

STATEMENT OF

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BEFORE

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND
ANTITRUST LAW

COMMITTEE OF THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

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EXPLORING CHAPTER 11 REFORM: CORPORATE AND FINANCIAL INSTITUTION
INSOLVENCIES; TREATMENT OF DERIVATIVES

Chairman Bachus, and members of the committee:

Thank you for inviting me to testify today. I am Seth Grosshandler, a partner at Cleary Gottlieb Steen & Hamilton LLP in New York City. I am co-chair of the Financial Contracts, Derivatives and Safe Harbors Advisory Committee to the American Bankruptcy Institute's Commission on the Reform of Chapter 11 and a member of the Legal Advisory Panel advising the Financial Stability Board on resolution questions. I represented the Securities Industry and Financial Markets Association in connection with the financial contract netting provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (for bank insolvency) and the Bankruptcy Code amendments of 2005 and 2006. I previously testified with respect to the 2005 Bankruptcy Code amendments before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee in 1999.

A large portion of my practice is dedicated to working on resolution plans for large financial institutions required under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which has allowed me to spend considerable time thinking about the resolvability of financial institutions. I have also been actively engaged with both market participants and regulators in the development and implementation of innovative approaches to financial company insolvency, such as "bail-ins" and single-point-of-entry resolution strategies. I also dedicate a substantial part of my practice to cleared and uncleared over-the-counter derivatives and other financial contracts, ensuring that close-out and other rights are protected in the event of an insolvency. I appear before you today in my individual capacity. The views I express are entirely my own, and not those of Cleary Gottlieb Steen & Hamilton LLP or any client or organization with which I am affiliated.

This experience has led me to the conclusion that the Bankruptcy Code safe harbors¹ serve a vital role in promoting systemic stability and resilience, have significantly increased the availability to end-users of derivatives and repurchase agreements and the liquidity of these transactions and related assets, have reduced the cost of transactions to end-users and have decreased the cost of financing to issuers of assets. The safe harbors protect counterparties under a wide variety of financial contracts, including contracts for the purchase or sale of securities and commodities, derivatives contracts, such as swaps and forwards, and repurchase agreements on securities and mortgage loans (collectively, “Safe Harbored Contracts”).² These contracts are used both by major financial market participants, such as dealers, banks, mutual funds, hedge funds and pension funds, and by businesses in the “real economy.” The benefits of the safe harbors accrue not only to users of Safe Harbored Contracts, but to issuers of assets and borrowers under loans financed by Safe Harbored Contracts. In particular, the safe harbor for repurchase agreements on residential mortgage-backed securities and whole loan mortgages serves to reduce the cost of mortgage financing to homeowners.

The risks related to Safe Harbored Contracts, which are secured by (or reference) financial assets and commodities, the value of which can change rapidly, are fundamentally different from the risks related to other contracts; the protections afforded by the safe harbors are aimed at reducing the risks unique to Safe Harbored Contracts. These protections are especially important to central counterparties, who facilitate and reduce risk in markets for Safe Harbored Contracts by interposing themselves between parties to such contracts (acting as the “buyer” to the “seller,” and the “seller” to the “buyer”). By protecting counterparties’ rights to terminate their Safe

¹ See 11 U.S.C. §§ 362(b)(6), (7), (17), (27), 362(o), 546(e)-(j), 548(d)(2), 553(a)(2)(B)(ii), (a)(3)(c), (b)(1), 555, 556, 559, 560, 561, 562, 753 and 767 (2012).

² See 11 U.S.C. §§ 101(25) (forward contract), (38A) (master netting agreement), (47)(repurchase agreement), (53B) (swap agreement), 741 (securities contract), 761(4) (commodity contract) (2012).

Harbored Contracts, net amounts owing between the parties, and to exercise rights against related collateral, the Bankruptcy Code safe harbors serve as a firewall, ensuring that the failure of one party does not expose its counterparties to excessive, unquantifiable and therefore un-hedgeable risks. This firewall has been effective in allowing major market participants, such as Lehman Brothers, MF Global and Enron, to exit the market without causing cascades of failures throughout the financial system as a result of Safe Harbored Contracts. Of course, the Lehman bankruptcy did create risks in the financial system, but they, by and large, were not related to Safe Harbored Contracts, and the risks to counterparties and the financial system would have been far greater without the safe harbors.

