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*By electronic submission to [www.federalreserve.gov](http://www.federalreserve.gov)*

Mr. Robert deV. Frierson  
Secretary  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue, N.W.  
Washington, D.C. 20551

Re: Comment Letter on the Notice of Proposed Rulemaking on Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations

Docket No. R-1538; RIN 7100 AE-52

Ladies and Gentlemen:

We are pleased to submit this comment letter on behalf of Citigroup Inc., The Goldman Sachs Group, Inc., JPMorgan Chase & Co. and Morgan Stanley (collectively, the “**Banks**”). The Banks appreciate the opportunity to comment on the notice of proposed rulemaking (the “**proposed rule**”) published on May 11, 2016 by the Board of Governors of the Federal Reserve System (the “**Board**”).<sup>1</sup> The proposed rule is an important step toward enhancing the resolvability of U.S. global systemically important banking organizations (“**G-SIBs**”) and the stability of the global financial system. While the Banks strongly support the proposed rule, they request that the Board consider certain clarifications and modifications, which are intended to reduce unnecessary compliance burdens by ensuring that the appropriate scope of entities and qualified financial contracts (“**QFCs**”) are covered and to address certain other

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<sup>1</sup> Notice of Proposed Rulemaking, *Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions*, 81 Fed. Reg. 29169 (May 11, 2016).

technical issues. As set forth in greater detail below, these clarifications and modifications include:

- Clarifying and modifying the scope of covered entities subject to the proposed rule to exclude entities that are not under the operational control of the parent holding companies of G-SIBs;
- Clarifying and modifying the scope of QFCs subject to the proposed rule to exclude certain QFCs that do not contain relevant default rights or transfer restrictions or do not pose a risk to orderly resolution and certain QFCs entered into with affiliates of a counterparty, central counterparties (“**CCPs**”) or financial market utilities (“**FMUs**”);
- Adopting a phased-in compliance approach consistent with the related final rule issued by the Office of the Comptroller of the Currency (“**OCC**”); and
- Adopting certain technical amendments and clarifications regarding compliance mechanisms, interaction with other regulatory requirements, and certain defined terms.

These proposed clarifications and modifications are consistent with the proposed rule’s goal of eliminating certain default rights and transfer restrictions that the Board and the Federal Deposit Insurance Corporation (the “**FDIC**”) consider to be a material impediment to the orderly resolution of a U.S. G-SIB and the U.S. operations of a foreign G-SIB. Part **Error! Reference source not found.** of this letter provides additional background information regarding the proposed rule. Part II discusses the comments in more detail.

## I. Background

Most U.S. G-SIBs, including all of the Banks, have developed a single-point-of-entry (“**SPOE**”) resolution strategy, or a variation thereon, for their orderly resolution under the U.S. Bankruptcy Code.<sup>2</sup> Under an SPOE strategy, the top-tier parent of the U.S. G-SIBs would be put

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<sup>2</sup> Their strategies are laid out in the public summaries of their 2015 Resolution Plans submitted under Title I of the Dodd-Frank Act. See Resolution Plans, available at: <https://www.federalreserve.gov/bankinfo/reg/resolution-plans-search.htm>. The Board and the FDIC have both acknowledged the viability of the SPOE strategy itself. Compare the 2016 Feedback Letter to Citigroup (Apr. 12, 2016) available at: <https://www.federalreserve.gov/newsevents/press/bcreg/citi-letter-20160413.pdf> (the Federal Reserve and the FDIC found no deficiencies with Citigroup’s SPOE Strategy) to the 2016 Feedback Letter to Bank of New York Mellon (Apr. 12, 2016), available at: <https://www.federalreserve.gov/newsevents/press/bcreg/bank-of-new-york-mellon-letter-20160413.pdf> (the Federal Reserve and the FDIC invited Bank of New York Mellon four times to consider an “alternative strategy” to its multiple-point-of-entry bridge bank strategy). In addition, the FDIC has similarly indicated that the SPOE strategy is the FDIC’s preferred strategy for resolving the U.S. G-SIBs under Title II of the Dodd-

into a bankruptcy proceeding, while its operating subsidiaries would be recapitalized as needed and could be restructured or wound down in an orderly manner outside of bankruptcy or other resolution proceedings.<sup>3</sup> An impediment to an orderly SPOE resolution is the ability of counterparties to certain QFCs to terminate those QFCs based on a parent or other affiliate of the direct G-SIB party becoming subject to insolvency proceedings, even when the direct G-SIB party is performing on the QFCs (a “**cross-default**”).

The direct party to the vast majority of transactions under QFCs entered into by a U.S. G-SIB with a third party is an operating subsidiary of the U.S. G-SIB, rather than its top-tier bank holding company parent.<sup>4</sup> The ability to terminate QFCs based on a cross-default may impede the orderly resolution of U.S. G-SIBs by imposing losses on the G-SIBs’ operating subsidiaries, even where the operating subsidiaries are solvent, well-capitalized and otherwise performing on the QFCs.<sup>5</sup>

The proposed rule seeks to eliminate this impediment by prohibiting a covered entity (as defined below) from becoming party to a new QFC with a particular counterparty, and requiring the covered entity to amend any existing QFCs with that counterparty, if a triggering event occurs,<sup>6</sup> unless either the counterparty agrees to adhere to the ISDA Protocol (as defined below) or all new and existing QFCs with that counterparty reflect the following requirements and restrictions:

- The exercise of cross-default rights are expressly limited, and transfers of parent guarantees are expressly made effective, to the same extent as under Title II of the

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Frank Act. *See, e.g.*, Martin J. Gruenberg, Chairman of the FDIC, Remarks at the Eurofi High Level Seminar 2016 (Amsterdam, The Netherlands, Apr. 21, 2016); Martin J. Gruenberg, Chairman of the FDIC, A Progress Report on the Resolution of Systemically Important Financial Institutions, Speech at the Peterson Institute for International Economics (Washington, D.C., May 12, 2015); *see also* Notice, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed. Reg. 76614 (Dec. 18, 2013).

<sup>3</sup> Even in the case of a foreign G-SIB that would be resolved under a multiple-point-of-entry (“MPOE”) strategy, its U.S. operations are likely to be resolved pursuant to an SPOE strategy. The reason is that all foreign banking organizations with \$50 billion or more of U.S. non-branch assets are required to establish an IHC and move all of their U.S. subsidiaries, including their U.S. broker-dealer subsidiaries, accounting for 90% of their U.S. assets, under the U.S. IHC by July 1, 2016 and the rest by July 1, 2017. *See* 12 C.F.R. § 252.152(c)(2).

<sup>4</sup> While the parent may provide a guarantee or other credit enhancement in respect of its operating subsidiary’s QFCs, which credit enhancement would itself fall within the definition of QFC under the Dodd-Frank Act (as defined below), the proposed rule recognizes a distinction between a credit enhancement in respect of a QFC and the underlying QFC transaction.

<sup>5</sup> 81 Fed. Reg. 29171.

<sup>6</sup> The triggering event in the proposed rule would be the covered entity or any of its covered affiliates (as defined below) becoming a party to a new QFC with the same counterparty or any of its affiliates after the proposed rule becomes effective.

Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”);<sup>7</sup> and

- Cross-default rights related to a covered entity’s affiliate becoming subject to U.S. bankruptcy or other U.S. or non-U.S. insolvency proceedings are not permitted, and transfers of a parent guarantee or other affiliate credit enhancement are not restricted upon the parent or other affiliate becoming subject to U.S. bankruptcy or other U.S. or non-U.S. insolvency proceedings, subject to certain exceptions.

The proposed rule is part of a broader set of actions by the Board, the FDIC and regulators in other jurisdictions to improve the resolvability of U.S. and foreign G-SIBs and enhance the stability of the global financial system. More specifically, the proposed rule complements the Board’s recent notice of proposed rulemaking on total loss-absorbing capacity, long-term debt, and clean holding company requirements for U.S. G-SIBs and the U.S. intermediate holding companies (“**IHCs**”) of foreign G-SIBs.<sup>8</sup> It also complements the ongoing work of the Board and the FDIC on resolution planning for the U.S. G-SIBs and the U.S. operations of foreign G-SIBs under both Title I and Title II of the Dodd-Frank Act.

The proposed rule also complements the international protocol developed by the International Swaps and Derivatives Association (“**ISDA**”) at the request of various financial regulators around the world, including the Board and the FDIC (the “**ISDA Protocol**”). The ISDA Protocol provides for the contractual recognition of statutory stays under certain special resolution regimes and contractual limitations on early termination rights based on cross-defaults under ISDA Master Agreements and certain other types of financial contracts. Like the proposed rule, the ISDA Protocol contains a number of creditor protections designed to mitigate the potential adverse impact on any adhering counterparties, as well as a number of features designed to address cross-default on a universal, industry-wide basis in a manner that increases market certainty, transparency and equitable treatment of counterparties. As of the date of this letter, 23 G-SIBs (including the Banks), as well as certain other dealers, have adhered to the ISDA Protocol. As noted above, one method of complying with the proposed rule is through adherence to the ISDA Protocol.

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<sup>7</sup> In addition, the proposed rule would require an express recognition of the limitations on direct default rights and the transfer powers of the FDIC under Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act (the “**FDI Act**”).

<sup>8</sup> Notice of Proposed Rulemaking, *Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies*, 80 Fed. Reg. 74926 (Nov. 30, 2015).

The Banks strongly support the goals of the proposed rule to promote the resolvability of U.S. G-SIBs and the U.S. operations of foreign G-SIBs in a manner that preserves financial stability and does not require any taxpayer support. Nevertheless, as detailed below, the Banks believe that certain modifications and clarifications should be made to the proposed rule to ensure that it achieves its stated goal without having any material adverse collateral consequences.

## II. Discussion

The following sections address the comments described in Part **Error! Reference source not found.** in additional detail. Some of the comments below address questions specifically raised by the Board in its proposed rule and restate these Board questions for convenience.

### A. Clarify and Modify the Scope of Covered Entities Subject to the Proposed Rule

*Question 2: The Board invites comment on the proposed definition of the term “covered entity.”<sup>9</sup>*

#### 1. Define “subsidiary” of a covered entity by reference to GAAP consolidation standards and exclude entities that are not under the operational control of the parent holding company

Proposed Section 252.82 includes, in the definition of “covered entity,” the subsidiary of a covered entity, other than a subsidiary that is a covered bank.<sup>10</sup> The proposed rule does not itself include an independent definition of “subsidiary.” In the absence of an independent definition, this term would appear to have the meaning given to it under Regulation YY. “Subsidiary” is defined in Regulation YY by reference to the definition under section 3 of the FDI Act<sup>11</sup> to mean “any company which is owned or controlled directly or indirectly by another company.”<sup>12</sup> Control under the Bank Holding Company Act is found whenever a company owns 25% or more of a class of voting securities of another company, controls the majority of its board or exercises a “controlling influence” over the company.<sup>13</sup> This concept of control was designed to serve other policy purposes, in particular, the separation between banking and commercial activity through the Bank Holding Company Act’s many restrictions on companies that acquire “control” or “controlling influence” over banks and on those companies’ investments in non-banks.

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<sup>9</sup> 81 Fed. Reg. 29176.

<sup>10</sup> Proposed Rule § 252.82.

<sup>11</sup> 12 C.F.R. § 252.2(s).

<sup>12</sup> 12 U.S.C. § 1813(w)(4)(A).

<sup>13</sup> 12 U.S.C. §1841(a)(2).

A bank holding company's investment in an entity could give rise to a control relationship within the meaning of the Bank Holding Company Act even where the bank holding company does not have the practical ability to ensure that the entity has adequately remediated its QFCs to comply with proposed Sections 252.83 and 252.84. The current definition of "control" would require G-SIBs to amend the QFCs of many minority-owned entities that are not operationally integrated with the G-SIB and over which the G-SIB has no day-to-day operational control or real-time visibility into the transactions of the entity necessary to achieve compliance. Although bank holding companies are well-practiced in addressing the consequences of "control" for purposes of compliance with their responsibilities under the Bank Holding Company Act where a minority investment results in a bank holding company having a "controlling influence" over a company, day-to-day operational control is typically not needed in order to ensure compliance with the Bank Holding Company Act and will often be absent in the case of a minority investment. Where a bank holding company lacks operational control, it would need to rely on applicable governance rights and other negotiated mechanisms to ensure that the independent management of the entity remediates its QFCs in compliance with the proposed rule. The broad scope of the proposed rule, its monitoring requirements and its impact on existing transactions make it likely that the burden would be placed on the management of such a subsidiary to bring its QFCs into compliance with the proposed rule, and the management may lack the willingness to dedicate resources for remediation. Moreover, such economically passive minority investments would not pose a risk to the resolvability of the G-SIB group. Examples of such entities include joint ventures in which the bank holding company holds a minority stake and operational control rests entirely with the joint venture partner.<sup>14</sup>

As a result, the Banks believe that the more appropriate and relevant standard for purposes of this rule should instead be whether entities are consolidated for financial reporting purposes under Generally Accepted Accounting Principles ("GAAP"). Under GAAP consolidation principles, a company would consolidate any entity in which it holds a majority voting interest or over which it has the power to direct the most significant economic activities if it also holds a variable interest in the entity. Both are a reasonable proxy for the fact that the company has both a significant economic exposure to the entity and operational control over the entity. GAAP consolidation more accurately reflects which subsidiaries expose a parent's operations to

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<sup>14</sup> For example, a G-SIB may partner with a foreign entity in order to create a joint venture as a means of gaining exposure or entry into a foreign market. The G-SIB would frequently maintain a non-controlling minority stake in the joint venture entity, and would have no operational control and limited visibility into its day-to-day operations. The joint venture entity would not otherwise be subject to the proposed rule or to the regulations of the Board. Remediation would also be very difficult, especially if the joint venture entity's counterparties are regional clients not otherwise familiar with the rule's requirements. In addition, the G-SIB would have to institute a coordinated, real-time tracking mechanism in order to ensure that it does not inadvertently trade with counterparties that have not also remediated their QFCs with counterparties of the joint venture entity.

material risk than does the Bank Holding Company Act definition of control, and subsidiaries that are financially consolidated and subject to operational control are generally fully integrated into the parent's enterprise-wide governance, policies, procedures, control framework, business strategies, information technology systems, and management information systems. Accordingly, GAAP consolidation should generally be applied for purposes of defining subsidiaries under the final rule.<sup>15</sup>

