MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

March 28, 2011

Via Electronic Filing

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

Re: Responses to Interim Final Rule Implementing Certain Orderly Liquidation Authority Provisions

Dear Mr. Feldman:

Managed Funds Association ("MFA")[1] appreciates the opportunity to respond to the Federal Deposit Insurance Corporation's (the "FDIC") Notice of Interim Final Rule Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Interim Final Rule"). MFA supports the goal underlying Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), creating an orderly liquidation authority ("OLA") for financial firms whose failure threatens the financial stability of the United States. On November 18, 2010 and January 18, 2011, MFA submitted comment letters to the FDIC in response to the FDIC's proposed rule.[2] This letter supplements our two previous letters.

Before discussing the specific issues raised in the Interim Final Rule, we believe it is important to identify the principles that should be the foundation for all of the FDIC's rules under Title II.

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[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] MFA's November 18, 2010 comment letter is available at:
http://www.managedfunds.org/downloads/MFA.Letter.on.Orderly.Liquidation.Authority%20.final.pdf.
MFA's January 18, 2011 comment letter is available at:
http://www.managedfunds.org/downloads/MFA%20comment%20letter%20on%20OLA%20proposal.pdf.

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Underlying Principles

As stated in our November and January letters, MFA supports an OLA that is designed to achieve Congress's goal to unwind failing firms that pose a threat to the stability of this country's financial system in a manner that is fair, efficient, transparent, and predictable and that maximizes value and minimizes creditor (and, if possible, shareholder) losses.[3] As the FDIC states in the Interim Final Rule, the Dodd-Frank Act mandates "transparency" in the liquidation process and "incorporates procedural and other protections for creditors to ensure that they are treated fairly."[4]

We remain deeply concerned that the broad discretion given to the FDIC to assign contracts and selectively pick-and-choose the assets and liabilities that survive a liquidation has the potential to further destabilize markets at a time when those markets are already rattled by the pending failure of a systemically significant firm. Without clearly established rules regarding such decisions, market participants may have the impression that the FDIC is subject to non-statutory considerations, particularly to the extent that certain market participants are considered "winners" or "losers" as compared to liquidation under the Bankruptcy Code. This concern would undermine market confidence in the OLA, which would inhibit the FDIC's ability to liquidate firms in a manner that reduces systemic risk.

Accordingly, MFA believes it is critical that the FDIC establish clear rules and processes that, to the fullest extent possible, mirror those under existing bankruptcy law and provide for the maximum transparency and participation of affected parties practicable under the circumstances. We encourage the FDIC to base its rulemaking on the following principles:

- Harmonize the OLA with the Bankruptcy Code. To the closest extent possible, the rules for the OLA should be brought in line with the United States Bankruptcy Code (the "Bankruptcy Code" or the "Code"),[5] the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") and related case law. The only exceptions to this principle should be those limited features of the OLA that allow the FDIC to avert an imminent threat of a financial market meltdown.

  This not only will foster confidence in the OLA process, but it is also Congress's express intent. Congress gave the FDIC broad authority to adopt appropriate rules and regulations in connection with the liquidation of a covered financial institution but specified that, "[t]o the extent possible," the FDIC "shall seek to harmonize" any such rules and regulations with "the insolvency laws that would otherwise apply to a covered financial company."[6]

[3] Dodd-Frank Act § 204(a), 12 U.S.C. § 5384(a).

[4] 76 Fed. Reg. 4207 (Jan. 25, 2011).

[5] 11 U.S.C. §§ 101, et seq.

[6] Dodd-Frank Act § 209, 12 U.S.C. § 5389.

The Bankruptcy Code contains extensive, well-understood provisions that have been refined and amended numerous times over several decades. The Code is supplemented by detailed procedural rules (the Bankruptcy Rules) and a well developed body of case law. This process has cemented many legal principles and increased predictability for all parties in interest. As a result, investors and others in the financial community—including members of the MFA—are sufficiently comfortable with the bankruptcy process that they are willing, both in advance of and during a possible insolvency proceeding, to provide the financing and liquidity that are critical to the stable functioning of the markets.[7] In order to establish similar confidence in the OLA process, the FDIC's rules should make clear that the FDIC will seek to follow the text of the Bankruptcy Code and the well-established body of case law and practice used to interpret and implement the Code.

- <u>Targeted and Limited Use of Title II.</u> The Dodd-Frank Act authorizes appointment of the FDIC as receiver only where doing so is necessary to preserve the "financial stability of the United States."[8] Congress has directed the FDIC to allow a company to enter normal bankruptcy proceedings in all other cases, and the Bankruptcy Code has been highly successful in resolving insolvencies in a fair and transparent manner. The FDIC therefore should clarify in its rulemaking that it will recommend its appointment under OLA only as necessary to avoid systemic risk.