One of the tangible effects of the safe harbors under “business as usual” conditions, that is, prior to a bankruptcy, is the increase of the liquidity of Safe Harbored Contracts, which reduces both the cost of these transactions and the costs to the issuers of the assets underlying the transactions—the securities or commodities being bought or sold, the mortgages and credit card receivables being financed, the risks being hedged. These benefits flow directly from the certainty provided to market participants that, in the event of the failure of their counterparty, they will be able to realize the value of their bargained-for security, crystalize their loss and hedge the risk related to their counterparty’s failure.

It should be noted, however, that, in the context of systemically important financial institutions, immediate close-out may not be the ideal approach. While risks to the financial system would be far greater if counterparties could not immediately close out, the wide-spread and immediate liquidation of contracts and collateral following the failure of a major financial institution can negatively affect markets for less liquid assets. Indeed, this dynamic was present for certain parts of Lehman’s book of Safe Harbored Contracts and increased losses to the

Lehman estate. Instead, an approach that provides for the continuity of Safe Harbored Contracts would be preferable in the case of a failed systemically important financial institution, as it would avoid immediate close-outs. I discuss possible approaches at the end of this testimony. However, the risks associated with counterparty contagion that the safe harbors mitigate are far more detrimental to the financial system than the effects of widespread close-outs. Therefore, even if mechanisms for promoting the continuity of Safe Harbored Contracts upon the failure of a systemically important financial institution cannot be achieved, the current safe harbors should be preserved.

Safe Harbors Reduce Systemic Risk by Protecting Against Contagion

Systemic risk can manifest itself in a variety of ways. One example is the risk that the failure of one financial institution could cause a chain reaction of failures in the financial system because of the high degree of interconnectedness within the system. Interconnectedness is inherent in financial markets and the business models of many financial market participants, especially dealers or “market makers.” Because there are always at least two parties to any Safe Harbored Contract, major financial market participants are by definition interconnected to one another and, generally, to non-financial companies as well. Similarly, many of the Safe Harbored Contracts that market participants enter into are related or connected to other of their own Safe Harbored Contracts. For example, dealers and other major market participants generally seek to hedge market exposure. Thus, if they are exposed to a risk under one Safe Harbored Contract they will attempt to hedge that risk under a matching and offsetting Safe Harbored Contract (or on a portfolio basis), creating a web of interconnected financial contracts.

While interconnections can be reduced (and industry and regulators have indeed been taking steps to reduce interconnections), they cannot be eliminated. When considering how to address systemic risk, the question therefore becomes how the risks associated with such interconnections are handled during the insolvency of one of the parties to a transaction. While the safe harbors do not address all aspects of systemic risk, they have proven to be very effective in containing the risk of contagion by allowing counterparties to terminate volatile financial contracts with the debtor quickly, thus limiting their exposure to possibly catastrophic losses from the failure of the debtor. This is the very reason why Congress enacted the safe harbors in the first place.³

The effectiveness of the safe harbors in containing contagion was demonstrated during the bankruptcy of Lehman Brothers. None of Lehman Brothers' counterparties (many financial institutions among them) failed because of losses under Safe Harbored Contracts with Lehman.⁴ Almost all counterparties exercised their safe harbored rights to terminate, net and exercise rights against collateral, with only approximately 3% of Lehman's derivatives book remaining outstanding after three months following its bankruptcy petition.⁵ If these counterparties were not

³ See e.g., Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 19 (1984) (statement of Hon. Walter E. Fauntroy) ("The great fear is that a chain reaction would result because of the complex interrelation of many transactions and firms, putting at risk hundreds of billions of dollars and threatening the solvency of many institutions."); H.R. REP. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583 (stating that the 1982 safe harbor amendments "are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possible [sic] threatening the collapse of the affected market"); Bankruptcy Reform Act of 1978: Hearing on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the H. Comm. on the Judiciary, 95th Cong. 524 (1978) (statement of Stuart D. Root, Esq.) (stating that the absence of close-out rights for futures commission merchants would have "a potential domino effect"), *available at* http://www.archive.org/stream/bankruptcyreform1978unit/bankruptcyreform1978unit_djvu.txt.

