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Invested in America

February 19, 2016

Via Email (regs.comments@federalreserve.gov)
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 Proposed Rules Regarding 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 Unsecured Debt of Systemically Important U.S. Bank Holding Companies

[Docket No. R–1523; RIN 7100 AE–37]

Dear Mr. deV. Frierson:

The Asset Management Group[1] of the Securities Industry and Financial Markets Association ("SIFMA AMG" or "AMG") appreciates the opportunity to comment on the notice of proposed rulemaking ("TLAC Proposal")[2] promulgated by the Board of Governors of the Federal Reserve System (the "Board") regarding total loss-absorbing capacity, long-term debt and clean holding company requirements for systemically important U.S. bank holding companies ("Covered BHCs") and the intermediate holding companies of systemically important foreign banking organizations ("Covered IHCs").[3]

SIFMA AMG supports the Board's general goal of ensuring that Covered BHCs are well capitalized and resilient; however, we are concerned that the TLAC Proposal's "Clean Holding Company" requirements will have an adverse and unnecessary impact on asset managers' clients, including mutual funds, money market funds and pension funds. Our concern principally centers on one of the corporate practices that would be prohibited under the TLAC Proposal: guaranteeing subsidiary liabilities that are subject to certain default rights. In addition, AMG seeks clarification

[1] SIFMA AMG's members represent U.S. asset management firms whose combined global assets under management exceed $34 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

[2] 80 Fed. Reg. 74925 (November 30, 2015).

[3] To simplify the presentation, this letter addresses the TLAC Proposal as it applies to Covered BHCs; however, all comments are equally relevant to the parallel provisions of the TLAC Proposal that would restrict Covered IHCs.

regarding the scope of instruments and contracts that will be subject to the prohibition on offset rights. Finally, AMG is concerned that the TLAC Proposal may have an adverse affect on important secondary market liquidity.

Thus, as discussed below, AMG recommends that the Board amend the TLAC Proposal to:

- eliminate the guarantee prohibition;
- modify the prohibition against Covered BHCs entering into third-party qualified financial contracts ("QFCs") to permit Covered BHCs to guarantee third-party QFCs of their subsidiaries;
- if the guarantee prohibition is not eliminated, clarify that it applies only prospectively;
- confirm that the prohibition on Covered BHCs providing certain offset rights does not affect the ability of guaranteed subsidiaries to provide offset rights to their counterparties; and
- allow Board-regulated institutions to engage in market making activities with respect to Covered BHC's affected debt and capital instruments.

I. The TLAC Proposal Will Severely Harm the Ability of Asset Managers to Trade with Covered BHC Subsidiaries.

AMG's members manage investment needs for their clients and in doing so also manage liquidity needs and hedge various market risks. To achieve these objectives, AMG's members often transact, on behalf of their clients, with Covered BHCs through their subsidiaries. In some cases, such subsidiaries are depository institutions; however, in many instances, Covered BHCs transact through subsidiaries that are not depository institutions or that are thinly capitalized, and the Covered BHCs provide credit support in the form of holding company guarantees. Such guarantees ensure that the Covered BHC entity to whose credit risk clients are exposed is well capitalized, which is due in part to regulatory capital requirements. Moreover, AMG members are able to base their counterparty credit analyses on audited financial statements and other financial information that is subject to regulatory oversight provided by the SEC (under its reporting requirements for publicly traded companies) and by the Board (in the course of its supervisory authority).

AMG members may neither want to nor be permitted to trade with certain counterparties absent a guarantee from their Covered BHC. For example, AMG members, by regulation and/or clients' investment guidelines, may not be able to trade with counterparties who do not independently meet minimum rating requirements or other credit risk criteria.[4] This, in turn, could

[4] For example, in the context of undertakings for collective investment in transferable securities ("UCITS") incorporated in Ireland pursuant to the Central Bank UCITS Regulations, relevant credit ratings of certain OTC derivatives counterparties must be taken into account in connection with the required credit assessment process for such counterparties. Where such counterparty is downgraded to A-2 or below (or comparable rating) by the relevant credit rating agency, a new credit assessment of the counterparty must be conducted

reduce the number of eligible counterparties with whom AMG members could trade and concentrate counterparty risk and exposures. For these various reasons, Covered BHC guarantees often play a critical role when AMG members transact on behalf of clients.

With these considerations in mind, AMG makes the following three recommendations to amend the TLAC Proposal.

