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VIA ELECTRONIC SUBMISSION TO FSB@BIS.ORG

Financial Stability Board
Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: ***Consultative Document - Cross-Border Recognition of Resolution Action***

Ladies and Gentlemen:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits these comments in response to the Financial Stability Board's ("**FSB**") consultative document on cross-border recognition of resolution actions (the "**Consultative Document**").[1] The Working Group appreciates the concerns raised by the FSB. The Working Group is interested in finding feasible solutions that benefit the entire marketplace. However, the Working Group has genuine concerns with certain aspects of the Consultative Document and the FSB's approach to implementing the concepts set forth in the Consultative Document.

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

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[1] *See Cross-border Recognition of Resolution Action,* Consultative Document, Financial Stability Board, Sept. 29, 2014 , *available at* http://www.financialstabilityboard.org/wp-content/uploads/c_140929.pdf.

II. BACKGROUND.

As stated in the Consultative Document, the FSB made a commitment to "develop policy proposals on how legal certainty in cross-border resolution can be further enhanced."[2] This effort was undertaken in response to concerns that, if a large, cross-border bank were to enter resolution proceedings, the ability of the bank's counterparties to simultaneously exercise close-out rights with respect to derivatives could harm both the resolution efforts with regard to the bank and market stability generally.[3]

At present, certain insolvency regimes institute a stay on termination rights in the event that a bank becomes insolvent under an applicable regime. For example, the Orderly Liquidation Authority provisions (the "**OLA**") of the Dodd Frank Act[4] and the European Union Bank Recovery and Resolution Directive (the "**BRRD**")[5] each create a brief stay of termination rights. During that stay, regulators and administrators are expected to search for potential transferees of the insolvent bank's assets, including its derivatives book. In the event that a transferee is found, the non-defaulting party generally is prohibited from exercising close-out rights and is required to continue performing its contract with the transferee. If no transferee is found, then the non-defaulting party's close-out rights are reinstated after the expiration of the stay.

As made clear in the Consultative Document, the FSB's concerns primarily relate to cross-border trades. Whereas the U.S. Bankruptcy Code[6] includes provisions for cross-border coordination of generic insolvency proceedings, specialized insolvency statutes like the OLA and BRRD generally do not include provisions for the international application of their provisions. As a result, a non-defaulting party in one country may not be subject to or bound by the specialized insolvency statutes in another country.

Particularly in the context of a large bank with multiple foreign branches, the FSB has expressed concerns related to enforceability of specialized insolvency statutes and uniformity of treatment among the bank's counterparties.[7] As a result, the FSB, through the Consultative Document, proposed a process whereby G-20 jurisdictions might update their resolution regimes

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[2] *Id.* at iii.

[3] *Id.* at 1.

[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[5] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2001/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament of the Council Text with EEA relevance.

[6] 11 U.S.C. §§ 101 *et seq*. (the "**Bankruptcy Code**").

[7] Consultative Document at 11.

to enhance cross-border recognition of resolution actions.[8] However, that process and the necessary statutory changes in the respective jurisdictions may take some time.

As a result, the FSB directed the International Swaps and Derivatives Association ("**ISDA**") to create a contractual solution to the concerns articulated by the FSB. That request led to the formation of the Resolution Stay Protocol (the "**Protocol**") with respect to termination rights under the ISDA Master Agreement. The Protocol would amend the ISDA Master Agreement to incorporate the recognition of the various stays that exist under specialized insolvency regimes. Effectively, the Protocol would create an opt-in mechanism in which adhering parties agree to be bound by the provisions limiting termination rights in certain specialized insolvency statutes. The Protocol would also include the stay of certain cross-default rights with regard to cases under the Bankruptcy Code and certain foreign resolution regimes.

While the direct scope of the Protocol extends only to adhering parties, which will initially include "global systemically important banks … and other large dealer banks,"[9] as a practical reality, those market participants are very likely to require like terms in their ISDA Master Agreements with all counterparties. In addition, the Consultative Document indicates that the FSB expects efforts will be made to "promote use of appropriate contractual language on stays by market participants that are not prudentially regulated."[10] As a result, the indirect effect of the Protocol may be to constrain termination rights on virtually all swap market participants.