⁴ Kimberly Ann Summe, *Lessons Learned from the Lehman Bankruptcy*, in ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 59, 77 (2010), *available at* http://media.hoover.org/sites/default/files/documents/Ending_Government_Bailouts_as_We_Know_Them_59.pdf.

⁵ *Id.* at 79.

protected by the safe harbors, these positions would have been indefinitely frozen, causing potentially catastrophic capital and liquidity implications for counterparties in addition to any losses under the contracts. While subsequent failures (and near-failures) occurred during the financial crisis, they had other causes—mainly losses caused by outsized exposures to the subprime mortgage market and the seizure of the inter-bank credit market. The effects of these dynamics were exacerbated by the political uncertainty caused by letting Lehman fail, while shoring up other institutions, which led to or exacerbated runs on not just broker-dealers, but on insured depository institutions (the first time runs had occurred since the Great Depression).

The effectiveness of the safe harbors in containing contagion was evident in the insolvencies of other financial companies, such as the failures of MF Global in 2011 and Enron in 2001. MF Global was a leading broker in a variety of U.S. and European commodities markets, but was able to exit the market safely and without disrupting financial markets.⁶ Enron was a party to one out of every three gas transactions and one out of every five electricity transactions in the United States.⁷ Despite this massive and unrivaled market presence, no other major financial institution failed as a result of Enron's bankruptcy.

Repealing or Substantially Narrowing the Safe Harbors Would Have Significant Negative Effects on Counterparties and Markets Related to Safe Harbored Contracts

The safe harbors are not a silver bullet against all systemic risk, but repealing them or substantially narrowing them would eliminate the most effective tool for addressing the risk of

⁶ Jack Farchy, *MF Global's Demise Felt by Commodities Exchanges*, FT.COM (Nov. 1, 2011), <http://www.ft.com/intl/cms/s/0/418fa2f2-046c-11e1-ac2a-00144feabdc0.html?siteedition=uk#axzz2wiK4MXNO>.

⁷ Committee on Governmental Affairs Members and Staff, Committee Staff Investigation of the Federal Energy Regulatory Commission's Oversight of Enron Corp. 19 (2002), available at <http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/111202fercmemo.pdf>.

contagion. This would decrease the resilience of financial markets and increase the risks to financial market participants, thereby increasing systemic risk.

Absent safe-harbor protection, counterparties would be subject to the Bankruptcy Code's automatic stay and assumption/rejection powers, which would subject Safe Harbored Contract counterparties to a variety of risks. Unlike other contracts, the value of Safe Harbored Contracts typically can change rapidly based on the fluctuating value of the underlying assets or collateral, prevailing market conditions and other factors. The inability of counterparties to terminate such contracts and foreclose on collateral exposes them to risks that cannot be hedged effectively. If the debtor is given the right to assume or reject Safe Harbored Contracts in bankruptcy, this effectively gives the debtor an indefinite option to perform or terminate the contract, making it impossible to effectively hedge the related risks in an adequate manner. It could also potentially give the debtor the right to "cherry pick" between contracts, exacerbating losses to creditors. Although the Bankruptcy Code provides protections to secured creditors, the mechanisms are not timely enough and are too cumbersome to obtain to effectively protect counterparties under volatile Safe Harbored Contracts, especially on a large scale, such as during the failure of a systemically important financial institution.

For example, a party who is owed 100 by the debtor at the time of the debtor's insolvency, and who has 105 in collateral, would be protected from risk if it could immediately terminate the contract, realize on 100 of the collateral and return the remaining 5 of collateral. However, if the counterparty is unable to terminate, and the value of the contract changes such that the debtor owes the counterparty 120 and additional collateral is not posted, the counterparty is exposed to a loss of 15. Similarly, if the value of the collateral were to decrease to 80, and the debtor did not post additional collateral, the counterparty would be exposed to a loss of 20. Further, the

increased loss for the counterparty would result in a larger claim against the estate, which would potentially reduce recoveries for other creditors of the estate.