- <u>Transparency.</u> Bankruptcy is a transparent, public process in which trustees must: (1) publicly file periodic reports outlining the financial condition of the estate (including detailed accounts of revenues and expenditures); (2) provide a final accounting when they close the estate; and (3) generally seek bankruptcy court approval—following notice to affected creditors and an opportunity for a hearing—for most significant actions, including sales of assets out of the ordinary course of the debtor's business and for approval of settlements of litigation and other disputes. We encourage the FDIC to adopt similar processes and procedures under the OLA to ensure a transparent process.

- <u>Creditor Participation.</u> Creditor involvement in the bankruptcy process is not only permitted but highly encouraged. In complex proceedings, creditors committees are typically formed, and they, along with other creditor groups, participate actively. A covered financial company's creditors will likely include large financial institutions and other sophisticated market participants that not only will have familiarity with the covered financial company (having extended credit to it), but that will also have considerable market expertise. They can bring an important perspective to the FDIC that can help "inform and aid" the FDIC as receiver. The FDIC should adopt rules that permit creditor participation in liquidations under the OLA similar to the process in bankruptcy.

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[7] *See* MFA's November 18th letter at 2.

[8] Dodd-Frank Act §§ 203(b)(2), 206(1), 12 U.S.C. §§ 5383(b)(2), 5386(1).

- Disclosure and Review. Virtually all actions taken by the FDIC over the course of an orderly liquidation can vitally affect the rights of creditors. However, only in limited instances, including disputes regarding claim disallowance, does the statute expressly afford creditors judicial review.[9] We strongly encourage the FDIC to adopt rules to provide creditors an opportunity to obtain judicial review except where Title II expressly bars it.[10] Without robust rights of judicial review, creditors of the covered financial company will have little interest in holding claims against a firm subject to the OLA. Such creditors are likely to sell their claims, and terminate financing relationships, the moment they believe a systemically significant firm is experiencing distress. This behavior would actually exacerbate volatility in financial markets, contravening the entire purpose of the OLA.

With these opening remarks as background, we now turn to the specific issues and questions raised in the Interim Final Rule.

Additional Payments to Similarly Situated Creditors

In the Interim Final Rule, the FDIC asks if there are "additional ways to reduce moral hazard and increase market discipline and to clarify that all creditors should assume that they will receive no additional payments and their recovery will be limited to what will be paid according to the order of priorities established under section 210(b)." Similarly, the FDIC asks whether there are "additional ways to counteract any impression that shorter term debt is not at risk."

We think the short answer is that the FDIC should amend its Interim Final Rule to provide that only providers of ongoing, necessary, non-financial services will be eligible to receive additional payments, and then only to the extent that such additional payments meet the statutory criteria. In this regard, the FDIC should remain faithful to Dodd-Frank's directive that similarly situated creditors should be treated the same and that the exception to this rule—the circumstances in which the FDIC can make additional payments to particular creditors—should be narrow and invoked only when "necessary" either to "maximize . . . value" in the receivership or to continue operations that are "essential" to the receivership or to a bridge financial company.[11] To achieve this statutory goal, we encourage the FDIC to eliminate any suggestion that creditors may be potentially eligible for additional payments if the contracts underlying their claims have a term of less than a year. While we note and appreciate the language in the Interim Final Rule that short-term creditors will only receive extra payments if the statutory criteria are met, we continue to believe that including the length of the debt instrument as a relevant factor is neither necessary nor appropriate. Further, we are concerned that distinguishing between creditors based on the length of the financing they provide is likely to lead to distortions in the allocation of capital as market participants will be incentivized to provide short-term financing

[9] Dodd-Frank Act § 210(a)(3)-(5), 12 U.S.C. § 5390(a)(3)-(5).

[10] Dodd-Frank Act §§ 202(a), 205(c), 12 U.S.C. §§ 5382(a), 5385(c).

[11] Dodd-Frank Act § 210(b)(4), 12 U.S.C. § 5390(b)(4).

rather than longer-term financing, particularly to weakening financial companies that may be subject to the OLA.

