THE RISK MANAGEMENT ASSOCIATION

COMMITTEE ON SECURITIES LENDING

August 5, 2016

Via electronic submission

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
E-mail: regs.comments@federalreserve.gov

Re: 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)

Dear Mr. Frierson:

The Securities Lending Committee of the Risk Management Association ("RMA Committee")[1] welcomes the opportunity to submit this letter to the Board of Governors of the Federal Reserve System (the "Federal Reserve") on behalf of several of its members that participate in the securities lending industry as agent banks on behalf of their clients. These members include securities lending agents ("Agent Banks") such as The Bank of New York Mellon, Citibank, N.A., JPMorgan Chase Bank, N.A., The Northern Trust Company and State Street Bank and Trust Company, among others.

[1] The RMA Securities Lending Committee acts as a liaison for RMA member institutions involved in agent lending functions within the securities lending industry by providing products and services, including hosting several forums, conferences and training programs annually and sharing aggregate composite securities lending market data, free of charge.

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This letter addresses the Federal Reserve's proposed rule that would impose restrictions on qualified financial contracts ("QFCs") of systemically important U.S. banking organizations and the U.S. operations of systemically important foreign banking organizations (the "Proposed Rule").[2]

The RMA Committee supports the Federal Reserve's goals of improving the resolvability of U.S. global systemically important banking organizations ("G-SIBs") and foreign G-SIBs that operate in the United States. In particular, we recognize the need to impose restrictions on financial transactions whose disorderly unwind has substantial potential to frustrate the orderly resolution of G-SIBs. However, the marginal cost of any such restrictions must be outweighed by the marginal benefit to resolvability and the stability of the U.S. financial system.

We appreciate the Federal Reserve's efforts to alleviate the compliance burden of the Proposed Rule, in particular, with regard to the generous proposed compliance period. However, this letter highlights certain aspects of the Proposed Rule where we believe the marginal costs of compliance outweigh the potential resolvability benefits. Consequently, we propose concrete alternatives that would significantly reduce the costs and burdens of these restrictions while still advancing the fundamental goal of increasing G-SIB resolvability. We limit our comments to the application of the Proposed Rule to QFCs commonly used in securities lending.

I. Executive Summary

- Securities lending authorization agreements between the securities lender and the Agent Bank ("SLAAs") and similar service agreements that may be considered QFCs by virtue of a credit enhancement provided therein should be excluded from the scope of covered QFCs. An SLAA is a banking service agreement that establishes an agency relationship between the lender and the Agent Bank, and is not analogous to a master agreement between counterparties to securities financing transactions such as a master securities lending/loan agreement (an "MSLA"), a master repurchase agreement (an "MRA") or an ISDA Master Agreement. SLAAs rarely, if ever, have default rights tied to the Agent Bank's insolvency and do not require the Agent Bank to pledge a security interest to the lender to secure the Agent Bank's obligations to the lender. Because non-defaulting beneficiaries under SLAAs lack the incentive to terminate these agreements or contest a transfer of these agreements to a bridge institution in the event of a G-SIB insolvency, including such agreements within the scope of

[2] *See* Federal Reserve, *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. 29,169 (May 11, 2016) [hereinafter "Release"].

covered QFCs for the purposes of § 252.83 would not materially enhance G-SIB resolvability.

- QFCs with a sufficient U.S. nexus should not be covered QFCs for the purposes of § 252.83. There is no ambiguity that such QFCs would be subject to the stay-and-transfer provisions of the Title II Orderly Liquidation Authority ("OLA") and the Federal Deposit Insurance Act ("FDIA"). As such, requiring amendments to these QFCs would impose significant burdens on Agent Banks and their clients (including public and private pension funds, ERISA plans, endowment funds of not-for-profit institutions, insurance companies, investment funds and other similar entities or funds into which such entities invest) without offering significant benefits to G-SIB resolvability.

- QFCs without applicable default rights or transfer restrictions should be excluded for the purposes of § 252.83. In particular, amending QFCs that contain neither default rights that would be subject to a stay under OLA or FDIA, nor transfer restrictions that could potentially impede transfer of the QFCs to a bridge institution would not enhance resolvability.

