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October 26, 2020

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: *Part 190 Bankruptcy Regulations (RIN 3038-AE67)*

Dear Mr. Kirkpatrick:

The Investment Company Institute[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission ("Commission") on the Commission's supplemental proposal ("Supplemental Proposal") to update its Part 190 regulations.[2] The Supplemental Proposal is intended to address a concern raised by several commenters that certain of the amendments to Part 190 that the Commission proposed in April ("April Proposal")[3] potentially could undermine the enforceability of derivatives clearing organization (DCO) rules regarding close-out netting. While ICI supports the Commission's withdrawal of the proposed provisions that would have permitted temporary continued operation of an insolvent DCO, we oppose the Supplemental Proposal's addition of a temporary stay. For the reasons described below, we do not believe the Commission's proposed stay is necessary and have significant concerns that, if adopted, the stay provision would likely increase, rather than decrease, the risks associated with a potential DCO insolvency.

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$26.9 trillion in the United States, serving more than 100 million US shareholders, and US$7.8 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] *Bankruptcy Regulations*, 85 Fed. Reg. 601110 (September 24, 2020), *available at* https://www.cftc.gov/sites/default/files/2020/09/2020-21005a.pdf.

[3] *Bankruptcy Regulations*, 85 Fed. Reg. 36000 (June 12, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-06-12/pdf/2020-08482.pdf.

I. Background

ICI's members—including US registered investment companies, such as mutual funds, ETFs, and other funds that are regulated under the Investment Company Act of 1940 ("registered funds"), and non-US regulated funds[4] (together with registered funds, "regulated funds")—use derivatives in a variety of ways. ICI accordingly has a strong interest in the safety and soundness of the derivatives markets, including the protection of customer collateral and funds.

ICI supports the Commission's intent in the April Proposal to enhance customer protections and bring much needed clarity and modernization to the commodity broker liquidation process.[5] Additionally, we support the Commission's intention to establish new regulations regarding the liquidation of a DCO, especially in light of the implementation of the clearing requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the Dodd-Frank Act's Orderly Liquidation Authority (OLA) special resolution regime. As detailed in our July comment letter, however, we are concerned that certain aspects of the April Proposal would harm public customers and cause uncertainty and market disruption in a time of stress.

We understand that several DCOs and a futures commission merchant (FCM),[6] expressed concern that operation of proposed Regulation 190.14(b)(2) and (3) could undermine the enforceability of certain DCO closeout netting provisions and questioned whether, for bank-affiliated clearing members, the proposed regulation would cause these arrangements to no longer qualify as a "qualifying master netting agreement" (QMNA) for purposes of the bank capital requirements that have been established by the US prudential regulators.[7] Proposed Regulation 190.14(b)(2) and (3) would have allowed a DCO to continue operating for six or fewer days after an order for relief was entered where, among other things, continued operation would facilitate resolution under OLA or transfer of clearing operations to another DCO and all or substantially all of the clearing members of the DCO would be able to, and actually would, continue making variation margin payments.

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[4] "Non-US regulated funds" refer to funds that are organized or formed outside the United States and are substantively regulated to make them eligible for sale to retail investors, such as funds domiciled in the European Union and qualified under the UCITS Directive (EU Directive 2009/65/EC, as amended), Canadian investment funds subject to National Instrument 81-102, and investment funds subject to the Hong Kong Code on Unit Trusts and Mutual Funds.

[5] ICI's comment letter on the April Proposal is available at https://comments.cftc.gov/Handlers/PdfHandler.ashx?id=29391 ("July comment letter").

[6] Comments on the April Proposal are available at https://comments.cftc.gov/PublicComments/CommentList.aspx?id=3097.

[7] For these purposes, the US prudential regulators are limited to the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System ("Federal Reserve Board"), and the office of the Comptroller of the Currency.

Currently, the definition of QMNA requires that "any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than . . . [i]n receivership, conservatorship, or resolution under the Federal Deposit Insurance Act, [OLA] or under any similar insolvency law applicable to GSEs, or laws of foreign jurisdictions that are substantially similar to" the foregoing.[8] This definition does not, however, exclude a bankruptcy subject to Part 190. The Commission explains that, as a result, "to the extent that proposed §190.14(b)(2) and (3) acts as a stay, it would undermine the QMNA status of DCO rules," with detrimental capital implications for bank-affiliated clearing members.[9]

The Supplemental Proposal is intended to address these concerns by withdrawing proposed Regulation 190.14(b)(2) and (3). However, it also would add a new stay that would be applicable in the bankruptcy of a systemically important DCO (SIDCO). The stay would prohibit the liquidation of contracts cleared by the SIDCO for a brief time after bankruptcy in order to foster the success of a Title II resolution. The Commission stay would become effective only if the Commission concludes that the prudential regulators have taken steps to make the proposed Part 190 stay consistent with the QMNA status of SIDCO rules.