A. The Guarantee Prohibition Should Be Eliminated.

Under the TLAC Proposal:

> *A global systemically important BHC may not directly: . . . Guarantee a liability of a subsidiary of the global systemically important BHC if such liability permits the exercise of a default right that is related, directly or indirectly, to the global systemically important BHC becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding other than a receivership proceeding under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.* [5]

AMG believes that the TLAC Proposal's prohibition on guarantees that permit such default rights (the "Guarantee Prohibition") would effectively eliminate many Covered BHC subsidiaries as viable trading partners, particularly those that are non-depository institutions.

As noted above, under current market practice, Covered BHCs provide guarantees as credit support for many subsidiaries that engage in swap and other market transactions, with attendant cross-default rights available against a guaranteed subsidiary in the event the Covered BHC guarantor becomes subject to a receivership or otherwise insolvent. That practice, however, is inconsistent with the Guarantee Prohibition. For example, under the 2002 ISDA Master Agreement, the commencement of proceedings under Chapter 11 of the Bankruptcy Code by a parent guarantor of a subsidiary that is a party to such an agreement would generally trigger a cross-default right in favor of the subsidiary's counterparty.[6] Similar consequences arise under the widely used master repurchase and securities lending agreements published by SIFMA. Such default rights

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without delay. *See* Part 2, Chapter 1, para. 8(3) and (4) of the Central Bank UCITS Regulations. Where a counterparty is not rated, this credit assessment would typically rely on a guarantee provided by a parent BHC with the appropriate rating. While not explicitly addressed in the current regulatory framework, UCITS Notice 10.10 issued by the Central Bank of Ireland (and replaced by the Central Bank UCITS Regulations as of November 1, 2015) specifically stated that an unrated counterparty would be acceptable where the UCITS is indemnified or benefits from a guarantee provided by an entity with a rating of A-2 or equivalent.

[5] TLAC Proposal § 252.64(a)(4) (Covered BHCs); *see also* § 252.165(d) (to a similar effect for Covered IHCs).

[6] *See* 2002 ISDA Master Agreement §5(a)(vii). AMG recognizes that the exercise of such cross-default rights may in the future be limited contractually in a manner largely drawn from the provisions of the orderly liquidation authority created by Title II of the Dodd-Frank Act, and that this might be accomplished through the promulgation of federal regulations which are expressly anticipated by the ISDA 2015 Universal Resolution Stay Protocol. As these federal regulations have not yet been published for comment, AMG does not at this time express any view as to the desirability or impact of such limitations.

are a critical feature of guarantee arrangements where the guarantee is a condition to trading, since the guarantee is no longer able to function as credit support when the Covered BHC becomes insolvent. If the Board's final TLAC rules were to include the Guarantee Prohibition as proposed, AMG members would be required to terminate, or to engage in extraordinary restructurings of, many trading arrangements entered into on behalf of their clients.

In addition, new trading relationships with Covered BHC entities would be severely limited because few Covered BHC subsidiaries, other than subsidiaries that are depository institutions, would meet requisite credit standards. Moreover, many laws and regulations prohibit insured depository institutions from engaging in various kinds of trading activities. For example, the so-called swap push-out rule prevents certain kinds of transactions from being transacted by insured depository institutions. Such limitations, operating in concert with the Guarantee Prohibition, could effectively eliminate many Covered BHC organizations as providers of certain kinds of swap transactions.

For these reasons, AMG urges the Board to eliminate the Guarantee Prohibition when it finalizes the TLAC rules.

B. The TLAC Proposal's Prohibition Against Covered BHCs Entering into Third-Party QFCs Should Be Modified to Permit Covered BHCs to Guarantee Third-Party QFCs of Their Subsidiaries.

Under the TLAC Proposal:

> *A global systemically important BHC may not directly: . . . Enter into a qualified financial contract with a person that is not a subsidiary of the global systemically important BHC.*[7]

The TLAC Proposal defines QFC by reference to the same term as it is defined under Title II of the Dodd-Frank Act.[8] The Title II definition is worded broadly, and it not only encompasses QFCs that are entered into directly by a party, but also encompasses guarantees provided by the party in respect of another party's QFCs.[9] As a consequence, the TLAC Proposal's prohibition on a

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7 TLAC Proposal § 252.64(a)(3) (Covered BHCs); *see also* § 252.165(d) (to a similar effect for Covered IHCs).

8 *See* TLAC Proposal § 252.61 (Covered BHCs); *see also* § 252.161 (to a similar effect for Covered IHCs).