- The Federal Reserve should, consistent with the UK Prudential Regulation Authority's rule regarding contractual stays in financial contracts governed by third-country law (the "PRA Rule") and Section 60a of the German Recovery and Resolution Act (the "German Legislation"), clarify that obligations under covered QFCs would continue to be enforceable notwithstanding noncompliance with the final rule. Such a clarification is necessary to provide comfort to the market that the final rule would not impact the enforceability of these QFCs, and in particular, that outstanding transactions could not be voided on the basis of technical non-compliance with the Proposed Rule.

- Given the significant compliance burdens on Agent Banks relative to principal-based activities, the compliance deadline for covered QFCs entered into by an agent on behalf of a principal should be extended by six months.

II. Background on Agency Securities Lending

A. Overview

Securities lending and borrowing involves a transfer of securities from a lender to a borrower who provides the lender with collateral in the form of securities or cash. Securities lenders largely consist of institutions such as public and private pension funds, ERISA plans, endowment funds of not-for-profit institutions, insurance companies, investment funds and other similar entities or funds into which such entities invest. Borrowers in securities lending transactions largely consist of broker-dealers, banks and other financial institutions. Agent Banks help facilitate securities lending by lending securities on behalf of underlying lenders to pre-approved borrowers.

Diagrams showing the structure of typical agency securities lending transactions using fixed income collateral (Exhibit I-A) and cash collateral (Exhibit I-B) are attached hereto as exhibits.

Institutions that participate in securities lending transactions support capital markets activities and facilitate trade settlement.[3] By increasing the supply and availability of securities for these and other market activities, securities lending improves global market liquidity. A joint report produced by The International Organization of Securities Commissions concluded that "securities lending is an integral component of nearly all active securities markets," that "[t]he securities-driven market increases the liquidity of securities markets by providing a means for participants to borrow securities on a temporary basis" and that "[t]he growth of securities lending is attributable in large measure to the positive effects securities lending has had on both investment activity and securities settlement arrangements."[4]

Agency securities lending services and the related provision of securities replacement guarantees (described below) are industry standard market practices at Agent Banks. These services have been a customary outgrowth of Agent Banks' custody and related activities for decades, and have long been regulated, examined and treated by regulators as traditional banking services.[5] Members of the RMA Committee provide custodial and securities lending services both in and outside of the United States; Agent Banks acting as securities lending agents include many of the largest financial institutions in the world.

B. Collateral Practices

Securities loans are marked-to-market daily and subject to a daily margin maintenance requirement. Typically, securities loans are over-collateralized by a margin

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3 The discussion and analysis in this comment letter focus on the securities lending industry and indemnified agency securities lending in particular. Nonetheless, the analysis contained herein applies generally to all types of repo-style transactions conducted on an agency basis, including repurchase, reverse repurchase agreements, securities lending and borrowing transactions. Thus, to the extent applicable, references in this comment letter to "securities lending transactions" may be read to include other repo-style transactions; all proposals set forth in this comment letter apply equally to all types of repo-style transactions.

4 International Organization of Securities Commissions, Securities Lending Transactions: Market Development and Implications 55 (July 1999). *available at* http://www.bis.org/cpmi/publ/d32.pdf.

5 *See, e.g.*, Securities Lending, Federal Financial Institutions Examination Council, Supervisory Policy (1985).

of 2% to 5%, depending on the type of collateral provided and certain characteristics of the loaned securities. In some cases, based on the creditworthiness of the borrower and the characteristics of the exposure, margins may exceed 10%. At the beginning of a trade, collateral is accepted by the Agent Bank before or concurrent with delivery of the loaned securities to the borrower. Similarly, at the end of a trade the Agent Bank releases the collateral back to the borrower concurrently with or after the return of the loaned securities.

Cash collateral is typically reinvested for the benefit of the underlying lenders, predominately in daily marked investments, such as overnight or term repurchase agreements (documented under an MRA), money market fund shares or other high credit quality instruments.

C. Securities Replacement Guarantee

As a standard market practice, Agent Banks typically indemnify their underlying lenders for any shortfall between the value of the collateral and the value of the securities in the event of a borrower default. This service is commonly referred to as "borrower default indemnification" (the "Replacement Guarantee"). It is important to note that Agent Banks typically do not indemnify the lender for cash collateral investment loss with respect to such collateral except, in some cases, for repo counterparty default. As such, Replacement Guarantees only result in credit exposure to borrowers and not to the underlying lenders.