Finally, the impact of the Protocol and the related FSB efforts will go beyond the financial markets. Market participants in the energy and commodity markets frequently use the ISDA Master Agreement to trade physical commodities. As discussed further below, constraints on close-out rights in physical commodity agreements would likely have a negative effect on commodity markets.

III. THE FSB'S PROCESS FOR ADDRESSING CROSS-BORDER RESOLUTION COORDINATION SHOULD BE MORE INCLUSIVE.

The FSB's process in implementing its cross-border resolution reforms raises concerns. While the Working Group understands why the FSB chose to instruct ISDA to move forward with the Protocol prior to the adoption of statutory solutions to the issues addressed by the Protocol, the reliance on a contractual solution to statutory issues is concerning for two reasons. *First*, non-financial end-users, including energy market participants, were largely not part of the negotiation process that led to the Protocol. As the Protocol may fundamentally change all market participants' termination rights, a broader selection of market participants should have been included in the drafting of the Protocol. A broader group of market participants would have

[8] *Id.* at 8-11.

[9] *Id*. at 12.

[10] *Id*. at 13.

been instructive, as the interests of non-financial end-users may not align well with the interests of swap dealers and other large financial institutions.

For example, under the two uncleared swap margin proposals in the U.S.,[11] the related proposal in Europe,[12] and the Basel Committee on Banking Supervision ("**BCBS**" or "**Basel**") and the International Organization of Securities Commissions' ("**IOSCO**") framework for margin requirements for uncleared swaps,[13] initial margin posted by swap dealers must be segregated with a third-party custodian. However, initial margin posted by non-financial end-users most likely would not be segregated in such a fashion. Because of the differences in treatment of collateral, a swap dealer would be more likely to recover the full value of that collateral if it were posted to an insolvent counterparty. As such, the dealer has less incentive than non-dealers to protect its right to avoid a stay of its close-out rights.

Second, the use of a contractual approach may circumvent the regulatory and legislative process in a number of jurisdictions. In the United States, there are a number of resolution regimes and the treatment of derivatives contracts under those regimes varies. For example, swaps are exempt from the Bankruptcy Code's automatic stay,[14] while swaps are subject to a 24-hour stay under the OLA.[15] The difference in the treatment of swaps under those resolution paradigms is intentional. The United States Congress made deliberate choices when determining how swaps would be treated under different resolution regimes. Forcing market participants to adhere to the Protocol circumvents Congressional intent by contract.[16] At the very least, entities

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[11] *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, Notice of Proposed Rulemaking, 79 Fed. Reg. 59,898 (Oct. 3, 2014), *available at*: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-22962a.pdf and *Margin and Capital Requirements for Covered Swap Entities,* Proposed Joint Rule, 79 Fed. Reg. 57347 (Sept. 24, 2014), *available at: http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf*.

[12] *See Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012* (Apr. 14, 2014), *available at* http://www.esma.europa.eu/system/files/jc_cp_2014_03_cp_on_risk_mitigation_for_otc_derivatives.pdf.

[13] *See Margin Requirements for Uncleared Derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions (Sept. 2013) *available at*: http://www.bis.org/publ/bcbs261.pdf.

[14] 11 U.S.C. §§ 362(b)(17); 560.

[15] 12 U.S.C. §§ 5390(a)(9); 5390(a)(10)(B)(i).

[16] There are two potential paths through which all market participants may be effectively forced to adhere to the Protocol or a similar document. *First*, regulators could prohibit swap dealers and other prudentially regulated financial institutions from transacting with counterparties that have not adhered to the Protocol or a similar document. Given the role that swap dealers play in derivatives markets, a market participant would largely be shut out of those markets if they could not transact with dealers. *Second*, the swap dealers and other large financial institutions may seek to force all of their counterparties to adhere to the Protocol or similar agreement so there is symmetry across their portfolios in the event of an insolvency. For example, if an insolvent Protocol adherent had an existing swap with a non-financial end-user that it hedged with another Protocol adherent, the non-financial end-

other than globally systemically important financial institutions ("**G-SIFIs**") and large derivatives dealers should not be subjected to the Protocol (or a similar protocol) until the G-20 jurisdictions complete their relevant legislative and regulatory processes.