However, while GAAP consolidation should be the general standard, some flexibility is necessary to ensure that entities as to which the bank holding company does not have day-to-day operational control are excluded, regardless of whether they are consolidated under GAAP principles. For this reason, merchant banking portfolio companies should be excluded from the definition of subsidiary under the final rule. An asset manager affiliated with a financial holding company may make a majority or minority investment in a portfolio company that is engaged in activity that is not financial in nature under the merchant banking authority of section 4(k) of the Bank Holding Company Act for a prescribed period. Notwithstanding the fact that the investment could give rise to a control relationship for purposes of the Bank Holding Company Act and could also give rise to consolidation under GAAP, section 4(k) of the Bank Holding Company Act prohibits the financial holding company from routinely managing or operating the portfolio company except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition of the portfolio company.<sup>16</sup> Therefore, by law, the financial holding company is not permitted to control the portfolio company's compliance with a rule as dynamic as the proposed rule. For this reason, the final rule should exclude any portfolio company held under the merchant banking authority from the scope of covered entity, even if it would be a subsidiary for GAAP consolidation purposes.

In addition, sponsored funds should be excluded from the definition of subsidiary under the final rule, even if they would be consolidated under GAAP consolidation principles. As an initial matter, each sponsored or advised fund is a separate legal entity that is distinct from its

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<sup>15</sup> An example of this approach can be found in the Federal Banking Agencies' capital rules, which are designed to measure the capital adequacy of a financial institution on a consolidated basis. These rules default to GAAP consolidation except in special circumstances. See, e.g., 12 C.F.R. Part 217; Consolidated Financial Statements for Holding Companies, Federal Reserve Reporting Form FR Y-9C. More recently, the Federal Banking Agencies, Farm Credit Administration and FHFA adopted accounting consolidation as the standard for determining subsidiary and affiliate status in their final swap margin rules, after initially proposing a 25% "control" standard similar to that used in the Bank Holding Company Act. According to the Agencies, "the vast majority of commenters argued for a modified definition of control that did not use the 25 percent threshold." In adopting GAAP consolidation instead of the "control" test under the Bank Holding Company Act, the Agencies stated their belief that using financial accounting should "address many of the concerns raised by commentators," including by being "responsive to commentators' concerns that the proposed definitions were over-inclusive." See 80 Fed. Reg. 74,840, 74,860 (Nov. 30, 2015).

<sup>16</sup> 12 U.S.C. § 1843(k)(4)(H)(iv); 12 C.F.R. § 225.171(a).

sponsor or investment advisor. The sponsor or investment advisor has no claim on the fund's assets nor may it use the fund's assets for its benefit, and it is the fund's shareholders, rather than the sponsor or advisor, that bear the risk of investment losses and the benefits of any investment gain. Accordingly, a sponsored or advised fund should not be included in the definition of subsidiary.

If the GAAP financial consolidation standard is not adopted for the purpose of defining "subsidiary," at a minimum the final rule should exclude from this definition entities over which a covered entity does not exercise operational control. This would include merchant banking portfolio companies, joint ventures, sponsored funds, securitization vehicles and DPC subsidiaries.

## **2. Define "affiliate" of a covered entity to exclude entities that are not under the operational control of the parent holding company**

Proposed Sections 252.83 and 252.84 apply to QFCs that a covered entity "entered, executed or otherwise became a party to before the date this subpart first becomes effective, if the covered entity or *any affiliate* that is a covered entity or a covered bank also enters, executes or otherwise becomes a party to" a QFC.<sup>17</sup> Similar to "subsidiary," the proposed rule does not provide an independent definition of "affiliate" and therefore, this term would appear to have the meaning given to it under Regulation YY. "Affiliate" is defined in Regulation YY generally, and has the same meaning as section 2(k) of the Bank Holding Company Act and section 225.2(a) of Regulation Y.<sup>18</sup> Under the Bank Holding Company Act, affiliate is defined as "any company that controls, is controlled by, or is under common control with another company."<sup>19</sup> For the same reasons set forth in connection with the definition of "subsidiary," the Banks believe that an "affiliate" of a covered entity should exclude entities that are not under the operational control of the bank holding company, and should instead be defined generally by reference to whether both entities would be consolidated in accordance with GAAP, subject to a further exception for merchant banking portfolio investments and similar investments where the bank holding company does not have the practical ability to mandate compliance with the proposed rule.

### **B. Clarify and Modify the Types of QFCs Subject to the Proposed Rule**

*Question 5: The Board invites comment on the proposed definitions of "QFC" and "covered QFC." Are there financial transactions that could pose a similar risk to U.S. financial stability if a GSIB were to fail but that would not be included within the proposed definitions of*

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<sup>17</sup> Proposed Rule § 252.83(a)(ii) (emphasis added).

<sup>18</sup> 12 C.F.R. § 252.2(a).

<sup>19</sup> 12 U.S.C. §1841(k).

*QFC and covered QFC? Are there transactions that would be included within the proposed definitions but that would not present risks justifying the application of this proposal? Please explain.*<sup>20</sup>

**1. Clarify the scope of QFCs subject to the express acknowledgment requirements of Section 252.83**

Proposed Section 252.83 is intended to address “the risk that a court in a foreign jurisdiction may decline to enforce the QFC stay-and-transfer provisions of [the U.S. special resolution regimes].”<sup>21</sup> As explained in the Preamble, these provisions temporarily (and, under certain circumstances, permanently) stay the exercise of certain direct and cross-default rights, and override certain transfer restrictions, related to a covered entity becoming subject to a proceeding under one of the U.S. special resolution regimes.

To ensure uniform enforcement of these stay-and-transfer restrictions across all jurisdictions, proposed Section 252.83 would require *all* QFCs to be amended to explicitly provide that:

“(1) The transfer of the covered QFC . . . from the covered entity will be effective to the same extent as the transfer would be effective under the U.S. special resolution regimes if the covered QFC . . . were governed by the laws of the United States or a state of the United States and the covered entity were under the U.S. special resolution regime; and (2) Default rights with respect to the covered QFC that may be exercised against the covered entity are permitted to be exercised to no greater extent than the default rights could be exercised under the U.S. special resolution regimes if the covered QFC was governed by the laws of the United States or a state of the United States.”<sup>22</sup>

While the Banks recognize the importance of ensuring that “all covered QFCs . . . would be treated the same way in the context of an FDIC receivership under the Dodd-Frank Act or the FDI Act,”<sup>23</sup> there are two types of QFCs that do not need to be amended in order to satisfy this goal.

First, there are certain categories of transactions that fall within the definition of QFC<sup>24</sup> but that do not contain any transfer restrictions or default right that would be subject to the

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<sup>20</sup> 81 Fed. Reg. 29176.

<sup>21</sup> 81 Fed. Reg. 29173.

<sup>22</sup> Proposed Rule § 252.83(b). Please also see certain suggested clarifications to the text of this provision *infra* Section II.I.1.

<sup>23</sup> 81 Fed. Reg. 29174.

