

[18] Because the one-business-day stay under the Dodd-Frank Act may terminate as late as 5:00 p.m. on the business day following the appointment of the FDIC as receiver, *i.e.,* after the markets close, in some cases the valuation will necessarily take place on the following business day.

reasonable determinants of value" for collateral as of the specified date, damages should be measured as of the earliest subsequent date on which a commercially reasonable determinant of value is available. The legislative history of Section 562 makes clear that Congress contemplated circumstances much like those described here: "in certain unusual circumstances, such as dysfunctional markets or liquidation of very large portfolios, there may be no commercially reasonable determinants of value for liquidating any such agreements or contracts or for liquidating all such agreements and contracts in a large portfolio on a single day."[19] In such cases, the appropriate date for measurement of damages is a mixed question of fact and law.[20]

Another fact-based approach to valuation of collateral in the event of contractual (*i.e.,* non-bankruptcy-related) default is found under the Uniform Commercial Code. In such cases, parties are typically required to dispose of collateral in a "commercially reasonable manner."[21] Indeed, the FDIC has proposed a similar approach for the disposition of property of a covered financial company that serves as collateral under a secured agreement other than a QFC. The recently proposed §380.51 would permit a secured creditor to seek consent from the receiver to liquidate such property "by commercially reasonable methods taking into account existing market conditions."[22] For this reason, we recommend that the FDIC permit a similar approach for QFCs

We recognize that there is tension between the need for a flexible approach and the FDIC's efforts to establish a clear date for valuing collateral. Nonetheless, a more flexible approach to the timing of valuation is critical in these circumstances for several reasons. Several Institute members tell us that, if their collateral were required to be valued at "fire sale" prices for purposes of determining any residual claims, their risk management policies would generally require the funds to sell the collateral

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[19] H.R.Rep. No 109-31 at 134-35 (2005). A recognition that the mere existence of a price (*i.e.,* if there are opportunistic buyers in a distressed market) does not necessarily mean that such a price is "commercially reasonable" is also consistent with approaches taken by the FASB and the SEC with respect to fair valuation. *See, e.g.*, FASB Accounting Standards Codification, Fair Value Measurements and Disclosures, 820-10-35-51F ("If the weight of the evidence indicates the transaction is not orderly, a reporting entity shall place little, if any, weight … on that transaction price when estimating fair value…."); SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, SEC Press Release, Sept. 30, 2008 ("The results of disorderly transactions are not determinative when measuring fair value.").

[20] *See In re American Home Mortgage Holdings, Inc.,* 411 B.R. 181, 193 (Bankr. D. Del. 2009) (exploring the meaning of "commercially reasonable determinant of value," and determining that "[w]hether a specific methodology is commercially reasonable and correctly applied is a mixed question of fact and law" to be considered by a court).

[21] *See, e.g.,* Bond Market Association, Master Repurchase Agreement, September 1996 version, available at http://www.sifma.net/agrees/master_repo_agreement.pdf. The model ISDA credit support annex that is typically used when a swap transaction is collateralized contains similar terms.

[22] *See* March 15 Notice, *supra* note 11. The proposed rule is intended to implement Section 210(c)(13)(C) of the Dodd-Frank Act, which requires a non-defaulting party to obtain permission from the FDIC as receiver before exercising control over any property of the covered financial company for 90 days. QFCs are explicitly excluded from this requirement.

quickly, into the distressed market, further exacerbating a declining and disorderly market; this would be the case even if the conventional wisdom was that the market would stabilize and the value would recover in a short timeframe. Members also indicate that if collateral were required to be valued as of the date of termination in a distressed market, they may begin to require a higher level of collateralization, particularly in the repurchase agreement market. This would substantially increase financing costs for the many securities firms that use repurchase agreements to finance their fixed income and equity securities inventories, and would drastically reduce a borrower's ability to borrow in periods of financial market distress.[23]

We recommend that in circumstances where a creditor under a QFC may not reasonably be able to dispose of collateral immediately upon taking control of it, either because of market disruptions or because the amount of collateral that would be sold as a result of simultaneous QFC terminations would itself cause market movements, the FDIC should require the creditor to dispose of the collateral by commercially reasonable methods taking into account existing market conditions, and should value the collateral – and any residual claim – in accordance with the actual price received for such collateral. While this may impose on the FDIC a burden of monitoring the performance of creditors, as discussed above we believe such occasions will be extremely limited, because in these circumstances the QFCs generally should be transferred to a bridge financial company pursuant to the FDIC's mandate to avoid disorderly liquidation of collateral. Moreover, creditors have little incentive to dispose of collateral in a manner other than one that is commercially reasonable and offers them the best opportunity for recovery.[24] Ultimately, we believe that in the limited circumstances we describe, the minimal additional burden on the FDIC and the marginal lack of certainty and clarity are a far superior result compared to the potential market impact of driving creditors to unload substantial amounts of collateral into an uncertain market in a short period of time.

Adjustments for Market Fluctuations

Our recommendation to value collateral for QFCs no earlier than the time at which a creditor is entitled to take control of the collateral would eliminate the concern, described in question 5 of the Notice, regarding the possibility of a fluctuation in value between the date collateral is valued and the date it may be sold by a creditor. If the FDIC does not take our recommendation, and instead uses the date of appointment of the FDIC as receiver or, as suggested in the Notice, the day *prior* to the appointment of the receiver in some circumstances, such differences would need to be resolved.

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[23] The importance of the U.S. repo market is further underscored by the fact that it is the market in which the Federal Reserve operationally implements U.S. monetary policy. *See* Report of the Task Force on Tri-Party Repo Infrastructure, Payments Risk Committee, May 17, 2010, available at http://www.newyorkfed.org/prc/report_100517.pdf.

[24] In theory, a creditor could watch the market for longer than necessary, hoping for an increase in value but allowing the receivership to take on most of the downside risk (*i.e.,* any loss would result in a corresponding unsecured claim, while any gain up to 100 percent of the original value would accrue to the creditor). Given that a creditor can only expect to receive a fraction of any unsecured claim, however, most of the downside risk would in fact be borne by the creditor.

We recommend that secured creditors be made whole to the greatest extent possible, while any overage should accrue to the receivership. That is, in the event the value of collateral on a $100 claim is $98 on the date of valuation and $102 on the date the creditor takes control of– and therefore may dispose of – the collateral,[25] the creditor should return $2 to the receivership. Should the market move in the other direction, such that the value of the collateral is $102 on the date of valuation and $98 on the date the creditor takes control, the creditor should receive a $2 *secured* claim in addition to the collateral. The creditor should not be penalized by the existence of the one-business-day stay, which prevents it from exercising its contractual rights to take control of the collateral immediately.[26]

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ICI appreciates the FDIC's attention to our comments. If you have any questions, please contact me at 202/326-5815, Mara Shreck at 202/326-5923, or Rachel Graham at 202/326-5819.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

[25] In the event a creditor cannot reasonably dispose of collateral on the date of termination, as discussed above, we recommend that any overage due to the receivership or residual claim of the creditor be based on the price eventually received for the collateral, which the creditor should have disposed of by commercially reasonable methods taking into account existing market conditions.

[26] This approach is consistent with Section 210(a)(7)(B) of the Dodd-Frank Act, which states that in no event should a creditor receive less than the amount the creditor would be entitled to receive under chapter 7 of the Bankruptcy Code.