IV. THE FSB'S PROPOSALS AND THE PROTOCOL HAVE MATERIAL ADVERSE CONSEQUENCES FOR PHYSICAL COMMODITY MARKETS.

As noted above, participants in energy and commodity markets frequently use the ISDA Master Agreement (with the applicable Annex or Annexes) to trade physical commodities. In addition, banks and other swap dealers use numerous other forms of master agreements to trade physical commodities (*e.g.*, NAESB, EEI, WSPP). Constraints on close-out rights in physical commodity transactions would likely have a deleterious effect on the supply chain and on the commodity markets generally.

Many systemically important banks and their affiliates participate in physical commodity markets. If such a bank becomes insolvent, the ability to instantly set-off or close-out physical transactions with that entity or, through cross-default, their affiliates, is essential to the preservation of an orderly market. Given the complexity of moving a commodity from its producer to its ultimate end-user, many commodity markets operate using daisy-chain transactions. In daisy-chain transactions, any intermediate purchasers of a commodity "book-out" the transaction and cash-settle their obligations. Physical delivery of the commodity may only take place between the producer (or some other entity that has physical possession of the commodity) and the ultimate end-user. However, every party in the daisy chain has to be able to perform its obligations or the daisy chain collapses.

These transactions generally qualify as "forward contracts" under the Bankruptcy Code and are not subject to a stay.[17] The absence of a stay allows market participants to quickly exit daisy chains with insolvent counterparties so they can satisfy their commercial need for a physical commodity or their obligation to provide that commodity to a counterparty. Imposing a stay on physical market participants would likely result in significant market uncertainty and disruption as failures to deliver occur where the insolvent counterparty is unable to perform or where the market expects that counterparty to be unable to perform in the near future. Even if regulators were able to transfer the physical commodity transactions of an insolvent entity to a bridge company, that uncertainty may not dissipate as the bridge company may not have all the licenses necessary to transact in the relevant commodities and may not have the ability to take or make physical delivery.

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user's immediate exercise of its close-out rights could lead to the insolvent entity no longer having an effective hedge in place.

[17] 11 U.S.C. §§ 101(25); 362(b)(6); 556.

For example, Lehman Brothers Commodity Services ("**LBCS**") was an active participant in the natural gas and power markets. During the Lehman Brothers insolvency, market participants were able to exercise their cross-default rights under their various master trading agreements and significant market disruption was avoided. LBCS filed for bankruptcy two-and-a-half weeks after its parent. The imposition of a stay or other limitation on the exercise of cross-default rights during that period would likely have led to significant market disruption.

In light of the foregoing issues, the Working Group respectfully requests that the FSB exclude physical commodity transactions from the scope of the undertakings recommend in the Consultative Document. In addition, the Working Group requests that the FSB direct ISDA to amend the Protocol to exclude physical energy and commodity transactions from its scope. The requested modifications to the scope of the FSB's proposal and the Protocol would not be contrary to the FSB's goals as physical commodity markets are not systemically important financial markets and would simultaneously avoid harming the physical supply chain and the physical commodity markets.

V. THE IMPOSITION OF STAYS MAY INCREASE THE CHANCES OF A "RUN-ON-THE-BANK."

The Protocol and the related FSB undertakings may not achieve the goals of reducing risk and increasing stability in financial markets. The imposition of a stay may, under the best circumstances, make the resolution of a troubled entity easier, but the presence of a stay may make insolvency more likely or, at least, may accelerate an entity's path to insolvency. In short, the FSB's proposal may exacerbate the very problem it seeks to cure. Specifically, by forcing market participants to adhere to stays that would not otherwise be applicable in the event of counterparty bankruptcy or a cross-default, the FSB's proposals may lead to a "run-on-the-bank" as counterparties seek to close out trades with a troubled institution prior to a stay taking effect. In contrast, in the absence of a stay, counterparties may be more comfortable taking the risk associated with a troubled counterparty.

VI. THE TREATMENT OF AFFILIATES UNDER THE FSB'S PROPOSALS AND THE PROTOCOL WILL HAVE AN ADVERSE IMPACT ON BUY-SIDE MARKET PARTICIPANTS.