9 The Title II definition reads: "The term 'qualified financial contract' means any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the Corporation determines by regulation, resolution, or order to be a qualified financial contract for purposes of this paragraph." 12 U.S.C. § 5390(c)(8)(D)(i). In turn, Title II gives each of the elements of that definition ("securities contract, commodity contract, forward contract, repurchase agreement, swap agreement") a broad definition, which in each case ends: "any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in [cross-reference], *including any guarantee or reimbursement obligation in connection with any agreement or transaction referred to in* [cross-reference]" (emphasis added). *See, e.g.,* 12 U.S.C. § 5390(c)(8)(D)(ii)(XII) (the final subclause of the definition of securities contract).

Covered BHC entering into a QFC with non-subsidiaries (the "QFC Prohibition") would prohibit it from guaranteeing any QFC entered into by a subsidiary.

This would appear, in the first instance, to be an unintended consequence of the TLAC Proposal's incorporation by reference of the broad Title II definition; otherwise, the Board would not have stated that the Guarantee Prohibition "would be a complement" to the ISDA 2014 Resolution Stay Protocol (which addresses certain QFC guarantee arrangements).[10] In other words, it appears (as discussed in Part I.A above) that Covered BHCs were intended to be permitted to guarantee QFCs entered into by their subsidiaries, provided that the guarantees do not violate the Guarantee Prohibition.

If, despite first appearances, the Board intended that Covered BHCs should not be permitted to guarantee subsidiary QFCs in any circumstance, then AMG urges the Board to reconsider that intention. As discussed above, AMG members are responsible for managing liquidity needs and hedging various market risks for their clients. QFCs are the principal transactions that serve those important purposes. Such transactions include various repurchase and securities lending transactions, as well as swap and other derivatives transactions. In transacting QFCs on behalf of clients, AMG members seek to achieve best execution and mitigate counterparty risk by transacting with a broad set of counterparties. Where a Covered BHC transacts in these instances through a subsidiary that is not itself independently well capitalized (as many do), it is critical that Covered BHC parent guarantees be permitted. For the reasons discussed above in connection with the Guarantee Prohibition, the final TLAC rules should permit Covered BHCs to guarantee third-party QFCs of their subsidiaries.

C. The TLAC Proposal's Guarantee Prohibition, if Not Eliminated, Should Be Clarified.

As discussed above, implementation of the Guarantee Prohibition as proposed would require AMG members to terminate, or to engage in extraordinary restructurings of, many contractual arrangements entered into on behalf of their clients. If the Guarantee Prohibition is not eliminated as suggested above, the final TLAC rules should, at a minimum, make clear that the prohibition is prospective, effectively grandfathering guarantees of transactions (e.g., QFCs) entered into prior to the effective date of the final TLAC rules.

AMG believes that the Board intended prospective application of the Guarantee Prohibitions, given both the absence of a clear statement of retroactivity in the TLAC Proposal and the material impact and disruption that its retrospective application would have on the credit risk for existing transactions. Clarity as to the prospective scope of the Guarantee Prohibitions would avoid any uncertainty regarding AMG's members being afforded the opportunity, on behalf of their various clients, to determine the extent to which they wish to expose their clients to credit risks that, by design of the TLAC rules, would be significantly different from pre-TLAC credit risks. AMG's

[10] The ISDA 2014 Resolution Stay Protocol addressed transactions governed by ISDA master agreements (a subset of QFCs).

members would need to consider, on a BHC-by-BHC basis, how the TLAC rules alter important considerations that drive counterparty credit risk assessments.

For this reason, while we request above that the Board eliminate the Guarantee Prohibition, any prohibition that remains should be drafted clearly to have only prospective application.

II. The Board Should Confirm that the TLAC Proposal's Prohibition on Covered BHCs Providing Certain Offset Rights Does Not Affect the Ability of Guaranteed Subsidiaries to Provide Offset Rights to Their Counterparties.

Under the TLAC Proposal:

> *A global systemically important BHC may not directly: . . . Issue any instrument, or enter into any related contract, with respect to which the holder of the instrument has a contractual right to offset debt owed by the holder or its affiliates to a subsidiary of the global systemically important BHC against the amount, or a portion of the amount, owed by the global systemically important BHC under the instrument.*[11]

Under current market practice, it is common for a party to a QFC to have a right of set-off (or "offset") that permits the party, upon the default of its counterparty, to set-off obligations owing by the party against amounts owed by the counterparty under agreements between them. These kinds of bilateral offset rights are expressly contemplated by the U.S. Bankruptcy Code, which also recognizes valid "master netting agreements" and the enforceability of netting and set-off within certain prescribed limitations.[12] They are thus a critical element of any related credit risk analysis, as they inform the calculation of net counterparty credit exposure from time to time; and they represent an important means of facilitating insolvency recovery while respecting the need to balance competing creditor rights.