<sup>24</sup> Proposed Rule § 252.81; 12 U.S.C. 5390(c)(8)(D).

stay-and-transfer provisions of the U.S. special resolution regimes (and, in some cases, may not be documented under written contracts at all). These types of QFCs do not give rise to the risk that counterparties will exercise their contractual rights in a manner that is inconsistent with the provisions of the U.S. special resolution regimes.

For example, there are millions of cash-market transactions entered into on a daily basis that are typically not documented in any written agreement other than a simple trade confirmation (which may not be signed until after the trade settles, given the short term nature of such transactions) and do not contain default rights or transfer restrictions. However, such transactions may fall within the definition of a QFC. Absent an exclusion for such types of transactions, the proposed rule would require the creation of new written agreements containing the explicit provisions required by proposed Section 252.83 where no written agreements currently exist, which would fundamentally alter the documentation practices in such markets. This would make compliance with the proposed rule requirements not only unnecessarily burdensome but also highly impracticable. Other examples of QFCs that typically do not include transfer restrictions or default rights of the type that would be subject to the provisions of the U.S. special resolution regimes include spot FX transactions (to the extent not documented under an ISDA Master Agreement or similar master agreement) and transactions (cash or otherwise) executed in retail brokerage or investment advisory accounts pursuant to retail brokerage or investment advisory account agreements, which may number in the millions at certain covered entities. Remediation of this population of contracts (which in the case of retail contracts are largely with individuals rather than corporate entities) to include the express provisions required by proposed Section 252.83 would require an enormous client outreach effort that would be extremely burdensome while providing no meaningful resolution benefits.

Second, there is a large population of QFCs that contain insolvency-based default rights or transfer restrictions, but are governed by U.S. law.<sup>25</sup> Examples of such QFCs include the standard form repurchase and securities lending agreements published by Securities Industry and Financial Markets Association (“SIFMA”), which contain very limited events of default including a typical “act of insolvency” of the direct party. The Banks believe that such QFCs should not be required to be remediated to include the express provisions required by Section 252.83 if they are governed by U.S. law.<sup>26</sup>

The express acknowledgment required under proposed Section 252.83 provides that default rights are permitted to be exercised to no greater extent, and transfers are effective to

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<sup>25</sup> In many cases, these QFCs are also entered into with counterparties that are organized in the United States.

<sup>26</sup> Many of these QFCs also contain no provisions that would be prohibited under Section 252.84, so there would be no need to remediate them to comply with the requirements of Section 252.84.

the same extent, as they would be if the QFC were governed by the laws of the United States or a state thereof. Where the contract is expressly stated to be governed by such laws, a separate acknowledgment should be unnecessary.<sup>27</sup> Thus, requiring an amendment of the foregoing types of QFCs to include the express provisions required under proposed Section 252.83 would not provide any material resolution benefit but would significantly increase the remediation burden on covered entities.

Accordingly, the Banks recommend excluding from the scope of proposed Section 252.83 any QFCs that (i) do not contain any transfer restrictions or default rights that would be disregarded or suspended under the U.S. special resolution regimes or (ii) are governed by the laws of the United States or a state thereof.<sup>28</sup>

## **2. Clarify that QFCs containing no prohibited provisions do not require remediation under Section 252.84**

Proposed Section 252.84 is intended to facilitate the orderly resolution of a G-SIB under the Bankruptcy Code “by preventing the QFC counterparties of a GSIB’s operating subsidiary from exercising default rights on the basis of the entry into bankruptcy by the GSIB’s top-tier holding company or any other affiliate of the operating subsidiary.”<sup>29</sup>

While Title II of the Dodd-Frank Act restricts counterparties’ exercise of such cross-default rights, the Bankruptcy Code and the FDI Act do not. Proposed Section 252.84 requires G-SIBs to amend their QFCs to ensure that “when a GSIB entity enters resolution under the Bankruptcy Code or the FDI Act, its affiliates’ covered QFCs will be protected from disruption to a similar extent as if the failed entity had entered resolution under [Title II of the Dodd-Frank Act].”<sup>30</sup>

More specifically, subject to certain exceptions set forth therein, proposed Section 252.84 provides that:

“(1) A covered QFC may not permit the exercise of any default right with respect to the covered QFC that is related, directly or indirectly, to an affiliate of the direct party becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding. (2) A covered QFC may not prohibit the transfer of a covered affiliate credit

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<sup>27</sup> Moreover, such a QFC does not pose the type of extraterritorial risk that Section 252.83 of the proposed rule is designed to mitigate, particularly if it is entered into with a U.S. counterparty.

<sup>28</sup> At a minimum, the Banks request that QFCs that are governed by U.S. law or a state thereof and are entered into with a counterparty that is organized in the United States be exempted from the requirements of proposed Section 252.83.

<sup>29</sup> 81 Fed. Reg. 29174.

<sup>30</sup> *Id* (internal footnote omitted).

enhancement, any interest or obligation in or under the covered affiliate credit enhancement, or any property securing the covered affiliate credit enhancement to a transferee upon an affiliate of the direct party becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding.”<sup>31</sup>

If a QFC does not contain any default rights that would be triggered directly or indirectly by an affiliate of the covered entity becoming subject to an insolvency, resolution or similar proceeding, or any provisions that would restrict the assignment of covered affiliate credit enhancements in the event an affiliate of the direct party becomes subject to such proceedings, there should be no need to take any action to amend such QFC, as the QFC would already be compliant with the requirements of Section 252.84. Therefore, the final rule should clarify that such QFCs do not require any remediation.

### **3. Exclude from the requirements of Sections 252.83 and 252.84 certain other types of QFCs that do not pose a risk to resolution**

The Preamble to the proposed rule explains that the definition of “covered QFC” is intended to limit the proposed rule’s restrictions “to those financial transactions whose disorderly unwind has substantial potential to frustrate the orderly resolution of a GSIB.”<sup>32</sup>

The definition of QFC encompasses a large range of market transactions that have distinct risk profiles, including traditional capital market activities such as purchases and sales of securities from and to an underwriter or initial purchaser, as well as client onboarding agreements. While these contracts may fall within the technical scope of the QFC definition, these types of transactions frequently include only transfer restrictions and not default rights, and therefore would not pose a risk to the resolution of the covered entity or the covered entity’s affiliates, or to the financial stability of the broader market. Accordingly, the Banks request that these types of QFCs be excluded from the remediation requirements of Sections 252.83 and 252.84.

In addition, there are certain instruments issued in the capital markets that may fall within the definition of QFC, but which the Banks believe should be excluded from the definition of “covered QFC” under proposed Sections 252.83 and 252.84. One example of such a capital markets instrument is a warrant or certificate representing a call option, typically on a security or a basket of securities,<sup>33</sup> that allows the holder of the instrument to benefit from the appreciation of the value of the underlying security or basket. These instruments are fully paid

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<sup>31</sup> Proposed Rule § 252.84(b).

<sup>32</sup> 81 Fed. Reg. 29176.