In the Interim Final Rule, the FDIC states that the reason for distinguishing between long-term and short-term debt holders is to distinguish bond holders from "providers of financing who have made lines of credit available to the covered financial company that may be essential for its continued operation and orderly liquidation." Later in the Interim Final Rule, however, the FDIC states that short-term lenders are highly unlikely to qualify for an exemption from potential claw-backs of additional payments because the exemption only applies to "payments or amounts necessary to initiate and continue operations essential to the implementation of the receivership or any bridge financial company." These two statements appear to be inconsistent with each other and reinforce market participants' uncertainty about the potential for unnecessary additional payments being made to short-term debt holders.

The Interim Final Rule also makes clear that the FDIC has authority under Section 210(c)(13)(D) of the Dodd-Frank Act to "enforce lines of credit to the covered financial company and agree to repay the lender under the credit agreement." Given this explicit authority to deal with providers of lines of credit, it is unclear why the FDIC also would need to exercise its authority under Sections 210(b)(4), (d)(4), or (h)(5)(E) to make additional payments to providers of lines of credit.

Accordingly, we strongly urge the FDIC to amend its Interim Final Rule to eliminate the provision that creditors are eligible for additional payments if the contracts underlying their claims have a term of less than a year. We believe this amendment is important to achieve two of Dodd-Frank's important mandates—that similarly situated creditors should generally be treated the same and that the FDIC should "harmonize" Title II with the Bankruptcy Code. Indeed, on this very issue, Congress provided the safeguard that additional payments to preferred creditors can occur only if all similarly situated creditors are assured that they will receive at least as much in the receivership as they would if the covered financial company had been liquidated under Chapter 7 of the Bankruptcy Code.[12] In bankruptcy, the policy of "equality of distribution among creditors" is "fundamental"[13] and accomplished without regard to arbitrary considerations such as the term of the contract underlying a creditor's claim. While bankruptcy courts have sometimes permitted in Chapter 11 reorganizations additional payments to "critical vendors" under a judge-made "doctrine of necessity," the statutorily-mandated priority scheme in Chapter 7 liquidations calls for all general unsecured creditors to be paid ratably.[14]

[12] Dodd-Frank Act §§ 210(b)(4)(B), (d)(2)(B), 12 U.S.C. §§ 5390(b)(4)(B), (d)(2)(B).

[13] *See In re Combustion Eng'g*, 391 F.3d 190, 239, 241, 248 (3d Cir. 2004) ("The Bankruptcy Code furthers the policy of 'equality of distribution among creditors' by requiring that a plan of reorganization provide similar treatment to similarly situated claims. . . . Several sections of the Code are designed to ensure equality of distribution from the time the bankruptcy petition is filed."); *see also Union Bank v. Wolas*, 502 U.S. 151, 161 (1991) (noting, "[P]reference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.") (citation omitted).

[14] 11 U.S.C. § 726.

We further urge the FDIC, when serving as receiver, to carefully examine requests for additional payments by creditors that claim they provide essential services or financing to the receivership. The experience in bankruptcy has at times been that so-called "critical" vendors have not been all that critical, and debtors have permitted their payment ahead of other similarly-situated creditors without the necessary proof that the preferred vendors really are critical to the debtor's ongoing operations and their payment will benefit all creditors. Preferential treatment should be proven to be necessary to maximize the value of the estate for all creditors, and "preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors."[15]

Moreover, if the FDIC allows some creditors to receive additional payments beyond those afforded other, similarly situated creditors, it will be difficult for the FDIC to ensure that all such creditors receive at least the amount they would have received in a Chapter 7 liquidation, unless it is demonstrably clear that the additional payments to the favored creditors brought value to the receivership estate that, on a net basis, increased the payments to all unsecured creditors. The FDIC should therefore not only rarely invoke its authority to make additional payments to any creditors, but it also should issue a rule that, prior to making an additional payment to a creditor, the Board of Directors of the FDIC must document, on a quantitative and qualitative basis, how the additional payment to the creditor will benefit the estate and enable all creditors (including those not receiving the additional payments) to receive at least as much as they would in a Chapter 7 liquidation in which all general unsecured creditors would receive the same ratable payments.

Accordingly, we encourage the FDIC to propose for public review and comment regulations setting forth mechanisms as to how the FDIC, as receiver, will ensure that all creditors will receive at least as much in the receivership as they would in a Chapter 7 bankruptcy liquidation. This is a critical protection for creditors, and in each case the determination of the liquidation value for the covered financial company must be made with great care, with an opportunity for creditor input, and also with maximum opportunity for judicial review at the request of creditors.