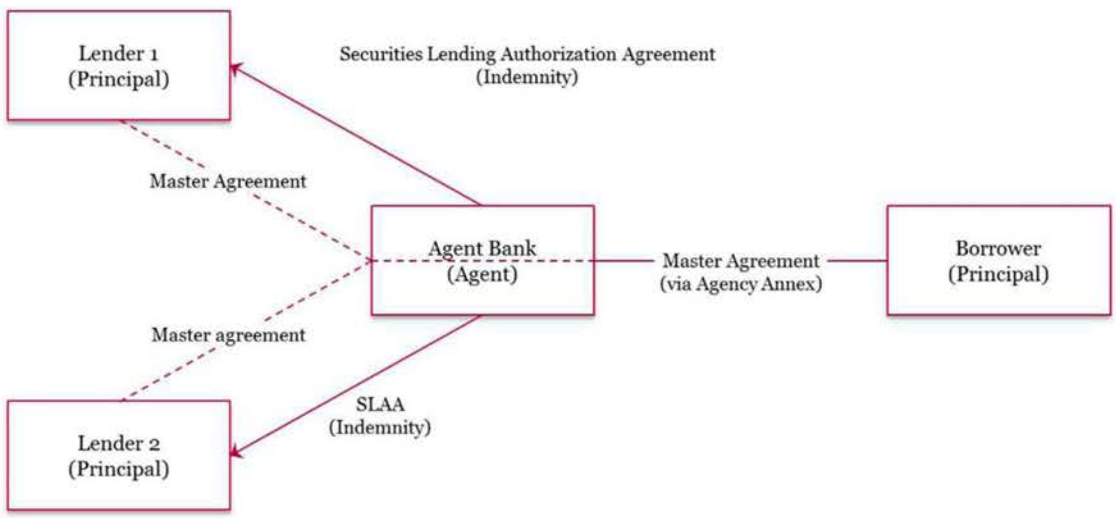
Any exposure to borrowers for Agent Banks under Replacement Guarantees is mitigated in a number of ways. Foremost, securities lending transactions typically are secured by an excess amount (102% to 105%, and sometimes up to 110%, of the value of the loaned securities) of cash or liquid securities collateral. Collateral is marked-to-market daily. In marking-to-market, the daily mark is made based on the prices at close of the prior day and any additional required collateral is posted the same day. In the event of a borrower default, the Agent Bank would first look to the marked-to-market collateral posted, which reduces risk of loss to the Agent Bank.

Further limits to Agent Banks' liability under Replacement Guarantees are set forth in Agent Banks' SLAAs. Significantly, in the event that cash collateral is posted, the underlying lender is responsible for selecting the manager of any reinvestment of the cash collateral (whether the Agent Bank or otherwise) and approving the investment guidelines. As mentioned above, pursuant to the SLAA (except where the Agent Bank provides repo counterparty default indemnification), the underlying lender bears the risk of any principal investment loss with respect to reinvested cash collateral and the Agent Bank bears no responsibility for shortfalls of cash collateral due to any loss on reinvestment.

D. Documentation

Agent Banks generally lend securities pursuant to (i) an SLAA between the securities lender (who is typically not a G-SIB) and the Agent Bank, and (ii) an MSLA (either pursuant to an industry standard form or a bespoke form) between the borrower and the Agent Bank (acting in an agency capacity). Often times, the SLAA also authorizes the Agent Bank to invest and reinvest cash collateral received in connection with a loan in certain approved investments, including reverse repurchase transactions with either the same or a different borrower pursuant to an MRA. An SLAA is a banking service agreement that establishes an agency relationship between the Lender and the Agent Bank, and is not analogous to a master agreement between counterparties to securities financing transactions such as an MSLA, an MRA or an ISDA Master Agreement. Figure 1 below contains a graphical representation of the contractual relationships involved in a typical securities lending relationship.

Figure 1



It is important to note the borrower is not a party to the SLAA (pursuant to which the Replacement Guarantee is provided). Although an Agent Bank's replacement obligation might be triggered by a Borrower's default under the MSLA, the Borrower has no contractual privity with the Agent Bank vis-à-vis the Replacement Guarantee. Similarly, in the overwhelming majority of cases, MSLAs do not reference SLAAs or the indemnities provided therein.

* * *

As discussed in greater detail below, the implementation of the Proposed Rule as currently drafted would impose significant compliance costs on U.S. Agent Banks and their clients that do not correspond to a benefit to a G-SIB's resolvability or financial stability.