<sup>33</sup> The underlying securities may be issued by the same entity that issues the warrant or by a third party.

up front by the investor and, accordingly, the investor does not have to come out-of-pocket for any further payments, even if the underlying security or basket declines in value. In some cases, these instruments are supported by parent credit enhancements. Similar to other capital markets instruments, these instruments are issued pursuant to an offering document and in compliance with the relevant securities laws. They are purchased by multiple underlying investors whose identities are generally not known to the issuer. These instruments tend to be issued on a frequent basis, with each issuance linked to different underlying reference assets and purchased by different pools of investors. In addition, these instruments may trade in the market, in some cases as listed warrants on securities exchanges. It would not be possible, therefore, for a covered entity issuer to ascertain whether a particular investor in such instruments has also entered into other QFCs with the covered entity or any of its covered affiliates (or vice-versa) for purposes of complying with the proposed mechanism for remediation of existing QFCs. It would also be extremely difficult, if not impossible, to amend outstanding issuances, as this would require the affirmative vote of a substantial number of separate voting groups of holders to amend the terms of the instruments, and obtaining such consent would be expensive because of “hold-out” premiums, and sometimes impossible, to achieve.

For this reason, the Banks request that warrants, certificates and similar instruments issued in the capital markets be excluded from the definition of “covered QFC” for all purposes under the final rule.<sup>34</sup>

### **C. Modify the Proposed Rule’s Treatment of Counterparty Affiliates for Purposes of Retroactive Remediation**

The definition of “covered QFC” under proposed Sections 252.83 and 252.84 includes both new QFCs that a covered entity enters, executes or otherwise becomes a party to, as well as any QFCs that the covered entity “[e]ntered, executed, or otherwise became a party to before the date this subpart first becomes effective, if the covered entity or any affiliate that is a covered entity or a covered bank<sup>35</sup> also enters, executes, or otherwise becomes a party to a

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<sup>34</sup> If these instruments are not excluded from the definition of “covered QFC” entirely, the Banks request at a minimum that they not be treated as “QFCs” for purposes of clause (ii) of the definition of “covered QFC,” so that the requirements of the rule apply only prospectively to issuances by a covered entity after the effective date of the final rule and legacy issuances are allowed to remain on the balance sheet and roll off as these instruments expire. In addition, the Banks request that the compliance period for such new issuances be extended to allow time to establish new issuance programs to the extent required to comply with the final rule.

<sup>35</sup> “Covered bank” is defined as “a national bank, Federal savings association, federal branch, or federal agency.” Proposed Rule § 252.81.

QFC with the *same person or affiliate of the same person* on or after the date this subpart first becomes effective.”<sup>36</sup>

The Banks agree that the definition of “covered QFC” should include existing QFCs between the covered entity and the counterparty, as well as existing QFCs between an affiliate<sup>37</sup> of the covered entity that is a covered entity or covered bank (a “**covered affiliate**”) and the same counterparty. Requiring counterparties to remediate existing QFCs with a covered entity and all of its covered affiliates in order to enter into a new QFC with the covered entity is an important step toward maximizing industry compliance and achieving the goals of the proposed rule. In contrast, the Banks believe that including new QFCs entered into with *an affiliate of the counterparty* in the trigger for retroactive remediation would make compliance with the rule overly burdensome and impractical for both counterparties and covered entities. Such a requirement would demand the G-SIB to track each counterparty’s organizational structure, which would be subject to continual change. In order to do so, G-SIBs would have to rely on affiliation information provided by counterparties, which would subject counterparties to enhanced reporting burdens. Certain types of counterparties may be reluctant to share such information. Moreover, imposing a restriction on the ability of a counterparty to trade with members of a G-SIB group unless the counterparty’s affiliates also agree to remediate their QFCs has the effect of imposing compliance burdens on the counterparty’s affiliates and limiting their ability to act independently.

In addition, excluding a counterparty’s affiliates from this definition would not undermine the ultimate goals of the proposed rule because, to the extent that a covered entity or any of its covered affiliates enters into a new QFC with an affiliate of the counterparty, existing QFCs with such counterparty affiliate would still have to be made compliant with the rule requirements.

Accordingly, the Banks request that the phrase “or affiliate of the same person” be deleted from the definition of “covered QFC.”

In the event that the definition of “covered QFC” is not modified in the final rule to eliminate the phrase “or affiliate of the same person,” at a minimum the Banks request that the meaning of “affiliate of the counterparty” be established by reference to GAAP consolidation principles (or IFRS consolidation principles, as applicable), rather than the Bank Holding Company Act definition. The Bank Holding Company Act definition of “control” is often

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<sup>36</sup> Proposed Rule § 252.83(a)(2)(ii) (emphasis added); *see also* § 252.84(a)(2).

<sup>37</sup> As noted in Section II.A.2 above, “affiliate” is not a defined term in the Proposed QFC Rule released by the Board. Instead, it is a defined term under Regulation YY, which incorporates the definition of “affiliate” from section 2(k) of the Bank Holding Company Act. 12 C.F.R. § 252.2(a). Please refer to our comments in Section II.A.2 with respect to our recommendation as to the scope of entities that should be considered “affiliates” of the covered entity for purposes of the proposed rule.

determined by factors that may not necessarily be known or knowable to a party outside of the counterparty group, and the list of controlled entities is subject to change over time. For example, a counterparty may be deemed to “control” a company under the Bank Holding Company Act definition because of the materiality of the business relationships that exist between these two parties, and the covered entity may not have any information regarding the existence or importance of such business relationships. Similarly, a counterparty may “control” a company by virtue of owning a sufficient amount of shares that carry special voting rights that make those shares a separate class of voting securities for purposes of the Bank Holding Company Act. A covered entity may not have the information to determine whether the shares held by its counterparty constitute a separate class of voting securities, if it has knowledge of the counterparty’s ownership of the shares at all.

Even if the covered entity imposed a reporting obligation on the counterparty, many counterparties are not regulated bank holding companies and would therefore be wholly unfamiliar with the Bank Holding Company Act definition. Requiring them to supply covered entities with the information necessary to enable the covered entity to track affiliation among counterparties under the Bank Holding Act definition would substantially increase the compliance burden on counterparties, and may in certain instances be impracticable.

#### **D. Clarify and Expand the Exclusion of QFCs with CCPs and Certain Other Types of Counterparties**

*Question 6: The Board invites comment on the proposed exclusion of cleared QFCs, including the potential effects on the financial stability of the United States of excluding cleared QFCs as well as the potential effects on U.S. financial stability of subjecting covered entities’ relationships with central counterparties to restrictions analogous to this proposal’s restrictions on covered entities’ non-cleared QFCs.<sup>38</sup>*

##### **1. Exclusion for cleared QFCs should extend to the client-facing leg**

The proposed rule currently excludes covered QFCs “to which a CCP is party”<sup>39</sup> from the requirements of proposed Sections 252.83 and 252.84. The Banks support exclusion of cleared QFCs where the covered entity acts as clearing member from the scope of the final rule, because the Banks agree with the Board that clearing through a CCP “provides unique benefits to the financial system as well as unique issues related to the cancellation of cleared contracts.”<sup>40</sup> The Banks also agree that excluding covered QFCs “to which a CCP is party” from the scope of the proposed rule is appropriate in light of the unique nature of the relationship

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<sup>38</sup> 81 Fed. Reg. 29176.

<sup>39</sup> Proposed Rule § 252.88(a).

<sup>40</sup> 81 Fed. Reg. 29176.

among CCPs and their members, which is governed by general membership requirements and differs in material respects from an arms'-length bilateral contractual relationship between two market participants. Given this difference, the Banks agree that the exercise of rights by a CCP vis-a-vis its members is more appropriately addressed through other vehicles rather than through this proposed rule.