The length of the Part 190 stay would be the shorter of (i) the period of time beginning on the commencement of the proceeding and ending at the later of 5 pm ET on the business day following the date of the commencement of the proceeding and 48 hours after the commencement of the proceeding;[10] or (ii) the shortest such period specified in an action by any of the prudential regulators in relation to a QMNA determination. The proposed provision would explicitly prohibit continued collection or payments of initial or variation margin during the Part 190 stay.

II. <u>ICI Supports the Commission's Withdrawal of Proposed Regulation 190.14(b)(2) and (3)</u>

We support the Commission's withdrawal of proposed Regulation 190.14(b)(2) and (3). As explained in our July comment letter,[11] the continued operation of a DCO has the potential to result in significant continued losses for customers and exacerbate stress. A DCO will generally only enter bankruptcy if it determines that its waterfall is insufficient or will fail to return it to solvency and stability. In such a situation, requiring customers to continue contributing funds to the DCO would cause customers to incur greater losses and impair liquidity at a time of significant market stress. In addition, the possibility of a DCO continuing to operate following bankruptcy would likely exacerbate

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[8] *See, e.g.,* 12 C.F.R. 324.2 (FDIC definition of QMNA).

[9] Supplemental Proposal at 60111.

[10] This formulation of the stay period is consistent with the stay period the prudential regulators have adopted in the context of their regulations on stays in qualified contacts of certain banks subject to their supervision. *See, e.g.,* 12 C.F.R. 382.4 (FDIC rules).

[11] *Supra* note 5, at 23.

stressed market conditions by creating uncertainty as to when and whether a customer will be able to enter into replacement trades. It is therefore strongly preferable from both a public customer protection and systemic risk perspective that the trustee instead stem losses by terminating DCO operations promptly and liquidating the cleared positions.

As the Commission has recognized, the withdrawal of proposed Regulation 190.14(b)(2) and (3), without additional measures, is sufficient to address the concerns of commenters regarding enforceability of DCO close-out netting provisions.[12] The elimination of these provisions will leave no doubt that, upon a DCO insolvency, clearing members will be able to close out and net in accordance with the DCO rules. Accordingly, as a result of the Commission withdrawing these provisions, Part 190 should not act as a barrier to a QMNA determination.

III. The Commission Should Not Adopt a Stay Under Part 190

A. A Stay Under Part 190 is Unnecessary

The Commission's intention in proposing a stay that would apply to SIDCO contracts for a brief time after bankruptcy is to provide the FDIC, the Federal Reserve Board, and the Secretary of the Treasury with enough time to initiate proceedings under OLA. We appreciate that that the deliberative process by which the FDIC, the Federal Reserve Board, and the Secretary of Treasury determine whether a SIDCO should be placed into resolution under OLA may take some time.[13] The Commission is concerned that a SIDCO could file for bankruptcy before OLA has been triggered, resulting in termination of the SIDCO's derivatives contracts with its members.

We support preventing the needless destruction of value that could result from the liquidation of contracts when there is a viable alternative available. We believe, however, that the Commission's proposed stay is not necessary to achieve this objective and its negative consequences, as explained below, far outweigh any potential benefits.

Although it may indeed take some time for the relevant agencies to "turn the three keys," a DCO's recovery tools should give the agencies more than enough time. DCOs have clearing fund, liquidity provisions, operational default provisions, and a variety of other risk management tools at their disposal. In practice, these tools may not be completely effective to preclude an insolvency. However, it seems extraordinarily unlikely that they would be so ineffective as to fail to give the FDIC, Federal Reserve Board, and Secretary of the Treasury enough time to decide whether to trigger OLA proceedings.

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[12] *See, e.g.,* Supplemental Proposal at 60111.

[13] The steps that these agencies must take are often referred to as the "three keys" that must be turned to initiate OLA proceedings. *See, e.g.,* FDIC Office of Inspector General, *The FDIC's Progress in Implementing Systemic Resolution Authorities under the Dodd-Frank Act*, Office of Audits and Evaluations Report No. AUD-14-001 (Nov. 2013) at 3, *available at* https://www.fdicoig.gov/sites/default/files/publications/14-001AUD.pdf.

Indeed, Congress enacted OLA as a measure that could be used for bank holding companies and other Bankruptcy Code debtors that have far fewer resources available than a SIDCO. If Congress believed a stay in bankruptcy or similar measure were necessary to provide the agencies with the time necessary to turn the three keys, it could have added that to the statute. The fact that it did not implicitly suggests Congress believed that either such a stay was not necessary or that adding such a stay on top of OLA's stay would be harmful to customers and counterparties. We believe it would be inappropriate for the Commission to substitute its judgment for that of Congress in this regard.