III. Scope of Covered QFCs Under Section 252.83

The preamble to the Proposed Rule indicates that one of the Federal Reserve's primary objectives is to reduce the risk that courts in foreign jurisdictions would disregard statutory provisions that would stay the rights of a failed firm's counterparties to terminate their contracts when the firm enters a resolution proceeding under one of the special resolution frameworks for failed financial firms created by Congress under the Federal Deposit Insurance Act and the Dodd-Frank Act and potentially transfer those contracts to a bridge institution.[6]

The Proposed Rule would require covered companies to conform all of their QFCs. In particular, under the Proposed Rule, MSLAs, MRAs and certain SLAAs would be considered QFCs subject to the limitations and restrictions imposed by the final rule ("covered QFCs"). As described in more detail below, a large number of these agreements do not contain restrictions that pose significant barriers to resolvability, which is a goal the Proposed Rule is trying to address. Accordingly, we believe that the Proposed Rule should be tailored to ensure that, consistent with the PRA Rule and the German Legislation, the scope of covered QFCs more closely coincide with those financial contracts whose disorderly unwind would pose the most significant barrier to resolvability.

A. Recommendation 1: SLAAs and similar service contracts should be excluded from the scope of covered QFCs.

Some SLAAs may be considered QFCs by virtue of the Replacement Guarantee that Agent Banks provide to the lenders. However, SLAAs typically do not contain provisions that would impede the resolution of a G-SIB. For example, SLAAs rarely, if ever, have default rights tied to the Agent Bank's insolvency, and do not require the Agent Bank to pledge a security interest to the lender to secure the Agent Bank's obligations. Although some SLAAs may contain termination rights or contractual restrictions on assignability, such restrictions would not present an issue in the case of a G-SIB resolution.

Termination of an SLAA ends the Agent Bank's service obligation to act for the client, but does not accelerate any securities financing transaction or other indebtedness of the Agent Bank. Ultimately, lenders have no incentive to contest a transfer of an SLAA to a bridge institution upon a G-SIB insolvency, since they are the recipient of the Replacement Guarantee. It will always be in a lender's best interest to consent to or

[6] Release, supra note 2, at 29,170.

permit a transfer so as continue to receive services under the SLAA and to benefit from the credit protections that the Agent Bank provides. The likelihood that a lender would contest an OLA or FDIA mandated transfer to a bridge institution is therefore highly remote.

Given the very low risk to resolvability posed by the SLAAs and high compliance burden that would be associated with amending agreements with hundreds of clients, we respectfully request that the Federal Reserve also exclude SLAAs and similar service contracts where the non-defaulting party has little incentive to contest a stay-and-transfer.

B. Recommendation 2: QFCs without a sufficient U.S. nexus should not be covered QFCs for the purposes of Section 252.83.

The text of § 252.83 of the Proposed Rule requires covered QFCs to "explicitly provide" that the conditions set forth in § 252.83(b)(1) and (2) are satisfied. In particular, this explicit acknowledgement requirement would apply to QFCs regardless of the governing law of the agreement. In the preamble to the Proposed Rule, the Federal Reserve expressed a desire to ensure that all covered QFCs, including QFCs governed by foreign law, entered into with a foreign party, or for which collateral is held outside the United States would be covered QFCs.[7] We believe that requiring explicit contractual acknowledgment under § 252.83 for QFCs with a sufficient nexus to the United States would unnecessarily increase the compliance costs of the Proposed Rule without offering corresponding benefits to financial stability.

1. U.S. Nexus Proposal

In particular, we believe that the resolvability concerns surrounding a given QFC are eliminated where:

(1) the QFC is governed by U.S. law;

It is unlikely that any court interpreting a QFC governed by U.S. law could have a reasonable basis for disregarding the stay-and-transfer provisions of OLA or FDIA, which are U.S. statutes.

(2) the QFC is entered into between entities organized in the United States; and

It would be even more unlikely that a court interpreting U.S. law as applied between entities organized in the United States could have a reasonable basis for disregarding the stay-and-transfer provisions of OLA or FDIA, which are U.S. statutes directly applicable to regulated U.S. entities.

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[7] Release, supra note 2.

(3) either:

(A) all obligations under the QFC are unsecured and not subject to a right of acceleration;

If the G-SIB is not required to pledge collateral to its counterparty under the agreement and its counterparty does not have a right of acceleration, there is no concern that a non-defaulting party could seize collateral upon a G-SIB insolvency in contravention of the stay-and-transfer provisions of OLA or FDIA.