However, there are many entities that do not have their own accounts or memberships with certain CCPs and that rely on clearing members, which are frequently covered entities under the proposed rule, to access CCPs and benefit from the use of CCP-cleared QFCs. Under a narrow interpretation, as currently written, the proposed rule's treatment of these entities could potentially undermine the rule's goals.

In particular, in the European-style principal-to-principal clearing model, the clearing member faces the CCP on one swap (the "**CCP-facing leg**"), and the clearing member faces the client on an otherwise identical, offsetting swap (the "**client-facing leg**"). Under the proposed rule as drafted, only the CCP-facing leg transaction is excluded, as that is the only transaction "to which a CCP is party,"<sup>41</sup> even though the client-facing leg is necessary to the mechanics of clearing and is only entered into by the clearing member to effectuate the cleared transaction. Thus, the proposed rule treats two pieces of the same transaction differently, which could potentially result in an imbalance in insolvency or resolution. The possibility of such an imbalance for the clearing member could expose the clearing member to unnecessary and undesired market risk.

In order to ensure that the treatment of the entire transaction is consistent, the Banks believe that the proposed rule should instead adopt the same approach taken under Section 2 of the ISDA Protocol, which allows the client-facing leg of a cleared swap with a clearing member that is a covered entity to be closed out substantially contemporaneously with the CCP-facing leg in the event the CCP were to take action to close out the CCP-facing leg. This would alleviate potential concerns of an imbalance for a clearing member in the event of insolvency or resolution.

By contrast, under the U.S.-style "agency" clearing model there are not two separate principal-to-principal transactions, but rather the clearing member acts as agent for (and guarantor of) the client vis-a-vis the CCP with respect to the cleared contract entered into with the CCP on behalf of the client. Under this model, although the contractual relationship between the client and the clearing member is typically governed by a bilateral account agreement between the client and the clearing member, arguably the CCP is a "party" to the entire cleared transaction entered into on behalf of the client by the clearing member pursuant to such agreement.

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<sup>41</sup> Proposed Rule § 252.88(a).

While the Banks agree that the rights of a CCP vis-a-vis a clearing member in respect of a cleared QFC should not be subject to the proposed rule, the Banks believe it should be clarified that where the covered entity is not the clearing member but instead is the client of a clearing member (whether under the U.S. agency model or the European model), the contractual rights between the covered entity client and its clearing member should be subject to the proposed rule. This would mean, for example, that the bilateral account agreement between a clearing member and its covered entity client should conform to the requirements of proposed Section 252.84 that prohibit the inclusion of default rights based directly or indirectly on an affiliate of the covered entity client entering into insolvency, resolution or similar proceedings.

## **2. Exclusion for cleared QFCs should extend to QFCs with other categories of FMUs**

Subject to the comments noted above, the Banks support excluding QFCs with CCPs from the scope of the proposed rule. For similar reasons, the Banks believe that QFCs with other types of multilateral FMUs, such as payment and settlement systems, should also be excluded from the requirements of the proposed rule. For example, an extension of credit by a central securities depository (a “CSD”) to a covered entity that is a member of the CSD in connection with the settlement of securities transactions would fall within the definition of “covered QFC” under the proposed rule, absent an express exclusion.

Similar to CCPs, the relationship between a covered entity and an FMU is not a bilateral contractual relationship amenable to amendment by negotiation between the parties. Rather, as with CCPs, this relationship is governed by the rules of the FMU, which set forth the terms upon which members participate in the system and the rights and obligations of the members and the FMU. In addition, in most cases there is no market alternative to continuing to transact with the FMU. Accordingly, as with CCPs, the Banks do not believe that the proposed rule is an appropriate or effective vehicle to address resolution-related issues with respect to a covered entity’s transactions with other types of multilateral FMUs.

## **3. QFCs with central banks and sovereigns should be excluded from the requirements of the final rule**

The Banks also recommend that QFCs with central bank and sovereign counterparties be excluded from the scope of the proposed rule. Practical experience with other recent documentation remediation efforts in connection with Title VII of the Dodd-Frank Act has demonstrated that it is extremely challenging to engage with such counterparties in document remediation. At the same time, such sovereign counterparties may be expected to take into account the broader resolution goals and global systemic stability considerations in any determination to exercise their contractual rights, thus reducing the concern that they would

exercise their rights in a manner that would undermine resolvability or the financial stability of the United States.

The special factors at issue with sovereign and central bank counterparties have been recognized by regulators in other jurisdictions, and have led to a carve-out of financial contracts with such entities from the United Kingdom Prudential Regulation Authority (“PRA”) rules on the recognition of contractual stays and from the analogous legislation in Germany. The Banks would request that the Board take a similar approach under the proposed rule and exclude QFCs with central banks and sovereigns from the final rule requirements.

#### **E. Clarify Two Aspects of Compliance by Adhering to the ISDA Protocol**

*Question 15: The Board invites comment on its proposal to treat as compliant with section 252.84 of the proposal any covered QFC that has been amended by the Protocol. Does adherence to the Protocol suffice to meet the goals of this proposal and appropriately safeguard U.S. financial stability?<sup>42</sup>*

Under the proposed rule as drafted, a covered entity may comply with proposed Section 252.84 through adherence to the ISDA Protocol and its annexes.<sup>43</sup> The Preamble to the proposed rule notes that the ISDA Protocol has the same general objective as the proposed rule while offering the ability to “address impediments to resolution on an industry-wide basis and increase market certainty, transparency, and equitable treatment with respect to default rights of non-defaulting parties.”<sup>44</sup>

The Banks support the use of the ISDA Protocol as a means of compliance with the final rule in a manner that ensures that a counterparty’s QFCs are all subject to the same set of creditor rights under a single industry standard package of creditor rights that offers enhanced creditor protections. The Banks also support the use of a U.S. Jurisdictional Module to the ISDA Resolution Stay Jurisdictional Modular Protocol that might be published by ISDA as a means of compliance that would promote broad market-wide adherence.

As described in Sections 1 and 2 below, in order to facilitate use of the ISDA Protocol as a mechanism for compliance, the final rule should adopt two technical clarifications.

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<sup>42</sup> 81 Fed. Reg. 29183.

<sup>43</sup> Proposed Rule § 252.85(a).

<sup>44</sup> 81 Fed. Reg. 29183.