B. The Commission's Proposed Stay Would Harm Regulated Funds

As described above, the Commission's proposed stay could be as long as 48 hours. In addition, it could be followed by OLA's one-business day stay. As a result, the two stays, applied consecutively, could prevent the liquidation of a SIDCO's derivatives contracts for as long as three business days or five calendar days. For example, if a SIDCO entered bankruptcy proceedings at 5:00 pm on Wednesday afternoon, the CFTC's proposed stay could extend until Friday at 5:00 pm. However, if resolution under OLA were triggered at 4:59 pm on that Friday afternoon, then the one business day stay under OLA[14] would be triggered and could extend until Monday at 5:00 pm, resulting in close-out rights being suspended for a total of three business days or five calendar days.[15]

We urge the Commission to withdraw its proposed stay provision. Suspension of close-out rights for up to three business days or five calendar days is unacceptably long, and could result in significant loss of value to public customers such as regulated funds, causing irreversible harm to these funds and their shareholders. During such an extended stay, the price of the relevant underlying assets could (and if a SIDCO is insolvent, likely would) move dramatically. However, customers would be precluded from entering into risk-reducing or replacement transactions to stem potential losses, since they will not know whether their contracts will be terminated or reinstated. Such a freeze not only threatens to cause public customers significant losses that they cannot mitigate; it also would create a liquidity event because customers will need to preserve as much liquidity as possible during the pendency of the stay in order to meet potential margin calls. The implications of the Commission's proposal are especially serious because in many instances, funds may not have a viable alternative to clearing certain derivatives contracts through a DCO other than the two DCOs that have been designated as SIDCOs.

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[14] The stay under OLA extends until 5:00 pm ET on the business day following the date of the FDIC as receiver. *See* 12 U.S.C. 5390(c)(10)(B)(i).

[15] Although the OLA stay only applies to the exercise of rights "solely by reason of or incidental to the appointment . . . of the [FDIC] as receiver for the covered financial company (or the insolvency or financial condition of the covered financial company for which the [FDIC] has been appointed as receiver)," the serious evidentiary issues as to whether the exercise of rights was due to the failure to post margin or the financial condition of the DCO (or both) would likely prevent clearing members from acting until the OLA stay is over. We note, in this regard, that in the analogous QFC stay context, the FDIC (and other prudential regulators) have required a counterparty to demonstrate by "clear and convincing evidence" that its exercise of remedies is not on account of the commencement of proceedings in respect of an affiliate. *See* 12 C.F.R. § 382.4(i).

ICI has consistently advocated to both US and global regulators that resolution stays must be as short as possible, but in no event longer than 48 hours,[16] consistent with the maximum period described in the Financial Stability Board's Key Attributes of Effective Resolution Regimes of Financial Institutions.[17] There is global acceptance of a 48-hour stay as the maximum appropriate period of time to facilitate an effective resolution of a systemically important bank without making resolution more difficult, harming market participants, and creating systemic disruption. A longer stay, as could result from application of the Commission's proposed stay, threatens to cause significant losses to customers and create additional uncertainty at a time of unprecedented market distress. These concerns are greatly exacerbated by the Supplemental Proposal's prohibition on continued collection or payments of initial margin or variation margin during the stay. Rather than facilitating a resolution, the Commission's proposed stay, especially when imposed in conjunction with the OLA stay, would likely make it more difficult to resolve a failing DCO, contrary to the Commission's objectives in this rulemaking.

ICI and its members have raised significant concerns about existing central counterparty (CCP) governance, risk, and default management standards and practices.[18] ICI and its members are strongly supportive of US and global efforts to reduce uncertainty and ensure fair treatment of regulated funds in the event of a CCP resolution, and have made specific recommendations to the Commission and other US and global regulators to further these goals.[19] The Commission's proposed Part 190 stay would undermine these efforts, as it would significantly increase uncertainty and customer loss exposure.

In addition, the Supplemental Proposal would create substantial legal uncertainty, as it is unclear how the Commission's proposed stay would interact with the safe harbors for close-out rights set out in the Bankruptcy Code or the clearing organization netting provisions of the Federal Deposit Insurance Corporation Improvement Act (FDICIA).[20] Section 556 of the Bankruptcy Code provides that the contractual right of certain parties to terminate a commodity contract because of the commencement of Bankruptcy Code proceedings "shall not be stayed, avoided, or otherwise limited by operation of any

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[16] *See, e.g.,* Letters from ICI Global and SIFMA AMG to EU regulators, dated June 29, 2017, *available at* https://www.ici.org/pdf/30761a.pdf, Jan. 23, 2018, *available at* https://www.ici.org/pdf/31084a.pdf, and Sept. 10, 2018, *available at* https://www.ici.org/pdf/31378a.pdf.