(B) the G-SIB's obligations under the QFC are unsecured; or

Similarly, if collateral is only pledged for the benefit of the G-SIB (defaulting party), but not the non-G-SIB defaulting party, there is also no concern that a non-defaulting party could seize collateral upon a G-SIB insolvency in contravention of the stay-and-transfer provisions of OLA or FDIA upon a G-SIB insolvency.

(C) the G-SIB's obligations under the QFC are secured by collateral held at a U.S. custodian or depository pursuant to a U.S. law governed collateral account agreement.

If the collateral is held with a U.S. custodian or depository pursuant to an account agreement governed by U.S. law, there is little concern that a court would permit a non-defaulting party to seize collateral in contravention of stay-and-transfer provisions of OLA or FDIA or otherwise disregard a U.S. court's order to freeze the collateral.[8]

Agreements that meet these criteria do not give rise to concerns about the applicably of the stay-and-transfer provisions of OLA and FDIA.

2. Compliance Burdens

8 As a technical matter, we note that it would not be meaningful to try to look through the immediate securities intermediary (in the case of securities collateral) or depository institution (in the case of cash collateral) to the ultimate location of the collateral. In the case of securities, under the indirect holding system established under Article 8 of the UCC, the debtor's interest in the securities is in the vast majority of cases a security entitlement against the securities intermediary, rather than an interest in the underlying securities. A secured party would not be able to look beyond the securities intermediary where the securities account is located to seize collateral, because (1) neither it nor the debtor has an interest in or claim against any entity upstream from the immediate securities intermediary; and (2) the books and records of any such upstream securities intermediary or depository would not reflect the credit or the debtor's interest. Similarly, with cash collateral held at a depository institution, the debtor's interest in the cash is a claim against the depository institution, rather than an ultimate claim on a central bank (where the depository institution might have a reserve account) or another depository institution that might hold an account in the name of the first depository institution.

We note that a large number of Agent Banks' SLAAs meet these criteria. In each such a case, there is no ambiguity that the QFC would be subject to the stay-and-transfer provisions of OLA and FDIA. On the other hand, if the Proposed Rule is adopted as currently written, these agreements would need to be re-negotiated and amended to conform to the requirements of § 252.83, a task that would be extremely time consuming for both Agent Banks and the underlying lenders without providing a corresponding benefit to resolvability. More generally, compliance would require Agent Banks to educate their clients, develop new documentation structures, and ultimately, may require a complete overhaul of existing market practice and documentation, potentially affecting thousands of client relationships.

Even adherence to an industry-wide protocol would be extremely burdensome. Although the existence of a protocol is helpful, Agent Banks would still be required to educate clients on, and obtain client consent to sign up to any such protocols. Compounding these difficulties is the fact that G-SIB Agent Banks may be required to adhere to these protocols on multiple levels; first, directly in respect of its principal-based activities and second, on behalf of parties for which Agent Banks act as agent.

We are also concerned that these multiple negotiations will be difficult because, by their nature, they will suggest to Agent Bank clients that submission of their U.S. law-governed SLAA to the U.S. resolution regimes lies within each client's discretion and is contingent on delivery of a supplemental consent. We believe there is no legal basis for such a view, but clients may be persuaded to the contrary by Agent Banks' insistence that client consent is required by law.

* * *

Ultimately, as a result of these burdens, underlying lenders may be deterred from continuing to lend securities. We therefore respectfully request that the Federal Reserve clarify that the explicit acknowledgement requirements of § 252.83 would not apply to QFCs that meet the U.S. nexus requirements set forth above. In particular, we request that the Federal Reserve explicitly acknowledge that such requirement would not apply to SLAAs (a large number of which satisfy the proposed U.S. nexus requirements) or alternately, that explicitly acknowledge that such requirement would not apply to SLAAs that met the U.S. nexus requirements.

C. Recommendation 3: QFCs without applicable default rights or transfer restrictions should be excluded for the purposes of Section 252.83.

As discussed in Section III.B above, the text of § 252.83 imposes an explicit acknowledgment requirement on covered QFCs. Many QFCs contain neither default rights that would be subject to a stay under OLA or FDIA resolution, nor transfer restrictions that could potentially impede transfer of the QFCs to a bridge institution.