**1. Clarify that adherence to the ISDA Protocol would also satisfy the requirements under Section 252.83**

First, the Banks believe the final rule should clarify that adherence to the ISDA Protocol would satisfy not only Section 252.84 but also Section 252.83 of the proposed rule. As drafted, the safe harbor for the ISDA Protocol set forth in proposed Section 252.85(a) only references the requirements of proposed Section 252.84. The Banks believe that this clarification would be consistent with the Preamble to the proposed rule, which explains that the ISDA Protocol “enables parties to amend the terms of their [contracts] to contractually recognize the cross-border application of special resolution regimes applicable to certain financial companies and support the resolution of certain financial companies under the United States Bankruptcy Code.”<sup>45</sup>

**2. Confirm that once existing QFCs have been remediated through adherence to the ISDA Protocol, new contracts with an adhering party will be compliant with Section 252.85 if they incorporate by reference the terms of the ISDA Protocol**

Second, Section 252.85(a) of the proposed rule provides that “a covered QFC may permit the exercise of a default right with respect to the covered QFC if the covered QFC has been amended by the [ISDA Protocol], including the Securities Financing Transaction Annex and the Other Agreements Annex.” Similar to other Protocols published by ISDA, the ISDA Protocol by its terms only amends contracts that have been entered into between any two adhering parties prior to the date of such parties’ adherence. It does not cover new agreements (e.g., new ISDA Master Agreements) entered into between two adhering parties subsequent to the date that both parties have adhered.<sup>46</sup> Under the prevailing practice with respect to Protocols published by ISDA, if two adhering parties to a given Protocol enter into a new agreement subsequent to their adherence date and would like the terms of such Protocol to apply to that new agreement, the terms of the relevant Protocol are usually incorporated by reference in a new bilateral agreement between the parties. Under the current ISDA Protocol, therefore, it would not be possible for adhering parties to amend a new QFC agreement entered into after their adherence date directly pursuant to the ISDA Protocol.

The Banks recommend that regulators confirm in the final rule that once a counterparty has adhered to the ISDA Protocol, new bilateral contracts entered into by a covered entity with that counterparty will be compliant with proposed Section 252.85 if they incorporate by reference the terms of the ISDA Protocol, provided that all existing covered QFCs between the covered entity or its covered affiliates and the counterparty have been brought into compliance

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<sup>45</sup> 81 Fed. Reg. 29181 (internal quotations omitted).

<sup>46</sup> ISDA Protocol, § 1(f). New transactions under an existing master agreement, however, would be covered.

via the ISDA Protocol. This would allow adhering parties to continue to benefit from the proposed rule's safe harbor for compliance based on ISDA Protocol terms with respect to future agreements between the parties and trade on consistent terms across all of their QFCs.<sup>47</sup>

## **F. Adopt a Phased-In Compliance Approach Consistent with the Related Final OCC Rule**

### **1. The compliance period should adopt a phased-in approach**

*Question 20: Would it be appropriate to impose different compliance deadlines with respect to different classes of QFCs? If so, how should those classes be distinguished, and which should be required to be brought into compliance first?*<sup>48</sup>

The proposed rule as drafted requires covered entities to be fully compliant with the rule restrictions on the first day of the calendar quarter that begins at least one year after the issuance of the final rule.<sup>49</sup> While this provides G-SIBs with some time to amend their covered QFCs to be compliant with the rule requirements, given the broad scope of QFCs required to be amended under the proposed rule, the Banks recommend adopting a phased-in approach for compliance that would extend the compliance deadline for covered QFCs with certain types of counterparties. This would allow time for necessary client outreach and education, especially for non-dealer counterparties that are currently unfamiliar with the ISDA Protocol or the proposed rule requirements. In addition, since the OCC is planning to release a rule substantively similar to the proposed rule applicable to covered banks, the Banks request that the Board coordinate with the OCC and extend the initial compliance deadline in order to be consistent with the deadline in the OCC final rule, to the extent the compliance deadline for the OCC final rule would be later.

The Preamble of the proposed rule states that the compliance period is designed to "provide covered entities with an incentive to seek the modifications necessary to ensure that their QFCs with their most important counterparties are compliant."<sup>50</sup> The Banks believe that a phased-in approach would be consistent with this goal. Specifically, the Banks believe that the original compliance period identified in the proposed rule (extended to coordinate with the OCC rule as necessary) should be limited to counterparties that are banks, broker-dealers, swap

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<sup>47</sup> QFCs with counterparties who are non-adherents to the ISDA Protocol, however, should not be permitted to comply with the rule by incorporating the ISDA Protocol terms by reference, as this would allow counterparties to benefit from the additional ISDA Protocol creditor protections without providing the resolution benefits of adherence on an industry-wide basis.

<sup>48</sup> 81 Fed. Reg. 29184.

<sup>49</sup> Proposed Rule § 252.82(b).

<sup>50</sup> 81 Fed. Reg. 29184.

dealers, security-based swap dealers, major swap participants and major security-based swap participants. These counterparties are likely to be among the covered entities' most active market participants and are likely already currently familiar with the ISDA Protocol or the proposed rule requirements.

Additionally, the Banks believe that the compliance period for QFCs with asset managers, commodity pools, private funds and other entities that are predominantly engaged in activities that are financial in nature (within the meaning of Section 4(k) of the Bank Holding Company Act) should be extended for six months after the end of the original compliance period identified in the proposed rule (as extended to align with the initial compliance period under the OCC rule, if necessary).

Finally, the Banks recommend that the compliance period for QFCs with all other combinations of counterparty types be extended to twelve months after the end of the first phase of the compliance period. These counterparties are likely to be the least familiar with the ISDA Protocol or the proposed rule requirements, and significant education and outreach would need to be undertaken for these counterparties. An extension beyond the second compliance period would be necessary to allow covered entities more time to amend their contracts with respect to these counterparties.

The Banks would not recommend an approach that would impose different deadlines with respect to different classes of QFCs, as opposed to different counterparty types, since the main challenge in connection with remediation is the need for outreach to and education of counterparties. Once a counterparty has become familiar with the requirements of the rule and the terms of the required amendments, it would be more efficient to remediate all in-scope covered QFCs with that counterparty at the same time.

## **2. Clarify the exclusion for QFCs entered into with covered banks**

The proposed rule provides that a covered entity is not required to conform a covered QFC to the requirements of proposed Section 252.83 or Section 252.84 to the extent that a covered bank is required to conform the covered QFCs to similar requirements of the OCC if the QFC is either a direct QFC to which a covered bank is a direct party or an affiliate credit enhancement to which a covered bank is the obligor. The Preamble explains that the OCC is expected to issue a proposed rule that would be substantively identical to this proposed rule in the near future.

While the Banks agree that covered banks should not have to comply with two different sets of rules, the Banks believe that the language of the exclusion is potentially confusing and it is not entirely clear under what circumstances an overlap would in fact arise. The Banks believe that this exclusion would benefit from further clarification to avoid legal uncertainty, and would also emphasize that timely issuance of the OCC's proposed rule is essential in order for the

interaction between the two rules to be fully assessed. As mentioned above, coordination may also be necessary to ensure that the compliance deadline for both rules are aligned.

#### **G. Clarify and Narrow the Proposed Rule's Agency Provisions**

*Question 17: The Board invites comment on all aspects of the proposed treatment of agency transactions, including whether creditor protections should apply to QFCs where the direct party is acting as agent under the QFC.<sup>51</sup>*

The Banks believe that the provisions of proposed Sections 252.83(a)(3) and 252.84(a)(3), which relate to transactions entered into by a covered entity as agent, should be clarified to exclude QFCs where the covered entity or its affiliate does not have any liability (including any contingent liability) under or in connection with the contract, or any payment or delivery obligations with respect thereto.

For example, there are many instances where an agent may simply execute an agreement on behalf of the principal but bear no liability thereunder, such as where an investment manager signs an agreement on behalf of a client. While not common, it is possible that such QFCs could contain events of default (for example, in so-called "key man" provisions) relating to the insolvency of the agent or an affiliate of the agent. However, the close-out of such QFCs would not result in any loss or liquidity impact to the agent. It would also be very challenging to track such provisions.