[17] Financial Stability Board (FSB), Key Attributes of Effective Resolution Regimes for Financial Institutions (October 15, 2014), *available at* https://www.fsb.org/wp-content/uploads/r_141015.pdf. The FSB Key Attributes provide that any stay should be "strictly limited in time (for example, for a period not exceeding 2 business days) . . ."

[18] *See, e.g.,* ICI and ICI Global Response to Financial Stability Board Regarding Guidance on Financial Resources to Support CCP Resolution and the Treatment of CCP Equity in Resolution (July 29, 2020), *available at* https://www.ici.org/pdf/32645a.pdf; A Path Forward for CCP Resilience, Recovery, and Resolution (March 10, 2020), *available at* https://www.jpmorgan.com/content/dam/jpm/cib/complex/content/news/a-path-forward-for-ccp-resilience-recovery-and-resolution/pdf-0.pdf.

[19] *Id.*

[20] *See generally* 11 U.S.C. §§ 362(b)(6); 556; 12 U.S.C. § 4404.

provision of this title or by the order of a court in any proceeding under this title." Section 404(a) of FDICIA states that, with certain exceptions, "the covered contractual payment obligations and the covered contractual payment entitlements of a member of a clearing organization to and from all other members of a clearing organization shall be terminated, liquidated, accelerated, and netted in accordance with and subject to the conditions of" the relevant clearing organization's rules notwithstanding any other provision of federal law. Even if it is the case that the Commission can override FDICIA and the Bankruptcy Code's safe harbors, there will at the very least be a great deal of legal uncertainty, which would serve to exacerbate an already stressed market.

IV. The Commission Has Provided Inadequate Public Notice and Opportunity for Comment

The Supplemental Proposal does not provide the public with adequate notice of the Commission's rule text or an opportunity for comment. The Supplemental Proposal does not include proposed rule text and the Commission suggests that it does not intend to publish draft rule text for notice and comment before finalizing it. Rather, it states that it will provide public notice and comment once the prudential regulators have taken actions sufficient to make the Part 190 stay provision consistent with the QMNA status of SIDCO rules. Public comment would be limited to whether the prudential regulators' actions are sufficient to achieve that objective.

This is a complex rule, the drafting and finalization of which is dependent on the actions of other regulators (*i.e.,* the prudential regulators). While the Commission summarizes in the Supplemental Proposal the key components and proposed operation of the rule, the lack of opportunity for the public to consider actual draft rule text is concerning. For example, as discussed above, it is unclear how the Commission's proposed stay will operate in conjunction with the OLA stay. Without proposed rule text it is difficult to assess this key point. As another example, the scope of the proposed rule is unclear. While the Commission indicates it intends to limit the rule to SIDCOs, it is unclear to which SIDCO contracts the proposed stay would apply. The Commission refers variously to "SIDCO contracts" and "derivatives contacts" but no proposed definition is provided of contacts that would be subject to the proposed stay.[21]

We also believe that the Commission's economic analysis is inadequate. We question how the Commission can undertake an accurate economic analysis that considers the potential costs and benefits of the rule without proposed rule text. Further, the Commission's economic analysis does not

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[21] Scope of contracts covered by the proposed stay was a significant point of public comment and revision by the prudential regulators when they adopted regulations on stays in qualified contacts of certain banks subject to their supervision. *See, e.g., 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*, 82 Fed. Reg. 42882 (Sept. 12, 2017), *available at* https://www.gpo.gov/fdsys/pkg/FR-2017-09-12/pdf/2017-19053.pdf (Federal Reserve regulations).

consider the significant costs to market participants of a stay that could, in conjunction with the OLA stay, extend for as long as three business days or five calendar days. Nor does the Commission's economic analysis take into account that the Supplemental Proposal withdraws the provision in the April Proposal that permits exchange of margin, replacing it with an explicit prohibition on exchange of margin. The inability to exchange margin during the stay period increases risks and potential costs to regulated funds. The Commission must address these procedural deficiencies before adopting any final rule.

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We appreciate the opportunity to comment on the Supplemental Proposal. If you have any questions about our comment letter, please feel free to contact me at (202) 326-5835.

Sincerely,

/s/ Sarah A. Bessin

Sarah A. Bessin
Associate General Counsel

cc: The Honorable Heath P. Tarbert
The Honorable Brian D. Quintenz
The Honorable Rostin Behnam
The Honorable Dawn DeBerry Stump
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