The inability to exercise close-out rights is particularly problematic where a counterparty has entered into back-to-back or related transactions. For example, a dealer or market maker generally will have entered into one or more offsetting transactions to eliminate its financial exposure and lock in a spread; the receipt of a payment under one contract offsets the obligation to make payments under the related contracts. A debtor's failure to post margin or make other payments required under the contract puts an immediate liquidity pressure on the counterparty. This liquidity pressure creates an immediate risk for counterparties, over and above any ultimate loss that may be realized on the contract. It is therefore critical for the non-defaulting party to close out contracts with the debtor, liquidate the collateral and use the proceeds to replace the position with a solvent, creditworthy counterparty. These risks do not exist nearly to the same extent for other creditors in bankruptcy. For example, the value of a loan secured by plant, property or equipment is not likely to change rapidly after the filing for bankruptcy.

These risks are particularly acute with respect to central counterparties, which interpose themselves between parties to Safe Harbored Contracts. Central counterparties reduce risk to the system and to clearing members by reducing net exposures and by maintaining collateral and other loss-absorbing mechanisms that prevent losses from being propagated through the financial system. Central counterparties therefore serve a role similar to that of the safe harbors—as a mechanism for containing contagion. But central counterparties can serve this risk-reducing function only if they can quickly close out Safe Harbored Contracts to contain and manage their own risk—otherwise, central counterparties become a vector for systemic risk.

One of the primary effects of the certainty and protections afforded by the safe harbors is to increase the liquidity of markets for Safe Harbored Contracts, which reduces the costs of both the safe harbored transactions and the costs to the issuers of the assets underlying such transactions. The history of the repurchase agreement market and the related safe harbor demonstrates well this dynamic. In the early 1980s, the securities dealers underwriting the issuances of U.S. Government debt (the so-called “primary dealers”) financed their purchases of Treasuries by entering into repurchase agreements on the purchased securities with other market participants in reliance on the “securities contract” safe harbor. In 1982, the Lombard-Wall bankruptcy case threw a shadow over the safe-harbor protection for repurchase agreements by holding that they were to be treated as secured loans rather than purchases and sales of securities and were thus subject to the automatic stay.⁸ The uncertainty that the case created had a substantial effect on the repurchase agreement market—the volume of repurchase agreement transactions dropped and the cost rose.⁹ As a result, there was a measurable increase in the U.S. Treasury’s borrowing costs and the cost of financing the U.S. debt. Concerned that the lack of a robust and liquid repurchase agreement market would impair the U.S. Government securities market, Congress created the safe harbor for repurchase agreements in 1984.¹⁰

⁸ *Lombard-Wall Inc. v. Columbus Bank & Trust Co.*, No. 82 B11556 (Bankr. S.D.N.Y., Sept. 16, 1982) (bench decision). Courts in later decisions rule to the contrary. See e.g., *In re Residential Resources*, 98 B.R. 2 (Bankr. D. Ariz. 1989).

⁹ Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 19 (1984) (statement of Hon. Walter E. Fauntroy) (acknowledging the “major impact” the ruling had on the repurchase agreement market and the resulting increase in repurchase agreement interest rates); Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 48 (1984) (statement of Peter D. Sternlight, Executive Vice President of the Federal Reserve Bank of New York) (stating that, in the aftermath of the Lombard-Wall case, some repurchase agreement participants withdrew from the market and repurchase agreement financing costs were negatively affected).

¹⁰ *Id.* at 18-19.

Lombard-Wall’s effect on the repurchase agreement market demonstrates what would be the result for other Safe Harbored Contracts were their safe-harbor treatment eliminated or scaled back: the price of such transactions would increase, liquidity would decrease and the markets for such contracts would undoubtedly shrink. In my experience, financial market participants simply would not enter into certain Safe Harbored Contracts without the protection afforded by the safe harbors, meaning that markets for those contracts could virtually disappear. Because of the direct and dramatic effect that eliminating or substantially narrowing the safe harbors would have on markets for Safe Harbored Contracts, a decision to proceed with such revisions equates to a determination that these markets do not provide value to the financial system or the broader economy and thus can be curtailed or eliminated.