Valuation of Collateral

Like the Bankruptcy Code,[16] the Dodd-Frank Act treats any portion of a secured claim that exceeds the fair market value of the underlying collateral as an unsecured claim, to be paid in the same manner as other general unsecured claims.[17] The Dodd-Frank Act does not define the term "fair market value." The FDIC's proposed rule contemplated that the FDIC would establish a fixed valuation for U.S. government securities, though that provision was amended in the Interim Final Rule to provide that all collateral, including U.S. government securities, will be valued at fair market value. We support this change because we believe that fixed valuations are

[15] *See In re Kmart Corp.*, 359 F.3d 866, 873-74 (7th Cir. 2004) (finding that in order to receive preferential payments ahead of similarly-situated creditors, there must be proof that a creditor is critical; to discriminate among unsecured creditors, discrimination must be necessary to facilitate a reorganization).

[16] 11 U.S.C. § 506(a)(1).

[17] Dodd-Frank Act § 210(a)(3)(D)(ii)(I), 12 U.S.C. § 5390(a)(3)(D)(ii)(I).

inconsistent with the statutory standard of fair market value and can lead to distortions in market activity.

In the Interim Final Rule, the FDIC asks whether "additional guidelines would be useful in creating certainty with respect to establishment of fair market value of various types of collateral for secured claims." We encourage the FDIC, after providing opportunity for public comment, to develop valuation rules and procedures that will allow it to establish a fair, transparent and predictable process to determine fair market value for all assets subject to the OLA. In this regard, we believe that the best test for "fair market value" is often the market itself. For example, in appropriate cases, the FDIC could seek to sell the collateral and allow the secured creditor to credit bid for the asset, thereby obtaining a true market valuation for the asset and, concomitantly, for the creditor's unsecured deficiency claim. In addition, the FDIC could look to the mechanisms provided in the contract, such as utilizing available quotes and market data from third-party market participants for similar financial assets.

The Interim Final Rule also asks "should the date of appointment of the receiver be used as the valuation date for all types of collateral, or only government securities or other publicly traded securities." On a related note, the Interim Final Rule asks for comments as to whom – the secured creditor or the receivership estate – "should receive the benefit or burden of market fluctuations between the date of appointment of the receiver and the date of payment of a claim." The context for these questions is not clear to us, at least to the extent that the questions are focused on swaps, repurchase agreements or other securities contracts. If such a contract is transferred to a bridge financial company, it is our understanding that the contract will continue, with each side having all the same rights, but with the bridge financial company substituted for the entity in receivership as the counterparty. If, instead, the contract is not transferred to a bridge, it is our understanding that the creditor will be able to declare a default and exercise its rights under the contract to close out the contract (or not), just as would be the case if the counterparty were in bankruptcy. In either context, it is not clear to us why the collateral will need to be valued for purposes of determining the amount of a secured claim by the creditor against the receivership estate.

Estimation of Contingent Claims

Finally, the Interim Final Rule asks if the FDIC should "designate a specific time during the term of the receivership to estimate contingent claims." We think the answer is "no." The difficulty that the estimation of a contingent claim presents is that, so long as the claim remains contingent, it remains uncertain whether the contingency giving rise to the potential claim will come to pass. Over time, however, the contingency may be resolved, either because it becomes clear that the contingency has come to pass or because it becomes clear that it will not. Therefore, while the contingency remains uncertain, the best course will often be to delay any estimation of the claim unless there is an immediate need to do so. For example, if any possible distribution to creditors is not on the horizon, and therefore there is no immediate need to estimate a contingent claim to determine the amount that must be paid or reserved for that claim from the funds available for distribution to other creditors, there would not appear to be any reason for the receiver to estimate the claim. This suggested approach of delaying the estimation of a contingent claim until and unless it is necessary to do so is consistent with the Bankruptcy Code, which provides for the estimation of contingent claims only where the fixing of the claim would "unduly delay" the administration of the bankruptcy case.[18]

Conclusion

MFA appreciates the opportunity to respond to the FDIC's questions on this crucial set of topics. As we stated in our previous letters, we recognize the importance of developing an effective liquidation framework for those financial firms whose failure could otherwise pose a real threat to the financial stability of the country. Because Title II of the Dodd-Frank Act establishes a new liquidation framework for financial firms whose importance cannot be overstated, investors now face a significant amount of uncertainty, potential confusion and fear with respect to the implementation and consequences of this new framework. As described above, we believe that it is critical for the proper functioning of our capital markets and the reduction of systemic risk that the FDIC create clear, objective, pragmatic and equitable rules regarding the implementation of the OLA. To this end, we hope that our comments have been helpful, and we are committed to continuing to work with the FDIC as it develops rules to implement the OLA.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other regulatory issues, please do not hesitate to contact Stuart J. Kaswell or me at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

[18] 11 U.S.C. § 502(c).