As noted above, it is common for Covered BHCs to guarantee the QFCs of their subsidiaries. It is thus important to AMG members that, when they transact with a guaranteed subsidiary of a Covered BHC on behalf of a client, the client's bilateral set-off rights against the subsidiary under guaranteed transactions (principally QFCs) are not compromised.[13]

It would appear that the TLAC Proposal's prohibition on offsets (the "Offset Prohibition") was not intended to affect offset rights under agreements between a guaranteed Covered BHC

[11] TLAC Proposal § 252.64(a)(2) (Covered BHCs); *see also* § 252.165(b) (to a similar effect for Covered IHCs).

[12] *See, e.g.*, 11 U.S.C. § 561 (protecting the exercise of contractual rights to offset or net termination values, payment amounts or other transfer obligations arising under or in connection with one or more protected contracts); 11 U.S.C. § 362(b)(27) (providing that the automatic stay will not affect the exercise of contractual rights to offset or net under master netting agreements).

[13] For example, the 2002 ISDA Master Agreement provides for offset rights between the two transacting parties. *See* Section 6(f) of the 2002 ISDA Master Agreement.

subsidiary and its counterparty (or any other offset rights that exist as part of the direct contractual relationship between the guaranteed subsidiary and its counterparty). The Board's intention is indicated by the use of the word "direct" in the Offset Prohibition in stating that a BHC:

> *may not directly . . . Issue any instrument, or enter into any related contract, with respect to which the holder of the instrument has a contractual right to offset debt owed by the holder or its affiliates to a subsidiary of the global systemically important BHC against the amount, or a portion of the amount, owed by the global systemically important BHC under the instrument.*[14]

Thus, it appears that, in the context of a guaranteed QFC, the Offset Prohibition would prevent the Covered BHC from including, directly in its guarantee, a provision giving the subsidiary's counterparty (or any of the counterparty's affiliates) a right to offset amounts owed by the counterparty (or an affiliate) to any subsidiary of the Covered BHC. In contrast, the Offset Prohibition does not appear to prohibit the subsidiary from itself granting rights of offset to its counterparty. Indeed, the Board likened the risk of prohibited offset rights to the risk presented by upstream guarantees, explaining that:

> *[Prohibited] offset rights are [a] device by which losses that should flow to the covered holding company's external TLAC holders in an SPOE resolution could instead be imposed on operating subsidiaries and their creditors.*[15]

AMG appreciates that the Offset Prohibition has been drafted to address those kinds of risks, but urges the Board to state affirmatively, when it finalizes the TLAC rules, that the Offset Prohibition will not affect the ability of a guaranteed subsidiary of a Covered BHC to provide offset rights to the subsidiary's counterparties.

III. The TLAC Proposal's Regulatory Capital Deduction Requirements May Negatively Impact Liquidity, Increasing Risks and Costs for Investors.

The TLAC Proposal would require all "Board-regulated institutions" (i.e., most bank holding companies, saving and loan holding companies, and U.S. intermediate holding companies of foreign banking organizations) to take regulatory capital deductions for certain GSIB debt and capital instruments they hold. Although the TLAC Proposal would recognize a limited underwriting exemption from these requirements, it would not recognize a similar exemption for market making activity.

We are concerned that the proposed rule will further exacerbate existing challenges to market liquidity, increasing risk management costs for investors and potentially accelerating contagion during times of market dislocation, as both trading desks and regional bank investors in

[14] TLAC Proposal § 252.64(a)(2) (emphasis added).

[15] TLAC Proposal at 74946.

GSIB securities would be have strong disincentives related to market making in, or holding, GSIB debt or capital instruments.

We therefore suggest that the TLAC Proposal's regulatory capital deduction requirements should include an exemption for market making activities, allowing Board-regulated institutions to engage in market making activities with respect to affected debt and capital instruments of Covered BHCs (including the Board-regulated institution's own debt and capital instruments), without subjecting such positions to regulatory deduction requirements.

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Should you have any questions or wish to discuss these matters further, please do not hesitate to contact Tim Cameron at 202-962-7447 or tcameron@sifma.org, Laura Martin at 212-313-1176 or lmartin@sifma.org, Michele Navazio at 212-839-5310 or mnavazio@sidley.com, or William Shirley at 212-839-5965 or wshirley@sidley.com.

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