The benefits of the safe harbors are also evidenced by the fact that many states have very recently—since the financial crisis—incorporated safe-harbor protections into their laws governing the insolvency of insurance companies. Rather than being subject to the Bankruptcy Code or other federal insolvency law, insurance companies are subject to state “rehabilitation” regimes, many of which did not originally contain safe harbors for financial contracts. As of 2013, at least 21 states had added safe-harbor protections to their insurer insolvency laws, and most of these safe harbors have been added since 2008. My understanding is that the drive to enact these reforms came from the insurers themselves (rather than from the banks and dealers) in an effort to gain broader and more cost-effective access to markets for Safe Harbored Contracts, such as repurchase agreements and swaps.

Elimination of the safe harbors could also affect the funding profile and stability of financial companies, including systemically important financial institutions. In the absence of safe harbors, the preference of parties providing funding would likely be for very short-term

transactions in order to reduce the likelihood of being trapped in term transactions upon a counterparty's failure. Further, all counterparties—secured and unsecured, short term and long term—would be more likely to stop engaging in new transactions (i.e., to “run”) at the first sign of weakness, making entities less stable and resilient. The safe harbors, therefore, provide counterparties the comfort necessary to engage in longer-term transactions and to continue to engage in transactions with a financial company notwithstanding signs of weakness.

Last but not least, the United States is not alone in providing safe-harbor protections for financial contracts. Since the financial crisis, numerous international bodies have considered the issue of systemic risk and financial company insolvency. The resounding consensus has been in favor of broad safe harbors for the termination of financial contracts, netting of amounts owing and realization on related collateral if such contracts cannot be transferred to a creditworthy successor within one or two days. This approach was enshrined in the Financial Stability Board's “Key Attributes of Effective Resolution Regimes for Financial Institutions,” which was endorsed by the Group of Twenty Finance Ministers and Central Bank Governors (the G20) and serves as the global standard for financial company insolvency regimes in the developed world.¹¹ This approach was based on the financial contract safe harbors under the bank insolvency provisions of the Federal Deposit Insurance Act and the Orderly Liquidation Authority provisions of the Dodd-Frank Act, which served as models for the “Key Attributes.” Both the Basel Committee on Banking Supervision and the International Monetary Fund, among others, support this approach.

Outside the sphere of financial company insolvency, there has been broad international support for safe harbors as effective means of protecting financial markets and cabining

¹¹ Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011), available at https://www.financialstabilityboard.org/publications/r_111104cc.pdf.

contagion. According to data from the International Swaps and Derivatives Association, Inc., as of 2010, there were thirty-seven jurisdictions allowing a non-defaulting party the right to terminate and net obligations under derivatives contracts in the event of insolvency.¹² Any action by the United States to scale back on the safe harbors would be at odds with the international trend towards providing robust safe harbor protections. More importantly, it would put U.S. firms at a significant competitive disadvantage.

More Targeted Measures Should be Pursued

Some have criticized the safe harbors and argued for their repeal, citing among other things the creation of skewed incentives and potentials for distortions in asset markets. These criticisms are particularly prevalent in academic circles. To the extent any such criticisms are justified, and that they outweigh the safe harbors' unquestionable benefits to the stability of financial markets, such risks should be addressed directly, through targeted means, and not by the blunt instrument of repealing or narrowing of the safe harbors.

Take for example the criticism that the safe harbor for repurchase agreements has created an incentive for large financial institutions to rely excessively on short-term repurchase agreements rather than on other forms of funding.¹³ The banking and securities regulators are uniquely positioned to address any such issues. In fact, regulators have already taken steps to reduce reliance on short-term funding through tougher capital and liquidity requirements,¹⁴ and

¹² David Mengle, The Importance of Close-Out Netting, ISDA Research Note, No. 1 (2010), *available at* <http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf>.

¹³ Mark J. Roe, Statement to the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary of the House, The Bankruptcy Code and Financial Institution Insolvencies (Dec. 3, 2013), *available at* http://judiciary.house.gov/_files/hearings/113th/12032013_2/Roe%20Testimony.pdf.