Therefore, the Banks recommend that the agent provisions in the proposed rule not apply to circumstances where the agent has no liability or ongoing performance obligations in connection with the contract.

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<sup>51</sup> 81 Fed. Reg. 29183.

## **H. Clarify the Proposed Rule's Interaction with Other Regulatory Requirements**

The Banks believe that amending covered QFCs to comply with the proposed rule's requirements should not trigger other regulatory requirements for covered entities. For example, while the Board's uncleared swap and security-based swap margin requirements apply to new swap and security-based swap transactions, and do not apply to a netting set containing only legacy swaps and security-based swaps, the Board and other relevant regulators refuse to categorically state that a legacy swap that is amended can always be treated as a legacy swap because doing so could "create significant incentives to engage in amendments and novations for the purpose of evading the margin requirements."<sup>52</sup> However, the Banks do not think that amending a covered QFC to comply with the proposed rule's requirement is an amendment of the type that should jeopardize the status of a legacy swap or security-based swap under these uncleared margin rules, as the purpose of the amendment is clearly not to evade the margin requirements but to comply with a separate rule adopted by the Board. Since many regulatory requirements applicable to QFCs have been adopted by regulators other than the Board, the Board may need to consult with other regulators, including the CFTC and SEC, to ensure that those regulators would not view amending covered QFCs to comply with the proposed rule as triggering such other regulatory requirements.

### **I. Adopt Certain Technical Amendments and Clarifications**

In addition to the comments above, the Banks would request that the Board consider the following technical amendments for purposes of clarifying the proposed rule text.

#### **1. Correction to clarifying amendments to capital and liquidity definitions**

The Banks welcome the Board's clarification that the capital and liquidity treatment of QFCs to which a covered entity is party will not be affected by the covered entity's compliance with the proposed rule,<sup>53</sup> including through any manner of compliance that meets the rule's requirements. The proposed rule addresses this need for clarification by amending the relevant definitions that specify the requirements of an eligible netting or collateral agreement in order for a banking organization to be eligible to apply netting and collateral treatment under the capital and liquidity rules. Under one of these requirements, which is common to all of the relevant definitions, the banking organization's exercise of rights under the agreement must not be subject to a stay or avoidance under applicable law in a relevant jurisdiction, subject to certain enumerated exceptions. The definitional amendments under the proposed rule intend

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<sup>52</sup> See Final Rule, *Margin and Capital Requirements for Covered Entities*, 80 Fed. Reg. 74,840, 74,851 (Nov. 30, 2015).

<sup>53</sup> 81 Fed. Reg. 29174.

to preserve QFCs' eligibility for netting and collateral treatment by providing a new exception from this no-stay-or-avoidance requirement.

The Banks believe the definitional amendments could be improved, and the intended purpose more plainly accomplished, by structuring the amendments as independent from the existing no-stay-or-avoidance requirement, because the provisions of the ISDA Protocol operate to limit the ability of a non-defaulting party to enforce its termination and close-out rights under the agreement in certain circumstances rather than to impose a stay on, or to avoid, such rights. Therefore, as an alternative to the Federal Reserve's proposed amendments and to more clearly and precisely accomplish the intended effect, the Banks propose that the clarifying amendment instead be structured as in the following example:<sup>54</sup>

*Qualifying master netting agreement* means a written, legally enforceable agreement provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default following any stay permitted by paragraph (2) of this definition, including upon an event of receivership, conservatorship, insolvency, liquidation, or similar proceeding, of the counterparty;

(2) The agreement provides the Board-regulated institution the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set-off collateral promptly upon an event of default, including upon an event of receivership, conservatorship, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than:

(i) In receivership, conservatorship, or resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs, or laws of foreign jurisdictions that are substantially similar\* to the U.S. laws referenced in this paragraph (2)(i) in order to facilitate the orderly resolution of the defaulting counterparty; or

(ii) Where the agreement is subject by its terms to, or incorporates, any of the laws referenced in paragraph (2)(i) of this definition;

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<sup>54</sup> The Banks also support conforming amendments to the definitions of "repo-style agreement," "eligible margin loan" and "collateral agreement" under Regulation Q, and "qualifying master netting agreement" under Regulation WW.

(3) A contract would not fail to satisfy the requirement in paragraph (2) of this definition where the events of default with respect to the counterparty under the contract or the default rights of the Board-regulated institution with respect thereto are limited to the extent necessary to comply with the requirements of subpart I of the Board's Regulation YY or any similar requirements of another U.S. federal banking agency, as applicable, under any method of compliance permitted thereunder.

~~(3)~~(4) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement); and

~~(4)~~(5) In order to recognize an agreement as a qualifying master netting agreement for purposes of this subpart, a Board-regulated institution must comply with the requirements of §217.3(d) with respect to that agreement.

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\* The Board expects to evaluate jointly with the OCC and Federal Deposit Insurance Corporation whether foreign special resolution regimes meet the requirements of this paragraph.

## 2. Clarify required amendments under Section 252.83

The Banks believe that the words “and the covered entity were under the U.S. special resolution regime” in proposed Sections 252.83(b)(1) and 252.83(b)(2) is potentially confusing, as the phrase could be read to mean that the substantive restrictions under the U.S. special resolution regimes should apply even if neither the covered entity nor any of its affiliates is in fact subject to a proceeding under a U.S. special resolution regime. The Banks believe that this is not the intent of these provisions, as the Preamble indicates “the requirements are intended to provide certainty that all covered QFCs would be treated the same way in the context of a receivership of a covered entity under the Dodd-Frank Act or the FDI Act.”<sup>55</sup>

The Banks therefore recommend that the language of these sections be amended to read as follows:

- In the event the covered entity or an affiliate becomes subject to a proceeding under a U.S. special resolution regime, the~~The~~ transfer of the covered QFC (and any interest and obligation in or under, and any property securing, the covered QFC)

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<sup>55</sup> 81 Fed. Reg. 29178.

from the covered entity will be effective to the same extent as the transfer would be effective under the U.S. special resolution regimes if the covered QFC (and any interest and obligation in or under, and any property securing, the covered QFC) were governed by the laws of the United States or a state of the United States ~~and the covered entity were under the U.S. special resolution regime~~; and

- In the event the covered entity or an affiliate of the covered entity becomes subject to a proceeding under a U.S. special resolution regime, default~~Default~~ rights with respect to the covered QFC that may be exercised against the covered entity are permitted to be exercised to no greater extent than the default rights could be exercised under the U.S. special resolution regimes if the covered QFC was governed by the laws of the United States or a state of the United States ~~and the covered entity were under the U.S. special resolution regime~~.

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The Banks strongly support the Board's goals underlying the proposed rule and appreciate the opportunity to comment on the proposal, and wish to thank the Federal Reserve for its consideration of these comments. Please feel free to contact Randall D. Gynn by phone at (212) 450-4239 or by email at [randall.gynn@davispolk.com](mailto:randall.gynn@davispolk.com) if you would like to discuss anything in this comment letter with representatives of the Banks.

Sincerely,

Davis Polk + Wardwell LLP

Davis Polk & Wardwell LLP

cc: Citigroup Inc.

The Goldman Sachs Group, Inc.

JPMorgan Chase & Co.

Morgan Stanley