The Protocol, under certain circumstances, would limit the ability of a market participant to exercise its cross-default rights, where an affiliate of that market participant's counterparty is an adherent to the Protocol and is subject to resolution under a Special Resolution Regime. In short, the Protocol would require market participants to effectively subject themselves to the Special Resolution Regimes of foreign jurisdictions as a consequence of trading with an entity that has a foreign parent that adhered to the Protocol. That result may circumvent the bankruptcy laws of such market participant's home jurisdiction and makes due diligence and credit analysis more complex. The FSB should respect the rights of market participants and should not limit their ability to exercise the cross-default rights afforded to them under the laws of the jurisdiction where their counterparty is organized.

VII. RESPONSE TO QUESTIONS CONTAINED IN THE CONSULTATIVE DOCUMENT.

The FSB requests market participants to respond to 5 questions. Please see our specific responses below.

1. ***Are the elements of cross-border recognition frameworks identified in the report appropriate? What additional elements, if any, should jurisdictions consider including in their legal frameworks?***

The cross-border recognition framework identified in the Consultative Document may require citizens of G-20 nations to waive their rights under the laws of their home country, and to potentially agree to the resolution regime of an entity with which they may not have contractual privity. Notwithstanding the different and diverse legal cultures and histories among the G-20 nations, the proposal raises the question of whether one particular type of market participant, financial institutions of a certain size and scope, should, under certain circumstances, be granted an exception to the normally applicable principles of the extraterritorial reach of national law. Establishing such an exception for a small number of market participants may run counter to the goal of ending "too-big-to-fail." Instead, such treatment may reinforce market perceptions that such entities are subject to a different set of standards. Requiring counterparties to waive their rights under the laws of their home countries and for which they have freely contracted as a condition of doing business with the largest participants in certain markets may serve only to add complexity to the resolution of such entities. Instead, the prudential regulators of the largest financial institutions should work with national authorities to create legal regimes which make it easier to resolve financial institutions under their own relevant legal frameworks, without limiting freedom of contract and rights granted under local law.

2. ***Do you agree that foreign resolution actions can be given effect in different ways, either through recognition procedures or by way of supportive measures taken by domestic authority under its domestic resolution regime? Do you agree with the report's analysis of these approaches?***

As stated above, national authorities should create resolution regimes, and, where necessary, prudential measures to address the resolution of financial entities in their home countries. Such regimes should not require counterparties to waive their rights and submit to foreign law where the parties have not expressly chosen to do so. The choice of law provisions chosen by the parties themselves should be enforced.

3. ***Do you agree that achieving cross-border enforceability of (i) temporary restrictions or stays on early termination rights in financial contracts and (ii) 'bail-in' of debt instruments that are governed by the laws of a jurisdiction other than that of the issuing entity is a critical prerequisite for the effective implementation of resolution strategies for global systemically important financial institutions (G-SIFIs)? Is the effective cross-***

border implementation of any other resolution actions sufficiently relevant for the resolvability of firms that the FSB should specifically consider ways of achieving their cross-border enforceability?

We do not agree that requiring a counterparty to waive its right to foreclose on collateral securing a trade is a critical prerequisite for resolving a complex financial institution. In a high-stress scenario, it is likely that some parties will agree to a stay of such rights and others will seek to protect themselves by closing out their trading relationships and holding onto collateral during times of extreme market uncertainty. Additionally, for parties that agree to the stay, it will likely be the case that the value of the collateral securing the trade may swing wildly in response to a highly volatile market. To the extent no "bridge institution" can be created after the stay, the only effect of such a stay is to potentially spread contagion and potentially harm the position of the counterparty that agreed to a voluntary stay not otherwise provided for in law. Exemptions from insolvency proceeding stays for financial contracts have historically been created in order to minimize such contagion. The FSB proposal goes against this widely adopted practice without providing substantial evidence that doing so will in fact lead to a more orderly resolution of insolvent large financial entities. This problem can be avoided by providing for the clear enforceability of privately contracted terms.

4. ***Do you agree that contractual approaches can both fill the gap where no statutory recognition framework is in place and reinforce the legal certainty and predictability of recognition under the statutory frameworks once adopted?***

It seems incongruous to argue that contractual approaches can be used to fill "statutory gaps" while at the same time undermining contractual rights by requiring certain institutions and their counterparties to waive mutually agreed upon contractual terms.

VIII. CONCLUSION.

The Working Group appreciates this opportunity to provide comments on the Consultative Document.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ David T. McIndoe
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