Including agreements without relevant default rights or transfer restrictions would impose a significant compliance burden on Agent Banks and their underlying lenders without materially enhancing resolvability. In particular, as discussed above, imposing § 252.83's explicit acknowledgment requirements to all covered QFCs would require a complete overhaul of existing market practice and documentation, potentially affecting thousands of customers at each institution, who are unlikely to be aware of the requirements of the final rule. More generally, as discussed above, compliance would require Agent Banks to educate their clients and develop new documentation structures. It is also of concern that these multiple negotiations will not be made easier by having to explain to Agent Bank clients that they must agree to stay certain remedies that do not in fact exist in their SLAAs.

Put another way, in many instances, these efforts are entirely unnecessary, as these QFCs do not contain default rights or transfer restrictions that would be implicated by OLA.[9] In particular, these QFCs would not, by their terms, permit a G-SIB's counterparty to terminate the transaction upon the G-SIB's entry into insolvency proceedings or contest a transfer of the obligations thereunder to a bridge institution.

Consequently, the RMA Committee respectfully requests that the Federal Reserve exclude from the scope of § 252.83 QFCs without default rights that might be subject to a stay under OLA or FDIA or transfer restrictions that could prevent a transfer to a bridge institution under OLA or FDIA.

IV. Other Recommendations

A. Recommendation 4(a): The Federal Reserve should clarify that obligations under covered QFCs would continue to be enforceable notwithstanding compliance with the final rule.

The Federal Reserve should include in the final rule a clarification that the obligations under a covered QFC would still be enforceable even if its terms do not comply with the requirements of the final rule. Regulators have provided similar assurances in respect of the PRA Rule and the German Legislation. Such clarification would provide comfort to G-SIB counterparties that the final rule would not impact the enforceability of these QFCs and in particular, that outstanding transactions could not be voided on the basis of technical non-compliance with the Proposed Rule.

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9 Many SLAA's contain a restriction upon either party's right to a voluntary assignment, but RMA members cannot recall an instance of a provision seeking to deny the rights of resolution authorities to step in. Such a provision, if it existed, would be unambiguously unenforceable.

B. Recommendation 4(b): The compliance deadline should be extended for parties that act through agents given the significant operational burdens.

The rule would be effective on the first day of the calendar quarter that begins at least one year after the issuance of the final rule. We appreciate the Federal Reserve's efforts to alleviate the compliance burden of the Proposed Rule, in particular, with regards to the generous proposed compliance period. However, we believe that Agent Banks face unique compliance challenges that merit an extended compliance period.

In particular, a key characteristic of agency securities lending is the potential for a large number of underlying principals. In contrast to principal-based activity, because of the agency relationship, Agent Banks will need to go through the extra steps of educating clients and obtaining explicit approvals to amend the SLAAs and their clients' MSLAs and MRAs. Although some of the larger and more sophisticated lenders may be aware of resolution stay initiatives, including the Proposed Rule, many lenders rely on their Agent Banks to keep them up-to-date on regulatory developments affecting the securities lending business. Even if the Proposed Rule is only meant to enhance the legal certainty of an OLA or FDIA G-SIB resolution, clients will need to be carefully guided through the rules and required documentation before they are comfortable agreeing to any amendments to their documentation.

Given the significant compliance burdens on Agent Banks relative to principal-based activities, particularly if the above recommendations are not incorporated into the final rule, we respectfully request that the compliance deadline for covered QFCs entered into by an agent on behalf of a principal be extended by six months, similar to the proposal set forth by the UK Prudential Regulation Authority in its consultation document CP 19/15. This extra time will ensure that clients understand the amendments to the documentation that the Proposed Rule would require and allow Agent Banks more time to meet the objections (discussed above) that may be raised in negotiations.

V. Conclusion

In conclusion, we encourage the Federal Reserve to take the time to consider these issues fully and we strongly encourage the Federal Reserve to adopt the proposals set forth in this letter. If desired by the Federal Reserve, the RMA Committee would be pleased to assist the Federal Reserve in the development of any of the recommendations discussed in this letter or in any other manner as the Federal Reserve undertakes to implement the statute appropriately and effectively.