¹⁴ *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and

plan further action.¹⁵ These rules address specific concerns about the funding profile of major financial institutions without increasing risks to counterparties that would arise if the safe harbors were instead narrowed or eliminated.

Consider also the criticism that the wide-spread close-out that can occur upon the failure of a systemically important financial institution can have negative effects on markets for less liquid collateral. Rather than eliminating the transactions in question, by narrowing or eliminating safe-harbor protection, I would encourage the committee to explore mechanisms that provide for the continuity of such transactions and that avoid close-outs. A case in point is the Federal Deposit Insurance Act’s treatment of Safe Harbored Contracts, which facilitates the transfer of a failed bank’s portfolio of Safe Harbored Contracts to a creditworthy successor—a successor that is solvent from a capital perspective and that has the liquidity to meet its obligations. Similar concepts exist under the Securities Investor Protection Act, which facilitates the transfer of a failed broker-dealer’s “customer” property and transactions to a successor broker-dealer, and Subchapter IV of Chapter 7 of the Bankruptcy Code and the Commodity Futures Trading Commission’s Part 190 Rules thereunder, which similarly facilitate the transfer of a failed commodity broker’s “customer” property and transactions to a successor commodity broker. Indeed, the recent “Chapter 14” bill proposed just such a mechanism in the context of special bankruptcy proceedings designed to allow financial institutions to restructure rather than

Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf>; Liquidity Coverage Ratio, 78 Fed. Reg. 71,818 (Nov. 29, 2013) (Proposed Rule), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2013-11-29/pdf/2013-27082.pdf>.

¹⁵ See Daniel K. Tarullo, Speech at the Americans for Financial Reform and Economic Policy Institute Conference (Nov. 22, 2013) (indicating the need to address short-term wholesale funding through regulation and outlining possible regulatory approaches), *available at* <http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm>.

liquidate.¹⁶ Such approaches may ultimately prove the most effective at reducing the systemic risks associated with the failure of a major financial institution.

Finally, as noted at the beginning of my testimony, there are many aspects to systemic risks. Some have argued that because the Dodd-Frank Act and related regulatory efforts are aimed at reducing systemic risk, that there is no longer any justification for the safe harbors and that they should therefore be repealed. At best, this argument fails to distinguish among the various aspects of systemic risk. As I have described, the safe harbors are aimed at preventing failures from cascading throughout the financial system—one form of systemic risk. But as the 2008 financial crisis demonstrated, there are many other forms of systemic risk. The Dodd-Frank Act reforms are largely aimed at reducing other forms of systemic risk.¹⁷ The fact that other aspects of systemic risk are being addressed through other regulatory means does not mean that the safe harbors are no longer justified or that they are no longer needed as a bulwark against cascading failures. To the contrary, the multiple aspects of systemic risk require that we deploy a variety of defenses.

Conclusion

In conclusion, the safe harbors should not be narrowed or repealed because they serve an important role in preventing the spread of financial contagion throughout financial markets. The certainty that these protections provide has created robust and liquid markets for Safe Harbored

¹⁶ Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (2013).

¹⁷ While the “single-counterparty credit limit” requirement of Section 165 of the Dodd-Frank Act is aimed at reducing interconnectedness, it would of course not eliminate it. The safe harbors would still be necessary to address counterparty contagion risk under the remaining interconnections. Further, while the Orderly Liquidation Authority provisions of the Dodd-Frank Act do address contagion risk, the Dodd-Frank Act provides that the Bankruptcy Code remains the preferred means of addressing financial company failures. Accordingly, it cannot be said to address contagion risk other than in the extreme cases in which it was designed to be used.

Contracts. This is not to say that the safe harbors cannot be improved upon. The Financial Contracts, Derivatives and Safe Harbors Advisory Committee, which I co-chaired with Judge James Peck, recommended to the American Bankruptcy Institute's Commission on the Reform of Chapter 11 a variety of potential improvements to the safe harbors. Other work is under way to develop mechanisms for providing continuity for financial contracts during the failure of a major financial institution and other improvements to the way the Bankruptcy Code addresses the failure of financial institutions. I encourage the subcommittee to consider these approaches when considering potential reforms to the Bankruptcy Code.

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