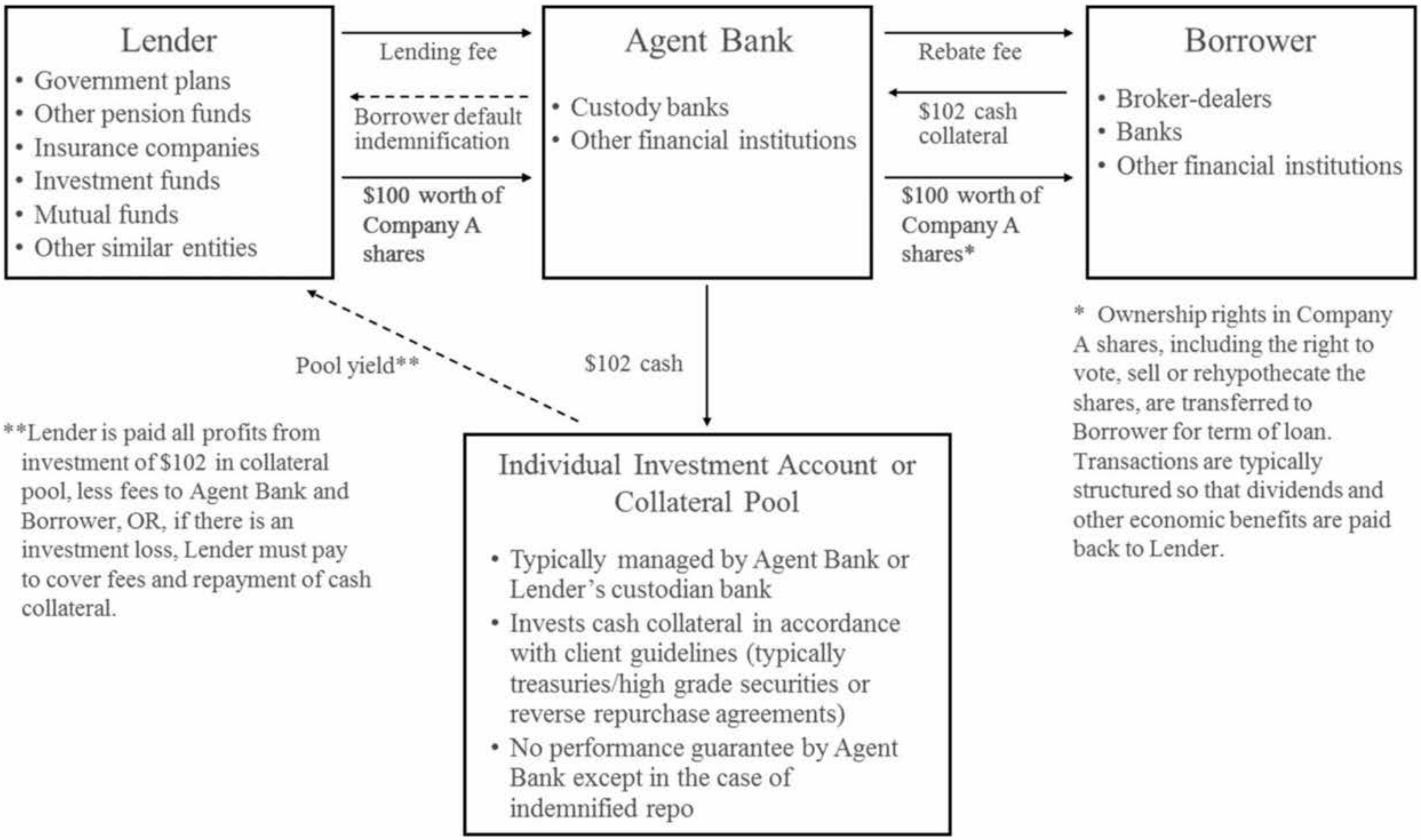
Sincerely,

Fran Garritt	*Jason P. Strofs*
Director Securities Lending & Market Risk Risk Management Association	Chairman Committee on Securities Lending Risk Management Association

<u>Exhibit I-A</u>
Typical Securities Loan Structure
(Fixed Income Collateral)

* Ownership rights in Company A shares, including the right to vote, sell or rehypothecate the shares, are transferred to Borrower for term of loan. Transactions are typically structured so that dividends and other economic benefits are paid back to Lender.

Exhibit I-B
Typical Securities Loan Structure
(Cash Collateral)



**Lender is paid all profits from investment of $102 in collateral pool, less fees to Agent Bank and Borrower, OR, if there is an investment loss, Lender must pay to cover fees and repayment of cash collateral.

* Ownership rights in Company A shares, including the right to vote, sell or rehypothecate the shares, are transferred to Borrower for term of loan. Transactions are typically structured so that dividends and other economic benefits are paid back to Lender.